Remuneration Governance in the Gulf

By Ray Everett and Hubertus von Drabich
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BACKGROUND

It is a generally accepted belief that remuneration and corporate governance issues may have contributed to the recent financial crisis. Therefore, many countries' regulatory bodies have encouraged stronger remuneration governance especially in financial institutions. The latest remuneration governance principles set out by authorities in Bahrain, the Kingdom of Saudi Arabia and the United Arab Emirates (UAE) have specifically addressed the issue of Remuneration Governance.

The importance of good corporate governance practice cannot be overstated. The Remuneration Committee is an essential element of the overall governance responsibilities of the Board of Directors and can greatly enhance the company's corporate integrity and improve confidence among shareholders.

As such, the Remuneration Committee should be responsible for ensuring that the remuneration structure of the company's top executives supports and reflects the company's corporate goals and strategy, while at the same time rewards the executives in a way that is competitive with the market. Furthermore, it is also imperative that rewards are tied to the achievement of performance targets based on measures consistent with shareholder interests over the short, medium and long-term.

The purpose of this Alert is to provide a broad overview of the role and responsibilities of Remuneration Committees as per the guidelines of local regulators and what McLagan considers to be market best practice.

BAHRAIN

In early 2010 the Bahrain Ministry of Industry and Commerce issued their new Corporate Governance Code which is based on nine core principles of corporate governance that adhere to international best practices.

Principle 5 of the Code pertains specifically to Remuneration Committees and their role in the organizations. The Governance Code states that the Board of Directors shall establish a Remuneration Committee consisting of at least three members (the Committee then needs to elect one member as the Chair), which shall review the company's remuneration polices and make recommendations to the Board regarding total remuneration for specific employees (including salaries, fees, expenses, pension plans, performance-related plans such as stock options or other deferred-benefit compensation and fringe benefits).

Similar to the guidelines of some of the other Gulf countries, the Bahraini Corporate Governance Code suggests merging the Remuneration Committee with the Nominating Committee but does not specifically require it.

The Remuneration Committee should include only independent directors or alternatively, only non-executive directors where the majority are independent. The Chairman needs to be an independent director.

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The Corporate Governance Code further states that the responsibilities of the Remuneration Committee should include the compensation of directors and officers, which should be "sufficient to attract, retain and motive quality staff, but at the same time not paying more than necessary." It also states that a portion of the officers' total compensation should be linked to the individuals' and company's performance with the intention of aligning officers' interest with shareholders' interest. These rewards may consist of performance related compensation "such as grants of shares, share options or other deferred stock-related incentive schemes, bonuses or pension benefits, but are not based on salary."

The Corporate Governance Code states that the shareholders should approve all performance related incentives plans, but not the grant to certain employees. Furthermore, it sets out conditions by which "shares should not vest and options should not be exercisable within less than two years of the date of award."

In terms of the non-executive directors' remuneration, the Corporate Governance Code states that the directors shall not receive any performance-related compensation.

KINGDOM OF SAUDI ARABIA

As mentioned in our last McLagan Alert (Rules on Compensation Practices), the Saudi Arabian Monetary Agency (SAMA) released their rules on compensation practices in May 2010, asking all banks to implement similar guidelines.

According to SAMA, every bank shall have a Nomination and Remuneration Committee (NRC) comprising of at least three members. All members of the Committee should be non-executive and preferably independent members of the Board of Directors of the bank (the Chairman should be an independent member of the board). SAMA expects the members to posses the necessary expertise and skill set that is needed to take independent decisions on compensation related matters. SAMA further lays out the terms of reference of the Compensation Committee, which comprises of a number of different factors, such as overseeing the compensation system's design and operation on behalf of the Board of Directors. This includes the preparation as well as reviewing compliance of the Compensation Policy before the Board provides its final approval.

The Committee also needs to review the Compensation Policy and evaluate it on its adequacy and effectiveness as well as make recommendations to the Board for amending it. Once done, the NRC will also have to review the implementation process of the Policy on a six months basis in order to ensure that its stated objectives have been achieved.

One of the key responsibilities of the Committee is to evaluate practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain. This impacts mainly the degree and the structure of compensation of key executives, for which the Committee has to provide recommendations to the executive board.

SAMA requested the NRCs to determine the banks' bonus pool based on risk-adjusted profit of the bank. With this in mind, the Remuneration Committee is expected to liaise with either the Chief Risk Officer or the Risk Committee in the evaluation of incentives created by the compensation system.

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UNITED ARAB EMIRATES

In October 2009, the United Arab Emirates (UAE) Ministry of Economy issued the Ministerial Resolution No. 518, concerning Governance Rules and Corporate Discipline Standards. Article 6, (1.b) of these rules refers exclusively to the main responsibilities of the Nomination and Remuneration Committee (NRC) in the UAE.

These rules entail the verification of ongoing independence of independent board members. Similar to SAMA's guidelines, the UAE Ministry sets out an exact definition of an independent member in order to create the ability to exercise a fair judgment after a fully independent consideration of the information given without any influence from management.

The NRC is also fully responsible for the formulation and annual review of the firm's compensation policy. This includes verifying that remuneration and benefits of senior management are aligned with the company's performance.

The Committee also needs to determine the company's needs for qualified staff at all levels in particular senior executive management. In addition, oversee and review the company's human resources and the training policy.

In line with laws and regulations, the NRC should organize and follow-up on procedures to the membership of the Board of Directors. Similar to the rules and guidelines of the other Gulf countries, the Committee shall be selected by the Board of Directors comprising a minimum of 3 non-executive members - at least two shall also be independent. One of the two independent members is to be elected as the Chair of the Committee but may not be the Chairman of the Board of Directors.

The importance of independence of the NRC members can not be overstated, given that the duties may result in conflict of interest. According to the UAE rules, these potential issues may include the following:

- "Verification of the integrity of financial and non-financial reports,
- Review of deals concluded with interested parties,
- Selection of non-executive board members and
- Fixation of remuneration."

The Board of Directors shall lay down the procedures, terms and decision-making powers for the NRC to follow. In addition, the Board of Directors shall set up control measures of the aforesaid responsibilities of the NRC. The NRC will also be required to formulate a report which outlines the processes, results and recommendations to the Board. Once done, the Board will then make a follow up on the laid out requirements to verify adherence.

MARKET BEST PRACTICE

Over the years, McLagan has worked with literally hundreds of Remuneration Committees and Boards both in the Gulf and Internationally.

While McLagan recommends adhering to all regulatory requirements, we have also provided additional information in relation to what we believe to be market best practice for the role of Remunerations Committees.

Oversight of Management: The Remuneration Committee is charged with evaluation of the CEO and where appropriate, the heads of major divisions. It

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should also oversee the Board Directors' evaluation and compensation. The Remuneration Committee is also responsible for management development and performance appraisal and succession planning of the CEO.

Overall Framework: The Committee needs to establish and oversee the company's compensation policy. This task begins with a review of the company's performance and the relation of past and current payouts on performance. The Committee should review materials relating to the company's current and proposed compensation programs and should have adequate information on comparable companies, on both pay levels and practices. To avoid skewing the data, it is especially important that the Committee ensures that the companies in the comparator group are appropriate by virtue of size, industry and any other appropriate criteria.

Independence: It is imperative that the Remuneration Committee be independent of executive management. Typically, the members should be independent outside Directors selected and approved by the Board and/or Shareholders. The issue of independence is typically one of the biggest challenges firms are dealing with in the Gulf in relation to the new regulations.

One size does not fit all: The responsibilities of the Remuneration Committee will vary from company to company and even within one company, for example, a start-up enterprise will have very different remuneration plan requirements from an established business and a suitable Remuneration Committee needs to be designed accordingly. Requirements vary with changing circumstances, both internally and externally to the firm. Therefore, the Committee must review practices regularly to ensure that the requirements continue to be suitable.

Regular meetings: The Committee should meet at least quarterly and have a regular calendar of meetings to include:

- Review of all incentive plans;
- Constant evaluation of performance targets and financial results;
- Annual compensation benchmarking of Senior Management; and
- Management succession.

It is also important that the Committee should periodically meet to review key compensation packages as a whole. Between meetings, Committee members should receive plenty of information on reviews about the firm's Compensation plans with regards to regulatory and accounting issues.

Clear information flow: The CEO and Head of Human Resources should attend some of the Committees' meetings to allow exchange of information and perspective, since the Committee will benefit from their expertise and viewpoint on the goals, scope and implementation of the company's executive compensation policy (from time to time, the committee should also consult other top executives such as the Head of Risk Management, Head of Compliance, Head of Audit or other committees such as the Risk Committee). Communication with the full Board must be open and ongoing. The Committee should therefore be responsible for making certain that the Board is fully informed of the company's compensation policies and other issues within its jurisdiction.

Approving key internal compensation decisions: The Committee should review, amend (if necessary), and determine the CEO's compensation recommendations on the remaining officer/key executive group (including the CEO's probable

successor) recognising the CEO's broad discretion in these matters. In addition, the Committee should also monitor summary data on the employee population as a whole including total personnel costs and periodically review changes in stock ownership of company management.

CONCLUSION

In terms of the roles and responsibilities of the Remuneration Committees, the recent guidelines of the authorities in Bahrain, the Kingdom of Saudi Arabia and the United Arab Emirates have similar requirements. It is imperative that members of this Committee are truly independent. In addition, we believe that Committee Members should have an in-depth knowledge of the financial sector in order to fully understand the uniqueness of this industry.

Even though it is not specifically stated in the Bahraini or UAE Corporate Governance rules, it is highly advisable that the Remuneration Committee works closely with selected department heads and/or other Committees such as the Audit Committee, Risk Committee, Head of HR, Head of Finance or Head of Compliance. This way, the Committee receives additional input which simplifies the final approval processes and recommendations to the Board. In addition, the Committees should appoint expert consultants to attend meetings from time to time to provide advice on benchmarking, compensation strategies, market practices and trends. More importantly, the consultant should provide a "neutral" perspective based on sophisticated knowledge of the organization and its industry.

Therefore, one question still remains: Is your organization's Remuneration Committee both compliant with local regulation and in line with market best practice? ■

For a number of years, McLagan has been providing Executive Compensation assistance to financial organisations in the region. In addition, we are running a fairly comprehensive GCC Top Executive survey as well as a Non-Executive Director & Chairman study. Please contact Mr. von Drabich or your local RM for further details.

Ray Everett is the Head of our Middle East practice and a member of McLagan's Executive Committee. Ray advices numerous Boards and Remuneration Committees in the region and internationally. He also has significant experience designing and implementing annual and long term incentive plans, performance management systems and salary bands.

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