The changing role of the management share plan in continental Europe

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Abstract Equity compensation is a hot topic in continental Europe in 2003. The majority of multinational companies are reviewing their current long-term incentive (LTI) plans in light of concerns about the downturn in the stock market, changing accounting laws, media scrutiny, more stringent disclosure requirements and increased focus on corporate governance. This paper examines the impact of these key factors on the LTI plan design and describes emerging trends such as the declining popularity of stock option plans, the increasing use of performance criteria and alignment with international best practices.

Keywords: *changing market practice; LTI plan designs; pay for performance link; corporate governance; enhanced disclosure requirements; options; international best practices*

Popularity of stock option plans

Stock option plans are the primary stock-based long-term incentive (LTI) plans offered by multinational companies in continental Europe. According to the Mercer's 2002 Global Stock Plan Practices of European Multinational Companies Survey,¹ stock option plans are the most popular long-term incentive plan in Europe, offered by 100 per cent of surveyed companies in Belgium and Sweden, 86 per cent in Germany, 83 per cent in the Netherlands and Switzerland, 80 per cent in France and 78 per cent in Denmark. In addition, it is often the only stock-based long-term incentive plan offered. One exception is the

financial services industry, where it is a common practice to offer at least two to three different LTI plan designs. Many of the global stock option plans were implemented four to five years ago and are offered only to management employees (however, in the high-tech industry all-employee option plans are also prevalent). Popularity of stock option plans was mainly caused by the rising stock market and favourable accounting treatment, ie companies are not required to record the stock option cost in their profit and loss account.

In addition, stock option plans often resemble benefit, rather than incentive, plans. Stock options are viewed by

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many companies as an add-on to total compensation and not part of total compensation. Award sizes are determined based on position/title and often do not differentiate between employees at the same level based on individual performance. The plan design is driven by country-specific tax laws to optimise tax treatment rather than to meet company-specific HR and business objectives. Therefore, the option plan designs tend to be fairly uniform within the respective European countries. Stock option plans usually also do not include company-specific performance criteria except in Germany where performance conditions are required by law for German-listed companies.

The current dominant equity compensation model in continental Europe seems to be a 'one size fits all' approach — management stock option plans with rather uniform plan designs. However, a number of recent developments have caused many European companies to re-evaluate the effectiveness of the current LTI practices and question whether over-reliance on stock option plans to incite and reward longer-term performance serves the best interests of the shareholders, employees and the company.

Key factors driving the change

Economic downturn

The current low share prices and bear markets have led to underwater options (the current stock price is below the option exercise price). Underwater options do not deliver any value to the employees and as such have no attraction or retention value. Because of this, European multinationals are realising that stock options should not be the only LTI vehicle offered and are now exploring

alternative ways to deliver long-term compensation.

Proposed accounting standard

The International Accounting Standards Board (IASB) is expected to finalise a new accounting standard for equity compensation in 2003, which will require an accounting expense to be charged for stock options at the year of grant for accounting periods starting from 1st January, 2004. Organisations could appear less profitable as a result. To date, options have typically had no accounting expense in Europe. The new accounting rules will become mandatory for EU companies in 2005 (in some cases in 2007). The prospect of accounting expenses has prompted many European companies to carefully analyse their stock option plan costs. There is pressure to decrease the number of options granted, reduce eligibility and modify the existing stock option plan design to minimise the accounting expenses. The proposed accounting rules will effectively level the playing field between stock option plans and other LTI plan vehicles. European multinationals are no longer bound to use stock options because they are cheaper.

Increased disclosure requirements

Several European countries have recently increased disclosure requirements for executive compensation.

In France, legislation introduced in 2001 requires listed French companies to disclose individual remuneration packages, including share options and other incentives, for all board members and the ten highest-paid executives in their annual reports.² In the Netherlands, as of September 2002, listed companies are required to disclose individual packages for executive and supervisory board

members.³ In Germany, the ‘suggestion’ to disclose individual pay packages for directors included in the voluntary corporate governance code in 2002 was upgraded to ‘recommendation’ in the subsequent revisions to the code in May 2003.⁴ The proposed IASB standard for equity compensation also requires detailed disclosure of LTI plan elements.

These new disclosure rules would probably lead to the convergence of LTI award levels first within respective European countries, then possibly on pan-European basis. Companies that continue to make grants above typical market levels will probably face shareholder and media criticism.

Corporate governance initiatives

In addition to adopting more stringent disclosure rules, a number of European countries have also introduced voluntary ‘comply or explain’ corporate governance codes in 2002 and 2003 to further increase transparency in executive compensation, improve overall financial reporting and disclosure and increase shareholder rights. These codes also propose best practices for LTI plan design to strengthen the link between pay and company performance.

For example, in the Netherlands a draft corporate governance code prepared by the Tabaksblat Committee commissioned by the Ministry of Finance and the Ministry of Economic Affairs made several suggestions for the LTI plan design:

- exercise of options should be made contingent on achievement of a certain level of performance;
- shares granted under a share plan should be held until the end of employment;
- the term of options should be limited to a maximum of seven years.

The final corporate governance code should become effective as of 1st January, 2004.

Similarly in Germany, the corporate governance code introduced in 2002 was amended in May 2003 to further enhance the transparency of executive remuneration and strengthen the link with company performance. The amendments concerning the LTI plan design include:

- share option and other LTI plan designs should be linked to relative company performance targets;
- performance-based part of executive remuneration resulting from extraordinary developments should be capped.

To comply with these corporate governance initiatives, the LTI plan designs in Europe are likely to become more performance-based and tailored to meet the business targets of individual companies.

Media scrutiny

The new transparency in executive compensation has also resulted in increased media scrutiny and criticism. Most of the recent articles across Europe find executive pay packages and LTI awards excessive in light of poor overall economic performance and call for even more transparency, regulation and performance hurdles. Many European multinationals are now aligning their LTI plans and award levels more closely with market and best practices to avoid negative publicity.

Emerging trends

In response to these economic and legislative developments, a number of key trends have emerged in 2003,

shaping the LTI plan designs in continental Europe.

Alternatives to stock option plans

There is an increasing interest in LTI plans, which deliver value in both bear and bull markets, especially from European companies struggling with underwater stock options. One of these plan designs is long-term share plans. Under the share plans, participants usually receive free shares if they remain employed for a certain time period (restricted share plans) or if certain performance criteria are met (performance share plans). There are several advantages to restricted share plans compared to option plans in the bear market. Restricted share plans:

- serve as a retention device even if share price remains flat;
- result in employee stock ownership causing employees to be more aligned with shareholder interests than options, which often does not result in stock ownership;
- do not become a disincentive in a down market;
- have less dilutive impact than stock options, as they require fewer shares to deliver the same value.

Provided that the performance criteria are properly defined, performance share plans deliver compensation based on the company's performance rather than based on factors, which may be perceived as out of the executive's control, such as market fluctuations. As such, these plans focus on both the specified performance goals and on stock price appreciation. The challenge is usually in setting multi-year performance targets. Other share-based management plans include stock purchase plans, where shares are

purchased at a discount, and bonus investment plans, where a certain amount of annual cash bonus is invested in company stock.

Delivering the potential LTI value through both option and share plans is already common in the UK. Of the UK's FTSE 100 companies, nearly two-thirds have both a share plan and an option plan for their executive directors. Across Europe, a shift from options to using actual shares is also encouraged by increased interest in long-term share ownership. Many believe that executives should own a certain amount of company stock to better align their interests with those of the shareholders.

Focus on performance over retention

There is renewed focus on performance-based incentives and more and more European companies are attaching performance conditions to the vesting of share or option grants, ie stock option or share awards only vest if certain performance criteria are met. If performance conditions are not met, awards are forfeited. Performance option and share plans are already prevalent in the UK and Germany. For German-listed companies, performance conditions are required by law.

The most popular performance measures in Europe are total shareholder return (TSR) and earnings per share (EPS). TSR can be absolute or relative — measured against a national or international peer group of companies. Other measures include earnings before interest and tax (EBIT), return on equity (ROE) and annual profit or share price growth. Performance criteria are also increasingly applied to individual performance. In future, option or share grants are likely to be based on individual performance rather than

position and there is further differentiation on grant sizes between top, average and low performers.

Interest in international best practices

The market place for executive labour is becoming increasingly global. Many European companies are recruiting board members and other senior executives outside their home country and are also implementing programmes to encourage internal management mobility and diversity. To facilitate these initiatives, incentive plans particularly the LTI plans should be in line with international best practices instead of following the local individual country practices. As LTI plans are rolled out globally, the plan designs aligned with international practices will serve the interests of a greater number of employees.

New equity compensation model

As a result of these recent developments and emerging trends, LTI plan designs in

continental Europe will probably be more:

- diverse: a mix of stock option and share plans or other LTI plan designs instead of stock option plans only;
- strategic: plan design is tailored to an individual company's unique HR needs and business targets;
- performance-based: plan designs include more individual and company performance criteria strengthening the link between pay and performance;
- international: plan designs are aligned with international best practices.

As such, the stock-based LTI plans will truly drive the individual and company performance and will only provide long-term compensation.

References

- 1 Mercer Human Resource Consulting (2002) 'Global Stock Plan Practices of European Multinational Companies', April 2002.
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- 4 See www.commissiecorporategovernance.nl.