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The Remuneration Structure of the Largest Dutch Listed Companies within the AEX-Index

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The research team would like to express its gratitude to Eumedion for the opportunity to undertake the present research, for their assistance and their confidence in the team.

1. Introduction

This study about the structure of director's remuneration is a student research conducted at the request of Eumedion as part of the PREMIUM Programme at Maastricht University. The project was done by a team of four master's students under the supervision and guidance of Dr. Mieke Olaerts.

Executive compensation and its different components, including base salary, variable pay and share options, have been a highly controversial issue and have attracted the attention of academics, legislator and media.[1] Executive remuneration practices of large financial institutions were considered to be a contributing factor to the global financial crisis.[2] Hence, in the aftermath of the global financial crisis, there were many reform proposals concerning executive remuneration considered by regulators in jurisdictions around the world.[3] One of the core themes that arose was the risk-based approach to executive remuneration.[4] This approach proposed an enhanced regulation of pay in financial institutions because of moral hazard concerns.[5] Further core themes concerned the necessity of a shift from short-termism towards a long-term focus and sustainability and a reconsideration of performance measures.[6]

This research analyses the remuneration structure of the 17 non-financial institutions listed on the AEX-Index, which have their registered office in the Netherlands.

The first part of the paper outlines the relevant legal provisions regarding director's remuneration and the opinions of academia regarding the topic.[7] It highlights the main evolution and new trends regarding the issue following the global financial crisis.

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[1] CHRIS ROWLEY; 'Executive Pay: Is It Too High?', *Cass Know* 2014. Retrieved 17 May 2015 from http://www.cassknowledge.com/sites/default/files/article-attachments/exec-pay-global.pdf; CCRS AND FINRISK; 'Challenges to Executive Compensation', *Ethical Finance Research Series*, 2nd Event, November 2, 2014; JAY LORSCH and RAKESH KHURANA, 'The Pay Problem: Time for a New Paradigm for Executive Compensation', *Harvard Magazine*, May-June 2010; STEVEN N. KAPLAN, 'The Real Story Behind Executive Pay: The Myth of Crony Capitalism', *Foreign Affairs Magazine*, May-June 2013; SARAH BUTLER; 'Barclays paid star trade £170m in five years following financial crisis', in: *The Guardian*, 24-05-2015. Retrieved 25 May 2015 from http://www.theguardian.com/business/2015/may/24/barclays-star-trader-financial-crisis-jonathan-hoffman-lehman-brothers

[2] DAVID F. LARCKER *ET AL.*; 'Follow the Money: Compensation, Risk, and the Financial Crisis', *Standford Closer Look Series*, September 8, 2014., p. 1; LUIS BRANDÃO MARQUES AND S. ERIK OPPERS; 'Chapter 3: Risk taking by banks: The Role of Governance and Executive Pay', *Global Financial Stability Report: Risk Taking, Liquidity, and Shadow Banking – Curbing excess while promoting growth*, International Monetary Fund, October 2014.

[3] KEVIN DAVIS; 'Regulatory Reform Post the Global Financial Crisis: An Overview', *The Australian APEC Study Centre*, Retrieved 20 May 2015 from: http://www.apec.org.au/docs/11_CON_GFC/Regulatory%20Reform%20Post%20GFC-%20Overview%20Paper.pdf, p 2.

[4] JENNIFER G. HILL; 'Regulating executive remuneration in the post financial crisis era: Common Law Perspectives', in Randall S. Thomas and Jennifer Hill, (Eds.), *Research Handbook on Executive Pay*, (pp. 219-240). Cheltenham, UK: Edward Elgar Publishing, p 12.

[5] GUERDON ASSOCIATES; *'Paying Executives to avoid Moral Hazard – A checklist for Boards'*. Retrieved on 20 June 2015 from http://www.guerdonassociates.com/articles/paying-executives-to-avoid-moral-hazard-a-checklist-for-boards/?print=pdf; JENNIFER G. HILL, 'New Trends in the Regulation of Executive Remuneration', *Law working paper*, March 2010, p 24.

[6] THOMAS SINGER; 'Linking Executive Compensation to Sustainability Performance', *Director Notes No. DN-V4N11*, May 2012, p. 1; HILL, 2010, p. 24.

[7] The reasons for excluding the financial institutions are elaborated on in chapter 2.1.

The second section analyses the structure of directors' remuneration. The target variable rewards as a percentage of base salary are analysed in order to determine short-term or long-term orientation of the companies. Following, the proportion of non-financial and financial performance measures in the short- and long-term variable pay is evaluated. In order to do so, an empirical analysis, based on the information provided by the remuneration policies and reports of the companies, is carried out. The objective of this analysis is to observe whether there is a focus on short-term or long-term variable remuneration in the remuneration policies of the analysed companies. In fact, the structure of directors' remuneration should promote the long-term sustainability of the company and ensure that remuneration is based on performance.

The third section focuses on the performance criteria used by the companies for determining the executives' remuneration. A special focus is put on the distinction between financial and non-financial performance criteria. This allows for an evaluation on whether there is more or less emphasis put on non-financial performance criteria when calculating the variable remuneration of directors. Non-financial performance criteria are generally considered to be relevant to the company's long-term value creation. Transparent performance criteria are a fundamental mean to facilitate the shareholders' assessment of the company's approach to remuneration of their directors.

The fourth section is concerned with the peer groups used by the companies pertaining to the study to benchmark the overall and/or the variable remuneration of their director. The focus in this regard is on the location of these institutions. This focus on paying competitively through comparing the level of pay to other companies is a debated topic in practice.[8] Whereas benchmark-adjusted compensation is generally considered to be a good idea, some authors are concerned about the companies that are chosen for the comparison.[9]

The fifth section examines share ownership requirements for directors in the companies pertaining to this research. Such a practice is often seen as an important and efficient mean to align the interest of the executives with those of shareholders on a long-term basis. [10]

Finally, general conclusions from the research are drawn, and suggestions are forwarded.

[8] MICHAEL L. BOGNANNO; 'Efficient markets, managerial power, and CEO compensation: CEO pay, often contentious, is the product of many forces', *IZA World of Labor 34*, 2014, p. 6; ROSS KERBER; 'U.S. pay gap also problematic in C-Suite', in *Reuters*, 19-06-2015. Retrieved 22 June 2015 from http://www.reuters.com/article/2015/06/19/us-executive-pay-csuite-idUSKBN0OZ2C120150619.
[9] CHARLES M. ELSON AND CRAIG K. FERRERE; 'Executive Superstars, Peer Groups and Over- Compensation — Cause Effect and Solution', *Journal of Corporate Law 38*, 2012-2013, p. 497-8.
[10] ANTHONY NYBERG ET AL; 'Agency Theory Revisited: CEO returns and Shareholder Interest Alignment', *Academy of Management Journal 53 (5)*, October 2010, p. 3.

2. Overview

Before elaborating on the empirical results of the research conducted, this part of the report provides for a general overview of the topic of directors' remuneration regarding the methodology of this research, the theoretical background of directors' remuneration and the applicable legal framework in the Netherlands.

2.1. Methodology of the Research

This research analyses the remuneration structure of the 17 non-financial institutions of the AEX-Index, which have their statutory seat in the Netherlands. The empirical study of this report analyses the financial and non-financial performance criteria of the short- and long-term variable pay and is based on the 2014 remuneration reports and policies of the companies. Specific details about the methodology adopted in the individual chapters are provided at the beginning of the respective chapters.

Due to the limited duration of the project, this student research was only able to analyse specific aspects of the remuneration structure of the 17 non-financial institutions within the AEX-Index. Hence, this report is not concerned with the compliance of the companies' remuneration report with their remuneration policies. It also does not analyse the trend over different years. Moreover, the four financial institutions of the AEX-Index are not taken into account because of their limited number and the resulting difficulty to draw clear conclusion or to identify a trend with regards to financial institutions.[11] Additionally, there are mandatory provisions for financial institutions in many regards.

2.2. Theoretical Background: Executives' Remuneration

Executive's compensation is an actively debated topic of Corporate Governance all around the world. It first became a prominent research area of Corporate Governance in the 1990s.[12] Executive pay has been reinterpreted from a Corporate Governance issue to an effective tool that allows the alignment of the interests of management with stakeholders; it has evolved from a corporate governance problem to

[11] There are four financial institutions with their statutory seat in the Netherlands: Aegon, Delta Llyod, ING Group, NN Group.
[12] Hill 2010, p.1

a solution.[13] The literature generally suggests a remuneration structure that is able to mitigate the agency problem and that incentivises executive directors to achieve better performances.[14]

Many authors consider that inappropriate compensation practices of large financial companies were a relevant cause of the financial crisis.[15] The criticisms are manifold: some argue that the overall level of pay was too high, other criticise that the structure of pay induced directors to pursue excessively risky and short-term strategies.[16] Especially problematic was the faulty incentive system for executives of financial institutions that allowed managers to invest in poor quality mortgage products or other badly structured financial products and therefore to focus on short-term profit.[17] Remuneration systems were not aligned to the company's risk appetite, strategy and long-term sustainability of the company.[18] Therefore, after the financial crisis many academics emphasized the importance of remuneration structures, which provide the correct incentives and signals for risk taking, i.e. a performance-related pay.[19] In the spirit of the legislator, also academia requires a shift from short-termism to long-termism, by requiring incentives for sustainable performance.[20] Thus, executive remuneration has been reconsidered from a corporate governance tool into a "risk-management problem" itself.[21]

Since the global financial crisis some have voiced the opinion that bonuses should be banned or that they should be limited to a given share of the total remuneration package.[22] Whereas the ban of bonuses remains a controversial topic all around the world, the issue of bonus cap has been tackled with regard to financial institutions within the European Union through the Capital Requirements Directive IV.

[13] HILL 2010, p. 10.
[14] JÖRN M. ANDREAS ET AL.; 'Determinants of Director Compensation in Two-Tier Systems: Evidence from German Panel Data', *CEFS working paper series*, June 2010, p. 8.
[15] DAVID F. LARCKER *ET AL*.; 'Follow the Money: Compensation, Risk, and the Financial Crisis', *Standford Closer Look Series*, September 8, 2014, p. 1; HILL, 2010, p 10; KEVIN RUDD; 'The Global Financial Crisis', *Monthly*, February 2009, pp. 20-29. Retrieved 18 May 2015 from http://search.informit.com.au/documentSummary;dn=610838417780601;res=IELLCC.
[16] MAURICE R. GREENBERD; 'Regulation of Executive Compensation in Financial Services', *Squam Lake Working Group on Financial Regulation*, February 2010, p. 2.
[17] W.H. BUITER, Lessons from the Global Financial Crisis For Regulators And Supervisors. Paper presented at the 25th anniversary Workshop" The Global Financial Crisis: Lessons and Outlook" of the Advanced Studies Program of the IFW, Kiel on May 8/9, 2009, p. 23.
[18] NAVEEN KUMAR, J. P. SINGH, Global Financial Crisis: Corporate Governance Failures and Lessons , Journal of Finance, Accounting and Management, 4(1), 21-34, January 2013, p. 25.
[19] W.H. BUITER; 'Discussion Paper No. 635: Lessons from the Global Financial Crisis For Regulators And Supervisors', *Discussion Paper Series*, 2009, p. 23.
[20] Green Paper of the European Commission on the EU Corporate Governance Framework, April 4, 2011, COM (2011) 164 final, p. 9; HILL 2010, p. 27.
[21] HILL 2010, p. 25.
[22] Regarding the ban of bonuses see: MOORAD CHOUDHRY; Abolish the Bonus System: The Unacceptable face of capitalism, Commentary on *CNBC* Website, 23-05-2013. Retrieved on 1 June 2015 from http://www.cnbc.com/id/100760202

2.3. Legal Framework

After the global financial crisis, there was a wide array of reform proposals concerning executive remuneration on the regulatory table in jurisdictions around the world. The first step at the European level regarding directors' remuneration was taken in the years following the Enron scandal. The Commission extended the mandate of the High Level Group of Company Law Experts to analyse a number of issues, including the remuneration of management.[23] Inspired by their suggestions, the European Commission issued the Recommendation 2004/913/EC fostering an appropriate regime for the remuneration of directors of listed companies and Recommendation 2005/162/EC on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, which were non-binding and aimed to avoid a "one-size-fits-all" solution.[24]

The European Commission realised that remuneration of directors can be considered as one of the key areas where executives may have a conflict of interest.[25] The 2004 Recommendation supports efficient remuneration. In order to achieve this goal, it recommends on the one hand disclosure of company pay policy, its structure and performance, as well as details of individual director's pay in the annual account. On the other hand it suggests a (binding or advisory) shareholder vote on company remuneration policies.[26] In addition, it recommends an *ex ante* approval of share option schemes.[27] Even if this Recommendation implicitly supports performance-based pay, it does not engage in pay design.[28]

Recommendation 2005/162/EC, which focuses among others on the role of board members in pay setting, confirms that the remuneration of directors is an issue where the conflict of interest is particularly high.[29] In the light of this research, the most relevant proposals of this recommendation are the creation of board committees, such as the remuneration committees, which should be composed by a 'sufficient number independent directors'.[30]

In the aftermath of the financial crisis, the European Commission started to focus, next to disclosure, additionally on the appropriate structure of remuneration.[31] The Commission Recommendation 2009/385/EC emphasised the complexity of the remuneration structures, the strong focus on short

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[23] TOM DIJKHUIZEN; 'The EU's Regulatory approach to Bank's Executive Pay: From "Pay Governance" to Pay Design', *European Company Law 11(1)*, 2014, p. 32.
[24] GUIDO A. FERRARINI; 'Executive Remuneration. A Comparative Overview', Law Working Paper No. 268/2014, *European Corporate Governance Institute*, October 14, 2014, p. 21.
[25] Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC), preamble recital 2.
[26] Ibid., preamble recital 5-8, Section II-IV.
[27] Ibid., Section IV, 6.1.
[28] FERRARINI, 2014, p. 21.
[29] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC), preamble recital 13.
[30] Ibid., Section II, 5.
[31] Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, (2009/385/EC), Section II, 3.

term achievements and excessive remuneration which cannot be justified by performance as the main issues in the design of pay.[32] This Recommendation aims to create a link between pay and predetermined and measurable performance criteria, to achieve long-term sustainability and to limit excessive variable remuneration.[33] Regarding the structure of pay, the Recommendation also suggests to include non-financial criteria, which are relevant to the long-term value creation of a company.[34] The requirement of a better link to performance and long-term value creation is also suggested regarding schemes under which directors are remunerated in shares, share options or any other right to acquire shares.[35] The shift to a more long-term thinking can be seen by the suggestions to defer a major part of the variable remuneration for a minimum period of time and that shares should not be vested for at least three years after their award.[36] It is generally acknowledged that a significant component of the variable remuneration should be deferred for a certain period subject to performance conditions.[37] Furthermore, it is recommended to deny the exercise of share options or other rights to acquire shares for at least three years after their award.[38] A further objective of this Recommendation is to ensure transparency of remuneration practices through a clear and easily understandable remuneration policy.[39]

A currently debated issue is the link between remuneration and performance of directors.[40] According to the proposal of the European Commission to enhance shareholder engagement the link between remuneration and performance is insufficient. This is due to the fact that the information that is disclosed by the companies is unclear and not comparable. Moreover, the shareholders often do not have the means to communicate their opinion on the remuneration of directors.[41] It is important to enhance shareholders' control on directors' remuneration in order to avoid directors to apply remuneration strategies which are not compatible with the long-tem performance of the company.[42] The proposal therefore aims to both, strengthen the link between remuneration and performance and to create a system with more transparency on remuneration policy.[43] Accordingly, Article 9a and b of the proposal require listed companies to publish information on the remuneration policy and on the individual remuneration of directors, which should be detailed and user-friendly. Article 9a (1) of the proposal provides that shareholders have the right to approve the remuneration policy and Article 9b (3) maintains that shareholders can vote on the remuneration report.

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[32] Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, (2009/385/EC), Preamble recital 2.
[33] Ibid., Preamble recital 6.
[34] Ibid., Section II, 3.2.
[35] Ibid., Preamble recital 8.
[36] Ibid., Section II, 3.3 and 4.1.
[37] Ibid., Section II, 3.3.
[38] Ibid., Section II, 4.1.
[39] Ibid, Preamble recital 1, Section II, 5.1.
[40] Proposal for a Directive of the European Parliament and the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, p. 4.
[41] Ibid., p. 5.
[42] Ibid., p. 5.
[43] Ibid., p. 5.

In Dutch Law, the relevant provisions on director's remuneration are to be found in Book 2 of the Dutch Civil Code and in the Dutch Corporate Governance Code. According to Article 2:135 of the Dutch Civil Code, which applies only to public limited liability companies incorporated in the Netherlands, the General Meeting adopts the remuneration policy of the company. The Dutch Civil Code sets some requirements regarding the disclosure of remuneration of directors in Art. 2:383c.

A guidance regarding the structure of directors' remuneration can be found in the Dutch Corporate Governance Code, which works according to the "comply or explain" principle. This instrument applies only to public listed companies which have their registered office in the Netherlands.[44] Furthermore it is not a binding legal instrument, but rather a composition of principles and best practices, which are regarded as reflecting the general view on good corporate governance, that enjoys wide support.[45] Therefore, it is not really surprising that the Code comes up with many of the principles discussed above under the regime of the European Recommendations. For example the principle on 'level and compensation of the remuneration' (II.2) states that variable remuneration should be linked to predetermined assessable and influenceable targets, which creates long-term incentives. It is also required that the structure of remuneration is simple and transparent and that the level and structure of remuneration is based on results, share price information and non-financial indicators that create a long-term value for the company. According to the principle of 'determination and disclosure of remuneration' (II.2), it is the supervisory board that determines the remuneration of every executive, based on a proposal made by the remuneration committee.

3. Analysis of the Variable Pay within the Remuneration Structure

In order to analyse the remuneration structure of the executive board of Dutch listed companies, the research focuses on the variable pay whereby executives are paid based on the level of performance of the company and the achievement of certain targets. In all of the non-financial companies listed on the AEX Index, there was a clear division between short-term and long-term variable pay. The generally agreed period of time which is referred to as the long-term in the remuneration reports analysed is three years.

In this chapter, the research conducted on the structure of directors' variable pay will be explained with regard to the provisions relevant to the governing of the topic, and the methodology used to conduct the research. In order to analyse variable pay, two aspects of the remuneration structure are examined. In order to calculate short-term and long-term variable pay, target pay is identified by the

[44] Dutch Corporate Governance Code. Retrieved 5 May 2015 from http://commissiecorporategovernance.nl/dutch-corporate-governance-code, Preamble recital 2.
[45] Dutch Corporate Governance Code, Preamble recital 4.

Supervisory Board. This pay is often identified in terms of a percentage of base salary in order to measure the targets in an identifiable manner, for example, the short-term variable target pay may be expressed as 150% of base salary. The research analysed the average short-term and long-term variable target in order to determine whether more emphasis is placed on short-term or long-term goals in the calculation of directors' remuneration. Performance criteria are used to benchmark director performance and identify the achievement of performance targets used to calculate director's variable pay. The average use of financial and non-financial performance criteria is calculated in order to determine what criteria are used the most in the calculation of variable pay. The Supervisory Board often retains a discretionary power to adjust the remuneration of directors either upwards or downwards.

3.1. Relevant Provisions

Recommendation 3.2 of the European Commission Recommendation 2009/385/EC provides that the *performance criteria should promote the long-term sustainability of the company and include non-financial criteria that are relevant to the company's long-term value creation.* [46] The DCGC outlines a number of best practices with regard to executive directors' remuneration in Part II.2 of the Code. It is outlined in Best Practice II.2.3 of the DCGC that *the supervisory board shall take into account, among other things, the results, the share price performance and non-financial indicators relevant to the long term objectives of the company, with due regard for the risks to which variable remuneration may expose the enterprise.*[47]

3.2. Methodology

This report compares the average short-term and long-term target variable pay as a percentage of base salary. The aim of this is to establish whether the companies are long-term orientated as recommended by the Dutch Corporate Governance Code. In order to compare the average short-term and long-term target pay, it was first necessary to identify the target pay as a percentage of base salary from the remuneration reports of the 17 non-financial institutions. It was possible to identify the short-term variable target for 16 companies and the long-term variable target reward for 15 companies. Within these 15 companies, one did not identify the target for long-term variable pay as a percentage of base salary but in shares; therefore, this company was also excluded. The targets were assigned to both

[46] Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, (2009/385/EC), Section II, 3. (3.2).
[47] Dutch Corporate Governance Code best practice provision II.2.3.

CEOs and Members of the Board with regard to nine companies for short-term variable pay and seven companies for long-term variable pay. These companies were analysed separately with regard to the two targets. For the short-term variable pay, the identifiable targets of the 16 companies were added together and divided by 16 in order to find the average. In order to identify the average target of long-term pay, the 14 identifiable targets as a percentage of base salary were added together and divided by 14.

3.3. Short-term and long-term target pay as a percentage of base salary

Following the Global Financial Crisis of 2008, there have been claims that excessive director remuneration contributed to this crisis[48] and other corporate governance failures; this led to an increased focus on executive remuneration with regard to the short-term versus long-term behaviour of directors. It was found that prior to the crisis; there were many incentives in place which encouraged executives to pursue a strategy which focused on maximizing market value on the short term rather than promoting long-term and sustainable corporate performance.[49]

As previously indicated, it was possible to analyse the short-term target pay of 16 companies and the long-term target pay of 14 companies. This was allocated separately for CEOs and other members of the board for nine and seven companies in the short and long-term respectively. For CEOs, the short-term variable target rewards ranged from 50% to 140% as a percentage of base salary and for other members of the board, the target rewards ranged from 45% to 120%. With regard to the long-term variable target, the targets for CEOs ranged from 50% to 285%, while the targets for other members of the board ranged from 45% to 197% as a percentage of base salary.

From comparing the short-term and long-term target pay as a percentage of base salary, it can be found that 12 of the companies featured on the AEX-Index identified a higher target for long-term variable pay than for short-term pay as a percentage of base salary. On average, of the identifiable 16 companies, the target pay as a percentage of base salary for short-term variable pay is identified as 89% for the CEO and 77% for other members of the board. With regard to the long-term targets of the 14 identifiable companies, they were identified as 130% for CEOs and 111% for other members of the board. This shows a higher target pay of 41% as a percentage of base salary for CEOs and a higher target of 34% as a percentage of base salary for other members of the board between the average short-term and long-term variable pay.

[48] Hill 2010, p. 2.
[49] HILL 2010, p. 27.

This shows that the achievement of long-term objectives is rewarded more highly than the achievement of short-term objectives. This appears to show an orientation favouring long-term development over short-term development of the company.[50]

3.4. Methodology

The second aspect of the variable pay which this report analyses relates to the use of financial and non-financial performance criteria in the assessment of directors' variable pay. In order to establish whether companies put more emphasis on financial or non-financial performance criteria, this report calculates the average use of financial and non-financial performance criteria in the short-term and in the long-term variable pay in order to determine which type is used the most.

In order to compare the average use of financial and non-financial performance criteria in assessing the target rewards of the short-term and long-term variable pay of the 17 non-financial institutions, it was first necessary to identify the percentage allocations of these financial and non-performance indicators for the short-term and long-term in the remuneration reports. It was possible to identify a division between financial and non-financial performance criteria in 16 companies with regard to short-term variable pay and in 14 companies with regard to long-term variable pay. Three of the 16 companies did not allocate a percentage with regard to the use of non-financial performance criteria in assessing short-term variable pay and eight of the 14 companies did not allocate such a percentage when assessing long-term variable pay. The identifiable percentages were added together and divided by the number of companies with the identifiable percentages in order to reach the average use of financial and non-financial performance criteria in the short-term and long-term variable pay.

3.5. The use of financial and non-financial performance criteria

This part relates to the analysis of the division of financial and non-financial performance criteria in determining both short-term and long-term variable pay. Non-financial performance criteria "*promote long-term and sustainable corporate performance*".[51] In the context of short-term variable pay, research shows out of the 16 companies that use non-financial indicators, there are 13 that allocate percentages to determine this type of remuneration. However, it must be taken into consideration that

[50] Ibid.
[51] HILL 2010, p. 27.

these non-financial performance criteria include individual targets, which differ from company to company.

With regard to short-term variable remuneration, the use of financial performance indicators average 75% among the identifiable 16 companies. The use of non-financial performance indicators average 25% in the assessment of short-term variable pay. Three of the companies do not allocate any percentage to non-financial indicators when assessing short-term variable pay. Of the 13 companies which do allocate a percentage for non-financial performance criteria, the percentage allocated ranges from 5-50% in assessing short-term variable target rewards.

With regard to long-term variable pay, the average percentage of the use of financial indicators is 86%, while the average percentage use of non-financial indicators comprises 14%. 14 of the companies have identifiable divisions; however, only 6 of these companies allocate a specific percentage to non-financial performance indicators. Among these 6 companies, non-financial performance indicators are weighted between 20 and 50%.

Possible reasons for the lower use of non-financial performance criteria in the assessment of long term variable pay will be discussed in more detail in the Performance Criteria chapter.

3.6. Discretionary power

There may be certain circumstances where it is necessary to adjust the variable pay of directors either up or down based on, for example, exceptional performance or grounds of unreasonableness. Article 2:135 paragraph 6 of the Dutch Civil Code provides that the Supervisory Board has the power to adjust the bonus of directors if the payment of such a bonus would be "*unacceptable to standards of reasonableness and fairness*." In the same spirit, Best Practice II.2.10 of the Dutch Corporate Governance Code provides that the variable remuneration may be adjusted upwards or downwards by the Supervisory Board if it would produce *"an unfair result due to exceptional circumstances*."

11 of the 17 companies analysed referred to discretionary power retained by the Supervisory Board. Six companies expressed this discretionary power in similar terms to the provision of the Dutch Civil Code, and three expressed it in similar terms to the best practice provision of the Dutch Corporate Governance Code. Other companies utilize this discretionary power in different ways. As will be discussed in the following section, one company uses this discretionary power as a specific performance criterion. In this case, the supervisory board has the power to grant an added bonus of 10% of base salary at their discretion. In yet another company the discretionary power consisted of a short-term variable pay modifier which may increase the short-term pay by 10% of base salary and

decrease by 20% of base salary at the discretion of the Supervisory Board. Furthermore, one company utilizes the discretionary power to decide on one-off motivated and disclosed payments to the Executive Board in special circumstances. Yet another company reserves the right of the Supervisory Board to reward extraordinary management achievements which create substantial added value for the company and shareholders. This discretionary power enables the Supervisory Board to adjust variable pay based on individual circumstances specific to the company and directors.

4. Analysis of the use of Performance Criteria in AEX Companies

In this chapter, the remuneration structure of the 17 non-financial institutions of the AEX-Index is observed in further detail through analysing the specific performance criteria which are used in calculating the remuneration in short-term and long-term variable pay. Specifically, the financial and non-financial performance criteria used are evaluated.

4.1. Relevant Provisions

Recommendation 2009/385/EC Section II, paragraph 3.2 establishes that the selection of criteria should "*include non-financial criteria that are relevant to the company's long-term value creation*". In general, the performance criteria should be predetermined and measurable. Moreover, Section II paragraph 5.2 a) of the recommendation provides that the remuneration policy should entail "*an explanation how the choice of performance criteria contributes to the long-term interests of the company*". The performance criteria in relation with the best practice provision II.2 DCGC shows that the variable component shall be linked to "*predetermined, assessable and influenceable targets*", which as good practice should be predominantly long-term in nature.

4.2. Methodology

According to the policies and reports of the companies, the performance criteria used in the determination of the remuneration package are divided between short-term and long-term variable pay. This analysis follows this division. In addition, financial and non-financial criteria are allocated on a percentage basis within these components of the remuneration structure. Moreover, it is identified when the specific criteria have individual percentages assigned or when the companies use an overall percentage for financial and non-financial criteria without providing further details. In the following analysis, the most common performance criteria in the short-term and long-term variable pay are identified. As a preliminary remark, it has to be stressed that when the companies allocate 100% to either financial or non-financial performance criteria, it is concluded that these companies attribute 0% to the other type of criteria, even if this is not explicitly stated in the remuneration report or policy.

4.3. Relevance of Performance Criteria

The design and implementation of the performance criteria in the short-term and long-term variable remuneration is an essential part of the remuneration policies and remuneration reports.[52] It is linked with the assistance and support of the interests of the company aimed to create long-term value.[53] Moreover, it is related to the strategy of the company through facilitating recruitment, retention and motivation. Thus, the effectiveness of the performance criteria in relation to the company interests and strategies depends on the selection of the performance criteria and the explanation of their relevance. This relevance can be assessed through observing the relevant weight attached to a specific criterion, i.e. the percentage attributed to it, which is used in assessing the remuneration.

It is significant to remark that proper performance criteria can serve as a tool for shareholders. Shareholders can use the criteria to obtain information about the company in general and about the means by which directors' remuneration is calculated. Therefore, these performance criteria would serve to increase transparency. Performance criteria may also serve to help investors understand the relation between payment and what the company recognises as its values drivers. Finally, they serve to encourage trust among the executive board, other members of the company and investors or outsiders.[54]

The focus of this chapter is based on non-financial performance criteria in particular. This is due to the fact that in recent years, the inclusion of non-financial performance criteria in the calculation of variable pay has been considered as increasingly important.[55] The inclusion of non-financial performance criteria in short and long-term variable remuneration is a good signal for developing a closer link to long-term company strategies. It has been argued that non-financial performance criteria help to achieve "*profitability, competitive strength and longer-term strategic goals*".[56]

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[52] ITTNER AND LARCKER; 'Non-financial Performance Measures: What Works and What Doesn't' Wharton University of Pennsylvania, (2000), Retrieved 19 June 2015 from http://knowledge.wharton.upenn.edu/article/non-financial-performance-measures-what-works-and-what-doesnt/
[53] Dutch Corporate Governance Code, Preamble recital 12.
[54] U.S. MERIT PROTECTION BOARD, 'Designing an Effective Pay for Performance Compensation System', 2006, Retrieved 15 June 2015 from http://www.mspb.gov/netsearch/viewdocs.aspx?docnumber=224104&version=224323&application=ACROBAT, p. 35.
[55] ITTNER AND LARCKER, 2000
[56] Ibid.

4.4. Disclosure of the Percentage of the Performance Criteria

The following section analyses the disclosure of specific or overall percentages of the performance criteria used for the calculation of the short-term and long-term variable pay. In both, short-term and long-term variable pay, the performance criteria are divided in financial and non-financial criteria.

4.4.1. Short-term Variable Remuneration: Financial Performance Criteria

Regarding financial performance criteria used by the companies in the short-term variable remuneration, it can be noted that all 17 companies use such criteria. However, there is a difference among these companies regarding the disclosure of the weight that they give to the individual criteria. There are 13 companies that disclose the percentage that they attribute to each of the financial performance criteria and three companies that disclose only the overall percentage. Furthermore, there is one company that uses this type of criteria but does not disclose the percentage, neither overall nor per criterion.

4.4.2. Short-term Variable Remuneration: Non-Financial Performance Criteria

According to the remuneration reports and policies of the companies analysed in this research, there are 15 out of 17 companies that use non-financial performance criteria to assess the short-term variable remuneration of their directors whereas the remaining two companies do not use non-financial criteria at all. Furthermore, out of the 17 companies that use non-financial criteria, 12 companies disclose the individual percentage of each of the performance criteria that they use and one company discloses only the overall percentage. Finally, only two companies do not disclose percentages.

4.4.3. Long-term Variable Remuneration: Financial Performance Criteria

In the long-term variable remuneration, 16 companies use financial criteria and one does not. Among the companies that use financial performance criteria, ten disclose the specific percentage for each criterion, whereas three disclose simply the overall percentage of the financial performance criteria in the long-term variable pay. Two do not disclose any percentage at all.

4.4.4. Long-term Variable Remuneration: Non-Financial Performance Criteria

With regard to long-term variable remuneration, eight out of 17 companies use non-financial performance criteria, eight companies do not use them, and one company provides no information on whether it uses non-financial criteria. Regarding the disclosure of the percentages attributed to the individual non-financial performance criteria in the long-term variable pay, it can be noted that five companies disclose the exact percentages, one provides the overall percentage and two of the companies do not disclose the percentage at all.

4.5. Performance Criteria: General Observations

This section makes general observations regarding the performance criteria used by the companies. Different aspects of the performance criteria are analysed and interesting observations are highlighted.

4.5.1. Frequently Used Performance Criteria

The most used short-term financial performance criteria are Free Cash Flow, EBITDA/EBITA (Earning Before Interest, Tax, Depreciation and Amortization/Earning Before Interest and Tax), Revenue and Net Sales Growth. The most commonly used long-term financial performance criteria are rTSR (Relative Total Share Return), EPS (Earning Per Share) and FCF (Free Cash Flow).

It was found that the most used short-term non-financial performance criterion is “Individual Targets” and customer satisfaction. However, there is a different interpretation of “Individual Targets” among the analysed companies. Sometimes this criterion includes factors such as employee and consumer satisfaction, and in other instances they concern specific performance objectives of individual directors. Other non-financial performance criteria that can be found are Responsible Retail Targets, Technology Leadership Index, Individual Leadership Measures, Sustainability, Loyalty and Market Position. The most used long-term non-financial criteria are Environment and Sustainability. [57] However in the reports, the meanings of these performance criteria are not explained.

4.5.2. The Use of Non-Financial Criteria in Variable Pay

It was found that 16 out of 17 companies use non-financial performance criteria in the calculation of short-term variable pay. However, in the long-term variable pay, only eight out of 17 of the companies used non-financial performance criteria.

The established conclusion that the companies pertaining to this research generally put more emphasis on non-financial performance criteria in the short-term than in the long-term variable pay is noteworthy to observe in more detail. A reason for this is that it may be a surprising outcome of the empirical evaluation, as non-financial performance measures are generally considered as long-term oriented forward-looking. Non-financial performance criteria are associated with future financial

[57] These criteria are used five times, for five companies.

performance and it refocuses managers' attention on long-term performance, rather than focusing on the short-term.[58]

However, by considering the nature of the non-financial performance criteria used for assessing the short-term variable pay, it can be noted that these measures are more assessable and probably more useful for the company if taken into account in the short-term. This may be explained by an example. 'Consumer Satisfaction' is a criterion taken into account by three companies in the short-term. Assessing this criterion on a one year basis is more transparent and gives clear results as the targets set on a yearly basis are more identifiable, than those set every three years.

Furthermore, it has to be noted that putting more emphasis on the non-financial criteria in the short-term allows companies to reassess these non-financial criteria each year, not only every three years as it is the case in long-term variable pay. Therefore, the non-financial institutions are able to adapt their strategy in a faster manner if there is for instance a change of economic situation and the previous performance criteria are no longer considered suitable.

Moreover, short-term performance measures such as sustainability might be part of a long-term business strategy plan of the company, therefore relating to a long-term goal but measured in the short-term. Thus, when the short-term goals are achieved, it has a financial effect in the realisation of the long-term remuneration goals. Such an assessment of non-financial criteria consequently has a positive impact on the long-term objectives of the companies.[59]

Nevertheless, this paper follows the opinion that the emphasis in the long-term on non-financial performance measures should be increased. As established above, the use of non-financial performance criteria is important and should therefore not be neglected in the long-term variable pay, which constitutes the bigger part of the overall variable remuneration.

4.5.3. Company Specific Indicators

In respect to some of the performance criteria, it was difficult to understand the reason why companies use them to establish the pay of their directors. An example in this regard is "number of employees involved in Voluntary Services Overseas". However, it is presupposed that this can be explained in relation to the business and values of the company. Nevertheless, in accordance with the explanation mentioned above in this paper, companies that use this type of criteria should explain its content and the reason why they chose to use it.

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[58] Ibrahim and Lloyd; 'The Association between Non-Financial Performance Measures in Executive Compensation Contracts and Earnings Management', *Elsevier Journal of accounting and public Policy 30*, 2011, p. 258.
[59] Ibrahim and Lloyd 2011, p. 260.

4.5.4. Number of Performance Criteria

The focus of this research did not concern the ideal number of performance criteria used for the determination the remuneration of directors. However, it has to be noted that there is a remarkable difference regarding the number of performance criteria used by the companies. It is especially interesting to note that some companies use only one financial or non-financial performance criterion for assessing the short- or long-term variable pay. There are two companies which use only one financial performance criterion in the short-term variable pay and six which do so in the long-term variable pay. With regard to non-financial criteria, there are six companies which only use one non-financial performance measure to assess the short-term variable pay and two companies which do so for the long-term variable pay. Nevertheless, it is important to point out that in relation to non-financial performance criteria; it is not always clear what they entail. Therefore, it may be that some of the criteria include more than one assessable measure. An example for this might be the performance criterion sustainability. It may be assessed according to an employee engagement index and a pollution assessment, therefore being one performance criterion that is assessed through two different methods.

4.5.5. Discretionary Power as Performance Criterion

It is important to note that in one non-financial company, there is a discretionary power of the supervisory board to adjust the short-term variable pay by a maximum of 10% of the base salary. This means even if the performance targets are not met, the supervisory board has the discretion to grant an additional bonus of 10% of the base salary. It has been argued by academics that this cannot be seen as positive as it mirrors a payment that is not based on proper execution of previously agreed targets. It is solely left to the supervisory board to determine this bonus, and therefore unmerited.[60]

Nevertheless, it can be argued that leaving the supervisory board a certain discretionary power with regards to the annual bonus can help when external factors outside the executive's control negatively influence the performance of the company. This can be for example a change in economic conditions. In this case, if the target would have been reached if this external element would not have occurred, the supervisory board should have the discretion to adjust the bonus upwards, even though the predefined target is not met. Hence we believe that granting the supervisory board a discretionary power to adjust the short-term variable pay can be positive. Nevertheless, the percentage of base salary should not be too high and the supervisory board should always clearly explain its decisions to make use of this discretionary power. The reason for this is to avoid exactly what the criticism of the discretionary power in the award of bonus was: arbitrary increase of bonuses for directors.

[60] DAVID F. LARCKER AND BRIAN TAYAN, 'Seven Myths of Executive Compensation', *Stanford Closer Look Series*, June 21, 2011, p. 3.

4.6. Performance Criteria: Positive Aspects and Aspects to improve

Following the evaluation of the empirical data that was collected, positive aspects as well as aspects to improve regarding performance criteria are identified. One positive point is that most of the companies' remuneration reports contain information about the performance criteria in both, short-term and long-term variable pay. In addition, we can observe that most of the companies also disclose the specific weight attributed to the criteria in the form of percentages. This is mainly done per criterion. There are only two companies which do not disclose percentages in the short-term variable and three that do not do so in the long-term variable remuneration. However, it is important to point out that some of the companies disclose an overall percentage, without specifying the exact percentage awarded to each criterion. This report/research puts forward the notion that a sound and clear remuneration report needs the exact disclosure of the percentages for each performance criterion. This is the best manner to maintain detailed information and ensure transparency in order for shareholders to understand how the remuneration of directors is calculated by the company.

Generally, in both short-term and long-term variable pay, it can be noted that the financial performance criteria are clear, specific and easy to measure. This is because they concern measurable financial metrics such as Free Cash Flow, Revenue or Total Share Return. The non-financial performance criteria are vaguer, broader, very diverse and hence difficult to assess. This observation can be confirmed by looking at the most used criteria, such as individual targets and sustainability. It is then questionable what these criteria exactly entail and how they are actually measured in practice. Without a clear answer to these types of questions it may be difficult to understand how the companies establish the remuneration of executive directors. Therefore, this report recommends further explanation regarding non-financial performance criteria, such as loyalty, Corporate Social Responsibility (CSR), personal safety and the aforementioned performance criteria. Such an explanation would serve to avoid situations leading to confusion of shareholders and other stakeholders in their ability to understand the criteria used for the determination of executive directors' remuneration.

4.7. Best Practices

The aim of this subsection is to point out best practice examples amongst the non-financial institutions of the AEX-Index with regards to clear non-financial performance criteria. It is analysed whether the non-financial institutions have assessable performance criteria which relate to the long-term objective of the companies. In this regard, it has to be stressed that it is not the purpose of this subsection to check compliance of the remuneration policies with the DCGC.

The DCGC states that '*the variable component* [of remuneration] *shall be linked to predetermined, assessable and influenceable targets, which are predominantly of a long-term nature*'. For this section regarding good practices, the focus is set on assessability of the performance criteria. As there is no clear definition of what can be considered as 'assessable' performance criteria in the DCGC, the assessment is based on our experience while analysing the reports. When evaluating the assessability of a performance criterion, we are taking into account whether the companies display details about the performance criteria which leave the possibility for the reader to track in how far the performance criteria have been fulfilled. Moreover, it should be clear to which percentage the performance criteria are taken into account when calculating the variable pay. Nevertheless, it should be noted that some companies specifically point out that they do not disclose details about the target of the performance criteria as they are considered as confidential or commercially sensitive information.[61]

Observing analysed companies of the AEX-index, generally it can be said that financial performance criteria are easier to assess as they concern measurable financial metrics, such as Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) in short-term variable pay or Total Shareholder Return (TSR) in long-term variable pay. Non-financial performance criteria are harder to measure as they concern criteria such as loyalty, sustainability, reputation and employee or consumer satisfaction. In this regard, it is important that the institutions clearly lay out what is meant by those non-financial criteria and in how far they are assessed. This can be done for instance by measuring these performance criteria according to a certain index or through indicating specific, appreciable data. This facilitates the comprehensiveness and transparency of the variable pay calculation towards investors and other interested parties. Hence, in the following a good practice in terms of the description of non-financial criteria is identified.

The performance criterion 'sustainability' in the short-term variable pay in one company[62] can be considered as an example for a good practice. Firstly, the percentage to which sustainability is taken into account when calculating the short-term variable pay is pointed out. Secondly, it is elaborated on how this sustainability is assessed. It points out ECO+ solutions, an Employee Engagement Index and Safety Performance as measures linked to assessing sustainability. Those measurements are then explained in more detail. The same is done in this non-financial institution for long-term non-financial performance criteria, which are Greenhouse-gas emissions (GHGE) reduction and Energy Efficiency

[61] Akzo Nobel, Randstad.
[62] Koninklijke DSM N.V., Remuneration Policy, 2014, p. 109.

Improvement (EEI). Those performance criteria are also explained further, it is not necessary to go into detail about the explanation at this point.[63]

5. Transparency and Clarity

The principle on the determination and disclosure of remuneration in the Dutch Corporate Governance Code provides that the remuneration report "*shall describe transparently and in clear and understandable terms the remuneration policy that has been pursued and give an overview of the remuneration policy to be pursued. The full remuneration of the individual management board members, broken down into its various components, shall be presented in the remuneration report in clear and understandable terms.*"[64]

The research team experienced difficulties in a number of reports in order to gather the information. It was not possible to identify the short-term variable target as of percentage of base salary of one of the analysed companies. With regard to the long-term target, it was not possible to identify the target for two of the companies. Moreover, we were unable to determine the general division of percentages between financial and non-financial performance criteria for one of the companies in relation to short-term variable pay, and we were unable to determine the general division of percentages between financial and non-financial performance criteria for two of the companies in the context of long-term variable pay. This was due to the lack of an express disclosure of this data in the remuneration reports and policies.

Furthermore, other companies required a great deal of studying in order to determine the precise targets and divisions as the data was not presented in clear and identifiable terms. In these instances, the relevant data was, however, ultimately identifiable.

With regard to the performance criteria, as aforementioned, the non-financial performance criteria are often vague; we therefore propose the provision of increased explanations of these types of performance criteria. It is crucial for a good understanding of the remuneration report and policy to define each criterion and describe in detail how the criteria can comply with a desirable high transparency standard. The requirement of more transparency regarding the remuneration reports and policies encapsulates the spirit of the new trends of the European legislation. This can for example be

[63] Koninklijke DSM N.V., Remuneration Policy 2014, Retrieved 4 May 2015 from p. 109.
[64] Dutch Corporate Governance Code, Principle II on Determination and Disclosure of Remuneration.

seen by the proposal for a directive on the encouragement of long-term shareholder engagement,[65] which aim is to create more transparency on remuneration policy.[66]

We found that many of the reports are not sufficiently clear, transparent or understandable in complying with the DCGC.

6. Share Ownership Requirements

Issuing shares to directors as part of the remuneration has become a frequent practice.[67] Additionally to this, certain remuneration policies for the executive board of companies include share ownership requirements for executives. These requirements usually entail a particular percentage of base salary that the director has to build up in stock in the company. The main idea behind the inclusion of share ownership requirements for executive directors in the remuneration policy is the minimisation of the risk that decisions by the executive directors are only focused on short-term results.

This subsection focuses solely on share ownership obligations in the remuneration policies of AEX non-financial institutions having their statutory seat in the Netherlands, not on general share holdings of directors in the company. The reason for this is that the focus of this research is on the structure of remuneration policies. Therefore, it would go beyond the scope of this report to examine whether CEOs or other members of the executive board acquired shares on a voluntary basis.

6.1. Context: Relevance of Share Ownership Requirements

Scholars have pointed out positive as well as negative aspects of director share ownership. An increased level of director share ownership ideally leads to interest alignment with the shareholders, meaning financial interest alignment but also alignment of preferences and actions.[68] Through this, the agency problems within a company can be diminished.[69] When there is no or a low share ownership of the executive, there is the risk that managers' may increase their personal gains at the expense of firm performance. The fact that there is a time requirement to hold a certain amount of shares in the

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[65] Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the Encouragement of Long-Term Shareholder Engagement and Directive 2013/34/EU as regards Certain Elements of the Corporate Governance Statement, COM(2014) 213 final.

[66] Ibid, p. 2.

[67] JACOB M. ROSE ET AL, 'The Influence of Director Stock Ownership and Board Discussion Transparency on Financial Reporting Quality', *Accounting, Organizations & Society 38(5)*, 2013, p. 390

[68] ANTHONY NYBERG *ET AL*., 'Agency Theory Revisited: CEO returns and Shareholder Interest Alignment', *Academy of Management Journal 53 (5)*, October 2010, p. 1031

[69] ARIFUR KHAN *ET AL*., 'Managerial share ownership and operating performance: Do independent and executive directors have different incentives?', *Australian Journal of Management 29(1)*, 2012, p. 48

NYBERG *ET AL*., 2010, p.3

company avoids the excessive risk-taking and short-term thinking of directors. Nevertheless, when there is too high share ownership of directors, managers get entrenched in the company and the agency problems are aggravated.[70] When executives have additional voting power, this allows them to protect their position in the corporation and shield themselves from disciplining mechanisms. Moreover, shareholding might also affect the executives' risk preferences.[71]

Generally, an inclusion of a shareholding obligation in the remuneration policy of a company has been perceived positively, even though some shortcomings have been observed. Recent studies[72] have pointed out a positive relationship between director share ownership requirement and the performance of the firm. Additionally, literature associates executive director share ownership with better financial performance and enhanced corporate governance.[73] Nevertheless, some commentators[74] pointed out potential flaws of share ownership of executive directors leading to a decrease of objectivity and partial (biased) financial reporting. This report does not assess the merits of these arguments, as this would fall outside the scope of the study.

6.2. Share Ownership Requirements within Non-Financial Institutions of the AEX-Index

Observing the non-financial institutions within the AEX-Index, nine out of 17 companies, so a little more than a half of the observed companies, have share ownership obligations for executives. The highest shareholding requirement is 400% of the base salary whereas the lowest is 100% of base salary. The most frequent share ownership requirement is 300% of base salary.[75] Hence, in the non-financial companies that have such a requirement, the shareholding obligation is always higher than the base salary, except for two companies where shareholding requirements are equal to the base salary. This is an interesting observation as this shows there is quite a weight on shareholdings of executive directors, which might imply that those corporations believe that this gives an incentive for the managers to act more in the firm's long-term interest.

In six out of the nine non-financial institutions, there is a distinction made between required shareholdings for the CEO and the CFO. It can be seen that the shareholding requirements for the

[70] NYBERG *ET AL* 2010, p.3
[71] Ibid.
[72] SANJAIB BHAGAT AND BRIAN BOLTON; 'Corporate Governance and Firm Performance', *Journal of Corporate Finance, 14,* 2008, p. 257–273; PAUL GUEST; 'The Impact of Board Size on Firm Performance: Evidence from the UK', *European Journal of Finance 15*, 2009.p. 385–404
[73] ROSE *ET AL*. 2013, p. 400
[74] MATHEW MAGILKE *ET AL*, 'Are independent audit committee members objective? Experimental evidence', *The Accounting Review 84(6),* 2009, 959–1982
[75] Out of 17 companies, three companies have a requirement of 300% of the base salary for the CEO, one company has this percentage of base salary as shareholding requirement for the CFO, and one company has this percentage as an overall share ownership requirement for executives.

CFO are always 100% of the base salary lower than the shareholding requirements of the CEO, except for one company, where the shareholding requirement is adjusted by 200% of base salary downwards for the CFO.

Five out of nine companies either do not say anything at all about the time period in which the executive director has to build up his shares or just state that shares can be build up over time. Three out of the nine companies indicate a time period in which the directors have to build up their shares in the company. Two companies imply a period of five years in which the director has to reach the required shareholding whereas one leaves the director only three years to build up the shares. Moreover, it can be examined that the shareholding requirement are higher in the companies where there is a longer time to build up shares. In one of the companies however there is the requirement to retain any shares derived from long-term incentives until the required level of shareholding is reached.

6.3. Observations

It is interesting to note that in one companies, even after executive directors have stopped working at this company, they are required to hold part of the shares of the shareholding requirement of it for at least two years. Hence, it could be argued that they are incentivised to stay concerned with the success of this company on a long-term basis, even after their cessation (as a result of the long-term effects of their actions). Observing the rest of the companies, four out of the nine do not indicate until when the shares have to be held. However, two out of the nine non-financial institutions indicate that the shares have to be held until the end of employment.

Concluding, it has to be noted that even though share ownership obligations can lead to an alignment of interests between executives and shareholders and have been perceived quite positively by academia, only a little less than half of the observed institution do not include such an obligation in their remuneration policy.

7. Peer Groups

This paragraph focuses on the peer groups used by the non-financial institutions pertaining to the research to determine their remuneration level. Questions of merit regarding whether these peer groups are the best possible constellation for each company or not are not evaluated, as such a study would require a detailed analysis of the characteristics of those companies. Instead, the attention of this subsection is directed towards assessing the number of companies that use a peer group to benchmark their pay level and the analysis of where these companies used are located.

7.1. Background: Use of Peer Groups

It is a common practice amongst large public listed companies to rely upon a comparative peer benchmarking approach when designing executive compensation packages.[76] In order to do so, they select a "peer group" composed of companies that are of comparable size and complexity, in similar lines of business and with other suitable characteristics. The "benchmarking process" is realized by determining a target (as percentile) based on which the pay of the board members is established.[77] The primary reasoning behind this procedure is that companies want to be able to pay their board competitively; in order to attract and maintain well qualified people and expertise and to stay competitive.

7.2. Use of Peer Groups within the Analysed Companies

The practice of using peer groups to benchmark remuneration is also shared by the 17 AEX companies. In 2014, only two out of 17 companies did not use peer groups for benchmarking the remuneration of their executives.[78] Eight companies used a benchmarking approach to determine the base salary whereas 12 used it for establishing the overall remuneration package. It is surprising to see that two companies did not disclose the name of the companies they use for benchmarking the remuneration levels.[79] Additionally, they even failed to explain the reasoning behind this confidentiality. Generally, it can be noted that the peer groups for the base salary of the analysed companies mainly comprise European companies. Three companies use amongst others US companies for determining the base salary.[80] Four of the companies use US companies for benchmarking the overall remuneration.[81]

Amongst the companies that used peer groups for their base salary and/or overall remuneration 11 companies have additional peer groups for determining the long term variable pay. There is one company that does not use a peer group to determine the base salary and the overall remuneration but

[76] Elson and Ferrere 2012-2013, p. 491.
[77] Ibid., 493.
[78] Aalberts Industries, Reed Elsevier.
[79] Philips, Wolter Kluwer.
[80] Ahold Kon, Heineken, Randstad.
[81] Ahold Kon, Heineken, OCI, Wolters Kluwer.

only uses a peer group to determine the long-term variable pay.[82] Only one of the companies uses the same companies in both of its peer groups. These companies use mostly TSR (Total Shareholder Return) peer groups, which comprise competitor companies, to determine the LTVP (long term variable pay) of the CEO and the other board members.

This means that the variable pay was calculated based on the ranking system with regard to total shareholder return; therefore, the peer groups were changed to reflect companies of similar shareholder preference.[83]

7.3. Observations

In conclusion, we would like to advance the following suggestions. Assuming that the executive board members in fact have to be paid competitively (in order to attract and retain the competent people), we believe that the process of 'group compensation benchmarking' should not become a system that arbitrarily increases the remuneration of the board, based on an external factor. Thus we recommend the companies to compensate their executives on the basis of predominantly internal factors, such as personal and company performance.

This report makes the above assertion because of the attached risks to choosing a peer group. An example of this would be that the companies of the peer group are not carefully chosen and as a result the pay of a mediocre majority rises irrespective of their actual performance just because of the remuneration levels of a few exceptional CEOs.

We recommend increased transparency by the companies regarding the selection of companies that of which their peer groups consist. This allows a better understanding for those who have to look at the remuneration report. Furthermore, this report follows the opinion that the (labour market) peer groups used for the base salary should mainly take into account companies of the same region, whereas for the long-term variable pay peer groups the companies should benchmark the remuneration with regard to competitors. Moreover, companies that use foreign companies to establish the base salary of their board members should state valid reasons why they chose to include the foreign companies. This is especially important in instances where there is an involvement of companies which have significantly high remuneration levels in the peer group, for instance U.S. companies. In fact, according to a study of the New York-based Investor Responsibility Research Center Institute (IRRCI), it is proven that the

[82] Reed Elsevier.
[83] TNT Annual Report 2014. Retrieved 5 May 2014 from https://www.tnt.com/content/dam/corporate/pdfs/Archive/Quarterly%20reports/2015/AR2014/tnt-express-annual-report-2014.pdf, p. 55.

external benchmarking of executive remuneration contributes to the significantly high and rising pay in the U.S.[84]

8. Final Conclusions

In conclusion, this report analysed the structure of executive director's remuneration in the 17 AEX non-financial institutions having their statutory seat in the Netherlands. The general legal framework concerning director's remuneration in the Netherlands was identified. It is founded in the Dutch Civil Code and Dutch Corporate Governance Code.

Following, research was conducted on an empirical basis, and data was gathered from the remuneration policies and the 2014 annual reports of the aforementioned companies. On the basis of this empirical research, the second section identified the structure of the variable pay within the remuneration structure. A division between short-term variable pay and long-term variable was found. Furthermore, a division between financial and non-financial performance criteria within the variable pay was established.

8.1. Variable Pay Structure

The main findings were that the long-term variable target reward was higher as percentage of base salary than the short-term variable target reward. The average target reward in the long-term is 41 percent of base salary higher than the average target reward of the short-term variable pay. This indicates that there is more emphasis put on the long-term goals than on the short-term goals of the company. Another interesting observation was that the average of non-financial performance criteria in calculating the target reward was lower in the long-term than in the short-term variable pay. In the short-term, non-financial performance criteria constitute 25% of the pay on average whereas in the long-term, non-financial performance criteria only form 14% of the pay on average. Possible reasons for this are further discussed in the third chapter on performance criteria.

[84] Elson and Ferrere 2012-2013, p. 49.

8.2. Performance Criteria

The report evaluated the financial and non-financial performance criteria which form part of the calculation of variable pay in more depth. The focus was put on non-financial performance indicators. This is due to their increased importance in recent years after the financial crisis and recent corporate governance scandals.

8.3. Disclosure

It was observed whether the companies disclose the specific percentage given to each performance criterion, or only an overall percentage. It was found that most of the companies attribute percentages to each performance criterion. In the short-term variable remuneration, 13 companies disclose specific percentages for financial performance indicators whereas 12 companies disclose specific percentages for non-financial performance indicators. In the long-term variable pay, 10 disclose the specific percentages for the financial performance indicators whereas five disclose the specific percentage for the non-financial performance indicators.

8.4. Frequently used Performance Criteria

The most frequently used non-financial performance criteria in the short-term variable pay were individual targets and customer satisfaction. The individual targets indicator varied a great deal from company to company with regard to the extent of what it entailed. The non-financial performance criteria most used when assessing the long-term variable pay are environment and sustainability.

8.4.1. Use of Non-financial Performance Criteria

In the short-term variable pay, 15 out of 17 companies made use of non-financial performance criteria. In the long-term variable pay, 8 out of 17 companies made use of non-financial performance criteria. Hence, there is more emphasis placed on the use of non-financial criteria in the short-term rather than the long-term. This was a surprising outcome due to the fact that non-financial performance criteria are usually considered to be of long-term nature. A possible explanation of this could however be that non-financial performance criteria are more assessable and more adaptable to changing (economic) situations if taken into account in the short-term. Consequently, it was asserted that the non-financial performance criteria should not be neglected in the long-term variable pay as it constitutes a bigger part of the variable remuneration.

8.4.2. Use of Discretionary Power in Variable Pay

One short-term non-financial performance indicator identified was a 10% bonus of base salary at the discretion of the Supervisory Board. This removed the achievement of the target from the fulfilment of a certain performance criterion. This has been criticised with the argument that the award of such discretionary bonuses may be unmerited. However, this report supports the argument that exceptional performance of directors may be rewarded even if targets are not achieved due to economic circumstances. This power should be limited to a certain percentage of base salary and the use of this discretionary power should be justified in clear terms.

8.4.3. Performance Criteria: Positive Aspects/Aspects to improve

Positive aspects regarding the performance criteria are that most of the remuneration reports contain percentages to which the performance criteria are taken into account when calculating the variable pay, either specific or overall. Moreover, the financial performance criteria are clear, specific and easy to measure as they are displayed in financial metrics. However, aspects to improve with regard to performance criteria are that the non-financial performance criteria need clearer explanation about what they entail. Furthermore, more non-financial performance criteria should be used in the long term due to reasons mentioned above.

8.4.4. Best Practices

Due to the abovementioned findings, this paper proposes best practices to be implemented in the calculation of executive directors' remuneration and gives a company-specific example of a best practice. The focus is set on the assessability of the specific performance criteria. As the financial performance criteria can be measured based on financial metrics and are therefore quite transparent in their assessment, the focus is set on non-financial performance criteria. Non-financial performance criteria are by their nature harder to measure as they contain criteria such as loyalty or customer satisfaction. Performance criteria are considered assessable in this report when the percentage attributed to the non-financial performance criteria is identifiable and when an explanation on the assessability of the measure is provided, ideally an index or other objective assessment.

8.5. Share Ownership

Within the remuneration policy, nine out of seventeen of the analysed companies obliged shareholding requirements on directors. It is interesting to note that one company requires the part of the shareholding to be held for at least two years after cessation from the company. This report proposes that shareholding requirements may induce directors to be more long-term orientated due to the amount of personal capital locked in the company.

8.6. Peer Groups

There is a common practice within the analysed companies to benchmark aspects of the remuneration of their directors against peer groups. Despite the fact that positive aspects of benchmarking are identifiable, this paper suggests that internal factors should primarily be used in the calculation of directors’ remuneration. The process of ‘group compensation benchmarking’ should not become a system that arbitrarily increases the remuneration of the board, based on an external factor. Reasons for this are amongst others the risks connected to not carefully choosing a peer group.

8.7. Overall Conclusions

The structure of executive directors’ remuneration strives to induce directors’ to be more long-term oriented due to the higher target reward in the long-term variable pay compared to the short-term variable pay. Furthermore, it encourages them to take more non-financial measures into account as the assessment of their remuneration is increasingly based on these criteria. As previously identified, a number of issues were encountered with regard to the clarity, transparency and comparability of the remuneration policies and reports. This report suggests that these aspects regarding transparency should be improved through more detailed disclosure.

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