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Be careful what you wish for
Simplifying executive pay

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Simplifying executive pay

In a few weeks' time we expect the Investment Association Working Group to publish proposals for a 'radical simplification' of executive pay arrangements.

For some years media commentators, investor bodies and some investors have vilified the complexity of pay arrangements for company directors. Simple but effective remuneration is the Holy Grail of the executive remuneration world. But it is not entirely clear what is meant by complexity and it is not certain that this is the real problem.

Complexity does not necessarily equate to opacity which may be more of an issue. Complexity does not in itself create excess which also may be getting closer to the crux of the matter.

In any case, as we all know, sometimes when you get what you wish for there can be some nasty surprises.

What does seem to be clear is that almost everyone agrees there is a problem. This includes Government, the media, investors, the general public and many directors themselves.

If there was a simple solution it would have been found by now so we first need to identify the real problem and then we need to find some practical ways to manage it. Not dealing with it is not really an option given the increasing levels of mistrust between companies and their shareholders and a growing lack of confidence in our business leaders from employees and the general public. And of course the media generally do not miss an opportunity to stoke the fire whenever possible.

Complicated pension arrangements have been almost eradicated and replaced with salary supplements or defined contribution plans.

Multiple long term incentive plans have for the most part ceased.

Complex share matching plans have all but disappeared.

Most executive directors receive a salary, a bonus (of which a part is usually deferred), a pension supplement and an award of long-term performance related shares.

It is also entirely possible that if the problem is not solved we will see more regulations introduced, which will surely exacerbate rather than solve the issue. For example, we are already hearing a lot of noise about the ratio of CEO pay to the average employee and whether this should be disclosed (as in the US) or even capped. In our view monitoring ratios over time may be a useful internal tool for remuneration committees but there are too many variables involved in the calculation to make the disclosure of a ratio meaningful. Trying to impose a cap would be very difficult and, as we have seen where caps have been introduced to other aspects of remuneration, would almost certainly have unintended consequences. But these possibilities exist.

Are arrangements too complex?

So does the perceived complexity relate to the structure of remuneration? All of our research suggests that remuneration structures have become much simpler in recent years.

Or is it more to do with how the individual elements of remuneration are operated?

It could be argued that complexity has actually been added by shareholder best practice guidance which has been very effective in driving change. These changes include bonus deferral, post vesting holding periods, malus and clawback provisions, shareholding requirements – all of which add to the complexity of arrangements. But most would argue that these provisions are good practice and while there may be some practical complexities in operation, they are based on simple and worthwhile principles.

Is the way in which performance is measured too complex?

Is the perceived complexity more around the way remuneration is linked to business strategy and performance and the way in which performance is judged?

Companies operate in different markets and industry segments and logic says that good performance may mean something different in different companies. So while using multiple performance metrics may add a level of complexity to an incentive plan, in principle this may reflect the real complexity of a particular business.

It may also be argued that performance is now being judged more 'in the round' than may have been the case previously, taking into account factors other than just financial performance which might encourage long term sustainability and corporate responsibility.

> Annual bonus plans typically have many more measures than used to be the case. These often include non-financial measures that can be hard to quantify. They do not always include an underpin of financial performance.
>
> Long term plans are also increasingly based on multiple measures other than the usual TSR and EPS which have been used for years. This may include strategic milestones as well as other financial measures.

Factors such as health and safety, customer service, governance, employee engagement, leadership and succession planning are also now often included in overall performance measurement. However, while incorporating non-financial metrics may be considered a positive move this raises an issue with how the measures are assessed and how to disclose the degree to which targets have been met

Unfortunately it is often not clear from the disclosures in remuneration reports how the measures on which directors are rewarded are linked to the business strategy, what level of performance has been achieved and how the payouts are justified. This is often for sound reasons of commercial sensitivity but it can and does create mistrust.

This does not necessarily mean that the arrangements are too complex, but it can make the whole process appear opaque and this can create a sense of complexity which needs to be addressed.

Is it really about whether incentives work?

Many commentators will agree there is no problem with directors being paid well for good performance. But when it comes to director pay there are a number of problems; what is good performance as opposed to just doing the job? How do you measure performance and how do you ensure that the targets set are appropriate and stretching? And how do you disclose these in such a way that it is clear that directors have earned their pay?

Here is where we start to encounter complexity as there are no easy answers to these questions. Incentive plans are designed to drive behaviours but it can be very difficult to drive the right behaviours and a badly designed plan can result in directors taking a short term approach rather than encouraging long term stewardship. Investors must accept some responsibility in this, by demanding levels of growth which may not be sustainable. Remuneration committees too must accept their part in ensuring that incentive plans are well thought through and well executed.

This suggests that the target setting process needs better focus.

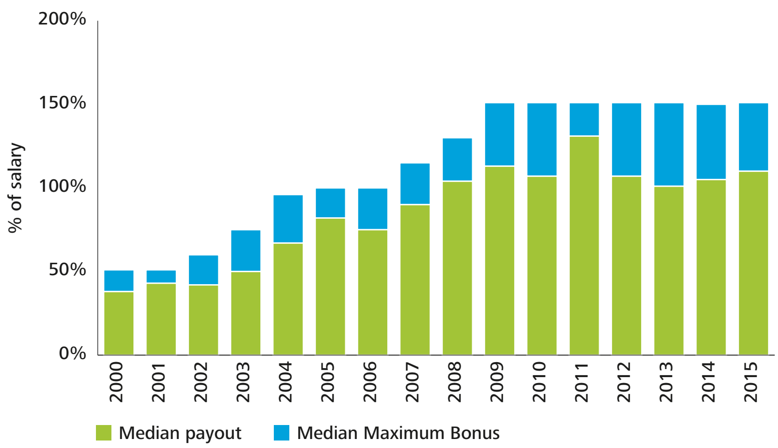
Investors are rightly demanding that companies provide more information about the targets and we expect them to take a robust line this year on whether sufficient information has been provided to justify the bonus payouts.

However, even under the new voting regime, so far there is little evidence that shareholders are prepared to seriously challenge companies on the robustness of the measures and targets and it is rare for a company to receive a significant vote against the remuneration report in reaction to the size of bonus payout relative to company performance.

Annual bonus

The annual bonus is, in our view, an element of some concern. In the larger UK companies, the bonus potential has tripled over the past 15 years. And yet the median payouts are consistently around 70% of the potential with typically only around 5% of companies making no payment in any year. In fact, in around three quarters of companies the payouts have been at, or above, the on-target level every year.

Figure 1. Bonus in FTSE 100 companies



The annual bonus conundrum

Do remuneration committees ensure that the targets are sufficiently stretching in relation to the potential size of the payout? Does the committee challenge the budgetary targets provided?

Is it always appropriate to link bonus targets to budgets?

Do plans contain sufficient checks and balances? For example, are performance criteria measured independently or are there appropriate hurdles that must be met before there is any pay out under any criteria?

Does the remuneration committee exercise discretion to ensure that payouts properly reflect overall performance?

Do the clawback and malus provisions have sufficient 'bite'?

Long term plans

In large UK companies maximum awards under long term plans have more than doubled over the past decade or so but these plans do generally appear to be linked more strongly with performance. In any year around 25% of plans do not vest and the median level of vesting is typically well under 50% of the maximum award.

However, the drive towards simplification has resulted in trying to achieve a number of different aims with one plan. So previously different types of plans may have been used for different purposes – to encourage growth, to align directors with shareholders, to incentivise directors to achieve certain goals. Is it surprising that by trying to achieve all these objectives with a single plan we end up meeting none of them?

The long term lottery

What is the real purpose of long term plans? Are they trying to achieve too many things?

Is it possible to design long term incentive plans which really drive long term value creation and long term stewardship?

How well does the long term incentive plan really incentivise and motivate? Is it really more about shareholder alignment?

Executive directors often feel as though they have little influence on performance and that the outcomes are a lottery.

The problem of setting three year targets in volatile and challenging times is also perhaps too difficult. Shareholders have proven unwilling to trust companies to design plans which might more effectively drive strategy and again have done little to challenge the fundamentals of what plans are designed to deliver and whether they are 'right' for the company.

So is it really about quantum?

Are the arguments about complexity really about the size of the pay packages for directors in larger UK companies? This is a factor which cannot be ignored.

Current data based on the 'scenario charts' which all companies must now disclose (these show the potential annual earnings for each individual director, ignoring the impact of share price), suggests that the median maximum potential annual earnings for a CEO of a FTSE 100 company are just short of £5m. While we don't have exactly comparable figures for the year 2000 our data suggests that this was more likely to be in the region of £1.7m, which represents a threefold increase. This equates to something like an 8% per annum increase over the past 15 years. The increase in average earnings of all employees over this period has been, on average, less than 3% per annum.

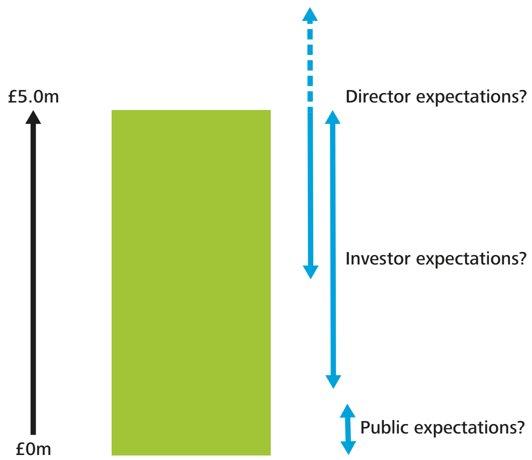
Since 2000 a CEO of a FTSE 100 company has seen potential earnings increase by around 300%

Of course, this is the maximum that may be earned and most directors do not actually walk away with the maximum on a regular basis. So we can look at the 'on-target' scenario as a proxy for what directors might 'expect' to get in a year if performance has been good. The current median annual earnings for a CEO of a FTSE 100 company for on-target performance is around £2.8m. Again, we do not have exactly comparable data for 2000 but based on our historic database we estimate the equivalent earnings in 2000 to be around £1.2m. This represents something like a 6% per annum increase over the period.

These are significant increases and the fact is that in many cases the link between earnings and long term, sustained performance is at best unclear. The reality is that many directors can reasonably expect to receive at least the on-target earnings in most years.

This topic is worthy of a discussion in its own right but in our view, if this is the real issue, then simplification alone is not the answer. To address the issue of quantum will require acceptance from all parties that there is a problem and a debate about what changes can be made to remuneration structures and to the way in which remuneration is governed and the processes by which decisions are made. And how will we get any agreement from shareholders, directors and other stakeholders on the right quantum?

Figure 2. Pay expectations



What might an alternative look like?

Fixed pay only

If the answer is that performance related pay just does not work then the obvious alternative is to make all remuneration fixed. This has a clear advantage of being completely transparent.

But are we going to be able to get comfortable with what the level of fixed pay would look like? There is likely to be a very large gap between what directors might consider reasonable, what shareholders might expect and general public perception.

From a shareholder perspective the average starting point might be something equivalent to current on-target expectations. However, directors in high performing companies might set their starting point somewhere towards the current maximum level while lower performing companies would be unlikely to fix pay below the on-target level, making the average well above current target levels. Overall this will almost certainly be inflationary.

We should also consider how this would play out where a director has underperformed – in this scenario a director could walk away with large sums of money not related to performance.

Some element of pay which is at risk and subject to performance must surely remain.

Fixed pay plus annual bonus

If setting targets over the long term is too difficult and if it is true that payouts are more of a lottery than an incentive to drive performance then maybe performance related pay should be limited to an annual bonus only, potentially with a large part subject to deferral. But as we have already noted, the annual bonus is the element of the package which seems to us to be the most problematic.

If we believe that an annual bonus should be part of the package then there are a number of issues which need to be addressed.

Making the annual bonus plan work

- Remuneration committees need to thoroughly test the targets to ensure that they are stretching in relation to the potential rewards.
- In most businesses payouts should not be consistently above target; this may require a change in the way targets are thought about, determined and communicated but the link between payouts and performance needs to be restored.
- Performance should be assessed in the round – the measures should reflect and support the business strategy and remuneration committees need to ensure that the measures chosen drive the right behaviours and do not encourage short termism. Remuneration committees should be able and willing to make adjustments to payouts to reflect the overall performance of the company and the individuals.
- Conversely shareholders should accept that the right answer, in some circumstances, is for committees to exercise discretion upwards as well as downwards.
- There should be appropriate hurdles in place to ensure that no part of the bonus can be paid unless certain minimum targets are met.
- Malus and clawback provisions could be strengthened to ensure that performance is sustained.

Long term rewards

Given the issues with the annual bonus the answer may be to remove the short term element from the package altogether. If we also believe that the idea of a long term performance plan is flawed and are not comfortable with the potential level of a fixed only remuneration package, this opens up the possibility of making awards of shares, or share options, with no long term performance targets. There are a number of provisions that could be included to make this work effectively:

- The size of the award could be based on the performance, company and/or individual, over the period prior to the award.
- There could be a significant vesting period and further retention periods where appropriate.
- Shareholding requirements could be strengthened.
- Clawback and malus provisions could be extended to provide real 'bite'.
- A minimum performance hurdle could be introduced.

Share options, with appropriate provisions in place to guard against windfall gains or short term thinking, have the benefit of only having a value where the share price increases. This makes them potentially a better way of aligning pay and performance.

The key here would be in deciding what the quantum of this award would be and whether shareholders could be comfortable with the potential size of awards where there are no longer term performance conditions.

Be careful what you wish for

UK quoted companies are complex organisations and each one has different strategic aims and is at a particular place in the business cycle, facing specific and unique challenges. It is therefore unrealistic to try and impose a single structure across all companies.

At the same time it is important that remuneration committees and directors recognise that the levels of remuneration and the apparent lack of any clear link to performance is potentially damaging to the UK business environment and is fostering distrust and cynicism in society generally. And as already noted above, there is always the very real danger that if we do not address these issues, more regulation may be introduced which is unlikely to be helpful.

The real problem as we see it, is not really about complexity, but about making sure that the pay of directors is fair and transparent to the directors themselves, shareholders and to the outside world. Aiming for simplicity alone is likely to increase levels of remuneration and weaken any link to long term stewardship.

Remuneration committees must be able to make decisions about what structure of remuneration best suits their particular circumstances. For some this may mean little change from the current arrangements; for some a structure of fixed pay plus an annual bonus may be the right answer, for others it may be fixed pay plus an award of share options. In our view there can be no single structure which will work for all companies and shareholders need to be prepared to accept that reality and judge the arrangements for each company in the context of the specific circumstances.

But the committee must also take on board some of the issues raised above in relation to how individual elements of the package are operated and be prepared to make changes where necessary.

Shareholders must help effect the change by engaging with companies, providing clear and direct feedback and by using their voting power where necessary. We need to be realistic about how quickly and how far the structure of remuneration can be changed but we know that shareholders can wield significant influence where there is a real desire for change.

The proposals from the Investment Association may be the first step along this road. Above all we need to be sure that whatever we do gets us to a better place and does not instead create a new set of problems.

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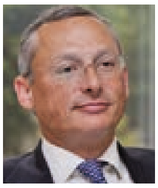

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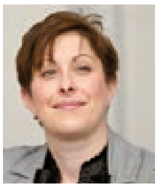

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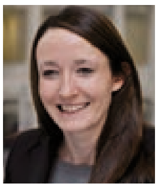

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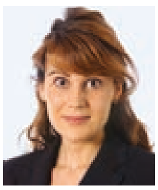

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