high pay centre

# PERFORMANCE-RELATED PAY

## WHAT DOES BUSINESS THINK?

# 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.

The High Pay Centre was formed following the findings of the High Pay Commission. The High Pay Commission was an independent inquiry into high pay and boardroom pay across the public and private sectors in the UK, launched in 2009.

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# Foreword

**Simon Walker**, Director General of the Institute of Directors

Performance-related pay can be a key driver of success. Companies of all sizes have policies that reward individual contributions through mechanisms such as commission and bonuses. When it comes to senior executives there are higher standards, and rightly so. Pay must be sufficiently long-term to encourage them to plan five, ten or twenty years ahead.

However, in some corners of corporate Britain pay for top executives has become so divided from performance that it cannot be justified. Runaway pay packages, golden hellos, and inflammatory bonuses are running the reputation of business into the ground.

Large companies need to look closely at the role excessive pay is playing in fuelling an anti-business backlash from the public and some politicians. IoD members are justifiably concerned at the impact this is having on their own small and medium-sized companies.

As remuneration committees begin to consider this year's pay deals, I would urge them to take note of the shareholder backlash we saw last year. There is a responsibility on the part of directors and boards to restore the link between long-term performance, accountability, shareholder return and executive rewards. Groups like the IoD and High Pay Centre will continue to keep on the pressure until companies take note. ■

# Introduction

The High Pay Centre is currently undertaking research into the issue of performance-related pay. The pay packages for many top earners, including bankers, financial services professionals and particularly the leading executives of Britain's biggest companies are now largely comprised of 'performance-related' bonuses and incentive payments.

Intuitively, the idea that people should be paid according to how well they do their job sounds sensible. However, this is what salaries and regular organisational pay reviews and performance appraisals are intended to reflect. The approach favoured by most major UK corporations of making annual awards sometimes many times the size of base salary to their executive teams, has had a number of by-products.

While salaries for FTSE 100 Chief Executives, for example, have increased at a relatively stable rate in recent years, the explosion of bonuses and so-called 'long-term incentive payments' has seen total pay for a FTSE 100 CEO increase from around £1 million in the late 1990s to nearly £5 million today.[1]

This in itself symbolises a growth in the incomes of the very rich that has proved politically unpopular. Polls suggest that 80% of the public think the Government needs to do more to reduce the gap between rich and poor.[2]

Furthermore, it is questionable whether 'performance-related pay' accurately reflects good performance. Executive 'performance-related pay' is mainly linked to company-wide performance targets around metrics such as share price or profitability. Yet research from the High Pay Centre found that increases in executive pay between 2000 and 2013 were far greater than the increase in company profits or market value.[3] And even if these measures did correspond, it is questionable whether such crude metrics accurately represent a valid proxy for the performance of large and complex organisations, or if it is possible to extrapolate the individual executive's contribution towards the achievement of company-wide targets.

Furthermore, performance-related pay may provide little additional motivation to executives who already possess the drive and competitiveness to rise to the top of the UK's biggest companies. Many studies have suggested that while performance-related pay can work for low-paid, low-level jobs, for example in sales positions, where success can be relatively easily defined, it is extremely challenging to apply to more complex, strategic positions where the employee is already very well-paid. Conversely, executives who are motivated by pay and are heavily incentivised to deliver profit or share price increases may concentrate on doing so by cutting costs, in new technology or staff training, for example, to the long-term detriment of the company and the economy.

As such, commentators such as the economist Andrew Smithers, have suggested that the prevalence

[1] Manifest MM&K Directors Remuneration Survey 2013 and 2014
[2] http://www.inequalitybriefing.org/brief/briefing-31-most-people-want-the-government-to-cut-the-gap-between-rich-and
[3] http://highpaycentre.org/blog/new-high-pay-centre-report-performance-related-pay-is-nothing-of-the-sort

of performance-related executive pay is a key weakness for the UK economy while others, including the Director General of the Institute of Directors Simon Walker, have also warned that public anger deriving from the failure of huge executive pay packages to correspond with exceptional performance is a threat to the very existence of the free-market economy.

As such, there are legitimate concerns regarding both the principle and the application of performance-related pay.

This paper sets out some of the views of members of the Institute of Directors on performance-related pay, taken from a survey filled in by over 1,000 directors of small, medium and large companies in late 2014.

Many IoD members are likely to have practical experience of performance-related pay in their own businesses. As fellow business leaders, they may have some sympathy with executives who have been criticised for their excessive remuneration. At the same time, they might also be more acutely sensitive to the costs of any damage done to the reputation of business as a whole. Thus, their views are an important contribution to the debate on pay.

# Key findings

**01 How important, in your opinion, are the following factors when assessing good company performance? (Rank in 1-5 with 5 very important)**

| | 1 Not important at all | 2 | 3 Neither important nor unimportant | 4 | 5 Very important |
|---|---|---|---|---|---|
| **Profitability** | 0% | 1% | 2% | 31% | 66% |
| **Shareholder value** | 2% | 3% | 11% | 43% | 41% |
| **Jobs created** | 5% | 10% | 45% | 32% | 7% |
| **Investment** | 2% | 7% | 35% | 46% | 9% |
| **Customer satisfaction** | 0% | 0% | 2% | 23% | 74% |
| **Reducing environmental impact** | 5% | 11% | 39% | 37% | 9% |
| **Contribution to society** | 4% | 10% | 35% | 42% | 9% |
| **Reputation** | 0% | 1% | 6% | 29% | 64% |
| **Brand recognition** | 1% | 3% | 17% | 44% | 35% |
| **Employee engagement** | 0% | 1% | 6% | 40% | 53% |

**High Pay Centre commentary**
Profitability, which relates to 'earnings per share' one of the two most common metrics used to award performance-related pay packages (together with 'total shareholder return') is judged to be important by respondents. However, customer service is thought to be even more important, with reputation just behind and employee engagement also thought to be 'very important' by over half of the respondents.

By contrast, fewer than half cite ‘shareholder value’ – yet the notion that companies should be run in the interest of shareholders has been a key component of UK corporate governance for at least three decades. The 2006 Companies Act even enshrines ‘shareholder value’ in law, stating that UK Company Directors have a duty to promote the maximum return for their shareholders over the long-term, while also having regard for societal and environmental considerations.

The respondents, though, have a very different, customer-orientated view of business success, with healthy profits, a positive reputation and a motivated, committed workforce also more important indicators of success than returns to shareholders.

### 02 How would you define exceptional personal performance by an executive?

| | |
|---|---|
| Has a vision for their company which inspires employees and customers | 87% |
| They have an in depth understanding of the opportunities and challenges facing their business in today's market place. | 75% |
| They drive their company revenues and financial performance to new heights | 60% |
| They are a champion of their business in the wider community and a strong advocate of corporate social responsibility. | 48% |
| Other (please specify) | 13% |

**High Pay Centre commentary**

The ability to engage customers and employees is seen as more critical to performance than revenue generation (though a majority thought this was a component of exceptional performance too).

Again, this suggests a broader, more complex view of company success than that inferred by most corporate performance-related pay plans, focused on profitability and shareholder value.

## 03 What is the most important driving force for executives?

| | |
|---|---|
| Building a successful company | 54% |
| Financial reward | 13% |
| Status/reputation | 10% |
| Praise/recognition | 6% |
| Other (please specify) | 6% |
| Power/autonomy | 5% |
| Motivating the workforce | 5% |

**High Pay Centre commentary**
Despite the huge increases in executive pay that have occurred in recent decades, intended to attract, retain and motivate CEOs, only a small minority of respondents felt that this was what drives CEOs.

This is coherent with other research on executive pay, suggesting that highly-skilled people in positions of key responsibility, already well-paid in comparison to wider society, are not motivated by the prospect of even more money. Interestingly, however, few respondents identify status, power or recognition as alternative motivating factors. They suggest that personal judgement of success seems to be motivation and reward in itself and that huge bonuses, formal honours or celebrity media profile are of secondary importance.

## 04 What are the biggest threats to public trust in business?

| | |
|---|---|
| Anger over levels of senior executive pay | 52% |
| Mistrust of products (product mis-selling) | 51% |
| Unsympathetic media portrayal of business | 51% |
| Unrealistic expectations from the public | 28% |
| Economic malaise translating into frustration with business | 27% |

**High Pay Centre commentary**
Excessive executive pay is judged to be the biggest threat to trust in business. This shows that top pay is not just a minority concern or a fringe issue, but a strategic threat to a vital part of the UK economy, recognised by business leaders themselves. This suggests a growing consensus that top pay in the UK has become dysfunctional. It shows that it is too simplistic to dismiss any challenge to top pay as being 'anti-business' or 'anti-capitalist' - in fact, such challenges in part echo the concerns of British businesses themselves.

The responses also reflect an interesting divide between business behaviours which undermine trust in business, and ways in which trust in business is undermined by others.

Product mis-selling was almost as big a threat to trust in business as executive pay, while nearly 2% of respondents mentioned issues relating to ethics, morals or integrity unprompted.

On the other hand, a majority of respondents blamed unsympathetic media portrayal while again, 2% attributed blame to an external factor unprompted – chiefly politicians' attacks on businesses; a lack of public understanding of what business does; and the assumption that the banking industry is characteristic of all business.

## 05 How important a threat to the success of your business is lack of public trust in business?

| | |
|---|---|
| Very important | 18% |
| Quite important | 30% |
| Neither important nor unimportant | 26% |
| Not very important | 16% |
| Not at all important | 10% |
| Don't know | 1% |

**High Pay Centre commentary**
Again, this is a striking finding. Nearly half of respondents think that a lack of public trust in business threatens their own business.

It then follows that the issues undermining public trust in business urgently need addressing.

In particular, there is clearly cause for action with regard to areas such as executive pay or product mis-selling, where business leaders themselves admit that business behaviour is harming trust in business and ultimately businesses' social license to operate.

### 06 Do you believe that performance-related pay for senior executives enhances company performance?

| | |
|---|---|
| Yes | 62% |
| No | 26% |
| Don't know | 12% |

**High Pay Centre commentary**

Though previous responses suggest that pay – or recognition, for which pay can serve as a proxy – are NOT the most important factors in motivating executives, respondents still believe that performance-related pay for executives is important to company performance.

This suggests that respondents are either unaware of the extensive research arguing that performance-related pay is at best unnecessary and at worst counter-productive, or that they find this runs contrary to their own experience of their own companies.

## **07** What factors should determine the level of performance-related pay?

| | **1** Not important at all | **2** | **3** Neither important nor unimportant | **4** | **5** Very important |
|---|---|---|---|---|---|
| **Meeting targets set by the board** | 2% | 2% | 8% | 38% | 50% |
| **Enhancing revenues** | 2% | 3% | 27% | 48% | 20% |
| **Increasing profits** | 1% | 1% | 11% | 45% | 41% |
| **Returns to shareholders** | 2% | 3% | 19% | 46% | 30% |
| **Returns to stakeholders** | 3% | 4% | 25% | 43% | 25% |

**High Pay Centre commentary**
'Meeting targets set by the board' emerges as the most important factor for determining the level of performance-related pay. Ostensibly, this supports the existing model used by most major companies in the UK. However, for major companies the targets overwhelmingly relate to profit increases and return to shareholders – clearly regarded as important by respondents to this survey, but noticeably less so than 'targets set by the board' which might encompass a wider range of measures.

The fact that only 30% of respondents felt that 'returns to shareholders' were 'very important' again suggests that businesspeople themselves are wary of the notion that 'shareholder value maximisation' is the ultimate objective of business and do not believe this should be the priority for executives (as it is implied to be in most companies' remuneration policy statements).

In addition to the options they were given, 6% of respondents stated a factor relating to employee engagement, 3% to customer satisfaction and 4% to trust/ethics (including the business's reputation and environmental and health and safety record), all unprompted. This suggests that there are a minority of businesspeople who believe that a business should be judged as much in terms of its contribution to wider society as by financial performance measures. This is not replicated by major company performance-related pay plans which overwhelmingly relate to financial performance.

## 08 What is the correct time horizon of company performance for determining performance-related pay?

| | |
|---|---|
| 1 year | 11% |
| 1-3 years | 48% |
| 3-5 years | 31% |
| More than 5 years | 5% |

**High Pay Centre commentary**

The issue of timeframe has proved one of the most problematic in relation to performance-related executive pay. Advocates argue that a longer timeframe removes the risk of incentivising executives to undertake short-term measures, such as cutting staff training or investment, in order to boost profits or returns to shareholders in a way that harms the company's long-term interest.

Opponents claim that longer timeframes merely increase the size of pay awards, on the basis that executives automatically discount the value of any pay package that they cannot immediately access - the longer the time period, the bigger the increase. Here, we see that respondents are broadly in favour of measuring performance over periods of up to three years, as is commonplace at most large UK companies, however over a third of respondents think that performance should be measured over a longer period.

### 09 Who should play the primary role in defining the performance-related pay of senior executives?

| | |
|---|---|
| The board as a whole | 45% |
| Non-executive directors | 30% |
| Shareholders | 17% |
| Employees | 2% |
| Regulators | 1% |

**High Pay Centre commentary**
Respondents value executive pay as a matter for the executives themselves, implying that individual executives should have their pay set by the board as a whole.

There is less support for independent non-executive directors (who intuitively might be considered more likely to hold pay down, as they would not be deliberating on the pay of someone who would help to set their own income, and would therefore have no personal interest in driving collective executive pay upwards). Fewer still suggest that shareholders should play the primary role in defining performance-related pay, while the notion that employees or regulators are the primary stakeholders receives negligible support.

Allowing executives at board level to participate in setting their own pay might be seen as contradictory to earlier responses implying that executive pay is generally agreed to be too high. However, it is interesting that the huge rises in executive pay since the 1990s have occurred on the watch of independent remuneration committee members, with their verdict rubber-stamped by shareholders since 2003. Some commentators have suggested that the colossal pay increases were not something that the executives themselves have demanded (though very few have turned them down). Perhaps if boards themselves set pay, executives would have to take more responsibility for their pay packages and would lower their demands for fear of appearing greedy or insensitive.

## 10 What should performance-related pay consist of?

| | |
|---|---|
| Long-term incentive plan (separately targeted and remunerated from basic salary and bonus plan) | 72% |
| Cash Bonus | 53% |
| Share options | 44% |
| Share awards | 28% |
| Other (please specify) | 3% |
| None of the above | 2% |

### High Pay Centre commentary

As with time horizons, the views of respondents largely reflect policy of large companies, where long-term incentive plans now constitute the biggest component of performance-related pay packages.

The problems and advantages of LTIPs largely mirror those associated with measuring performance over a longer time period – assuming that all individuals respond to the incentives in the manner expected of 'rational economic man' (far from certain) they reduce the risk of short-termism but increase total pay. However, the three year time period over which most LTIPs are measured is not sufficiently long-term, according to many critics.

Share awards – as part of bonus or LTIP payments – have largely replaced share options as a form of executive pay at big UK companies, so it is also interesting to note that more respondents preferred options to awards.

## 11 Should performance-related pay be deferred…?

| | |
|---|---|
| Yes | 53% |
| No | 34% |
| Don't know | 13% |

## …and if so, for how long?

| | |
|---|---|
| Up to 3 years | 58% |
| 3-5 years | 30% |
| More than 5 years | 4% |
| Until the executive leaves the company | 1% |
| Until the executive retires | 1% |
| Other (please specify) | 5% |

**High Pay Centre commentary**
As with the question on 'time horizon', proponents of deferral claim that it discourages short-termism while opponents suggest that deferred pay has to be larger, because executives will immediately discount the value of any award they cannot immediately access.

Respondents clearly support the principle of deferral, but there is little enthusiasm for deferring payments beyond five years. Some critics have argued that even this length is too short a time span for the effects of any bad decisions taken during the executive's tenure to occur.

### 12 Should performance-related pay be subject to clawback in case of subsequent poor performance?

| | |
|---|---|
| Yes | 55% |
| No | 38% |
| Don’t know | 7% |

**High Pay Centre commentary**

Respondents favour subjecting performance-related pay to clawback conditions by a similar margin to those in favour of deferring performance-related pay.

Requiring an individual to return payment awarded for good performance if, with the benefit of hindsight, performance is not as good as was originally thought, is basic fairness. In theory, it ought also to act as a safeguard against short-termism. However, in practice identifying and proving a case for clawback could prove a challenging and costly process, potentially involving expensive legal cases. This perhaps explains why a significant number of respondents oppose subjecting performance-related pay to clawback.

There is an additional danger that clawback provisions could be used to excuse lavish executive pay awards, on the grounds that they could be clawed back in future if proven to be undeserved, even if the clawback measures proved very difficult to apply. ■

# Conclusion

The opinions of IoD survey respondents do not represent the official views of UK businesses or even the IoD itself. Even if they did, the interests of the business lobby do not always align with the interests of wider society, and should be balanced alongside those of other stakeholder groups.

Nonetheless, the survey represents an informative snapshot of the perspective of a constituency that is important to the UK's economic success and whose views should have a bearing on the conduct of Government and corporate Britain.

The survey suggests a clear demand for reform of the way top pay is awarded in the UK. Respondents want to see a system that recognises performance in much broader terms encompassing customer service, strategic vision and employee engagement alongside profitability and market value. Performance-related pay should also be accountable and long-term.

Current levels of executive pay represent a threat to trust in business – and by association, are a genuine threat to the success of individual businesses across the country and to the ambitions for jobs, growth and prosperity of the UK as a whole. ■

Design | Rachel Gannon