# Conscience and Common-Sense make Effective Rem-coms


*The-Panelists,-seated-from-left-to-right-Messrs.-Dinesh-Weerakkody,Nihal-Fonseka,Franklyn-Amerasinghe,-Kanag--Isvaran,-Somasundaram-Skandakumar-and-Hon.-Eran-Wickremaratne*

The fifth module- “A Functioning Remuneration Committee”- of a six module series on Corporate Stewardship and Boardroom Governance conducted by the Sri Lanka Institute of Directors was held in the Cedar Room of the Cinnamon Grand on the 20 May 2010

Mr Franklyn Amerasinghe, former CEO and Director General of the Employers Federation of Sri Lanka and well respected expert on HR and IR issues was the provocateur/challenger of an elite panel which included Messrs S Skandakumar, Former Chairman, George Steuarts, Nihal Fonseka, CEO of the DFCC Bank and the Chairman of the Colombo Stock Exchange, K Kanag-Iswaran, President’s Counsel, Eran Wickremaratne, Member of Parliament and formerly CEO, NDB Bank and Dinesh Weerakkody, Managing Director, Cornucopia Limited.

*Messrs.-Franklyn-Amerasinghe--Mr.-Kanag--Isvaran,-Mr.-S.-Skandakumar,&-Hon.-Eran-Wickremaratne*

Mr Amerasinghe, in setting the scene for the evening's proceedings, stated that the module was aptly titled as a "Functioning Remuneration Committee" and not just a "Remuneration Committee" and noted that while the Remuneration Committee (RemCom) did not have the recognition that audit committees, in particular, enjoyed, recent surveys indicate that, given the growing importance attached to human capital, remuneration committees were gaining more prominence. Based on his knowledge, both practical and informative, of the workings of RemComs of companies, both in Sri Lanka and abroad, which followed good practices, he summarised some key principles which were common to them. He noted that the RemCom was responsible for formulating the remuneration policy, and strategy, of the Executive Directors and the Executive committee as well. He thought that this practice was not too widely prevalent in Sri Lanka. The RemCom was also tasked with assessing, and regularly reviewing, the appropriateness and the relevance of the remuneration policy in the context of the company's greater goals. This, he said, would cover all remuneration including bonuses, incentive payments, pensions, other non cash benefits and share incentive plans, if existing. The RemCom plays a key role in designing, and setting, the performance target of key senior personnel. He noted that most companies in Sri Lanka were now doing this. In all this, it should not be forgotten, he said that the RemCom is a sub committee of the Board and only makes recommendations to the Board. In recent times, RemComs were playing a more active role in reviewing major changes to company superannuation schemes and in ensuring that termination compensation of directors are fair and reasonable, to the company and to the individual, and are in conformity with the Companies Act. In executing all the aforesaid, it was therefore very important that members of RemComs were familiar with market trends, market comparators etcetera. It was also imperative that RemComs consisted of competent persons who, among others, had a good understanding of human resource management, development and administration. One way of strengthening the workings of the committee was to engage experts when, and where, necessary to advise on specific matters. Referring to a recent Mercer Survey, he articulated a few best practices that could be adopted. One was to have in place at the beginning of every year, an Annual Agenda. This would cover a mixture of recurring issues and topical specific issues, as and when they emerged. The result of such a proactive practice will be the establishment, and existence, of a policy/strategy that is proactive and not one emanating from ad-hoc, knee jerk reactions. Another was to ensure that all the members in the RemCom had a thorough understanding of the organisation's human resource philosophy. He noted that this could sometimes be a challenge where the independent directors or the combination of independent directors and non executive directors, comprising the RemCom do not have an absolute feel of the organisation's culture and DNA. It was therefore necessary to regularly dialogue with the executive directors and/or senior managers on such matters. Despite acknowledgement of the fact that the board had ultimate responsibility, increasingly, in recent times, shareholders were looking to the RemCom to justify to them the logic and rationale of executive compensation, particularly at the very senior levels. It was therefore essential, he said, for RemCom members to be very conversant with all the matters described before and be also familiar with the statutes and other laws. In concluding his opening remarks, Mr Amerasinghe drew attention to the necessity of RemCom's involvement in 'Succession Planning'. Just a list of potential in-house candidates and their state of readiness were, by themselves, inadequate, he said, in determining the effectiveness of a succession plan. It should include not only the ‘Who’ and ‘When’ but also the ‘Why’ and ‘How’. Plans must not be based simply on the recommendations from within but must extend, where necessary, to recruitment from the outside particularly if the organisation was envisioning a paradigm shift in their goals and operations. Most progressive companies now have, in general, a nice balance between “internal” and “external” succession.

Mr Kanag-Iswaran, speaking next, focused on the legal and compliance issues that members of RemCom must be aware of in carrying out their duties. Citing an old case, he quoted; “A Director is not a servant. He is a person who is doing business for the company; but not upon ordinary terms”. He said that in the days of yore, it was the articles of association which spelt out the manner in which a director was remunerated. Over the years, the articles became more specific in describing the remuneration procedures, methods of control, approval of it by the shareholders etcetera. Laws, as well as the practice, have since evolved gradually with such procedures, methods, and controls etcetera being included in the Companies Act. He said that Section 216 of the Companies Act comprises of 2 parts. The first part; - Sub-sections 1 to 5 authorises the Board to approve director remuneration at a level which it thinks is fair to the company. The key yardstick is “Is it fair to the Company ?” Remuneration to directors, he noted, could be for managerial services, compensation for loss of office or for any other reason…. as long as it could be justified as having been fair to the company. In justifying such fairness, a Board greatly depends on the advice, and opinion, of the RemCom. In arriving at such an opinion, the RemCom will, in turn, take into account the subject director’s expertise, experience, skills, reliability, hands on involvement, past performance, nature of responsibilities etcetera. This is of significance for the reason that the recipient, himself, can be personally held liable to the company for the payment unless he can prove that it was fair to the company at the time it was provided. So even if you go home with a handshake and, sometime later, somebody challenges you, you should be able to justify it yourself apart from the Board. Part two; - Sub-section 6 is a catch-all clause which caters, in particular, to companies incorporated prior to the coming to being, in 2007, of the new Companies Act. It reads; - “Nothing in this section shall prevent the articles of a company from providing for the authorisation by shareholders of payment of remuneration or the giving of other benefits to directors, and the provisions of subsections (1) to (5) of this section shall not apply to the payment of remuneration nor the giving of any other benefit approved by shareholders pursuant to such a provision in the company’s articles.” He also said that Section 216 was subject to Section 217 where the emphasis was on any loans given to directors in contravention of the provisions of the Act. Section 217 states that such unlawful loans shall be voidable at the option of the company and the loan shall be immediately repayable upon being voided by the company, notwithstanding the terms of any agreement relating to the loan. It goes on to say that where a prohibition is breached, the director shall be liable to indemnify the company for any loss or damage resulting from the transaction and where the company also fails to comply with the provisions of the Act, the company too will be guilty of an offence and every director who authorised the company to enter into that relevant transaction will be guilty of that offence. He added that such restrictions did not necessarily apply, in totality, to private companies if all the shareholders agree in writing to making such loans to a director or directors. He also spoke about the need to maintain accurate and clear Interest Registers and to have Certificates of Evidence which showed which directors voted in favour of certain remuneration and whether they thought it was reasonable and fair to the company. Notwithstanding such fairness and reasonability, there is always an onus on directors to confirm the company's solvency prior to making such payment. On being asked by Mr Amerasinghe for clarity on the concept of "reckless behaviour" when in the context of the reliance placed by boards on functional experts who sit on boards and whose advice was reasonably expected to be sound on matters requiring their specific skills, Mr Kanag-Iswaran said that Sections 184 onwards which deals with the duties of directors, recognize that not all the directors are competent with all the issues that come up before the board and they have to seek expert advice and/or advice from the fellow directors who may be experts in that area. He went on to remark that the Act allows for a situation where if the act of a board is challenged on the grounds that it has been reckless, the board can state that it relied on the opinions and advice of others who are in its reasonable opinion competent in the subject field.

*Mr.-Dinesh-Weerakkody-during-his-presentation*

Speaking next, Mr Weerakkody described a real life example in demonstrating what was essential in a RemCom member's tool-kit. He said that in his many dealings with company boards and RemComs, it was evident that most members lacked knowledge of the basic principles of a remuneration policy. For instance, a lot of them did not know what their target pay-point was!!!! Was it, for example, the 65$^{th}$ percentile or the 75$^{th}$ percentile? In fact, some of the participants did not have any understanding of the percentile concept. In crafting a pay policy, it is imperative, he said, that RemComs have an understanding of the underlying basis of remuneration and their market comparators. Is the basis just the fixed pay or Cost to Company (CTC)? - what is the basis of variable pay ?;- in their search for employees, who were they competing with ? and so on. The first step is for boards and RemComs to map the grades and costs of all their employees and through that arrive at the company's total employment cost. In deciding on their market comparators, he suggested that RemComs ask 3 basic questions; (1) who do you lose your staff to; (2) where do you wish to attract your staff from; (3) which is a company that attracts top talent. Speaking about talent, he said that companies must know where their key talent movements are? - Is it at executive level or senior management level and what is the percentage turnover? In terms of pay structures, he stated that his experience was that a start up company will focus more on a fixed pay, while the more mature companies will focus on short term and long term incentives. He added that surveys reveal that, in general, a CEO package will have approx 40 per cent to a 60 per cent variable component. So if you are getting Rs.100 as CEO about Rs.60 would be at risk. We call it 'risk pay'. At a senior manager level the variable component would vary between 20 per cent and 40 per cent. In arriving at the total cost, there is a need to quantify all the benefits if you are to arrive at a "like with like" comparison with other companies. Mr Weerakkody noted that more and more companies were now looking at performance criteria from 2 dimensions, which are the individual performance and organisational performance, both based on pre-agreed criteria at the beginning of the subject period and always subject to affordability. Employees, at all participating levels, are made aware of such criteria, up-front, and are sensitized on the mechanics of increment awarding and variable pay calculations. When done in this manner, the implementation of the "pay" strategy is more deliberate and proactive and as a result more effective. He stated that his Sri Lanka experience in this respect was mixed given that there were still a significant number of companies who resorted to reactive pay policies.

Mr. Fonseka shared some of his wide practical experiences relating to RemComs and executive remuneration. He said that when one looks at the cost side of a reasonably sized company's Income Expenditure statement, employee remuneration stands out as a material, and significant, number. In many companies it is the highest component. It is this which, invariably, draws the immediate attention of shareholders, although in practice they normally do not make an undue fuss unless something really abnormal has happened. In a way the question in their minds is as to how the pie has been shared. Given this, from a RemCom angle, the logic of the distribution is an important issue and if not addressed properly the negative perceptions of shareholders get exacerbated, particularly, if the executive influence on the board is disproportionately strong. He remarked that banks, in Sri Lanka, do not have this problem because the executive representation, if any, on boards is quite small. So, when there are instances of RemComs with both executive and non executive directors and, in addition, a board with strong executive representation, it is best that the compensation philosophy is well articulated, and understood, upfront, and made visible to all the shareholders and other interested stakeholders. You just can't wait for a year end to decide on the distribution; - the principles have to be deliberate and planned. Mr Fonseka also noted that merely applying inflation adjustments, year on year, to existing remuneration elements is not wise and certainly not sustainable. If you feel that it is not going to be fair for the company and/or to the employee, you have to then see what needs to be done and the RemCom has to be bold enough and strong enough, within an overarching sense of objectivity, to make the call in the best interest of all the parties. It is very important that RemComs do not put companies into positions which cannot be flexed in keeping with the business and financial position of the company. Just because you may have done well in a particular year does not guarantee that you will keep on doing so. So if you take on a fixed cost that recurs year after year after year, irrespective of the fortunes of the company, you will end up with problems. This is why it is important to have both a fixed and variable component where the variable is linked to the actual performance. We all go through bad, and good, patches and we need to be able to draw back and/or claw back, depending on the situation. He said that he was also firmly of the view that members of a RemCom must understand the business philosophy. For example, there is no use in saying that this is what you are going to do if your competition is doing something better, or more strategic. Speaking of other practical issues, he stated that a big challenge for RemComs was to get the starting point, or the lowest level, of a remuneration hierarchy right, particularly when such starting point is the result of collective bargaining in a highly unionised environment. If there are promotions into more senior levels of persons whose origins were at the lowest levels, the question of maintaining differentials also come into play and the whole remuneration game can get out of hand. Referring to succession planning, he said that his practical experience was that if there was a person, already in the organization, who was capable of succeeding in a higher position, he is not going to wait for 10 years to get to that position. He will most probably stay a maximum 2 years, in expectation, and if there is no promotion, he will go elsewhere. Therefore, there is a need to plan for a right mix between "internal" and "external" succession. If you do not infuse new blood, particularly at senior levels, you run the risk of losing innovation and you will never know of the best practices elsewhere. When asked by Mr Amerasinghe about his views on Employee Share Options, Mr Fonseka was of the view that it was good long term incentive provided the scheme was transparent and the reward to the employee was aligned with the interests of the shareholders. It is in this respect that it was important to carefully, and astutely, set the criteria that trigger share option awards.

Eran Wickremaratne whilst agreeing, in general, with the thoughts of the earlier speakers gave his views on pay structures, recruitment, succession planning and CEO compensation. He was of the view that remuneration packages had to be viewed as "whole". On the basis of your short and long term objectives, you have to structure the package in a manner that best serves the organization and the individual you are looking for. There must be some fit. He thought it was not appropriate to give share options to all levels of staff. He was of the view that compensation in the form of share options will appeal to the more influential decision maker at the top levels of the company hierarchy. On the other hand, the employees at the bottom levels of the organization will prefer more cash oriented remuneration. Talking about remuneration packages, he noted that there were still a lot of invisible benefits in such packages. He was of the view, that if one was to get stakeholder buy-in on executive remuneration, it was important to minimize such invisible benefits and create more transparency. For example, in advanced economies, you have compensation protection if you are a CEO; - if you lose your job you get paid and if you are taken over you get compensated and so on. This has led to enormous problems because CEOs and seniors have even deliberately managed the process to be taken over, often at prices to the detriment of the shareholder, because they know that in the event of a take-over they are more than well-off. These, he noted, were the challenges for RemComs. Making reference to the banking industry, in Sri Lanka, he thought that the presence of independent directors in the remuneration committee and the segregation of the roles of the Chairman and the CEO had done much to uplift its governance standards. He thought that this was the route for publicly listed companies to go in the future. Mr Wickremaratne opined that the role of the RemCom should be one of a strategic nature with focus on the HR needs of the organization and that the operational aspects should be left to the CEO and other senior managers. It was, however, important that there was a close linkage between the committee and the CEO. The RemCom's primary responsibility was to ensure that the company's remuneration policies and HR strategies were aligned and were positioned to serve the company's current and emerging needs. As regards succession planning, he saw the need for a short-term plan and a long-term plan, with the short term plan catering to emergency situations. The long term, on the other hand, will cater to paradigm shifts which often are better achieved by new blood. In practice, you will find that the persons who fit the short-term plan are those who are currently around the present incumbent i.e. in his peer group and those who fit the long term, if coming from within, may be one or two rungs lower than the present incumbent. In closing, Mr Wickremaratne stated that a country gets the leader it deserves and a company gets a CEO that the company shareholders deserve. A company CEO can get away virtually with anything unless the shareholders are going to hold the CEO responsible, and we don't have enough of that here. He took a view that the issue of executive pay is one for the shareholders and not one for government and to that extent he disagreed with President Obama's stand regarding executive pay. In the 1990s, the USA made moves to cap executive pay and people found ways around it by using share options. You try to cap it now; the affected parties will find other ways around it. The answer therefore is for shareholders to ensure that they have the right board, the right strategy and the right CEO at the right pay. What is required is better governance rather than more government. The outrage was on that the government was using taxpayer's money to bail out companies. When taxpayers find that their monies are also used to pay bonuses etcetera, the outrage increases. However, the debate is now turning around and people are beginning to look at it more rationally and are saying that it is a relative thing. People are really not opposed to paying a good CEO well, but at a time of crisis when you are unemployed and/or your pay is going down and the Senior Executive's pay is continuing as before, things do get hot. All this can be addressed via more transparency and RemComs have a challenge in their hand.

Mr S Skandakumar introduced himself as one associated with a Private Sector company, George Steuarts, which is celebrating its 175$^{th}$ anniversary this year. He stated that he had the good fortune to work for the company 34 of those years, the last 8 of them as Chairman. He said that his experience with remuneration committees was very limited but his experiences with HR, and remuneration related matters was very vast and that he wished to share with the audience what they did at George Steuarts regards recruitment of executives and their compensation. When interviewing for grass root level managerial positions, we asked ourselves a simple question. Can we see this person, he or she, someday sitting across the board room table as a director? So that was the starting point in the process that seeks potential than the mere recruitment. In this process we were aware, and we have to admit, that there may have been situations where people who came for interviews and who we knew were of exceptional quality did not get selected because of communication problems arising out of a lack of fluency in english and it is more than likely that we may lost one or two prospective chairmen. Once that question was answered and the letter of appointment prepared, during my tenure as the Chairman, I would personally hand it over to the candidate and while doing so, I will tell him;- "in this letter of appointment what is indicated is your monetary remuneration and the related terms and conditions;- However, what is not indicated is the environment that we offer you for your career development, the interpersonal relationship mechanisms we have created for you to facilitate that development and the values that we uphold. These are the qualitative aspects which will make you feel, when you get up in the morning, that make you really want to come to work. Over a period of time we realised that we may end up in a bottle neck position where we had more players than positions. So what we did was we set up independent subsidiary companies where these promising young people could take up positions in the boards of those companies and experience real life corporate stewardship and board-room governance. Once they got in there of course there came the problem of remuneration. They required higher remuneration and our companies needed to remain competitive, in terms of cost, in delivering a product and service to our customers. This was a balancing act. In the 90's when the Central Bank bomb exploded and the entire Steuart House was destroyed there emerged a very serious situation where our means of retaining the people who really mattered were limited. It was at that time we came up with a strategy to introduce a performance based incentive payment simultaneously with the inevitable pay cut. We said to the subsidiary boards; - 'you present your budget, at the beginning of the financial year and we, as the parent board, - remember we never had a remuneration committee but perhaps the parent board played that role, - would then indicate what our views are on that presentation, and then say 'if you reach these targets then you will be entitled to a fairly generous percentage of that profit as your incentive." We monitored the performance against the benchmarks on a quarterly basis and on the actual collection of cash, we made the incentive payments. We were a trading organization and cash was our life blood, so no payments were made until the profits were actually realised in cash. It must be noted that not all the incentive dues were paid at the end of each quarter because we had to allow for possible downturns. The effect that this had on executive efforts was incredible and very soon many executives were earning twice as much as their previous pay. Businesses grew and funds were always available for reinvestment. When I retired we had persons who had been us with us for more than 20 years. All in all, the expertise was there, the commitment was there and most importantly the loyalty was there. It is pleasing to note that this culture continues at George Steuarts even today. Ultimately, it all boils down to common sense and conscience and these are two characteristics that all RemComs must have if they are to add value to the companies they represent.

Judging by the questions asked, and the feedback given, by the audience, this was yet another very successful session. The success was purely a result of the very focused, and relevant, presentations of the panelists ably led by the challenger/provocateur Mr Amerasinghe.

The final module;- "Governance Issues of Specific Organizations" will be held on the 24 June 2010 at the Cedar Room, Cinnamon Grand commencing 1615 hours. The power-packed panel consisting of Mr. Hiran Cooray, - Chairman, Jetwing Sri Lanka, Ms Minnette Perera - Director Dilmah Fine Teas and Herbs, Mr. Rajendra Theagarajah – Managing Director / CEO Hatton National Bank PLC, Mr. Faizal Salieh – Managing

Director Amana Investments, Mr. Sanjiva Senanayake - Director Hemas Power Ltd and Deshamanya. C. P. De Silva - Former Chairman Aitken Spence & Ceylon Chamber of Commerce will be challenged by Dr Harsha Cabraal, President's Counsel.