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CHANGES IN THE COMPENSATION SYSTEM OF MANAGEMENT BOARDS OF GERMAN COMPANIES AFTER THE FINANCIAL AND ECONOMIC CRISIS

ZMIANY W SYSTEMIE WYNAGRODZEŃ CZŁONKÓW ZARZĄDU NIEMIECKICH SPÓŁEK PO KRYZYSIE FINANSOWYM I GOSPODARCZYM

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Streszczenie. Systemy i wysokość wynagrodzeń menedżerów to jeden z najważniejszych obecnie problemów w zarządzaniu. Kryzys finansowy i gospodarczy wykazał, że konieczne są zmiany w tym zakresie, które za sprawą braku samodyscypliny przedsiębiorstw muszą być wprowadzone przez państwo. W artykule przedstawiono aktualny stan regulacji w Niemczech oraz dokonano próby analizy zachodzących zmian wynagrodzeń zarządów spółek, po wprowadzeniu nowej ustawy. Teoretyczne fundamenty tych zmian są wyprowadzane z teorii pryn-cypał-agent.

Key words: compensations, management board, regulations.

Słowa kluczowe: odszkodowania, regulacje, zarząd.

INTRODUCTION

For many years, compensation of presidents and members of management boards has been the object of scientific analyses, initiated in the United States of America (Schwalbach 1999). The practice of compensating top managers has been a controversial topic in a never-ending public debate in Germany and in other countries of Western Europe (Hamann 2010). It is also a tremendous disappointment and disillusionment of the past scientific achievements, both at the theoretical and empirical layer. Research shows that the assumed effects of linking compensation with the company's performance are not fulfilled (Shlomo 2011). Discussions about the compensation of management boards intensified in particular in the period of the financial and economic crisis in the years 2007–2009.

Systems of compensating management board members are considered one of the most important factors, which became the catalyst for the crisis. As a result, the use of dubious incentives and payroll stimuli became a one-of-the-kind "hunting" for extra bonuses, without exercising due care when exposing the company to risk (Seyboth 2010). The relatively common practice in companies of basing management compensation dependent on short-term growth in value of shares thus fostering orientation on shareholders, proved wrong. The primacy of interests of shareholders led in the US and Western Europe to focusing on share prices and making compensation of managers dependent on them. Compensation systems of management boards based on short-term ratios, rewarding one-sided achievements, without sufficient sanctioning of failures, often led to losing sight of long-term suc-

cess of the company. Pursuit of profit maximisation and double digit margins was often in conflict with customer care and the building of a stable future of the company.

In the classic agency theory, the subject of which is cooperation between business entities, ownership is separated from control over companies (Erlei 2007). At that time, between the owner, known as "the principal" (shareholders), and managing company, known as "the agent", information asymmetry and conflict of interest appear that can lead to moral gambling, namely attempts of abusing information advantage and held power.

Capital owners, entrusting management of the company to managers, expect that their representatives will ensure maximisation of their property. However, managers having the informational advantage may try to become involved in such actions that will, primarily, maximise their personal benefits.

In order to limit conflict of interest between the principal and the agent, diverse solutions from the corporate governance arsenal are used. One such mechanism, which is supposed to harmonise the principal – agent relationship, is a suitable compensation system for managers.

This article is intended to show how and with which methods in Germany an attempt is being made to change the previous system of motivation of management boards. It attempts also at an analysis of the effects of implementation of new solutions on the example of the selected companies.

INSTRUMENTS OF SHAPING COMPENSATIONS OF MANAGEMENT BOARD MEMBERS AFTER CHANGES

Drawing conclusions resulting from research on the reasons for the crisis in the years 2007–2009 and from the full-scale public discussion, the government in Germany introduced, on 5th August 2009, the Act on the Appropriateness of Compensation of the Management Board – Vorst AG (Gesetz zur Angemessenheit der Vorstandsvergütung) (Gesetz 2009, Suchan 2009). Its theoretical roots are associated with the principal-agent theory and take account of shareholders value and stakeholders value models.

A cardinal objective of the new act is to establish a system of compensation for management board members which would bring about long-term and long-lasting development of the companies managed by them (Auf einem Blick 2009, Koch 2010). A specific compensation system was not defined in the Act (Handlungsempfehlung 2010). It was assumed that each company should develop appropriate criteria and structure of compensation of management boards on its own. The responsibility for the introduction of new regulations in every company rests with all members of the supervisory board (Labbe 2011). Legal regulations provided for in the Act were supplemented with new recommendations of the German Corporate Governance Code for stock-listed companies (Hexel 2009, Corporate 2010).

The introduced Vorst AG Act brought a number of new requirements that can be divided essentially into three thematic areas (Poss 2009):

- problem of shaping compensation (adequacy, criteria of assessment, restrictions for a part of compensations, etc.),
- responsibility of the supervisory board in the issues of compensation determination,
- control of compensation by shareholders and the public opinion (transparency, openness).

The Act envisages that compensation of the management board members should be appropriate in relation to tasks and achievements of said members. The supervisory board, when determining the amount of compensation, should take into account the economic situation and the level of compensations on the market, commonly adopted in the practice of companies, the upper threshold of which should not be exceeded without special reasons.

A new solution, as compared to the previous legislation in force, is reference to accomplishments of the management board as a criterion of determination of the amount of compensation. In order to determine the level of compensation in companies, commonly adopted on the market, it is necessary to conduct benchmarking using horizontal and vertical criteria.

Horizontal benchmarking is to take account of compensation for the management board members as compared to compensation in the industry to which the company is classified. The size of the company and the country of its seat are also important.

Vertical benchmarking is to take account of the amount and structure of compensation of the top management as compared to the level of compensation of managers at particular management levels within the company.

The compensation structure should also contribute to the long-term development of the company, increase income and profitability. Specifically, the problem relates to an appropriate relation between fixed and variable parts of compensation. In the previous practice of large-sized German companies and concerns, in these relations short-term variables of earnings components were dominating over the long-term. They were usually based on one, relatively two financial ratios (for example turnover, EBIT) and were dependent on, often, quarterly assessments.

According to new provisions of the Vorst AG Act, compensation of the top management should depend on the long-term accomplishments of that management. Additionally, it should be emphasised that the amount of compensation should be affected by the economic standing of the company.

To prevent excessive compensation, for example due to sudden growth in income (sale of a part of the business), the legislator introduced the possibility of the supervisory board determining the maximum amount of a variable part of compensation (cap). Even before the introduction of Vorst AG Act, in the case of "a considerable deterioration" in economic

standing of the company, the supervisory board had the possibility of reducing compensation of the management board members.

However, the supervisory board was authorised, rather than obliged to do this. Therefore, such changes in compensation were rarely introduced. Along with the provision of Vorst AG Act, the supervisory board must reduce earnings of the top management of a company with a difficult financial standing.

Vorst AG also introduced changes in the regulations on rewarding the management of the company with shares options. This option is a right to purchase shares in the long run at the price agreed upon in advance, even if the share price is many times higher. This instrument enables, one, in situations of marked increases in the share prices, to obtain a very high income. According to simple logic, options combine interests of shareholders and managers because they mean high bonuses providing there is an increase in the share price.

In practice, it often turned out that options led to high income in consequence of general improvement in the economic situation or temporary moods on stock exchanges, rather than achievements. Tremendous earning possibilities even induced some to manipulate balance sheets or misrepresent data in order to stimulate the share price in order to sell options at an exorbitant price.

In the new Vorst AG Act, regarding the risk of manipulation, the term for execution of options was extended to 4 years (the previous term was 2 years). So that the options awarded in the form of bonus could bring benefits, the management board must contribute to permanent growth in the company's value.

Changes were also introduced in regulations concerning insurance of Directors and Officers. It is insurance that enables the company to insure the management board members against civil liability resulting from the function performed by managers. The scope of insurance includes damages caused to the company through activities of the management board members. In this way, the company may secure itself against a situation, in which the financial condition of its managers prevent enforcement of damages necessary to remedy damage caused by them.

The Vorst AG Act introduced some material liability of the management board members to give an opportunity to change the mentality of managers. In the D&O insurance agreement, each management board member bears, obligatorily, responsibility in the case when he or she causes damage, from a minimum 10% of its value to maximum 1.5 times value of annual earnings.

A completely new solution introduced by the Act is the principle, which is present in the Anglo-Saxon area, known as "say on pay". It gives shareholders the right to determine the amount of compensations by way of a decision of the General Meeting.

In the legislator's approach to the problem of compensation, attention is paid not only to the direct interests of shareholders (shareholder value), but also, to the fact that, when determining variable components of earnings, interest of stakeholders should be included.

Thus, values that do not bear direct relation to the company's performance, such as, for example, satisfaction of employees, customers or CSR (corporate social responsibility), also come into play.

PRACTICE OF COMPANIES IN SHAPING THE COMPENSATION POLICY

Will the introduced Act truly begin a new era in the shaping of new systems of compensations, bonuses, rewards and other motivation tools, both tangible and intangible (Beine, Jahn 2010).

Based on an analysis of the results of conducted research, some observations can be made (Kompenhaus 2009). The analysis will cover, in particular, compensation and their structure with regard to the management board members of leading German companies, the shares of which are a part of the DAX (Deutschen Aktienindex) index. Average compensation of a member of the management board of 30 DAX companies (Table 1) was in 2010 EUR 2,915 million and was 21.96% higher when compared to 2009. As compared to 2007, namely in the pre-crisis period, these compensations decreased only slightly, by more than 3%. Thus, it may be noted that the financial and economic crisis had no effect on the amount of compensation of the top managerial bodies of these companies.

Table 1. The amount of total average compensation of the management boards of DAX companies in 2010 [in EUR 000]

Company	2010	2009	2008	2007
Deutsche Bank	6.526	5.568	995	7.549
Volkswagen	5.058	3.745	3.569	3.106
Daimler	4.390	2.219	2.777	4.257
Siemens	4.151	3.432	4.110	4.236
Allianz	3.784	3.087	2.389	3.529
Linde	3.725	3.366	3.695	3.322
SAP	3.591	4.453	3.023	3.996
Metro	3.423	2.964	2.902	3.259
RWE	3.380	3.621	3.478	3.119
BASF	3.214	2.200	2.730	3.264
Henkel	2.966	2.186	2.377	2.495
E.ON	2.953	3.217	3.667	3.269
Bayer	2.948	2.948	2.356	2.447
Adidas	2.874	2.624	2.104	2.653
Deutsche Post	2.677	2.873	2.192	2.847
MAN	2.637	907	2.705	2.344
BMW	2.596	1.531	1.377	2.336
Deutsche Lufthansa	2.586	1.336	2.144	2.151
Deutsche Börse	2.528	1.685	2.169	2.235
Thyssen Krupp	2.441	929	2.479	2.642
Merck	2.438	2.813	2.733	4.669
Münchener Rück	2.369	1.975	1.328	2.465
Heidelberg Cement	2.267	2.567	1.186	4.240
FMC	2.217	1.885	2.023	2.641
Infineon	1.961	901	1.054	1.492
Deutsche Telekom	1.846	1.750	2.410	1.984

Table 1 (cont.)

Company	2010	2009	2008	2007
Fresenius	1.747	1.421	1.669	1.783
K+S	1.166	1.537	2.019	1.457
Beiersdorf	864	1.287	949	1.236
Commerzbank	575	550	718	1.801
Ø DAX	2.915	2.390	2.297	3.012

Source: Studie zur Vergütung der Vorstände in der DAX – und MDAX – Unternehmen im Geschäftsjahr 2010, DSW, Technische Universität, München 2011.

In 2010, presidents of the management boards of 30 DAX companies earned on average EUR 4.537 million. The span between Martin Winterkorn from Volkswagen, with the greatest earnings (EUR 9.330 million), and Martin Lessing from Commerzbank Group, with the lowest earnings (EUR 0.617 million), turned out to be vast (Table 2).

Table 2. Total earnings of presidents of DAX companies in 2010 [in EUR 000]

No.	President of the Board of Directors	Company	Total compensation
1	Prof. Dr Martin Winterkorn	Volkswagen	9.330
2	Dr. Josef Ackermann	Deutsche Bank	8.987
3	Peter Löscher	Siemens	8.982
4	Dr. Dieter Zetsche	Daimler	8.824
5	Prof. Dr. Wolfgang Reitzle	Linde	6.954
6	Dr. Jürgen Großmann	RWE	6.665
7	Michael Diekmann	Allianz	5.856
8	Dr. Jürgen Hambrecht	BASF	5.237
9	Bill McDermott/Jim Hagemann Snabe	SAP	4.963
10	Herbert Hainer	Adidas	4.833
11	Dr. Eckhard Cordes	Metro	4.389
12	Dr. Frank Appel	Deutsche Post	4.370
13	Dr. Norbert Reithofer	BMW	4.296
14	Dr. Johannes Teysen	E.ON	4.239
15	Dr. Nikolaus von Bomhard	Münchener Rück	4.199
16	Kasper Rorsted	Henkel	4.161
17	Marijan Dekkers	Bayer	4.044
18	Reto Francioni	Deutsche Börse	3.658
19	Dr. Ben Lipps	FMC	3.625
20	Dr. Bernd Scheifele	Heidelberg Cement	3.552
21	Dr. Georg Pacht-Reyhofen	MAN	3.544
22	René Obermann	Deutsche Telekom	3.361
23	Dr. Ekkehard D. Schulz	Thyssen Krupp	3.349
24	Karl-Ludwig Kley	Merck	3.173
25	Wolfgang Mayrhuber	Deutsche Lufthansa	3.171
26	Dr. Ulf M. Schneider	Fresenius	2.762
27	Peter Bauer	Infineon	2.227
28	Norbert Steiner	K+S	1.632
29	Thomas-B. Quaas	Beiersdorf	1.101
30	Martin Blessing	Commerzbank	617

Source: Studie zur Vergütung der Vorstände in der DAX – und MDAX – Unternehmen im Geschäftsjahr 2010, DSW, Technische Universität, München 2011.

In the case of international benchmarking in Europe, in 2010, presidents of DAX "blue chips", with average compensation to the amount of EUR 4.537 million were classified between France (EUR 3.015 million) and Switzerland (EUR 65.352 million). In the U.S.A., the

average compensation of presidents of DJIA companies was EUR 12.093 million and was clearly higher than compensation in the best European companies.

The presented also Act had to contribute to change in the structure of the compensation of the management board members with focus on a longer time horizon.

In the example of DAX companies, some symptoms of change in this respect can be noticed. In 2010, some DAX companies remodelled their compensation systems when compared to 2009, through an increased share of long-term components of the variable part of compensation (Neuorientierung 2011). Despite the above, the structure of compensation is still dominated by short-term bonuses. It is still the case for the vast majority of DAX companies that paid 40.1% of earnings of management boards in the form of annual bonuses or royalties (40.3% in 2009).

Only 10.1% of the whole compensation (in 2009 – 3.6%) were bonuses covering the period of several-year activities. 20.8% (in 2009 – 22.2%) were earnings component in the form of share options (Chart 1). Therefore, it can be noticed that so far the changes assumed in the Act have not been fully implemented.

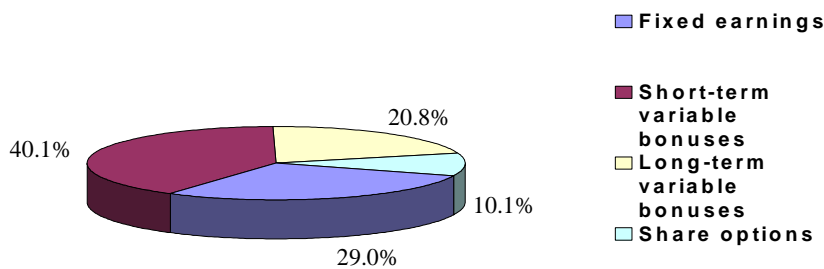


Chart 1. Compensations of the management boards of DAX companies in 2010
 Source: Studie zur Vergütung der Vorstände in der DAX – und MDAX – Unternehmen im Geschäftsjahr 2010, DSW, Technische Universität, München 2011.

The General Meeting' possibility to decide on earnings of the management board members is an instrument of exercising pressure on the supervisory boards to adjust the mechanism of compensations to the statutory requirements (Wenig 2010). From the research (Table 3) it can be concluded that more than 90 percent of shareholders in DAX companies were satisfied with the compensation systems in their companies. The only case of refusing the system occurred in 2010, during a ballot at the general meeting in HeidelbergCement. It is believed, that this regulation is barely effective (Kiefner 2010, Rap 2010).

Table 3. Decisions concerning compensation of the management boards of DAX companies at the general meetings in 2010 and 2011 [in EUR 000]

Company	2011	2010
Adidas	no ballot	yes (89.96%)
Allianz	no ballot	yes (86.20%)
BASF	no ballot	yes (98.36%)
Bayer	no ballot	yes (95.25%)
Beiersdorf	yes (97.88%)	yes (99.07%)

Table 3 (cont.)

Company	2011	2010
BMW	yes (95.83%)	yes (97.66%)
Commerzbank	no ballot	yes (96.97%)
Daimler	yes (97.38%)	yes (95.97%)
Deutsche Bank	no ballot	yes (58.06%)
Deutsche Börse	no ballot	yes (52.77%)
Deutsche Lufthansa	yes (98.41%)	yes (97.30%)
Deutsche Post	no ballot	Yes (98.27%)
Deutsche Telecom.	no ballot	yes (95.91%)
E.ON	yes (96.00%)	Yes (95.88%)
FMC	yes (99.71%)	yes (99.25%)
Fresenius	no ballot	yes (99.51%)
Heidelberg Cement	yes (96.04%)	no (45.82%)
Henkel	no ballot	yes (99.93%)
Infineon	yes (93.25%)	no ballot
K+S	no ballot	yes (93.22%)
Linde	no ballot	yes (98.56%)
MAN	yes (85.12%)	no ballot
Merck	yes (70.30%)	no ballot
Metro	yes (96.75%)	yes (98.11%)
Münchener Rück	yes (89.79%)	yes (98.33%)
RWE	no ballot	yes (96.14%)
SAP	no ballot	yes (96.14%)
Siemens	yes (96.70%)	yes (97.54%)
ThyssenKrupp	yes (94.91%)	yes (89.65%)
Volkswagen	no ballot	yes (99.44%)
ØDAX	93.43%	91.58%

Source: Studie zur Vergütung der Vorstände in der DAX – und MDAX – Unternehmen im Geschäftsjahr 2010, DSW, Technische Universität, München 2011.

CONCLUSIONS

Compensation of German management board members is a topic that is discussed heatedly not only in the scientific literature, but also in the public debate.

The fact that great incomes were also obtained by the managers of the companies, which were falling into crisis proved contradictory to the basic principles of capitalism. The Vorst AG Act was a response to the financial and economic crisis and actual or alleged excesses in the practice of compensating managers. In more than a year after the state introduced new principles, some symptoms of the companies' involvement in a shift in compensations of managers to long-term targets can be noticed.

In addition, variable parts of earnings of the management board members are oriented also on non-financial ratios, such as: customer satisfaction or corporate social responsibility.

It depends, above all, on the company's shareholders and the supervisory board members whether or not the changes introduced by the Act will truly lead to achieving the assumed objectives. Because of the Act, adjusting compensations becomes more and more precise. Orientation on common practice gives better possibilities of benchmarking.

A new element is the so-called verticality, in not only industry, but also concerning benchmarking of earnings inside companies. However, it should be remembered that legal regulations are only an instrument to stimulate conscious responsibility of the management board members for the long-term and long-lasting future of their companies. Only after many years and economical cycles, will it be possible to check without doubt, the effectiveness of the changes introduced now.

From the Polish point of view, the German experiences are interesting. In Poland, the compensation of management boards is hardly discussed. These compensations are not regulated by the state in any manner and are only affected by the market, which often leads to their revaluating and separating from companies' performance. Legal restrictions apply only to salaries of presidents and members of management boards in companies in which the State Treasury has shares of more than 50 percent. The maximum amount of their earnings cannot exceed six times average compensation in the country.

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