NO ROUTINE RICHES

REFORMS TO PERFORMANCE-RELATED PAY

high pay centre

About the High Pay Centre

The High Pay Centre is an independent non-party think tank established to monitor pay at the top of the income distribution and set out a road map towards better business and economic success.

We aim to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre is resolutely independent and strictly non-partisan. It is increasingly clear that there has been a policy and market failure in relation to pay at the top of companies and the structures of business over a period of years under all governments. It is now essential to persuade all parties that there is a better way.

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May 2015

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Foreword

Deborah Hargreaves

This report is the culmination of a year-long inquiry by the High Pay Centre into the system of performance-related pay for executives.

We have looked at the growing complexity of awards that has pushed directors' pay into the stratosphere, and found there is little discernible link with corporate success. In fact, there is an argument that it is actually damaging the economy.

We've tried to define exceptional executive performance, but found disagreements on what it constitutes as well as a confused system for measuring it.

When a system is not working, there are two solutions: Reform the system or scrap it. There have been attempts to reform performance-related pay over the past 20 years, but they have not worked.

We need to recognise the flaws in the system and stop paying CEOs on metrics that encourage gaming. We believe the system is no longer tenable and needs major reform. We have suggested ways of doing this.

I would like to thank the members of the committee overseeing this project who have generously given their time, expertise and advice. Simon Walker, Roger Barker from the Institute of Directors, Dr Ruth Bender from Cranfield university, John Plender from the Financial Times, David Pitt-Watson from London Business School, Andrew Smithers from Smithers & Co and Duncan Brown formerly with Aon Hewitt.

I would also like to thank Lord Sainsbury for funding our work.

This report draws on a number of other publications produced as part of this project. For previous reports see: http://highpaycentre.org/pubs

Executive Summary

Performance-related executive pay has now become a firmly established practice at nearly every major UK-listed company.

Pay packages typically include an annual bonus and 'long-term incentive plan' (LTIP) on top of base salary. While salary increases have been steady since the late 1990s, performance-related payments have increased dramatically, driving a rapid increase in total pay over the same period.

High Pay Centre analysis of the 'single figure' for the Chief Executive's pay declared by companies in their annual reports, suggests that the average FTSE 100 CEO was paid almost £5 million in 2014 -approximately a five-fold increase since the late 1990s.

The use of performance-related pay has been subject to a number of criticisms:

> The designated performance measures do not always align with the long-term interests of the company and can create perverse incentives;

> It is very difficult to isolate the contribution of an individual executive to the success or otherwise of the company as a whole

> Evidence on the value or effect of performance-related pay more generally is weak

> The processes and individuals that set performance-related pay are not subject to sufficient challenge or accountability

> Performance-related pay does not do what it 'says on the tin' – the weak relationship between pay and company performance.

The economist Andrew Smithers argues that both the measures used in performance-related pay packages, and their timeframe (at most 3-5 years) encourage behaviour that threatens the company's long-term market share and indeed, the productivity of the wider UK economy.

For annual bonuses, performance is generally measured using profit metrics, plus personal objectives and 'Earnings-per-Share (EPS). For LTIPs, 66 per cent of FTSE 100 companies use Total Shareholder Return (TSR), while 53 per cent use EPS (some companies use more than one metric). In most cases, TSR is measured relative to comparator companies, rather than on an absolute basis.

Citing figures showing falls in productivity and business investment in a favourable economic climate, Smithers argues that existing incentives can reward executives heavily for focusing on practices such as share buybacks, cost-cutting and under-investment in order to manipulate performance targets, even when these actions do not represent sensible business strategy.

Smithers' research tallies with wider evidence on performance-related pay. For boring, repetitive tasks where no intrinsic motivation for doing the job exists, a reward can provide some incentive to work harder or more effectively. However, for more complex roles – such as an executive position at a large company - rewards can 'crowd out' intrinsic motivation, encouraging executives to focus on manipulating the targets that lead to their reward, rather than the holistic interests of the company. This argument suggests that the very concept of performance-related executive pay is fundamentally flawed – it is impossible to design a performance measure, or even a series of performance metrics that accurately measure the complex dimensions of a company or an executive's success. Research also suggests that trying to achieve a longer-term approach to performance-related pay through deferred awards is flawed, and simply serves to drive up the value of pay packages in order to compensate for deferral.

Of course, performance-related executive pay also starts from the assumption that executives are the crucial determinant of company performance. But research by David Bolchover found that this assumption is highly questionable. Bolchover's interviews with business leaders, academics and other commentators identified a wide range of factors that help a company to prosper without much contribution from the lead executive. For example:

> Strength of the existing brand and company infrastructure

> The wider economic context

> The contribution of the executive's key advisers and the wider workforce

Whether or not these arguments are given due scrutiny by the remuneration committees that set pay or the shareholders who vote on it, is again debateable. Research from the Trades Union Congress shows that over a third of FTSE 100 remuneration committee members are themselves executives, while the CEOs of fund managers who control shareholder votes also regularly receive seven-figure pay packages, and thus have a vested interest in maintaining the consensus that this is a fair, proportionate market value of an executive.

Research for the High Pay Centre showed that bonus payments increased at roughly double the rate of Earnings Per Share and company profits between 2000 and 2013. For bonuses, just 1.3% of the variation in payments could be attributed to variation in pre-tax profits, even though this is ostensibly the primary performance measure used in bonus targets.

For LTIPs, no more than 27 per cent of the change in payment could be attributed to a change in either EPS or Total Shareholder Return in any year between 2004 and 2013.

The net result is that CEO pay growth has dramatically outpaced pay increases across the wider economy, without any corresponding increase in company performance.

As a result, faith in business has been undermined. Better corporate governance procedures are needed to correct perverse incentives, improve transparency and deliver proportionate pay awards.

Recommendations:

1. **Abolish Long-Term Incentive Plans** thereby removing one of the main vehicles for burgeoning executive pay awards.

2. **Pay cash only** in order to prevent unwarranted pay inflation as a result of deferred share awards

3. **Target broader range of company-specific targets, with an emphasis on productivity,** so as to better align with the long-term strategy of the company and the wider economic interest of the UK

4. **Broaden diversity of remuneration committees** to guarantee a sufficiently critical, challenging approach to performance-related pay packages.

5. **No golden hello payments for unadvertised positions** to encourage a more conventional competitive market for executive roles

Taken together, these changes would curtail excessive executive pay inflation and align directors' incentives with the wider economic interest.

Introduction

In recent years, the issue of performance-related executive pay has become politically explosive.

A culture of 'rewards for failure' has been castigated in the media. Politicians have proposed a range of policy measures designed to curb bonuses and incentive payments. A significant minority of shareholders have voiced their disapproval of executive pay packages at a number of leading UK companies.

Critically, however, shareholders have not opposed generous performance-related pay packages in sufficient numbers to force companies to revise their pay awards, other than in a handful of exceptional cases.

In 2014, a majority of shareholders in just one FTSE 100 company, Burberry, used their advisory vote to oppose pay awards made to the company CEO in the previous year. As of April 2015, shareholders of only one UK-listed company, Kentz Corporation (subsequently acquired by Canadian company SNC Lavalin), have used the new binding vote granted by 2013 Business Enterprise and Regulatory Reform Act to vote down a proposed executive pay policy, forcing the board to make changes to the policy. High Pay Centre analysis of the 'single figure' for their Chief Executive's pay declared by companies in their annual reports suggests that the average FTSE 100 CEO was paid almost £5 million in 2014 - approximately a five-fold increase since the late 1990s.

While commentators continue to debate the impact of the 2013 regulations and the future trends in executive pay, the verdict of the public seems emphatic.

- 80% think that the differences between high earners and low and middle-earners are unfair and don't reflect how hard people work.
- 82% think that when companies do well, the owners and the bosses benefit the most, but when they do badly the workers and wider society suffer
- Just 32% think that the pay gaps that exist in the UK between ordinary workers and top executives are necessary to encourage people to work hard and take risks [1]

A survey of Institute of Directors (IoD) members found that 52% identified anger over senior levels

[1] Polling for High Pay Centre conducted by ICM, April 2014 via http://highpaycentre.org/blog/ukip-supporters-say-tackling-rich-poor-gap-is-higher-priority-than-taxes-an

of pay as the biggest current threat to public trust in business, while 48% said that low levels of trust in business were a threat to their own business.[2]

This highlights the critical need for reform of the performance-related pay models used by leading UK companies. Business depends on public license to operate – if it is perceived to work exclusively for the interests of high income elites, then anti-business sentiment and Government policies designed to regulate business more tightly will become increasingly appealing. As the Director-General of the IoD has put it:

What has done the most damage to the reputation of business and the free market in recent years? It hasn't been the G20 protests, or the Occupy tent cities. It has been the greed of those who demand and secure rewards for failure in far too many of our large corporations.[3]

Given that performance-related annual bonuses and so-called 'long-term incentive plans (LTIPs) form by far the biggest component of executive pay, it is these elements of pay packages that should be prioritised for reform.

Performance-related pay is by its very nature intended to encourage executives to behave in a certain way, so it is also clearly vital to understand how incentives could support decisions that align with the interests of the UK economy – critics have argued that the focus of existing performance-related plans is doing great harm to the long-term health of the economy.

This report will firstly examine the structure of performance-related pay plans in the UK, as well as their historical evolution. It will outline the metrics companies currently use to define and measure exceptional executive performance, before outlining the flaws with this approach: how these measures create perverse incentives and the difficulties in isolating an individual's performance from wider contextual factors.

It will then examine the relationship between company performance and actual levels of executive pay, showing how pay growth has spectacularly outpaced increases in performance, even as defined on the company's own terms.

Finally, the report will propose reforms to current practices designed to deliver a proportionate model for performance-related executive pay that recognises and values good leadership while retaining the confidence of the wider public and encouraging sensible, long-term company stewardship. ■

[2] High Pay Centre, Performance-Related Pay: What does business think?, 2015 via http://highpaycentre.org/files/FINAL_IOD_report.pdf
[3] Speech by Simon Walker to High Pay Centre conference on performance-related pay, 15 April 2013 via http://highpaycentre.org/blog/simon-walker-iod-the-rights-and-wrongs-of-high-executive-pay

Chapter 1: How Performance-Related Pay is currently measured

In order to understand problems with existing Performance-Related Executive Pay practices, it is useful to understand how pay structures have evolved over the longer-term.

A history of performance-related pay incentives

Though annual bonuses and share options became increasingly common components of executive pay packages in the 1980s, analysis by Incomes Data Services traces the current structure and value of incentives back to corporate governance reforms taking place throughout the 1990s.

Public anger at rising levels of executive pay, as well as wider scandals such as the collapse of prominent listed companies Polly Peck and BCCI and the behaviour of Robert Maxwell, prompted the Cadbury Report into Corporate Governance, published in 1992. The report established two important principles relevant to executive pay:

Firstly, that pay should be set by a 'remuneration committee' of independent non-executive Directors; secondly, that Directors should primarily be accountable to shareholders.[4]

IDS note that remuneration committees are now universal across all major UK firms, while the principle of 'shareholder primacy' has been recognised by all subsequent enquiries and legislation relating to Directors' pay.[5] It is commonplace for company remuneration reports to state that the aim of remuneration policy is to align the interests of management with shareholders.

The Greenbury Report, published in 1995, reiterated this principle, and also emphasised the need for executive pay to reflect company performance, particularly over the long-term and in relation to other companies using key variables such as Total Shareholder Return (TSR, the total gain made by an investor encompassing share price gain plus dividend).

Current executive pay structures and practices

These recommendations essentially form the basis of executive pay as they stand today. IDS note that the various elements of pay packages now typically include:

- Base salary;
- short-term incentive, such as

[4] Incomes Data Services, Executive remuneration in the FTSE 350 – a focus on performance-related pay, 2014 p35
[5] Ibid p35

annual bonus paid in either cash or shares;

- medium-term incentive, such as deferred and matching shares;

- long-term incentive plans consisting of performance shares, share options or both running concurrently, usually awarded depending on performance against agreed targets over a three-year period; (the rise in LTIPs has coincided with a decline in the use of conventional share option awards)

- self/co-investment plan, whereby an executive buys shares in their company on the condition that the company will award them a matching number of shares. These arrangements are also subject to certain performance criteria

- pension contribution or cash in lieu.[6]

In addition to the increasing proportion of payments made in shares, rather than cash, an increasing proportion of total pay – particularly bonuses and LTIPs – is now subject to deferral periods. This means that the executives are awarded their bonus or LTIP payment at the end of the one or three year timeframe, but have to wait a further period before they can trade the shares. If subsequent evidence of negligence or poor leadership comes to light, the company can withhold payment.

As a result of these changes, the complexity of executive pay schemes has increased considerably. Graph 1 highlights the scale of the change.

In addition to the increase in the number of companies using mechanisms such as bonuses and LTIPs, their value as a proportion of total pay packages has also increased.

As such, executives are much more heavily incentivised to achieve performance-related pay targets, as these targets affect a higher proportion of their total pay. The value of median cash bonuses for FTSE 100 lead executives increased almost five-fold between 1996 and 2013, while LTIPs increased by around nine times.

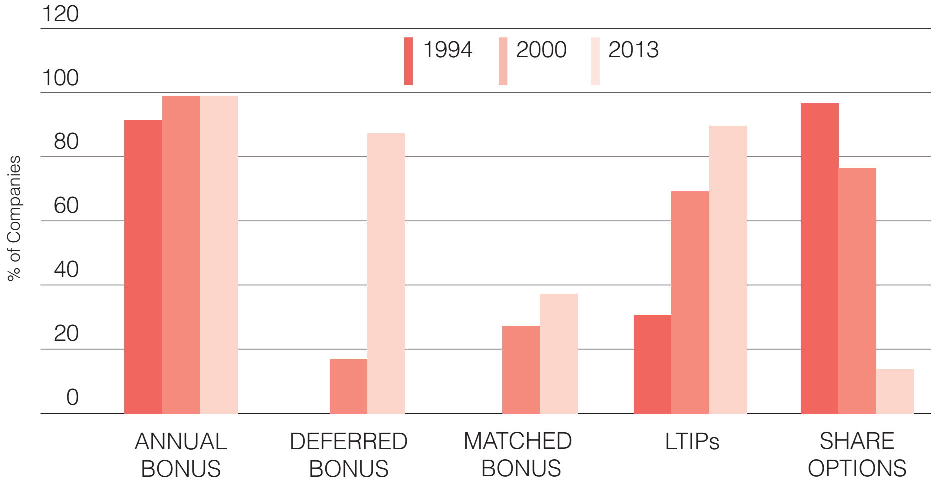
It is important to note that these increases did not result in a decrease in the value of CEO salaries, however. Additional payments were simply added on top of base pay.

Performance metrics

In terms of the specific metrics used in performance-related pay

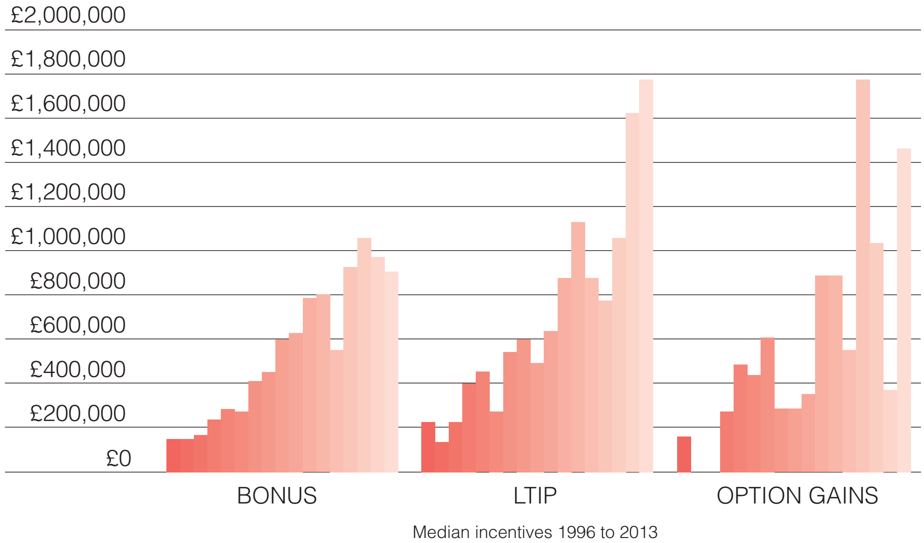
[6] Ibid p38-40

graph 01 Incentives Schemes in FTSE 100 Companies 1994 to 2013[7]



Source: ECR/HOC Employment Committe. 1995

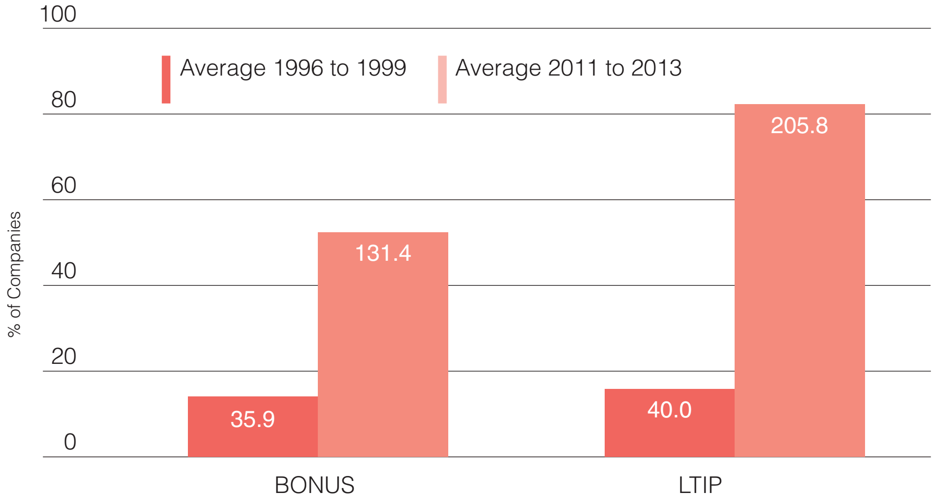
graph 02 Median cash incentive payments for FTSE 100 lead executives 1996 to 2013[8]



Source: ECR

[7] Ibid p41
[8] Ibid p44

graph 03 **FTSE 100 lead executive bonus and LTIP awards as percentage of salary averaged 1996 to 1999 and 2011 to 2013**[9]



Source: ECR

plans, IDS found that for annual bonuses, most FTSE 350 Directors targets were linked to company profits and Earnings per Share (EPS, the company's net income, excluding dividends to preferred stock, divided by the number of outstanding shares), as well as individual 'personal objectives'.

For LTIPs, 66 per cent of FTSE 100 and 65.1 per cent of FTSE 250 companies used TSR as one of the main performance metrics used to decide LTIP pay-outs in 2013, according to IDS (broadly similar to the 63.1 per cent across the FTSE 350 in 2000).[10] 53 per cent of the FTSE 100 and 51.7 per cent of the FTSE 250 target EPS in their LTIP (up from 27.8% across the FTSE 350).[11]

Separate research by the High Pay Centre, covering all UK companies in the 'Eurofirst' index of the largest European firms, produced similar results, finding that for 72 per cent of those companies (28 firms) used 'Relative TSR' as an LTIP target – ie the company's TSR performance over a stated time period, relative to another group of companies chosen by the company, or to an index such as the FTSE 100.[12] One company in the sample used absolute TSR.

The High Pay Centre analysis also found that all companies in the sample used at least one common measure in both their bonus and LTIP. For example, 63 per cent of those companies who use EPS in their annual bonuses also use it in their LTIP.[13]

[9] Ibid p45
[10] Ibid p17
[11] Ibid
[12] High Pay Centre, The Metrics Re-loaded: examining executive remuneration performance measures, 2015 p6 via http://highpaycentre.org/blog/metrics-re-loaded-examining-executive-remuneration-performance-measures
[13] Ibid p15

table 01 **Key annual performance targets used in the FTSE 350 2003/04 and 2012/13 (Source: ECR)[14]**

Target	2003/04 FTSE 100 (%)	2003/04 Mid-250 (%)	2012/13 FTSE 100 (%)	2012/13 Average bonus weighting* (%)	2012/13 Mid-250 (%)	2012/13 Average bonus weighting* (%)
Profit targets	45.7	54.4	65.0	49.8	51.5	63.9
Personal objectives	50.0	41.6	57.0	26.8	49.0	23.7
EPS	41.3	25.6	25.0	45.5	16.3	64.7
ROCE	19.6	7.2	9.0	16.0	7.1	26.9
Cash flow targets	15.2	11.2	35.0	18.8	23.4	24.4
Customer satisfaction/ service	6.5	1.6	11.0	15.0	5.9	15.7
TSR	2.2	1.6	4.0	25.0	1.3	29.1

* Where schemes have more than one target their contribution to the final payment are given weights. If a scheme has two targets – profit and EPS – 50% of the final bonus payout could be based on profit achievement and 50% on EPS performance. The figures in the column are an average of these weights for each target. Please note that bonus weighting not available for 2003/04

These 'cross-over' measures can be high yield measures for executives who can benefit from awards measured over single and multiple year periods on the same performance measure. In other words, the same achievement – eg growth in EPS – is rewarded twice, firstly in the annual bonus then in the LTIP.

The value of two schemes using identical performance metrics as incentives to good leadership is questionable, given that the company could remove either and the CEO would still theoretically be incentivised to achieve improved outcomes as measured by the same metric.

Furthermore, the use of EPS as a measure for both annual bonuses and LTIPs shows that there is nothing intrinsically long term about the measure being

[14] Ibid p11

used and long term is simply a reflection of the period over which EPS is measured. There was no evidence that companies had given consideration to measures which might properly be considered long term in the sense that measurement over the short term would be inconclusive, misleading or obsolete.

At least ostensibly, it seems likely that the chosen metrics – and performance-related executive pay in general – are designed to align executive interests with those of shareholders. The High Pay Centre's research found that many of the companies using TSR explicitly state that they use this measure because it is the best measure of value generated for shareholders or the best way of aligning executive interests with those of shareholders, while the objective of delivering long-term value for shareholders has been a theme of UK corporate governance dating back to the Cadbury Report.[15]

The pay-setting process

In addition to the broad objectives of the company's remuneration policy, the precise structure of performance-related pay policies is designed by the company's remuneration committee (often with advice from specialist remuneration consultants).

As noted above, companies are now required to put their pay policy to a binding shareholder vote at least every three years. Companies must also hold an annual advisory vote on the pay awards made the previous year.

In practice, the shareholder votes are controlled by the institutional investors, who have long-term holdings in leading UK companies and exercise trading and voting rights on behalf of the ultimate share-owners (eg ordinary workers with a pension plan or savings account).

Criticism of Performance-related Pay

Performance-related pay models have come under increasing criticism in recent years, perhaps unsurprisingly, given the extent to which their evolution over time has been affected by changes in political and economic orthodoxy; and the number of different factors that determine the structure of performance-related pay policy and the awards that it generates. These include

- Objectives of performance-related pay
- Measures used to determine performance
- Form of payment

[15] Ibid p26-29; for other examples of UK Corporate Governance regulation emphasising shareholder interests, see the various iterations of the Corporate Governance Code; the 2006 Companies Act; or the 'say on pay' rules in the 2013 Business Enterprise and Regulatory Reform Act.

- Time period over which performance is assessed (and over which pay is deferred, where applicable)
- Accountability of the pay policy design process
- The failure to do 'what it says on the tin' – the weak relationship between pay and performance

Examples of specific criticisms are as follows:

- The designated performance measures do not always align with the long-term interests of the company (or with the interests of other stakeholders or the wider economy) and can create perverse incentives;
- It is very difficult to isolate the contribution of an individual executive to the success or otherwise of the company as a whole, meaning it is possible for executives to benefit undeservedly from other contextual factors that enable a company to be successful
- Evidence on the value or effect of performance-related pay more generally is weak
- The processes and individuals that set performance-related pay are not subject to sufficient challenge or accountability

The following chapter will discuss these criticisms in more detail. ■

Chapter 2: Criticism of Performance-Related Pay models

The destructive effect of performance-related executive pay on the UK economy

In a paper for the High Pay Centre, City Economist and Financial Times columnist Andrew Smithers argues that performance-related pay models inadvertently encourage and reward short-termism, reflecting a conflict of interest between executives; and the company and the wider economy.

Smithers notes the different time horizons affecting executives and companies, suggesting that over time, the greatest risk to a company is loss of market share.[16] This risk is minimised through competitive pricing and investment – those companies that invest most judiciously in their equipment are able to reduce production costs and therefore maintain a competitive price for their output.

By contrast, executives are most concerned by the performance metrics affecting their performance-related pay plans, which tend to be at most 3-5 years in length. This is a short period over which a major investment in production equipment, for example, might be expected to bear fruit. Indeed, investment spending could, over the short-term, negatively affect company profitability, thereby reducing pay-outs for the executives, even if it is in the company's long-term interest.

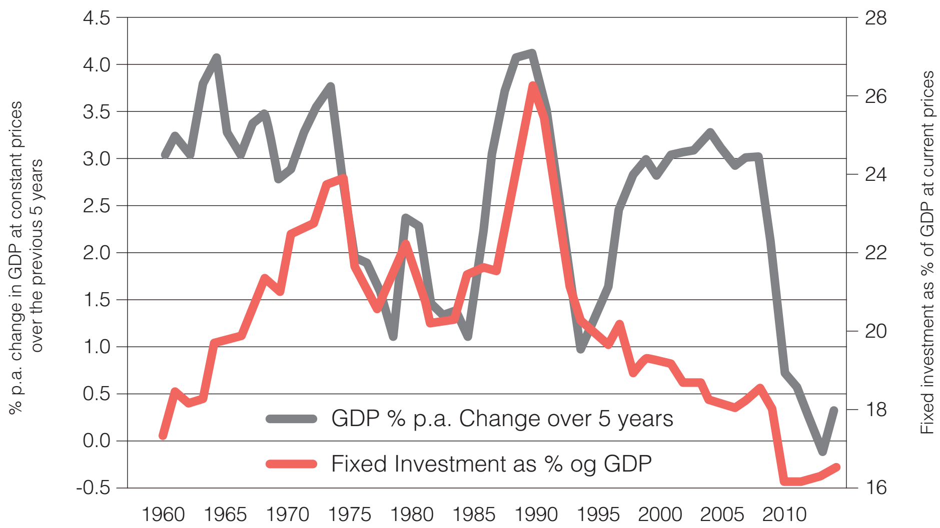
As such, current performance-related pay plans effectively encourage executives to slash investment – either in equipment or human resources –to a potentially unsustainable level, while pursuing speculative take-overs and concentrating resources on share buybacks in order to increase the share price and increase bonus or LTIP pay-outs.

Smithers hypothesises that business investment in the UK has declined rapidly since the mid-late 1990s, coinciding with an increase in the prevalence and value of executive performance incentives.

Smithers notes that this decline cannot be attributed to wider economic factors. Taking unemployment as a proxy for the state of the economy in general, there are periods in the 1980s and 1990s where rises in investment mirror falls in unemployment and vice versa, but there are also periods where the two bear little

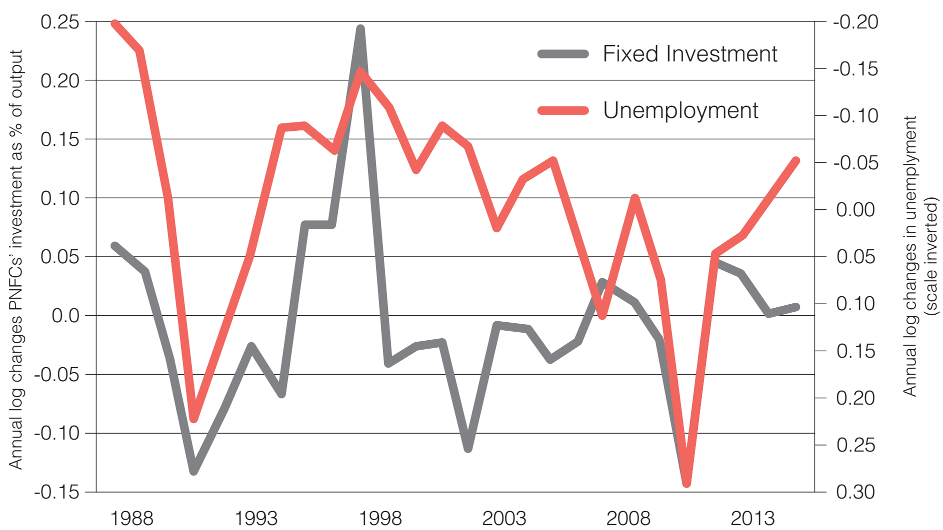
[16] Andrew Smithers, The Perverse Incentives of Modern Management, 2015 p1 via http://highpaycentre.org/pubs/the-perverse-incentives-of-modern-management-and-remuneration

graph 04 UK Growth and Investment since 1960[17]



Source: ONS via Ecowin

graph 05 Annual Changes in Private Non-Financial Companies Investment and Unemployment, 1998-2013[18]



Source: ONS via Ecowin

[17] Ibid p2
[18] Ibid p5

Similarly, the price of machinery and manufacturing equipment have risen more slowly than prices in general, while borrowing costs have also fallen. As such, the decline in investment cannot be attributed to these factors.

Falling investment is closely linked to low productivity, a problem that has plagued the UK economy for many years and is now a key priority for economic policymakers. So if Smithers is right that executive pay incentives are even partly responsible for a lack of business investment, this ought to prompt a major re-evaluation of the way that executives are paid.

Perverse incentives

There is much academic evidence to support Smithers position that performance-related pay creates perverse incentives.

Many researchers have found that rewards are an effective means of encouraging and reinforcing positive behaviour or actions. This is the intention for performance-related pay. However, critics have argued that the effectiveness of rewards diminishes as tasks become more complex.

For a boring, repetitive task where no intrinsic motivation for doing the job exists, a reward can provide some incentive to work harder or more effectively. However, for more complex tasks, individuals may already possess an intrinsic desire to do the job well. In the case of an executive role, this may relate to status or responsibility, or fulfillment derived from helping to provide jobs, prosperity or a valuable product or service.

Incentives, however, undermine this intrinsic motivation, and entice executives to focus on their reward. Tempted by a large enough sum of money, the individual in question – who would otherwise have been focused on achieving the best possible holistic outcome for the company over the long-term – becomes pre-occupied with meeting particular targets, looking for ways to game them or take short-cuts to realise their incentive payments, often to the detriment of the company.[19]

The case of the bankers manipulating the LIBOR rate is one obvious example. Traders conspired with banking colleagues to manipulate the interest rate, in order to advantage their trading position and thereby generate bigger bonus payments for profits generated. Ultimately, this proved ruinous to the reputation of the banking industry generally, and resulted in billion-pound fines for the institutions involved in the practice. Clearly, performance-related pay played a major part in the bankers' behaviour.

[19] See Tom Powdrill, The failure of executive incentive schemes, Renewal Journal, 2012 via http://www.renewal.org.uk/articles/the-failure-of-executive-incentive-schemes for a summary of academic perspectives on performance-related pay

It is not difficult to envisage a similar scenario in the case of business leaders, who are incentivised to deliver results as assessed by particular measures over the short timeframe of their executive career. It is arguably impossible to design a performance-related pay scheme that a) accurately and holistically measures performance in a way that reflects the nuanced and multi-faceted role of an executive and b) does so over a timeline that mirrors the impact of their decisions on the company (which may continue long after their departure). Metrics such as TSR and EPS are potentially flawed because they are too crude to accurately reflect the complex dimensions of a company or an executive's success. They are also susceptible to manipulation via processes such as stock buybacks or short-term cost-cutting.

Professor Alexander Pepper reaches broadly similar conclusions on the ineffectiveness of performance-related pay in his contribution to the High Pay Centre's essay collection on performance-related pay

> *'Empirical research from 1990 onwards… has failed to demonstrate a conclusive link between agents (executive) pay and corporate performance.'* [20]

Essentially, though the idea that paying executives according to how well they do their job leads to better performance is intuitive, the evidence suggests that it hasn't actually worked in practice.

In fact, the adoption of LTIPs has served only to distort the link between pay and performance and subject executive pay to wider criticisms, because of the tendency to discount the value of awards made in future. As LTIPs are measured over three-year time periods and sometimes subject to longer deferral or clawback periods, remuneration committees are compelled to increase their value in a vain attempt to make them more meaningful to the executives.[21]

Professor Pepper goes on to dismiss the idea that this is because performance-related pay hasn't been calibrated properly, and instead argues for 'better theories of executive compensation.' In other words, it is the concept of performance-related pay that is flawed, rather than the design.

Can executives make any difference?

Market forces are often identified as a cause of high executive pay. As the economy has become globalised, and highly-skilled

[20] Professor Alexander Pepper, Executive Pay: The Problem with Agency Theory in High Pay Centre, Performance Pay, New Ideas on Executive Remuneration, 2014 p9
[21] Ibid p10

professionals have become more mobile, their employment opportunities have increased, meaning that their employers have to pay a greater premium to attract and retain their services. With companies growing larger, the value of executive decisions becomes greater, creating a greater impetus to pay more for an individual who will make the right decisions.

There is considerable evidence to weaken these assumptions, however.

Firstly, analysis by the High Pay Centre of the Fortune Global 500 list of the world's biggest companies found that the mobility of executive talent is perhaps exaggerated. Fewer than 1 per cent of the CEOs of these companies were recruited from an international rival. 80 per cent of the CEOs had been promoted from within the ranks of the company.[22]

This suggests that executive skills are not so readily transferable from one company to the next, never mind one continent to another. While certain transferable skills are important, so too is a specific understanding of the organisational culture, markets and stakeholders, as well as a functional working relationship with key colleagues. Research compiled by the University of Delaware found that companies with CEOs who had been promoted from within tended to out-perform those that had recruited externally, suggesting that the risk of failing to sufficiently reward a CEO is greatly overplayed, and that successful talent-development processes are more important to organisational success than generous performance-related pay schemes.[23]

The second counter-argument to the idea that the market value of executives has increased focuses on the contribution that individuals can make to large organisations, with thousands of employees and operations spanning multiple continents.

A study for the High Pay Centre by management writer David Bolchover looked at the degree of responsibility that CEOs could take for corporate performance, and the degree of difficulty in identifying someone else who could exert a similarly positive impact.

The study encompassed interviews with a number of leading academics and commentators, as well as with CEOs themselves.

Bolchover concluded that it was difficult to precisely quantify the

[22] High Pay Centre, Global CEO Appointments: A very domestic issue, 2013 via http://highpaycentre.org/pubs/the-myth-of-global-high-pay-talent-market

[23] 4 Charles M Elson and Craig K Ferrere, Executive Superstars, Peer Groups and Over Compensation -Cause, Effect and Solutions in Journal of Corporate Law, Spring 2013, p27-29

impact that an individual CEO makes, thus making it difficult to prove or disprove whether they deserve to be heavily rewarded when the company does well difficult. As Luke Johnson (leading businessman who built up Pizza Express) puts it:

> *'Isolating one person's discrete contribution to the success of a large undertaking which employs thousands of people is an impossible task. I just don't see how it can be done.'* [24]

However, when large sums of money are being lavished on a particular individual, it seems that the onus should be on proving that they deserve it, rather than that they don't.

Bolchover's interviews identified many arguments emphasising the significant difference that an individual can make – for example, when taking particular strategic decisions – but also a number of ways in which it is perfectly possible for an organisation's success to be determined by factors beyond the CEO. Examples outlined by Johnson and Sir Philip Hampton (Chair of RBS and former senior executive at Sainsburys and BT) include:

- **Existing brand and company infrastructure:** 'Very often, the results owe more, for example, to an improving economy, or to a specific market in which the company operates which is doing particularly well, or to the strength of its existing brand, or to the fact that competitors are suffering for whatever reason, or to the research and development division which has come up with a new invention, and so on.' (Luke Johnson)

- **Wider economic context:** 'There are certain industries where macroeconomic factors are absolutely crucial, and way beyond the influence of any manager… If you are a mining business, for example, and you experience a sustained period when China is suddenly importing minerals like there's no tomorrow, without the world having developed the capacity to produce the volume to meet Chinese demand, then prices will inevitably rocket. And if the price of iron ore or zinc rockets, then you will make a ton even though you have made little contribution to the performance of that business'. (Hampton)[25]

- **Contribution of the wider workforce:** 'All the successful companies I have been involved in have relied on a team effort. That team might

[24] David Bolchover, Made to Measure: How opinion about executive performance becomes fact, 2015 via http://highpaycentre.org/files/FINAL_MADE_TO_MEASURE.pdf
[25] Ibid

be hundreds of people, and the CEO generally follows recommendations from the many advisers working with him. (Johnson) The bigger the system, the more the system counts, rather than the person at the top of it.' (Hampton)

In each of these scenarios – all of which are highly plausible - it would be possible for the CEO to fulfil 'their' performance criteria and receive a generous pay out as part of their performance related pay plan, without actually demonstrating the brilliant leadership that performance-related pay is supposed to incentivise and reward. Such scenarios epitomise a perception that top executives are raking in huge pay-outs simply for being in the right place at the right time.

This perception may not be entirely accurate, but Bolchover's study suggests that neither is it completely baseless – and it is doing great damage to the reputation of business.

Accountability

Performance-Related Pay has also been widely criticised on grounds of accountability.

Policies are designed by an independent remuneration committee, often acting on the advice of remuneration consultants. However, there are some suggestions of a conflict of interest.

Research by the Trades Union Congress found that over one third of FTSE 100 Remuneration Companies have another executive Director on their committee.[26] Given that these individuals' own pay is set in response to the 'going rate' for an executive, they have a vested interest in making pay packages as generous as possible.

The average FTSE 100 Remuneration Committee member was paid nearly £450,000 a year, roughly 16 times the average UK worker, while the highest paid was paid £9 million.[27] As such, it is questionable whether they are sufficiently challenging or critical of performance-related pay packages that others might consider overly generous.

Once the remuneration policy is prepared by the remuneration committee, it is subject to a shareholder vote every three years. In practice, however, shareholders are not always greatly engaged with the companies in which they invest.

Over 50 per cent of shares in listed UK companies are owned by overseas investors who, for

[26] Trade Unions Congress, A culture of excess: The pay of FTSE 100 Remuneration Committee members, 2015 via https://www.tuc.org.uk/sites/default/files/Acultureofexcesspay.pdf
[27] Ibid
[28] Office of National Statistics, Ownership of UK quoted shares 2012 via http://www.ons.gov.uk/ons/rel/pnfc1/share-ownership---share-register-survey-report/2012/stb-share-ownership-2012.html

practical reasons, may find it more difficult to engage with the stewardship of those companies and are thus less likely to scrutinise pay policies in detail.[28]

The average length of shareholding has also declined (some investors have speculated that most shares in the US are held for less than a minute) – and shareholders who are increasingly likely to trade their shares in the short or medium-term are also increasingly unlikely to be engaged with debates on executive pay.[29]

Finally, even amongst the longer-term UK based investors, voting and engagement over pay policy is in practice controlled by investment professionals, rather than the ultimate owners of the shares. The Kay Review notes that performance for most intermediaries in the investment chain is benchmarked over very short-term time horizons and remunerated accordingly.[30]

As such, these individuals take a short-term view of the performance of their investments and so cannot be expected to challenge companies operating on an overly short-term basis in the manner outlined by Andrew Smithers's criticisms.

Investment professionals managing shareholdings are also subject to conflicts of interest over the extent to which they benefit from a generous performance-related pay culture. Many investment firms are amongst the biggest UK-listed companies and their own senior executives are subject to similar performance-related pay plans as other big companies. For example, the Chief Executives of Standard Life (paid £5.5 million in 2014), Legal and General (£4.2 million) and Aviva (£2.6 million) are amongst the highest paid business leaders in the UK.

Therefore, they are unlikely to challenge an imperfect approach to performance-related pay - even if it leads to negative outcomes for the companies they invest in and for the wider economy - if it simultaneously benefits their own senior management.

While companies dispute that remuneration committees are insufficiently robust and challenging, and investors argue that they scrutinise pay policies critically and thoroughly, it is difficult to reconcile their case with the data on executive pay and performance over recent history. This is the focus of our next chapter. ■

[29] Daily Telegraph, How long does the average share holding last? Just 22 seconds, 18 January 2012 via http://www.telegraph.co.uk/finance/personalfinance/investing/9021946/How-long-does-the-average-share-holding-last-Just-22-seconds.html
[30] Department for Business, Innovation and Skills, Kay Review of Equity Markets, 2012, p41

Chapter 3: The relationship between pay and performance in practice

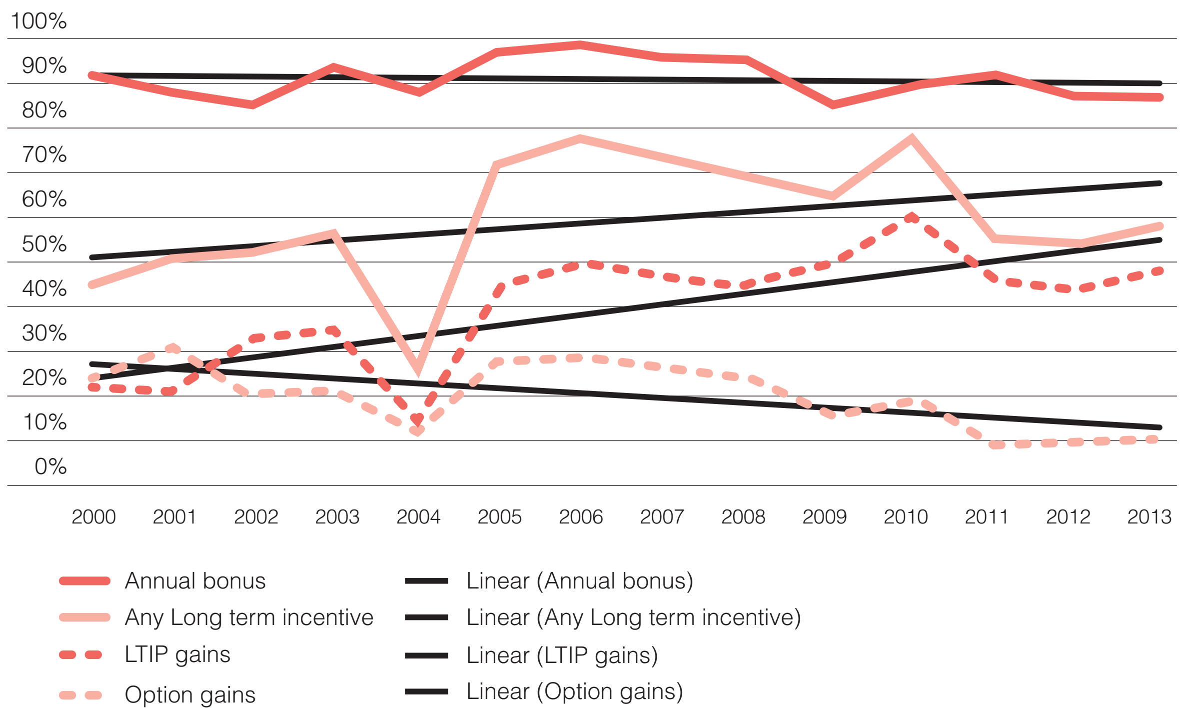
The divorce between pay and performance

Chapter 1 showed how performance-related pay plans have become more commonplace as part of executive pay packages and account for a much larger proportion of total pay. However, as Figure 14 shows, they also 'pay out' with increasing frequency. In every year since 2005, annual bonuses and long-term incentives payments have been paid to over 50 per cent of FTSE 350 Lead Directors, with payments of around 90 per cent (bonuses) and 70 per cent (LTIPs) now typical. When such awards are given out more commonly than not, it is questionable whether terms such as 'bonus' or 'performance-related' can accurately apply.

Again, there might be some justification for the frequent

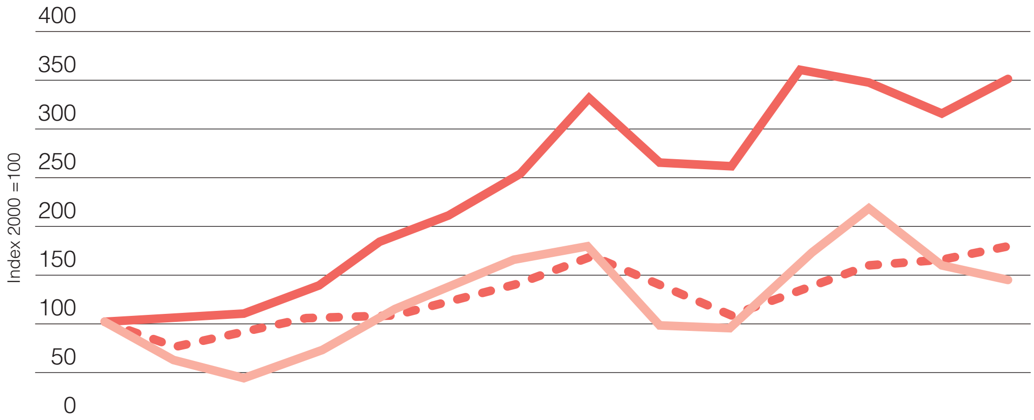
[31] Executive remuneration in the FTSE 350 – a focus on performance-related pay, p46
[32] Ibid, p13
[33] Ibid p14

graph 06 Proportion of FTSE 350 Lead Executives receiving an incentive 2000 to 2013[31]



Source: ECR

graph 07 *Indexed movements in FTSE 350 directors median bonus (bonus scheme participants only) and median performance metrics 2000 to 2013*[32]



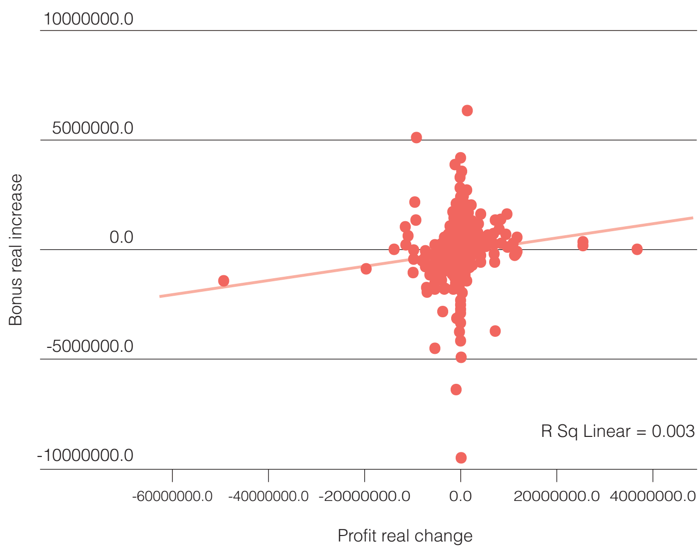
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Weighted average total bonus	100	105	112	138	186	210	253	332	264	262	359	347	318	350
Weighted average EPS	100	78	93	106	108	124	141	170	143	108	136	159	163	179
Weighted average pre-tax profits	100	63	43	66	103	139	168	179	97	94	165	217	161	144

pay-outs if this were matched by similarly consistent improvements in performance, as measured by the relevant metric. However, this has not happened. Even when using the specific measures of performance that are ostensibly used by companies to set the targets in their performance-related executive pay plans, pay has increased at a quicker rate than performance.

Annual bonuses

Chapter 1 showed how bonuses were most commonly linked to EPS and other measures tied to company profits. Graph 7 shows

graph 08 *Relationship between changes in pre-tax profit and changes in annual bonus payments in FTSE 350 companies 2000 to 2013*[33]

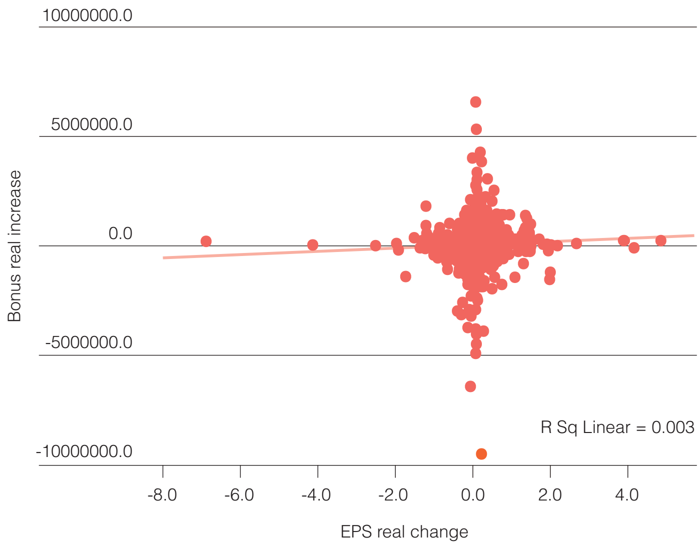


that across the FTSE 350, bonus payments increased at roughly twice the rate of EPS and pre-tax profits.

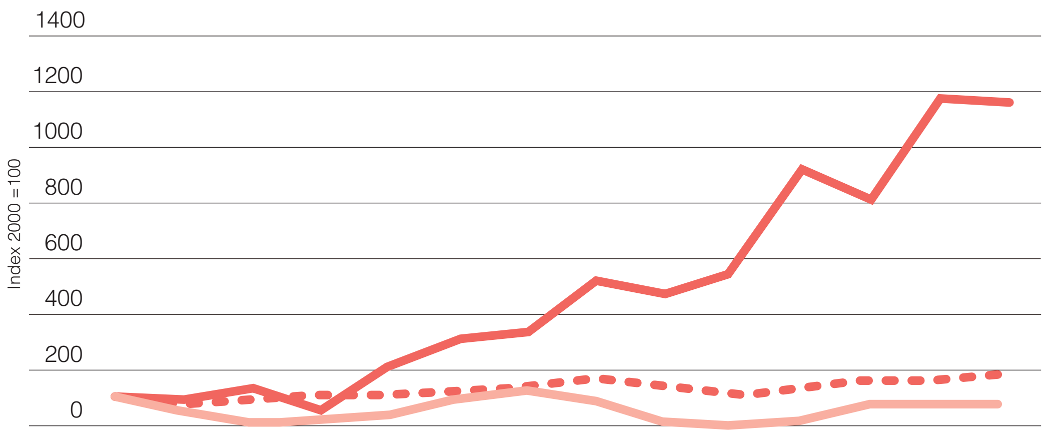
Looking at the year-on-year change in each individual's annual bonus compared to the change in pre-tax profits and EPS, the findings are even starker.

IDS analysis calculated that just 1.3% of the change in annual bonuses can be explained by changes in pre-tax profit. The other 98.7% of change in bonuses must be explained by additional factors. For EPS, IDS calculated that

graph 09 *Relationship between changes in EPS and changes in annual bonus payments in FTSE 350 companies 2000 to 2013*[34]



graph 10 *Indexed movements in FTSE 350 weighted average* LTIP gains and weighted average performance metrics 2000 to 2013*[35]



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Weighted average LTIP gains	100	95	133	58	212	323	338	523	477	546	923	813	1178	1169
Weighted average EPS	100	78	93	106	108	124	141	170	143	108	136	159	163	179
Weighted average three year TSR	100	48	12	19	40	98	134	93	15	0	16	85	75	74

annual changes accounted for just 0.3% of the change in bonuses.

'Long-Term' Incentive Plans

The conclusions from an analysis of LTIPs are broadly similar. The increase in the companies' chosen metrics of TSR and EPS fails to match the (much greater) increase in total LTIP payments made to FTSE 350 executives between 2000 and 2013.

When IDS examined the year-on-year change, they found a stronger relationship between the relevant performance metrics and LTIP awards than with annual bonuses. However, in each year examined, there was never more than one quarter of the variation in the value of the LTIP that could be explained by variation in either EPS or TSR.

table 2 *Relationship between ranked vested LTIP awards and ranked three-year changes in TSR for selected years*[36]

Year LTIP awarded	Correlation coefficient with three-year TSR change previous year	R-squared with three-year TSR change previous year	R-squared %
2001	0.33	0.11	10.7%
2002	0.41	0.17	17.1%
2003	0.18	0.03	3.4%
2004	0.15	0.02	2.3%
2005	-0.01	0.00	0.0%
2006	0.22	0.05	4.8%
2007	0.27	0.07	7.5%
2008	0.24	0.06	5.8%
2009	0.35	0.12	11.9%
2010	0.49	0.24	23.7%
2011	0.41	0.17	16.7%
2012	0.41	0.17	16.7%
2013	0.29	0.08	8.1%

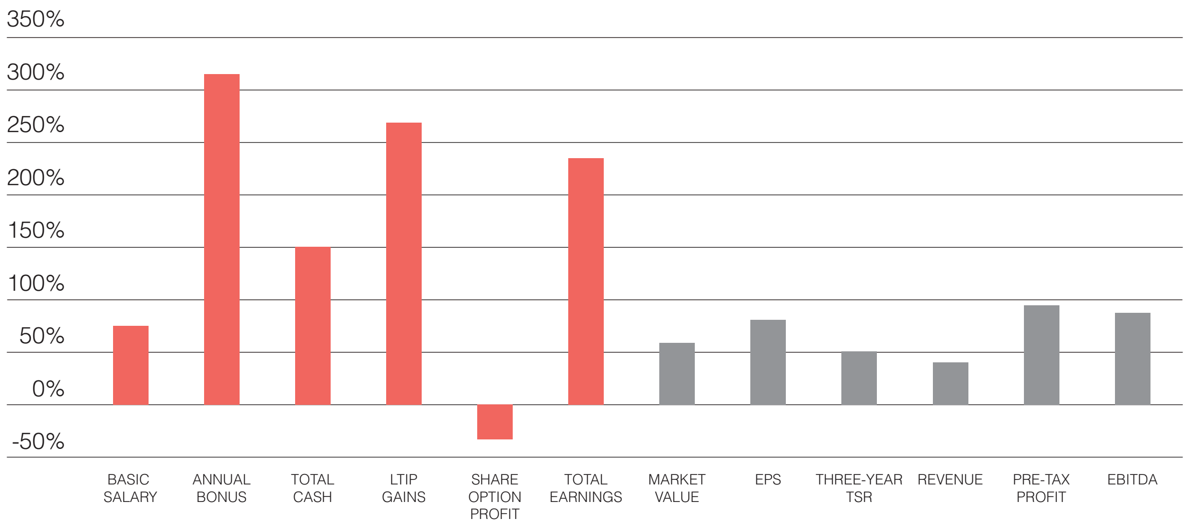
[34] Ibid p15
[35] Ibid p20
[36] Ibid p21

table 3 *Relationship between ranked vested LTIP awards and ranked three-year changes in EPS for selected years[37]*

Year LTIP awarded	Correlation coefficient with three-year EPS change previous year	R-squared with three-year EPS change previous year	R-squared %
2004	0.40	0.16	16.2%
2005	0.17	0.03	2.8%
2006	0.18	0.03	3.2%
2007	0.52	0.27	26.7%
2008	0.17	0.03	3.0%
2009	0.22	0.05	4.9%
2010	0.06	0.00	0.3%
2011	0.29	0.08	8.2%
2012	0.41	0.17	17.0%
2013	0.09	0.01	0.7%

[37] Ibid p22
[38] Ibid p7

graph 11 *Percentage change in median remuneration of FTSE 350 directors and selected corporate indicators 2000 to 2013[38]*



Total pay

The IDS analysis confirms suspicions that pay for the Directors of major UK companies has increased out of proportion to the success of their companies and even the particular measures of performance that are most commonly used as part of executive pay plans.

Perhaps as pertinently, this has also resulted in a striking increase in pay for executives in relation to the wider UK workforce, with major reputational repercussions for business.

The IDS figures compiled in late 2014 relate to pay from packages as detailed in 2013. So there maybe some hope that reforms enacted that year – specifically the binding shareholder vote on pay mandated by the Business Enterprise and Regulatory Reform Act – will strengthen the link between pay and performance.

This will require more detailed analysis as the data becomes available – but early signs are not promising. Analysis from the High Pay Centre suggests that the average pay for a FTSE 100 CEO in 2014 was just over £5 million – a slight increase on pay at the same companies a year earlier.

[39] Ibid p47

***graph 12** Indexed FTSE 350 lead executive and full-time employee earnings growth 2000 to 2013*[39]

There is a clear need to change the pay culture at the UK's top organisations. The use of existing performance-related pay practices requires not one leap of faith but several. Most of the assumptions underpinning performance-related executive pay lack supporting evidence and are subject to a wide range of plausible criticisms.

- Performance-related pay distorts priorities when applied to senior positions within an organisation
- Quantifying the contribution made by an individual executive to a major corporation is impossible
- The pay-setting process is rife with conflicts of interest and suffers from a lack of accountability

While these criticisms will no doubt continue to be debated, the weak to negligible relationship between increases in performance-related pay and the primary performance-metrics used to decide both bonus awards (EPS and company profits) and LTIPs (TSR and EPS) is more conclusive.

Performance-related executive pay has, for the past decade, delivered significant increases in pay without corresponding increases in performance. Payments have become the norm, rather than the exception.

As a reward or an incentive for exceptional leadership, current pay practices are failing. ■

Recommendations

For the reasons laid out in this report, we believe the current system of performance-related pay is directing excessive rewards to executives that are not earned by outstanding performance.

There is too much emphasis on short-term share price gains, which does not incentivise executives to build sustainable companies and causes damage to the economy. The evidence that current performance-related pay packages can incentivise excellent business performance in the future is weak – certainly, most data suggests that it has served only to inflate pay awards out of proportion to performance in the past.

The recommendations outlined below are short and simple, on the basis that previous attempts to reform executive pay have led to unmerited complexity. Indeed, there would be a strong argument for an executive pay system designed from scratch to contain no performance-related element whatsoever. Performance-related pay is not currently working, and we would be better off without it.

Whether such a dramatic change could be immediately applied to a system that has evolved over decades, however, remains questionable. These recommendations constitute a radical approach to performance pay, but also one that could be realistically implemented in the short to medium term

1. Abolish Long-Term Incentive Plans – LTIPs are one of the main vehicles for unearned executive payments. It seems clear that it is their concept, rather than their design, that is flawed. Linking the largest component of executive pay to crude performance measures that imprecisely represent the complex role of leading a large company is clearly a mistake. Having committed their time, effort and career to obtaining and maintaining an executive position, executives are already invested in the long-term success of a company, so there is no grounds for concern that the abolition of LTIPs would cause the interests of a business and its managers to diverge. As annual bonuses would remain, there would be still scope for the remuneration committee to recognise good performance over a period of years, but this would be the exception rather than the expectation.

2. Pay Cash only – There is also evidence that shows executives under-value their share awards, as they find it hard to judge how much they will ultimately pay-out, particularly when subject to lengthy deferral periods. While the benefits of share-based payments seem intuitive, in practice they are a weak trade-off for the pay inflation and the potential for executives to benefit from circumstances beyond their own control that also ensues. If shareholders deem executive shareholdings to be sacrosanct, the executives should be required to purchase shares with their own money.

3. Target broader range of company-specific targets, with an emphasis on productivity – The report highlights the limitations of the prevalent performance measures: they create the risk that executives will unduly prioritise practices such as cost-cutting, share buybacks and under investment. A wider, more strategic understanding of performance is required. Our survey of Institute of Directors members found that 'meeting targets set by the board' was felt to be the most important factor in determining levels of pay, so this proposal would enjoy the strong support of the business community.[40] Productivity is probably the best proxy from the national interest, given that it reflects an efficient, profitable business that invests judiciously. If performance-related pay is to continue, ways to popularise the publication of productivity figures – both for company's UK operations and their global business – should be further explored. This could include 'carrots and sticks' relating to the tax system. Remuneration committees should also disclose in the remuneration report how much of any bonus awarded has been due to financial engineering such as share buybacks.

4. Broaden diversity of remuneration committees – In order to ensure that the remuneration committees that draw up performance-related pay packages are sufficiently critical and challenging, membership of those committees should be broadened. The notion that executive pay practices represent the market rate for the individuals in question is fatally undermined by the indirect conflicts of interest and limited perspectives hindering the judgement of remuneration committee members who are themselves company directors. A broader range of age, gender, ethnicity and – crucially – professional background should be encouraged. Boards and remuneration committees constituted in this way already operate successfully in many European countries. Shareholders

[40] What does business think?

should also be more active in voting against remuneration committee members that have awarded egregious pay-outs when they appear for re-election on other boards.

5. No 'golden hello' payments for unadvertised positions – Many companies offer generous 'golden hello' payments when recruiting executives, in order to compensate them for the loss of their existing LTIP. This practice means that LTIPs have little use as a device to retain CEOs because companies can simply buy them out. The only effect is to drive up pay to provocative levels, rendering executive roles a lucrative prize before the candidate has even started the job. Golden hellos have already been banned in Switzerland. The UK should not resort to that step immediately, but should instead limit them to appointments to positions that have been advertised and subject to an open recruitment process, complete with details of the remuneration package. This would encourage a more conventional, competitive market for executive roles, potentially with ambitious candidates driving down the going pay rate. We could also start to move executive employment contracts closer to those of ordinary employees.

While these recommendations are targeted mainly at companies that implement pay policies and shareholders that approve them, they are also relevant to policymakers who could seek to apply them, at least on a 'comply or explain' basis via the UK Corporate Governance Code.

A better way forward

Taken together, these changes would curtail excessive executive pay inflation and align Directors' incentives with the wider economic interest. At the same time, businesses would retain the freedom to attract high-calibre leadership and reward it at their own discretion.

Too frequently what ought to be a good news story about a successful and well-led business becomes a hostile debate about levels of executive pay. By correcting perverse incentives, improving transparency and reinforcing the notion that an executive position is a privilege not a prize, these proposals would enable successful business leaders to enjoy the acclaim they deserve, rather than being subjected to opprobrium over their pay. In this way, even the executives themselves would eventually come to welcome such reforms.

Design Rachel Gannon
www.inkillustration.com

Printed on Cylcus Offset; 100%
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