2 The compensation setting process

The general roles of the board of directors are to set the company's strategic direction, to advise and monitor top management and to otherwise protect the interests of shareholders (e.g. Styles and Taylor, 2003; Hilb, 2005). Determining executive pay is an important task in fulfilling the board's duties (Finkelstein and Hambrick, 1996). This chapter describes institutional details of the executive pay setting process.

2.1 Purpose of compensation policies

Many companies have a charter for the board of directors and their committees. These charters outline in detail the purpose, tasks and responsibilities of the board and its committees. The purpose of compensation policies as frequently stated is that executive compensation is set such as to retain and attract executives who are needed to ensure the competitiveness and long-term success of the business. Most companies publishing a charter for the compensation committee further state the goal of establishing a link between pay and performance. For instance, the charter for the compensation committee of the UBS Board of Directors states that the compensation committee "will support policies and practices to attract, motivate and retain executives, ensure competitiveness, long-term business success, shareholder interests and a strong pay-performance link". While other companies use a different wording, the contents largely remain the same. Companies that do not have or do not disclose a compensation committee charter often state the same purpose in their annual reports. This would imply that compensation committees only pay as much as needed to attract and retain the necessary individuals at the top and that they aim at establishing a strong link between pay and performance. Some companies further mention that the value of the position or individual qualification required for that position play a role in determining compensation levels. This indicates that complexity influences executive pay.

2.2 Roles and responsibilities

The compensation committee's role is to either determine executive compensation or to make recommendations to the full board of directors. The board expects to adopt the compensation committee's recommendations with possible modest modifications

(Newman and Mozes, 1999). The compensation committee typically surveys market compensation levels, establishes performance benchmarks and salary policies, and evaluates management's performance against financial and non-financial goals. These activities, however, often depend on management's cooperation in providing background information and advice (Crystal, 1991). Even though the CEO usually is not a member of the compensation committee, he may sometimes attend its meetings. In companies that do not have a compensation committee, the full board assumes the role of determining executive pay. This is especially the case in small boards where all tasks are fulfilled by the combined board. Some Swiss companies further combine the specific responsibilities of nomination and compensation in a nomination & compensation committee. Many compensation committees use external compensation consultants to establish market conditions. These consultants typically compare the pay levels and structure of firms in the same industry and of similar size and make recommendations to the board of directors on how to compensate the CEO and his top management team. In some companies, the internal audit function regularly reviews the compensation setting process and submits a report to the board of directors.

2.3 Organization of the compensation committee

The compensation committee typically consists of three to four members of the board of directors, who are appointed for one year. A majority – and sometimes all – of its members are non-executive and independent. This should ensure that the objectivity required to perform their duties is not impaired. However, it is not uncommon that the CEO and other executives attend the meeting of the compensation committee without formal voting power. The head of HR occasionally functions as the secretary to the compensation committee. Furthermore, internal or external specialists may be invited to hold presentations if deemed necessary. Meeting minutes are usually made available to all members of the board of directors. Compensation committees meet less frequently than the full board, typically twice or three times a year, if circumstances do not require otherwise.

2.4 Elements and allocation of executive pay

Compensation is largely made up of five components: Salary, bonus, option grants, share grants and benefits. Salary and bonus are usually paid in cash. Bonuses are typically awarded for achievement of accounting-based performance targets of the prior year and