



Executive remuneration in the FTSE 350 – a focus on performance-related pay

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A report for the High Pay Centre

From

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1 Introduction

This report for the High Pay Centre provides an analysis of the structure and levels of executive remuneration in FTSE 350 companies since the mid-90s, including the role played by performance-related pay in determining the shape and size of executive pay.

This research for the HPC is part of a wider 9-12 month consultation exercise that will ask three key questions. These are:

1. How have we got here?
2. What is exceptional company performance?
3. How can executive remuneration be re-designed?

Research has been sought by the HPC for each of the topics throughout the consultation period. This report sets out our response to question 1. How have we got here?

1.1 Summary findings

In today's UK boardrooms executive remuneration policy is dominated by a pay for performance culture, with as little as a fifth of a top director's annual earnings paid as salary and the remainder made up of various incentive awards. The development of performance pay in top listed companies has a long history, stretching back more than 30 years and over that time incentive schemes have become more sophisticated and the rewards ever higher. Acceptance of this culture has spread beyond the boardroom, with all investors and all the main political parties now agreeing with the Secretary of State for Business that: 'generous rewards are justified where a company has shown strong long-term performance'.

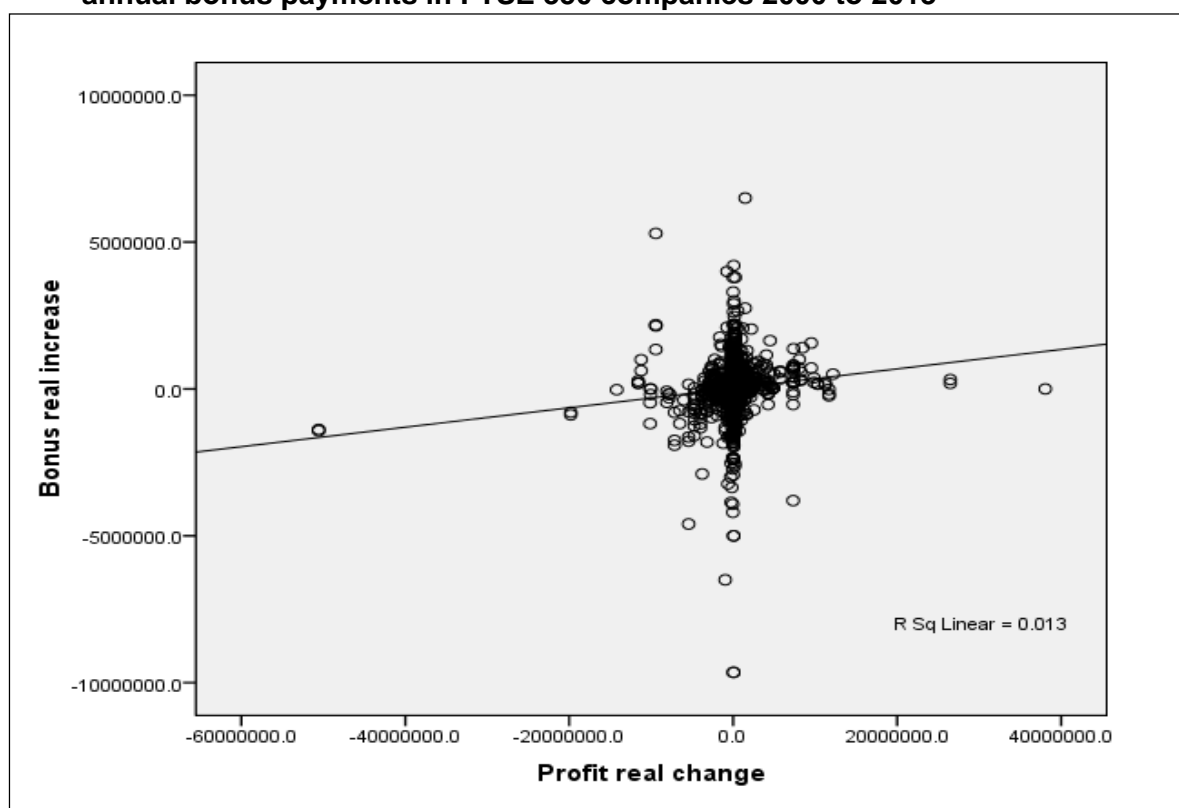
IDS Thomson Reuters has been asked by the High Pay Centre to explore the link between the pay of the FTSE 350 directors and company performance and to describe how boardroom remuneration has evolved. This report builds on earlier research conducted by us for the High Pay Commission in 2011 – *What are we paying for? Exploring executive pay and performance*. Given the emphasis on pay for performance we would expect to see a clear correlation between the incentives received by directors and key corporate metrics and scheme targets. But our research suggests that there is either no relationship or at best a weak link between directors' pay and performance. In summary, we found that:

- the statistical correlations between changes in two key annual bonus performance metrics, pre-tax profit and earnings per share (EPS), and subsequent bonus payments were insignificant;

- 98.7 per cent of the change in annual bonuses could not be explained by changes in pre-tax profit;
- 99 per cent of the change in annual bonuses could not be explained by changes in EPS;
- there was no noticeable correlation between the relative ranking of long-term incentive plan (LTIP) share awards and the relative ranking of changes in total shareholder return over three years;
- there was no noticeable correlation between the relative ranking of long-term incentive plan (LTIP) share awards and the relative ranking of changes in EPS over three years.

A more vivid illustration of how little changes in pre-tax profit contributed to changes in annual bonus payments can be seen in Graph 1, which plots the linear relationship between the two variables.

Graph 1 Relationship between changes in pre-tax profit and changes in annual bonus payments in FTSE 350 companies 2000 to 2013

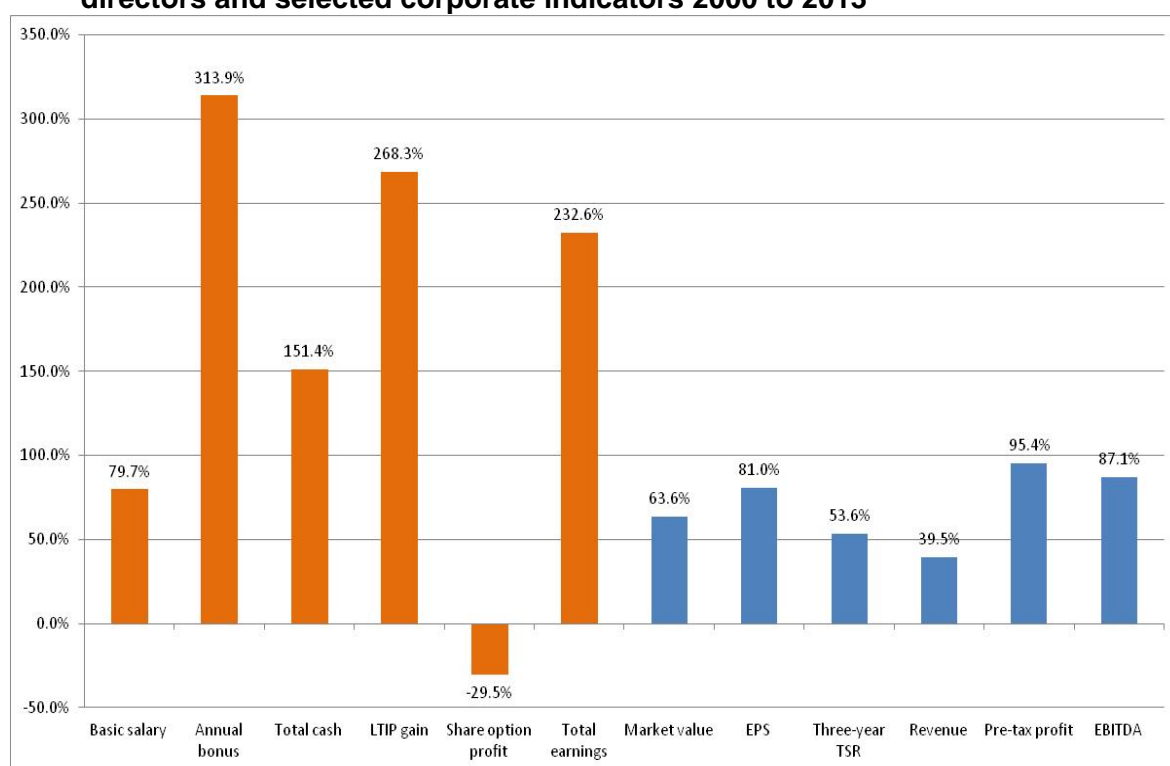


Seen over the longer term our research shows that increases in nearly all the key elements of FTSE 350 directors' remuneration have outstripped a range of corporate metrics. Looking at the period between 2000 and 2013 several trends stand out:

- FTSE 350 directors' median total remuneration has increased by 232.6 per cent since 2000, faster than selected corporate metrics;
- increases in median bonus and long-term incentive plans (LTIP) awards at 313.9 per cent and 268.3 per cent respectively outstripped the rise in total earnings;
- median share option profits went down by 29.5 per cent over the period;
- pre-tax profit growth at 95.4 per cent was the highest among the corporate metrics;
- the market value of the companies increased by 63.6 per cent over the period.

A more detailed overview of the trends since 2000 can be found in Graph 2.

Graph 2 Percentage change in median remuneration of FTSE 350 directors and selected corporate indicators 2000 to 2013



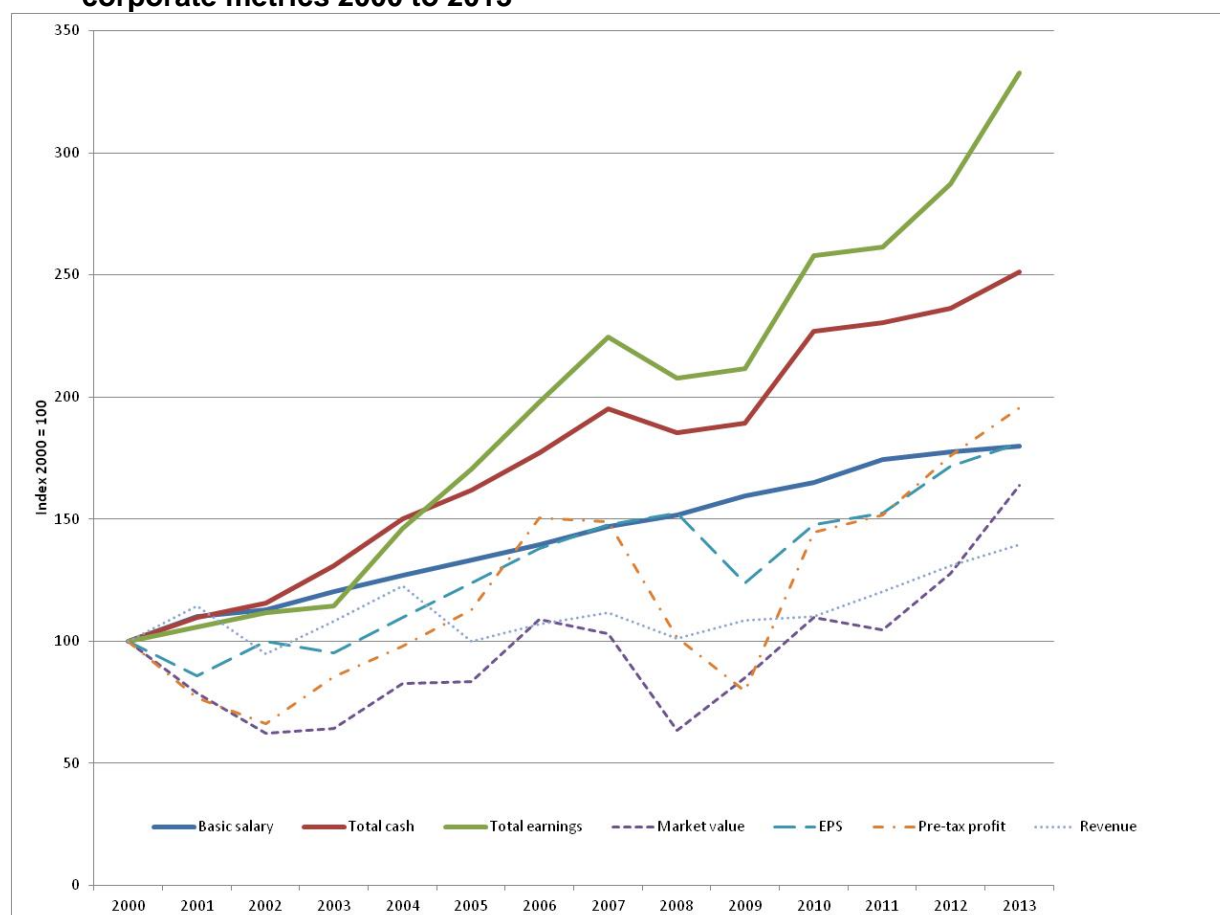
Based on our research, it would seem that pay for performance has not lived up to its promise – that directors will only be rewarded when there is clear evidence of corporate improvement or returns to shareholders.

2 Pay for performance – is it delivering?

Pay for performance is at the heart of today's executive remuneration policies, but are shareholders and other stakeholders getting what they are paying for? Is pay for performance actually delivering on its promise or are directors simply being handed ever increasing sums for little visible return? To explore this question, we draw on our historical data to look at the relationship between how much FTSE 350 directors have earned since 2000 and selected key corporate performance measures. Some of the corporate measures have been adopted as they also feature as targets in many incentive schemes, while others provide an overall picture of the health of the company.

A long-term perspective on how FTSE 350 directors' pay growth compares with changes in three key corporate metrics between 2000 and 2013 can be found in Graph 3. For ease of comparison, all the figures in the graph have been indexed.

Graph 3 Indexed FTSE 350 median boardroom pay trends and median corporate metrics 2000 to 2013



Graph 3 shows that over the whole period the increase in total earnings and total cash were greater than corporate performance, but within the overall trend there were significant fluctuations. In particular, during the years of recession most of the corporate metrics

declined and this seemed to have an impact on the total cash and total earnings received by FTSE 350 directors. Yet, despite the apparent relationship there were still disparities between the scale of the downturns in the corporate metrics and directors' earnings. In summary:

- in 2008, pre-tax income and market cap fell by 31.9 per cent and 38.4 per cent respectively, but total cash and total earnings only declined by 5 per cent and 7.5 per cent;
- in 2009, EPS and pre-tax income fell by 18.8 per cent and 21.7 per cent, but total cash and total earnings actually increased by 2.1 per cent and 1.9 per cent;
- any downturns in directors' remuneration were short lived with pay growth resuming after one year;
- by 2010 both total cash and total earnings surpassed their 2007 pre-recession peaks;
- by 2013, total cash was 28.9 per cent higher than its pre-recession peak and total earnings was 48.2 per cent higher;
- throughout the whole period since 2000, even during the recession, the majority of directors continued to receive substantial incentive awards;
- salaries continued to grow throughout the period regardless of corporate performance.

This picture is unchanged if the focus is narrowed by board position such as FTSE 100 lead executive. Despite an apparent link between declines in corporate performance and earnings, a similar disproportionate pattern of falls is evident.

Seen in the light of these graphs it appears that what directors earn each year is largely unrelated to corporate performance. But we can gain a better understanding of the relationship between pay and performance by looking at how different types of incentive are linked to the relevant corporate metrics. As such incentives are specifically geared to the achievement of various corporate metrics it is by probing this relationship that we should expect to see the strongest correlation between directors' rewards and company performance.

2.1 Bonus schemes and performance

Bonus schemes have been a firmly established part of FTSE 350 incentive practice for more than two decades, but their design has evolved over time. Despite this, the main purpose of a bonus scheme has remained largely unchanged – to incentivise directors to achieve short-term goals. Principally, these goals are focused on corporate targets that are more directly influenced by directors than shareholder-based objectives subject to stock-market volatility, as with long-term incentives.

An indication of the range of short-term targets underpinning annual bonus schemes is given in Table 1, which compares the metrics used in 2003/04 and 2012/13. The comparison suggests that the range of targets is relatively stable, although there are minor variations over time. In both periods profit metrics dominate, a finding which is reinforced by the high weighting given to the target in the latest year. Earlier studies also found that profit was the main measure in the majority of bonus schemes. The 1993 Hay Boardroom Pay Guide shows that 67 per cent of bonuses schemes targeted some measure of profit, while a separate 1991 incentive survey by Monks found that 77 per cent of short-term plans adopted a profit metric. But there have been shifts in the use of some of the other performance measures used in bonus schemes, in particular the reliance on earnings per share (EPS) seems to have declined. In 2003/04, for example, 41.3 per cent of FTSE 100 bonus schemes targeted EPS, but by 2012/13 this had declined to 25 per cent. In comparison, the targeting of cash flow has gained in prominence, a development that was especially noticeable after 2008 when companies wanted to reduce their debt commitments.

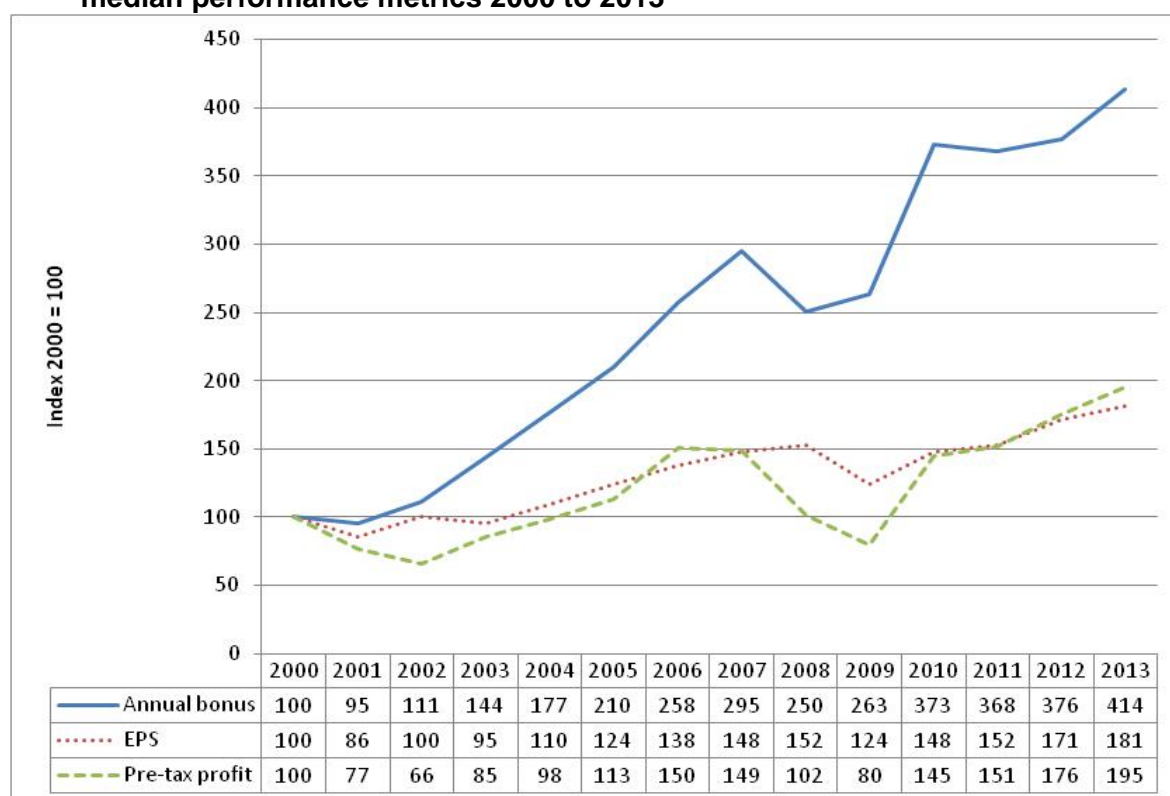
In addition to these key financial targets, a wide range of other measures have been used to underpin bonus plans and many schemes often rely on more than one objective. Notable in Table 1, for instance, is the prominence of personal objectives, which are normally used in conjunction with financial targets and usually carry a lower weighting. Some of these personal objectives may also be financial targets such as when a director is responsible for a subsidiary or division.

Target	2003/04		2012/13			
	FTSE 100 %	Mid-250 %	FTSE 100 %	Average bonus weighting* %	Mid-250 %	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

If a relationship between pay and performance is to be detected, it should be expected to be between these scheme metrics and the bonuses received by FTSE 350 directors. An outline of how the bonuses received by FTSE 350 directors have behaved since 2000 compared with two bonus metrics, pre-tax profit and EPS, is given in Graph 4. The graph compares the movements in median bonus and median pre-tax profit and EPS over the whole period.

Graph 4 Indexed movements in FTSE 350 directors median bonus* and median performance metrics 2000 to 2013

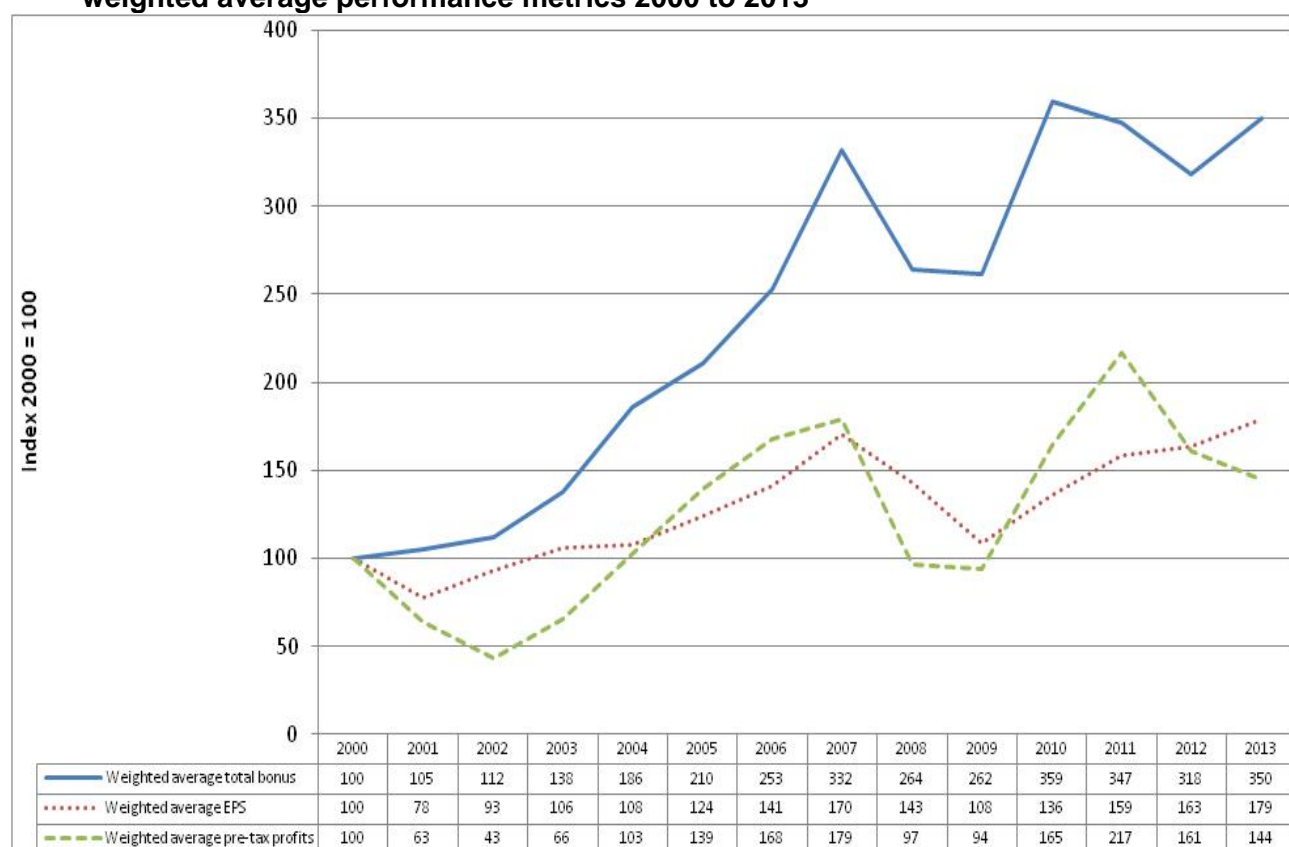


*** Bonus scheme participants only**

Taking the period as a whole, Graph 4 shows that bonus payments have risen more than three times faster than both pre-tax profit and EPS since 2000. But while the bonus gains for FTSE 350 directors have been disproportionate compared with the improvements in corporate performance, the shape of the graph does suggest that the ups and downs in pre-tax profit did have some impact on subsequent bonus payments. When pre-tax profits dipped during the recession, for example, so did the median bonus payments. The recovery in pre-tax profits then led to a recovery in median bonus payments.

But a focus on median bonuses does not fully capture bonus trends as they ignore the impact of the number of directors receiving a payment. To account for this we have calculated weighted averages, which reflect both the value of the payments received and the number of directors receiving them. For consistency, the corporate performance metrics have also been weighted. The results of this comparison can be seen in Graph 5. Although the numbers are different, Graph 5 also suggests that the ups and downs in pre-tax profit did have some impact on subsequent bonus payments.

Graph 5 Indexed movements in FTSE 350 weighted average* bonus and weighted average performance metrics 2000 to 2013



*Weighted average is the total sum paid in bonus and divided by the number of all FTSE 350 executive directors.

2.2 Bonus and performance metric changes not correlated

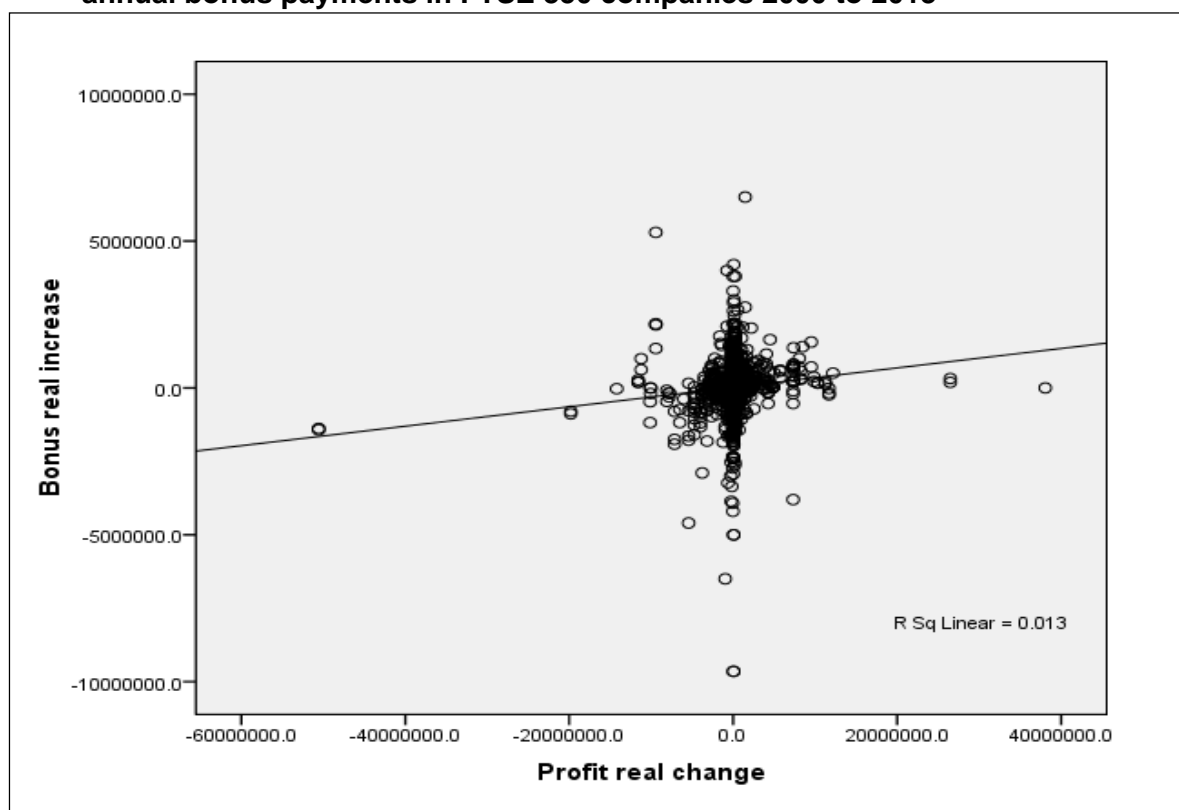
Yet, while both graphs are suggestive, they are not conclusive as they do not look at how individual bonuses reacted to changes in each of the schemes own performance metrics. To understand this relationship we need to adopt a more rigorous statistical approach. To gauge just how weak or strong the relationships are we looked for statistical correlations between changes in pre-tax profit, EPS and bonus payments. The aim was to see if an increase or decrease in pre-tax profit and EPS correlated with an increase or decrease in annual bonus awards. All the increases and decreases were calculated in cash due to the mathematical problem of calculating percentage changes involving zeros.

Despite the apparent relationship between pre-tax profit and annual bonuses suggested by Graph 4 and Graph 5, we found that the statistical correlation between changes in the two is weak or even non-existent. When we compared the cash change in each company's pre-tax profit with the corresponding change in each individual director's annual bonus over the whole 13 year period the Pearson correlation coefficient was just 0.114. Such a correlation coefficient measures the strength of the relationship between two variables, with plus 1 representing a perfect one-to-one positive correlation and minus 1 a perfect one-to-one negative correlation. A result close to zero suggests there is no relationship between changes in the two variables. Given that the correlation coefficient is so low it would seem that changes in pre-tax profit had only a weak influence in determining changes in how much directors receive each year in annual bonus.

To cover any possible reporting lags in annual accounts, we also compared the change in the bonus received by each individual director with a change in pre-tax profit in the prior year. This analysis produced an even lower correlation coefficient of just 0.038.

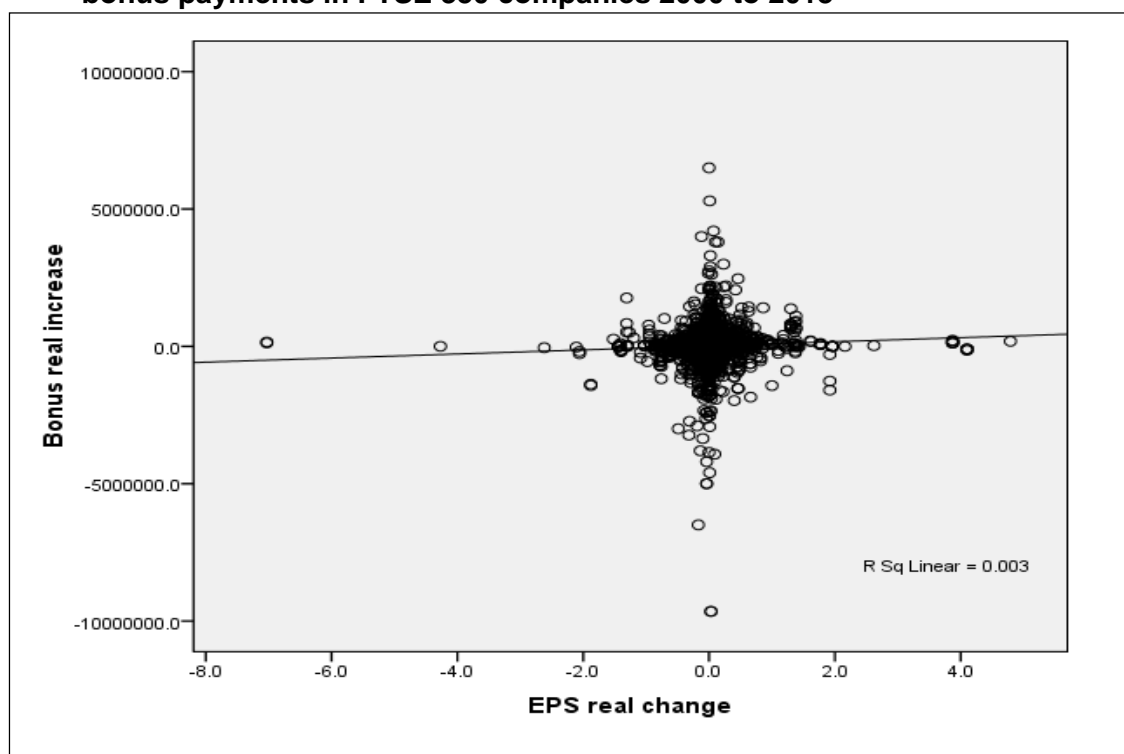
Our statistical analysis was taken a step further by measuring how much changes in pre-tax profit contributed to changes in annual bonus. This is captured by a figure called R-squared, which calculates how the percentage variation in one variable, pre-tax profit in our analysis, explains the percentage variation in another variable, annual bonus. Our findings are illustrated in Graph 6, which shows that the R-squared between pre-tax profit and annual bonus payments was just 0.013. In plain language, this means that just 1.3 per cent of the change in annual bonuses is explained by a change in pre-tax profit. The remaining 98.7 per cent is unexplained. Lagging the relationship between pre-tax profit and the subsequent annual bonus produces an even lower R-squared of just 0.001.

Graph 6 Relationship between changes in pre-tax profit and changes in annual bonus payments in FTSE 350 companies 2000 to 2013



A similar analysis looking at the relationship between annual bonuses and EPS gave similarly low correlations and regressions, whether the figures for the same year were compared or whether EPS was taken for the prior year. The same-year Pearson correlation coefficient between cash changes in EPS and cash changes in FTSE 350 annual bonuses was just 0.053 and when prior-year EPS was compared the equivalent figure was 0.066. Likewise, the linear analysis found that changes in EPS contributed little to the changes in annual bonus payments, as can be seen in Graph 7.

Graph 7 Relationship between changes in EPS and changes in annual bonus payments in FTSE 350 companies 2000 to 2013



Given that bonus schemes usually employ more than one performance target, a perfect one-to-one correlation or linear relationship between pre-tax profit, EPS and annual bonuses should not be expected. But given the predominance of profit measures in particular in bonus schemes and the high weight placed on their outcomes, a stronger relationship than we found with annual bonuses should be expected. In part, the lack of a relationship is undermined by the discretion retained by remuneration committees which is sometimes exercised when external circumstances change. This apparent breakdown in the relationship was particularly evident during the recent recession. At the time, because of the unforeseen circumstances, some companies revised their bonus targets mid-cycle and others decided to pay out bonuses even when targets were missed. Additionally, as our findings show, personal targets also play an important role in many bonus schemes and whether these are achieved or not may equally rely on a remuneration committee's judgment.

3 Long-term incentives and performance

As well as annual bonuses, the majority of FTSE 350 directors are eligible for long-term incentive awards. There are two principle long-term incentive arrangements: LTIPs and share option schemes. Of the two, LTIPs dominate FTSE 350 incentive practice, although a minority continue to favour share options. The crucial difference between LTIPs and share options is that LTIP participants are not required to buy shares before they can realise a gain. Participants in an LTIP are granted an initial block of 'free' shares at the beginning of a performance cycle, usually three years, and the value of any final award is dependent on pre-specified performance targets. In contrast, share option participants are given the option to buy company shares in the future at a price fixed at the date of grant. If the price of a share at the date of grant is £1 and the price at a future date is £2, the participant can buy the shares at £1, sell them for £2 and realise a £1 profit on sale. As with LTIPs, the final value of the option shares that a director can exercise is linked to performance, again usually over three years.

For both LTIPs and share options performance targets tend to be geared towards the interests of shareholders, but this is not universal practice. Following Greenbury, from the mid-1990s onwards, FTSE 350 companies increasingly adopted total shareholder return (TSR) as the principal LTIP target. Where this was the case, TSR performance was usually measured relatively, either compared with a basket of selected peers or against an index such as the FTSE 100. In 2012/13, some 66 per cent of FTSE 100 LTIPs and 65.1 per cent of mid-250 plans targeted TSR in some way or another. These targets also tend to have a high weighting. But TSR is not the only target used to underpin LTIP awards. Among the most prominent other targets is EPS, which was adopted by 53 per cent of FTSE 100 LTIPs and 51.7 per cent of mid-250 companies respectively. Likewise, these EPS targets also have a high weighting.

Viewed over the longer term, the prime importance of TSR as the main LTIP measure, whether compared with a group of selected peers or an index, is largely unchanged. In 2000, for example, some 63.2 per cent of all FTSE 350 plans used TSR as their main LTIP metric. In contrast, there has been an increase in the use of EPS as an LTIP target. In 2000, only 27.8 per cent of all FTSE 350 plans used EPS as an LTIP metric, often only adopted as an underpin in the early part of the decade. In many of today's schemes, half an LTIP grant is tied to TSR performance and the other half to EPS achievement.

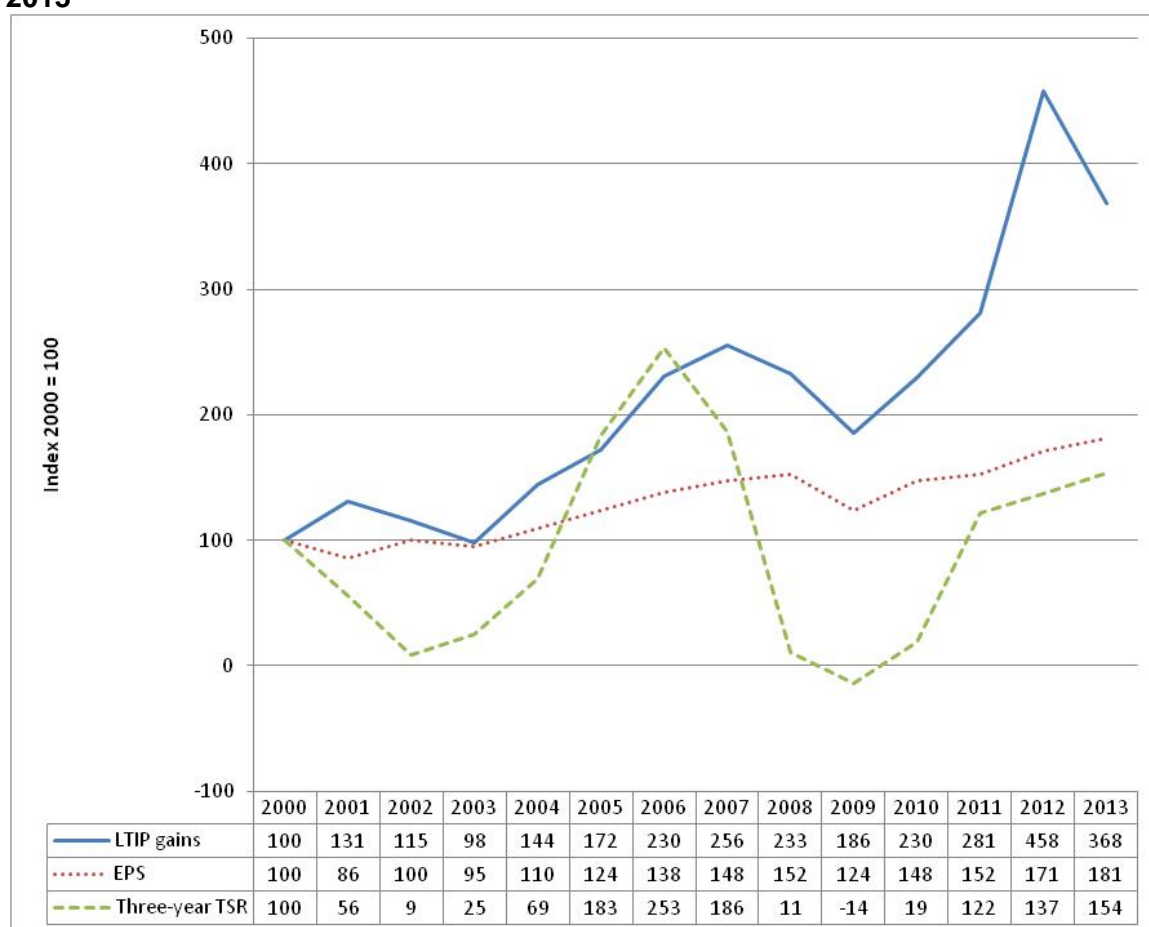
TSR and EPS also feature as share option targets, although both are less common than with LTIPs. Only 12.3 per cent of FTSE 100 share option schemes targeted TSR last year, while

more, 30.8 per cent, had EPS as an objective. The corresponding mid-250 figures were 14.5 per cent and 30.5 per cent. Other targets such as EBITDA also featured as option targets but the range of objectives was diverse with none registering in significant numbers.

3.1 LTIP awards compared with TSR and EPS

How much FTSE 350 directors have received in vested LTIP awards since 2000 compared with movements in TSR and EPS can be seen in Graph 8. The TSR figures in the graph represent the percentage increase in TSR over three years, which mimics the way TSR performance is most frequently measured. For ease of comparison all the figures have been indexed.

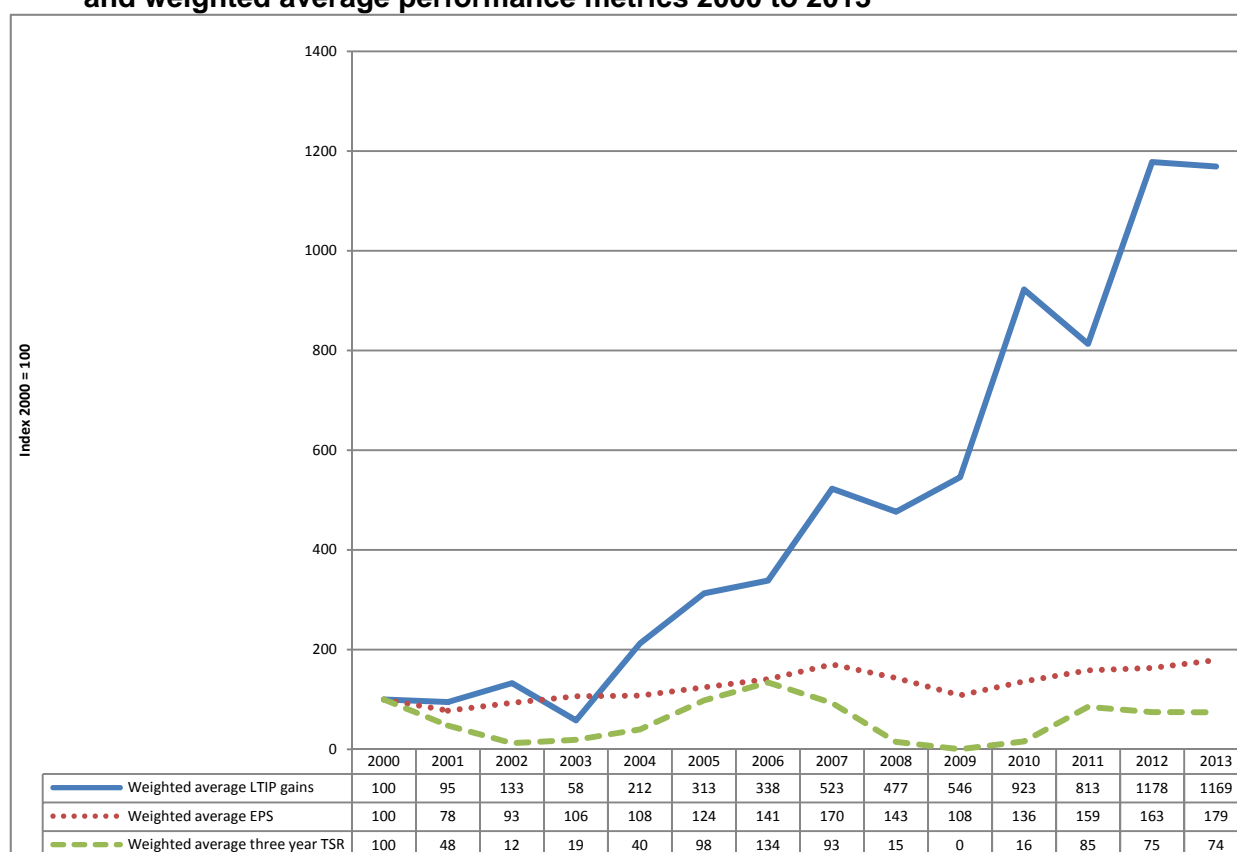
Graph 8 Indexed movements in FTSE 350 median vested LTIP awards* received by FTSE 350 directors and median performance metrics 2000 to 2013



* Vested LTIP awards only

As with bonus awards, the median figures do not fully show how directors have benefited from LTIP awards. The combination of higher grants and more directors benefiting from an LTIP significantly boosted the total value awarded per FTSE 350 director. This is best shown by comparing the weighted average vested LTIP award with corresponded weighted average movements in TSR and EPS. This comparison can be seen in Graph 9. This shows that between 2000 and 2013 the weighted average LTIP gain increased by over 1,000 per cent.

Graph 9 Indexed movements in FTSE 350 weighted average* LTIP gains and weighted average performance metrics 2000 to 2013



*Weighted average is the total vested LTIP awards divided by the number of all FTSE 350 executive directors.

But while such graphs provide an insight into LTIP and performance trends, they do not show the strength of the relationship between the awards received and the performance metrics. As with our bonus analysis, a more rigorous understanding requires the calculation of statistical correlations between LTIP awards and the two key performance metrics – TSR and EPS.

For our TSR analysis we compared each individual director's vested LTIP awards with the employing company's three-year change in TSR for the previous year. This lagging reflects the way vested LTIPs have been disclosed in company accounts as the final face value of share awards is only revealed in the year following the end of the performance cycle. The three-year TSR changes were ranked and compared with a similar ranking for vested LTIP awards. For clarity, our analysis concentrated on lead executives only and to mirror the way LTIPs work we calculated the correlations for each year sequentially.

A summary of our ranking correlation findings between TSR and LTIP for FTSE 350 lead executives is given in Table 2. Although the numbers vary across the period, in some years in

particular the correlation between three-year TSR rankings and the corresponding LTIP award rankings was noticeable, but still less than 0.5 which is sometimes seen as indicating a significant relationship. The R-squared figures also suggest that the percentage variation in LTIP rankings was more strongly linked to the percentage variation in three-year TSR rankings in some years than others. In 2002, for instance, some 17.1 per cent of the variation in the LTIP ranking was explained by the variation in TSR ranking, while in 2005 there was no detectable contribution. Taken overall, our findings would suggest there was some relationship between three-year changes in TSR and subsequent LTIP awards, but our results were still a long way from showing a robust link between pay and performance.

Table 2 Relationship between ranked vested LTIP awards and ranked three-year changes in TSR for selected years

Year LTIP awarded	Correlation coefficient with three-year 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%

A similar conclusion was evident when we looked at the relationship between LTIP awards and EPS, the other main LTIP performance metric. Likewise, the correlation coefficients were higher in some years than others, but again in most years the figures were low. The regression results also exhibited a similar pattern, as can be seen in Table 3 on the following page.

Table 3 Relationship between ranked vested LTIP awards and ranked three-year changes in EPS for selected years

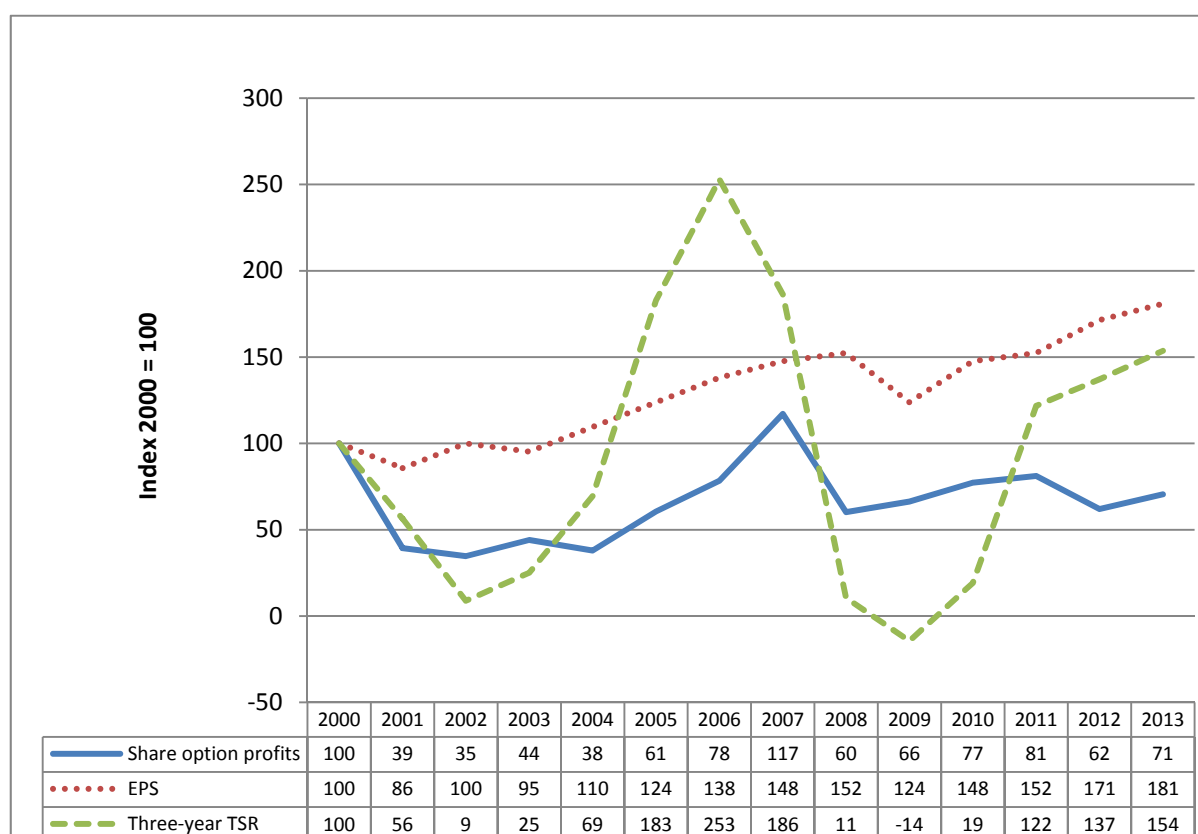
Year LTIP awarded	Correlation coefficient with three-year change EPS previous year	R-squared with three-year EPS change previous year	R-squared %
2004	0.40	0.16	16.2%
2005	0.17	0.03	2.8%
2006	0.18	0.03	3.2%
2007	0.52	0.27	26.7%
2008	0.17	0.03	3.0%
2009	0.22	0.05	4.9%
2010	0.06	0.00	0.3%
2011	0.29	0.08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

Not all directors granted LTIP shares, however, actually benefited from an award at the end of the performance cycle. Of those FTSE 350 directors granted LTIP shares between 2006 and 2009, for example, some 30.6 per cent did not vest because they failed to achieve their performance targets. Viewed more broadly, the low proportion of lapsed grants indicates that LTIP participants are much more likely to receive a payment than not, suggesting that it is not too difficult to exceed existing performance hurdles.

3.2 Share options trends

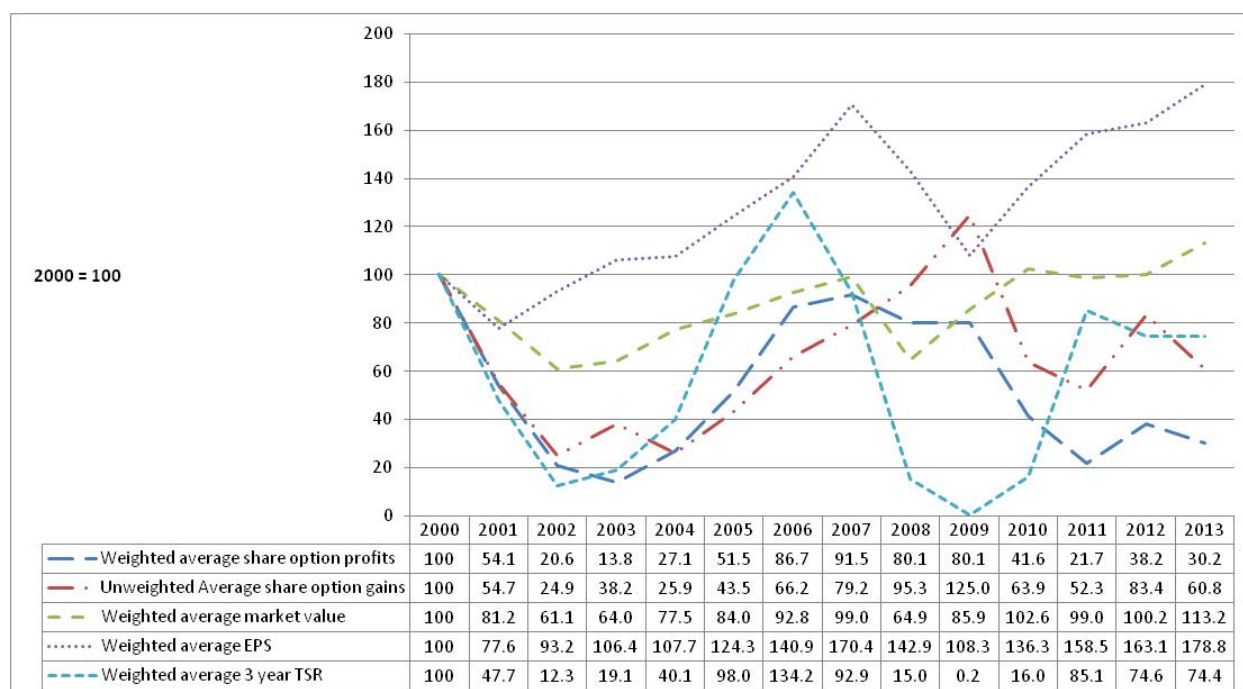
Only a minority of today’s top directors participate in share option schemes and consequently their importance as an incentive has declined significantly over the last decade. This sharp decline in the use of share options makes it more difficult to obtain a reliable picture of the link between option gains and performance. Moreover, as directors have a seven year window to choose when to exercise their options it is less clear what the relation between pay and performance would signify. But given that they remain part of the incentive armoury in some companies, for completeness Graph 10 plots the indexed median option gains since 2000 along with selected corporate indicators. This shows that over the whole period the change in the value of the exercised options was lower than the changes in the corporate metrics. As with our earlier analysis, we also calculated weighted averages to capture both the value of the options gains and the number of number of directors making exercises. The trend since 2000 can be found in Graph 11.

Graph 10 Indexed movements in FTSE 350 median share option gains* and median performance metrics 2000 to 2013



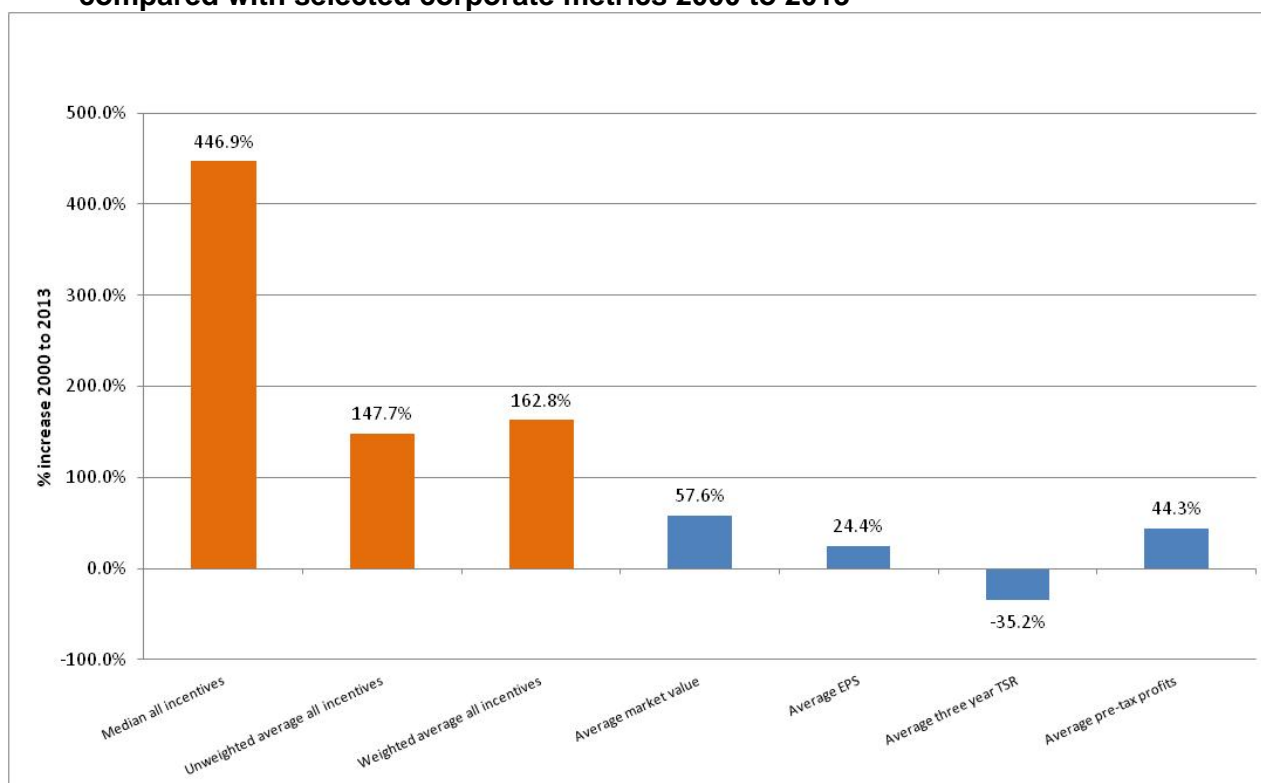
* Exercised share options only

Graph 11 Indexed movements in weighted and un-weighted average FTSE 350 share option gains and average performance metrics 2000 to 2013



Whichever graph is looked at the message is the same – the gains made by FTSE 350 directors following the exercise of share options has declined since 2000. But as Graph 12 demonstrates, the increase in other incentives has more than made up for any loss in options. The shows how much the combined value of all the incentives received by FTSE 350 directors has increased over the period. To provide context the graph includes some of the measures of corporate performance already analysed. As can be seen from the graph, the combined value of all the incentives received has increased at a faster rate than the featured corporate metrics.

Graph 12 Percentage increase in all incentive payments combined compared with selected corporate metrics 2000 to 2013



4 How executive pay has developed

4.1 1979 year zero

If a point in time can be identified when the earnings of board directors started to outstrip those of the rest of the workforce then the year might be 1979. The election of a new Conservative Government signalled a change in direction and a new attitude to incentives. This was summed up by the then Chancellor of the Exchequer, Sir Geoffrey Howe, who said in the new Government's first Budget: 'We need to strengthen incentives, by allowing people to keep more of what they earn, so that hard work, talent and ability are properly rewarded.' The first practical step in this direction was a reduction in the top rate of income tax, from 83 per cent to 60 per cent.

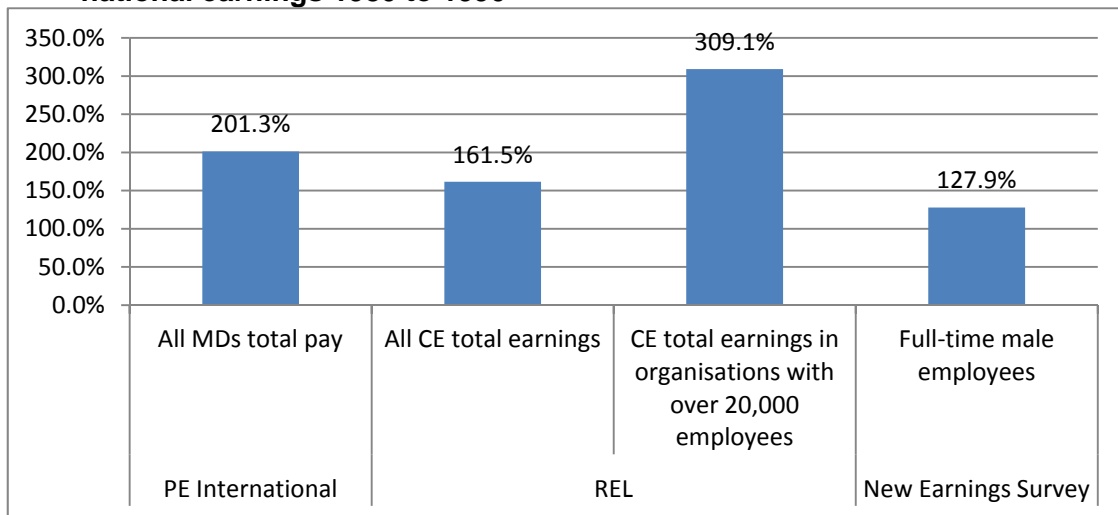
In the background to the new Government's measures were concerns that built up during the previous decade. The 1970s was a period of austerity and incomes policy and as a result many executives became exercised about narrowing pay differentials and high marginal income tax rates. Certainly, evidence from the period indicates that pay differentials were squeezed during the 1970s and clearly marginal tax rates were much higher than today. These circumstances led to feelings of dissatisfaction among British executives. As one participant at the time writes: 'If we look back to the 1970s, most of us who were involved in pay issues can remember the loud and constant complaints made by British executives that they were underpaid.' (Anthony Williams, *Just Reward?* Kogan Page 1994).

Given that the high marginal tax rates provided little incentive to pay cash, companies decided to boost the remuneration of their directors by developing complex tax efficient benefits packages. This was the period that witnessed the growth of the company car for executives along with more exotic arrangements such as leased suits and shirts. As these arrangements were difficult to administer, companies were more than ready to draw back from providing many of the benefits in favour of paying cash once the top tax rates were reduced. This reduction also meant that companies could also look to revive bonus schemes that had become less common in the 1970s compared with the 1960s. Now that directors could keep more of the money earned cash bonuses were once again considered worth paying as an incentive.

4.2 Pay gap between board and workforce pay widens in 1980s

Freed from incomes policies and high taxation, companies steadily began to increase the remuneration levels of executives. As a consequence, the gap between top pay and the rest of the workforce increased steadily throughout the 1980s. This is confirmed by data from several sources, although not all of these focus exclusively on board directors. One source is the regular management and executive salary surveys produced by commercial providers. Two providers in particular – trading at the time under the names of PE International¹ and Remuneration Economics Ltd (REL)² – produced surveys covering the whole decade. These surveys, however, concentrated on the pay of managers across all sections of the economy, not just the top listed companies. While their data does not overlap with the pay of directors of listed companies, their findings do illustrate the overall trend. This can be seen in Graph 13, which calculates the growth in the median total pay of three groups of top executives between 1980 and 1990 and compares their rises with the increase in weekly earnings of full-time male employees. The full-time male employee figures are taken from the official *New Earnings Survey* (NES) published annually from 1970 until it was replaced by the Annual Survey of Hours and Earnings (ASHE) in the noughties. Male earnings are used because the NES did not provide an all-employee figure at the time and as men made up the bulk of the workforce we have taken their pay as the most representative of the UK workforce.

Graph 13 Growth in median top executive pay compared with median national earnings 1980 to 1990



The graph indicates that executive pay growth did outpace the rest of the workforce during the decade, but most noticeably the highest increase of all was for chief executives of the largest organisations, those with over 20,000 employees. Between 1980 and 1990, this group's median total earnings – defined as salary plus bonus but excluding benefits – went

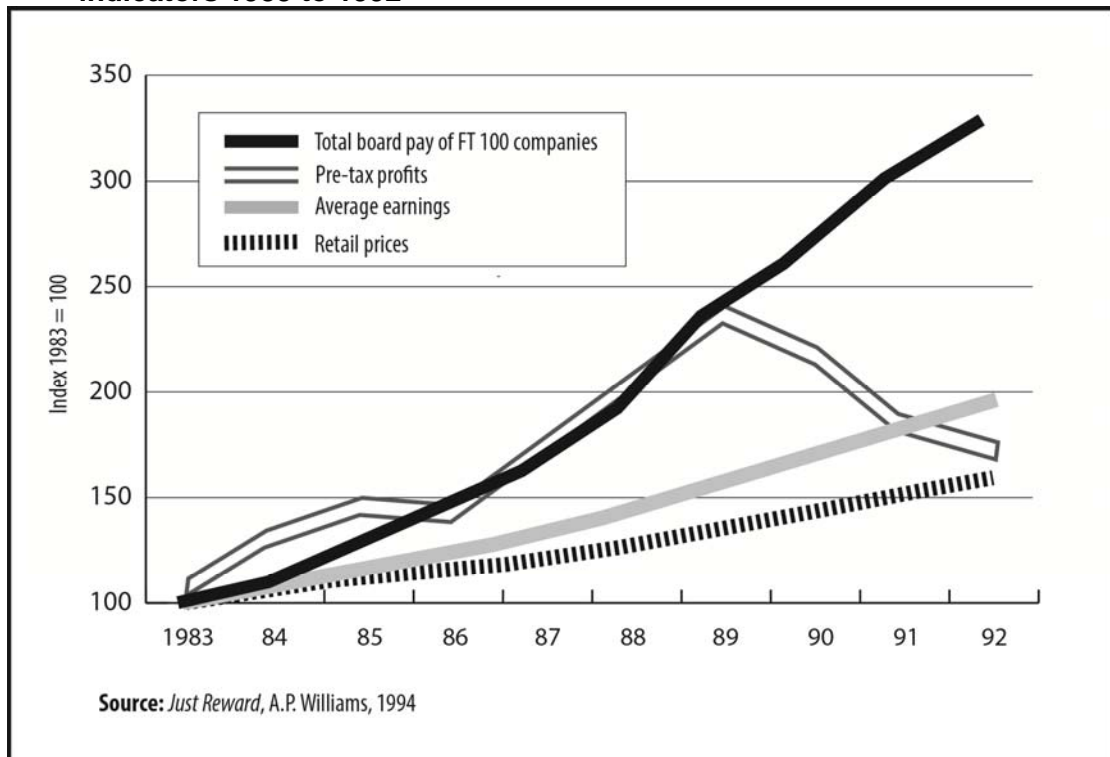
¹ Now known as Inbucon

² Now known as XpertHR

up by 309.1 per cent, which contrasted with a corresponding rise of 161.5 for cent for all chief executives in the same survey. At the same time, the median weekly earnings of all full-time male employees went up by 127.9 per cent, the lowest increase in Graph 13.

So the 1980s not only saw the start of a growing pay gap between the shop floor and the boardroom, but also a further widening within the executive class, with those in the largest firms making the greatest gains. How this translated into pay growth for top 100 listed company directors is illustrated by Graph 14, which is reproduced from Anthony Williams book *Just Reward?*. The graph indicates that total board pay increased by around 340 per cent between 1983 and 1992, while the equivalent rise in average earnings was around 200 per cent.

Graph 14 Growth in FTSE 100 total board pay compared with other key indicators 1983 to 1992³

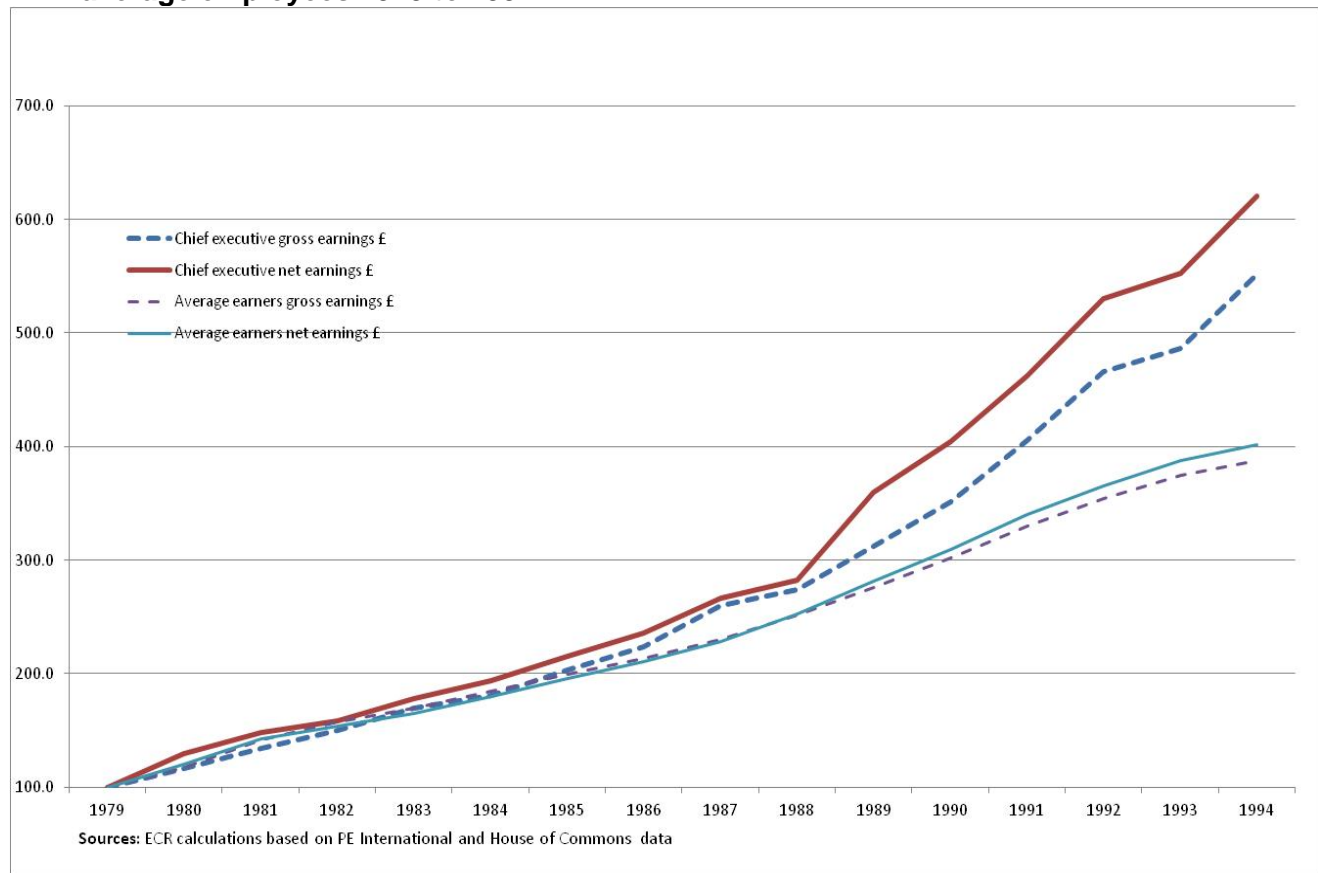


While the graphs above illustrate the scale of the growth in directors' gross earnings during the 1980s, they leave out another crucial part of the story – the gains made in take-home pay due to reductions in income tax. After 1979, the next crucial date in the Government's tax reform was the 1988 Budget when a single rate of top income tax of 40 per cent was introduced. This simplification was accompanied by the abolition of the existing higher rates of 45 per cent, 50 per cent, 55 per cent and 60 per cent. While in the same budget the basic

³ Please note it is not clear from the source whether board pay includes both executive and non-executive directors.

income tax rate was also reduced to 25 per cent, it was those on the highest incomes that benefited the most. Our calculations at the time show that as a result of the tax changes a single employee earning £10,000 in 1987/88, roughly the same as median national wages, would have received the equivalent of a 3 per cent pay rise as result of the lower basic rate. In comparison, the reduction in the top rate would give an employee earning £300,000 a pay rise equivalent to 45 per cent. Taking the period as a whole, our calculations show that based on PE International figures the net earnings of chief executives increased by 304.3 per cent between 1978/79 and 1989/90, whereas the median net pay of all full-time employees went up by 209.2 per cent. The corresponding rises in gross earnings were 251.7 per cent and 201.7 per cent (see Review 157, March 1994, p.20). These tax cuts along with high gross pay growth added a significant boost to the net earnings of chief executives as can be seen in Graph 15, below.

Graph 15 Indexed gross and net earnings growth of chief executives and average employees 1979 to 1994



Sources: ECR calculations based on PE International and House of Commons data

4.3 Tax changes spur incentive scheme growth

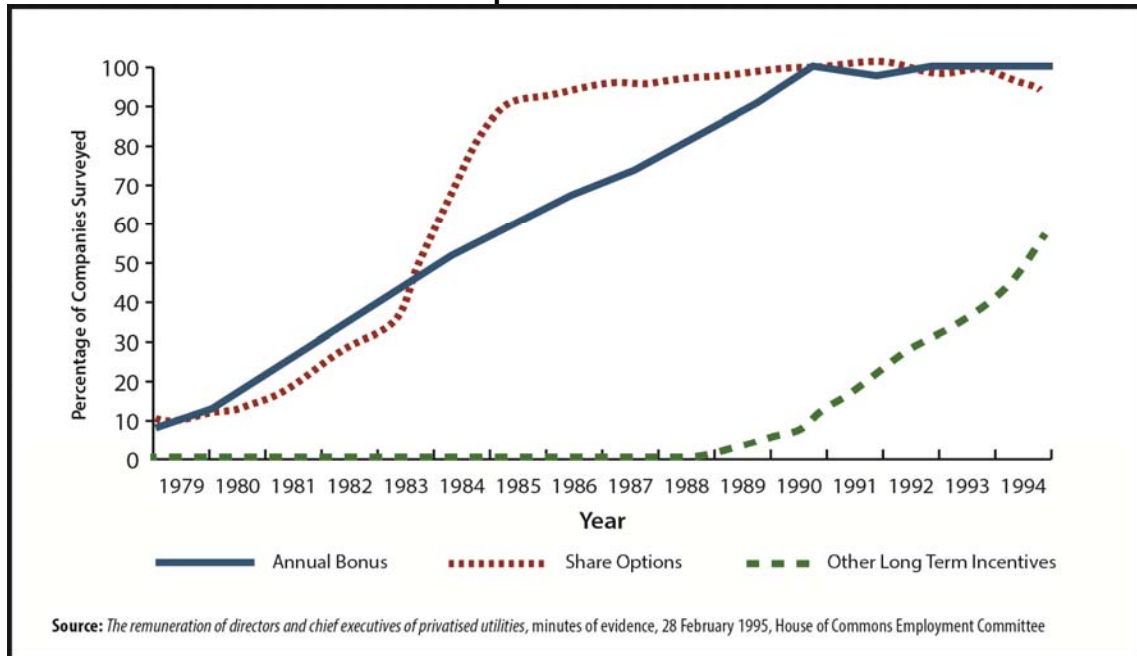
Boardroom pay trends in the 1980s were not confined to widening pay differentials as the decade also witnessed significant growth in incentive schemes. First, there was a marked rise in annual bonus plans in the early 1980s followed by a rapid introduction of executive share option schemes after 1984. Both these developments were spurred by Government tax changes. The reduction in the top marginal income tax rate in 1979, for instance, seems to have prompted companies to think about introducing formal incentive schemes. This was noted in the very first issue of our monthly Review, which reported on a discussion paper by management consultants Spencer Stuart (see Review 1, March 1981, p.2). For the paper, the consultants interviewed the chairmen and chief executives of some 32 companies and found that 15 had financial incentive schemes with defined performance targets, many of which were introduced as a result of the 1979 tax changes. Similarly, our review of a survey conducted by Monks reported that many large companies were introducing cash incentive plans in the wake of the 1979 Budget (see Review 19, September 1982, p.2). These plans were mainly reserved for directors and were often considered an addition to pay or a 'perk' rather than as part of a strategy to make a substantial part of directors' remuneration performance related. In the same issue, a survey of top companies by consultants Towers Perrin showed that a third of directors in half of companies were eligible for a bonus. The value of the on-target payments were above 15 per cent of salary and closer to between 20 per cent and 35 per cent.

Further impetus to the growth of boardroom incentives was provided by the 1984 Budget when tax breaks for executive share option schemes were introduced. In the Budget, the then Chancellor of the Exchequer, Nigel Lawson, announced that from 6 April 1984 share options would be exempt from income tax and any gains subject to capital gains tax only. Explaining the policy, the Chancellor stated: 'I am convinced that we need to do more to attract top calibre company management and to increase the incentives and motivation of existing executives and key personnel by linking their rewards to performance.'

As a result of this tax change there was a sharp upturn in share options schemes, which can be seen in Graph 16. The graph is reproduced from evidence submitted to the House of Commons Employment Committee's 1995 enquiry into the remuneration of directors of privatised utilities. In addition to charting the marked rise in share options, the graph also shows the steady rise in annual bonus schemes throughout the decade. More strikingly, however, is the first appearance of other long-term incentive arrangements at the end of the

1980s. These other schemes were starting to be considered as an alternative to share options, which by late 1980s and early 1990s were coming under critical scrutiny.

Graph 16 Development of annual bonus, share option and other long-term incentive schemes in UK companies



4.4 Share options under scrutiny in the 1990s

In part, the scrutiny was being fuelled by headline grabbing share option gains made by some individual directors. Our own analysis of options cashed-in during the last quarter of 1991, for example, found that one Glaxo director realised over £2 million in paper profits from the exercise of options (see Review 133, March 1992, p. 2). The receipt of such large option gains at a time when the UK economy was in recession attracted adverse publicity in both the media and Parliament and highlighted the growing disparity between boardroom pay and the rest of the workforce.

Adverse publicity coupled with evidence showing that option gains were volatile raised questions about whether they were a genuine reward for individual performance. Increasingly, they were being seen as a 'one-way-bet', especially as the majority of schemes did not involve formal performance targets. Directors could make substantial profits following the exercise of share options without any attendant financial risk. As the only performance condition was the rise and fall of share prices, which were as often buffeted by external events as corporate performance, it seemed that option profits were rewarding windfall gains rather than the abilities of individual directors. Moreover, given the tax rules, directors could pick and choose a time when they could maximise their gains as they had a seven year window to exercise their options.

During this period, share options were also losing their popularity as an effective incentive within boardrooms. This was because many options went 'under water' in early 1990s as exercise prices ended up higher than current market prices as a result of depressed stock markets. This meant that directors could no longer exercise their options and realise a gain on their sale. Further, neither were options achieving their original aim of turning directors into shareholders as many sold their shares shortly after exercise. The continuing reductions in top income tax rates also meant share options were losing their original tax advantage.

In the eyes of those responsible for determining directors' remuneration, options were losing their incentive effect and consequently there was a readiness to look at alternative long-term schemes. The time to consider such alternatives was opportune as many of the original option schemes were coming up for renewal in 1994/95.

4.5 1990s – a turning point

It was not just share option gains that were attracting adverse comment during the early 1990s as the recession had also provoked wider concerns about 'executive excess'. At a time when employees were either losing their jobs or being told they must accept pay restraint it seemed that directors' remuneration was untouched by the recession. Even the Prime Minister became involved. Addressing the CBI in 1990, the Prime Minister said: 'There is no point in urging lower wage settlements on others unless management is prepared to follow its own advice'.

As the decade wore on, these concerns were fuelled further by what many considered to be excessive increases for the executives of recently privatised utilities. The lightning rod for the dissatisfaction became the chief executive of British Gas, whose pay went up by 75 per cent in 1994, from £270,000 to £475,000. In response to the concerns, the House of Commons Employment Committee decided in 1994 that it would examine the whole question of executive remuneration in the privatised utilities. In its final 1995 report there was a split between committee members that mirrored more recent debates about the make-up of British boardrooms. The majority wished to leave the composition of remuneration committees unchanged, made up largely of non-executive directors (NEDs), while the minority wished to extend membership to shareholder and employee representatives.

4.6 Corporate governance takes centre stage

As the Employment Committee report illustrates, corporate governance had become a key feature in discussions about executive remuneration by the mid-1990s. This focus on corporate governance – how companies are directed and controlled – was new at the time and only surfaced as the result of some high profile corporate failures. The behaviour of Robert Maxwell and the collapse of the prominent stock market companies Polly Peck and BCCI exposed failings in the way listed firms were run and supervised. These financial scandals coincided with the heightened concern about executive excess and in the wake of these failures Sir Adrian Cadbury was asked in 1991 to come up with the first formal corporate governance framework for the UK. As Cadbury stated in the final report: 'It is...the continuing concern about standards of financial reporting and accountability...and the controversy over directors' pay, which has kept corporate governance in the public eye'.

Cadbury's final report appeared in December 1992 and three central principals articulated at that time have guided corporate governance ever since. These are:

- accountability to shareholders;
- the need for independent non-executive directors (NEDs);
- pay transparency.

While much of the emphasis of Cadbury was on audit, directors' remuneration was also a central concern. One of the key recommendations has had a lasting effect, that: 'Boards should appoint remuneration committees, consisting wholly or mainly of non-executive directors and chaired by a non-executive director, to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary.' Such remuneration committees are now universal across all major listed firms.

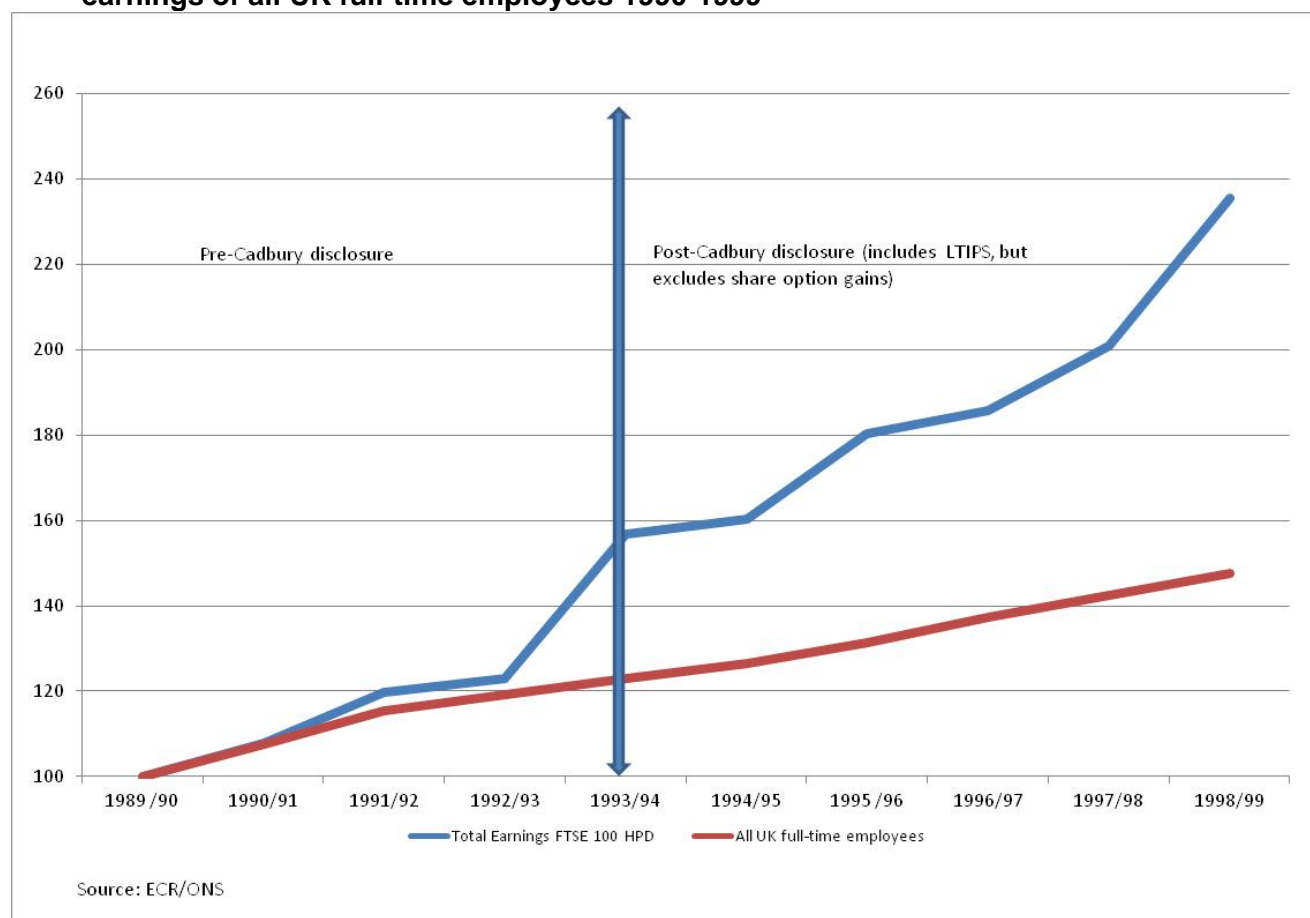
Another Cadbury principal has also had a lasting impact – that the only line of boardroom accountability is to shareholders. Other stakeholders, such as employees, were ruled out as having a legitimate say in either the direction of the companies they worked for or the remuneration of those running the firm on their behalf. Concerns about the emphasis on the importance of shareholders were also raised during the consultation period. Writing in the *Financial Times*, Sir Owen Green, the then chairman of BTR, said: 'The proposals relate almost exclusively to the well-being of investors...who are described as owners of the company' (FT June 9, 1992). But the chairman disagreed, explaining that: 'The concept of ownership as distinct from membership of a limited liability company is novel, untested and inappropriate.'

Despite these reservations, the Cadbury approach was maintained in all subsequent enquiries into directors' pay and even into legislation. Although far more comprehensive than Cadbury, the executive reporting regulations introduced by the coalition Government in 2013 continues to be dominated by the same themes – accountability to shareholders, transparency and the role of NEDs. The coalition Government's regulations are just the latest in a long-list of attempts to regulate directors' pay through corporate governance. In addition to Cadbury, other milestones include reports headed by Sir Richard Greenbury of Marks and Spencer in 1995 and Sir Ronald Hampel of ICI in 1998. Eventually, the voluntarism that characterised the approaches of Cadbury, Greenbury and Hampel was partially ended when the Government put some of the requirements on a statutory footing in 2002. This legislation has been superseded by the coalition Government's new executive reporting regulations.

4.7 Corporate governance fails to halt directors' pay growth

When Cadbury reported it was thought that its recommendations would be sufficient to either curb excessive boardroom pay growth or make decisions about how much directors received more understandable to outsiders and therefore more acceptable. Especially if these decisions were taken by 'independent' non-executives. Yet, as the Employment Committee's 1994/95 enquiry into directors' remuneration in privatised utilities clearly demonstrated, the hope was premature as 'fat cat' pay remained toxic in both the minds of the public and politicians. It turned out that better corporate governance was not the answer to slowing the growth of pay differentials, as can be seen in Graph 17. The graph, taken from directors' remuneration data collected by us from company annual accounts since 1990, shows that the total earnings growth of the FTSE 100 highest paid directors (HPDs) continued to outstrip the rest of the UK workforce. In the graph, directors total earnings includes fixed pay, annual bonuses and the value of any alternative long-term incentive plan (LTIP) awards vesting during the year, but not share option gains.

Graph 17 Indexed median FTSE 100 HPD total earnings vs median earnings of all UK full-time employees 1990-1999



Some care is needed when interpreting the HPD earnings' trend during the early part of the decade as the numbers are based on pre-Cadbury disclosure standards when transparency was limited to an unspecified total emoluments figure. The large upturn in HPD earnings in 1993/94 is probably due to more boardroom remuneration information coming into the public domain as a result of Cadbury rather than a reflection of a genuine increase in directors' pay. Nevertheless, the trend is clear, despite the corporate governance rules, Cadbury nor subsequent codes on directors' pay such as Greenbury and Hampel halted boardroom pay growth.

Each of these committees, however, did add new dimensions to corporate governance and the oversight of directors' pay. Greenbury in particular set the tone for the coming period with its emphasis on pay for performance. Unlike Cadbury, the committee's sole focus was on directors' pay with the preface to the final report explaining that: 'This report responds to public and shareholder concerns about directors' remuneration.' Its remit was: 'To identify

good practice in determining directors' remuneration and prepare a code of such practice for use by UK plcs.' Among its key recommendations were:

- remuneration committees should consist solely of independent NEDs;
- a remuneration committee report to be included in the annual accounts each year;
- the report should set out the remuneration received by each director by name;
- option grants should be phased;
- new long-term incentive schemes should require shareholder approval;
- performance-related pay should align with shareholder interests and give directors incentives to perform at the highest level;
- annual bonuses should be capped and paid partly in shares;
- new long-term incentives plans should preferably replace existing schemes or be part of a well-considered overall plan;
- consideration should be given to measuring performance relative to a group of comparator companies in key variables such as total shareholder return (TSR).

As this list indicates, the Greenbury recommendations were not just concerned with pay for performance. Another key thrust was to ensure that remuneration policies aligned the financial interests of executive directors with those of shareholders. This view was prompted by the growing influence of principal-agency theory, which although developed by academics in the 1970s only began to gain prominence in the 1990s. The theory states that principals, shareholders in the case of corporate governance, appoint agents, executive directors, to run the organisation on their behalf, but that the two groups have different financial interests. Shareholders to maximise returns and executive directors to maximise their own remuneration, potentially at the expense of the principals. To overcome this tension, it was suggested that directors should be incentivised to behave like shareholders and the main way to achieve this was to devise schemes that rewarded executives with shares. It was this view that sparked development of the share-based incentive schemes that play such a prominent role in today's boardroom remuneration strategies.

In addition, Greenbury signalled the end of tax relief on executive share options and the end of discounted share options. Following a debate about Greenbury's original recommendation that tax relief on executive share options should be abolished altogether, the Government eventually decided that tax relief would be allowed on grants worth up to £30,000. The Government did, though, completely abolish a measure introduced in the 1991 Budget that extended tax relief to discounted executive share options where the company also had an all-employee share scheme.

4.8 Structure of directors' remuneration

Greenbury's list of recommendations set the direction directors' remuneration would take up until the present, especially the stress on the importance of linking directors' rewards to performance and the alignment of directors and shareholder interests. These are the key themes that have dominated boardroom remuneration strategy ever since and have had a major impact on the shape of directors' pay packages. While incentives increasingly became a feature of executive pay from the early 1980s onwards, the response to Greenbury provided an impetus to the introduction of more complex, highly geared schemes. As a result, the current remuneration arrangements for directors in both the FTSE 100 and mid-250 will consist of a mix of fixed and variable reward vehicles, each designed to achieve different objectives and follow different payment cycles. The total remuneration arrangements could include:

- base salary;
- benefits;
- short-term incentive, such as annual bonus;
- medium-term incentive, such as deferred and matching shares;
- long-term incentives consisting of performance shares, share options or both running concurrently;
- self/co-investment plan;
- pension contribution or cash in lieu.

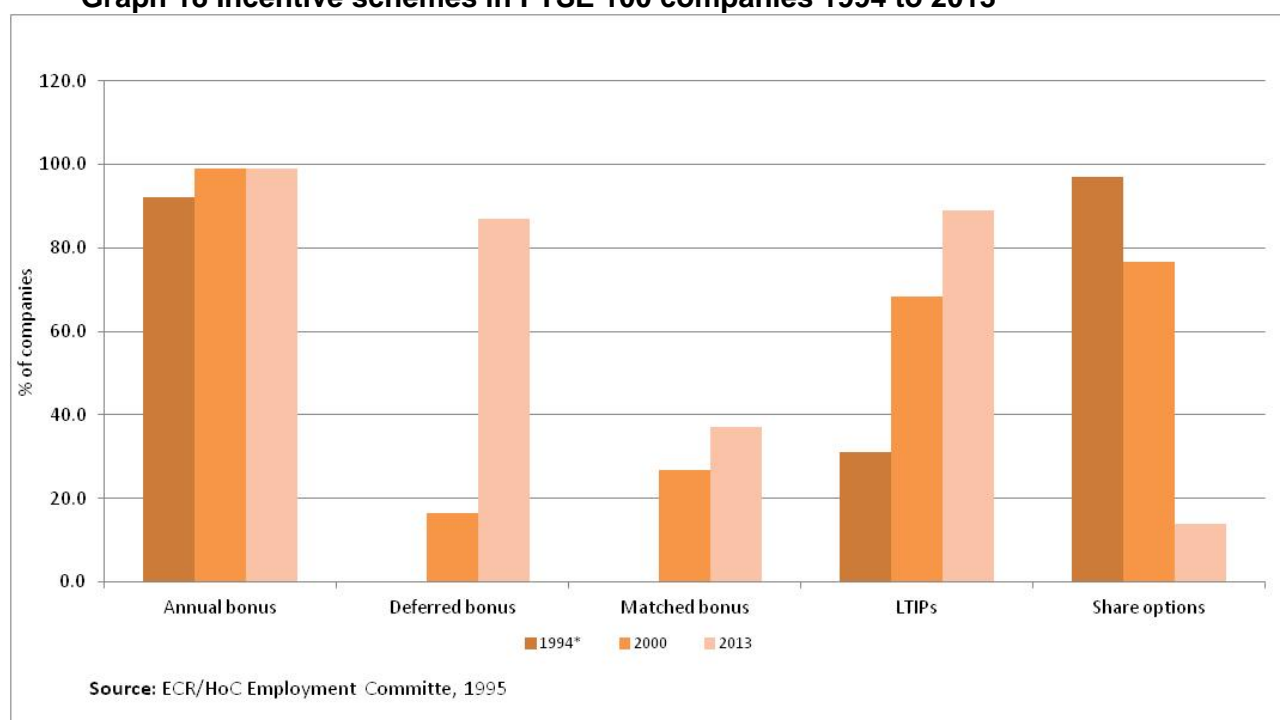
For today's directors, salary now only makes up a small proportion of the total earnings received each year. Taking fixed pay and incentive awards only, our research shows that salary plus benefits only made up just over a fifth of the total earnings of FTSE 100 lead executives in 2012/13. This represents a significant shift in the balance between fixed and variable pay over the last three decades. The shift towards variable pay was driven by a number of key trends since Greenbury:

- a pay for performance culture that increasingly dominated remuneration committee executive pay strategies;
- a policy of increasing the proportion of executive remuneration coming from incentives...but not at the expense of salary;
- a growing complexity of incentive arrangements with several schemes that often have overlapping aims and targets;
- ever-increasing potential maximum payouts from incentive schemes with more directors receiving incentives of higher value.

A picture of the changing shape of incentive scheme practice in the FTSE 100 since the mid-1990s can be found in Graph 18. The graph takes three representative years – 1994, 2000 and 2013 – to highlight the shift in bonus and long-term incentive practice. As annual accounts provided insufficient information in 1994, the data for that year is based on evidence submitted by Hay Group to the Commons Employment Committee report. Three themes stand out from the graph:

- bonus schemes have remained common throughout the period, but these have evolved into medium-term plans involving deferred and matching shares;
- deferred share bonus schemes dominated by 2013, with their growth taking off in the wake of the financial crisis;
- LTIPs now significantly outweigh the use of share options.

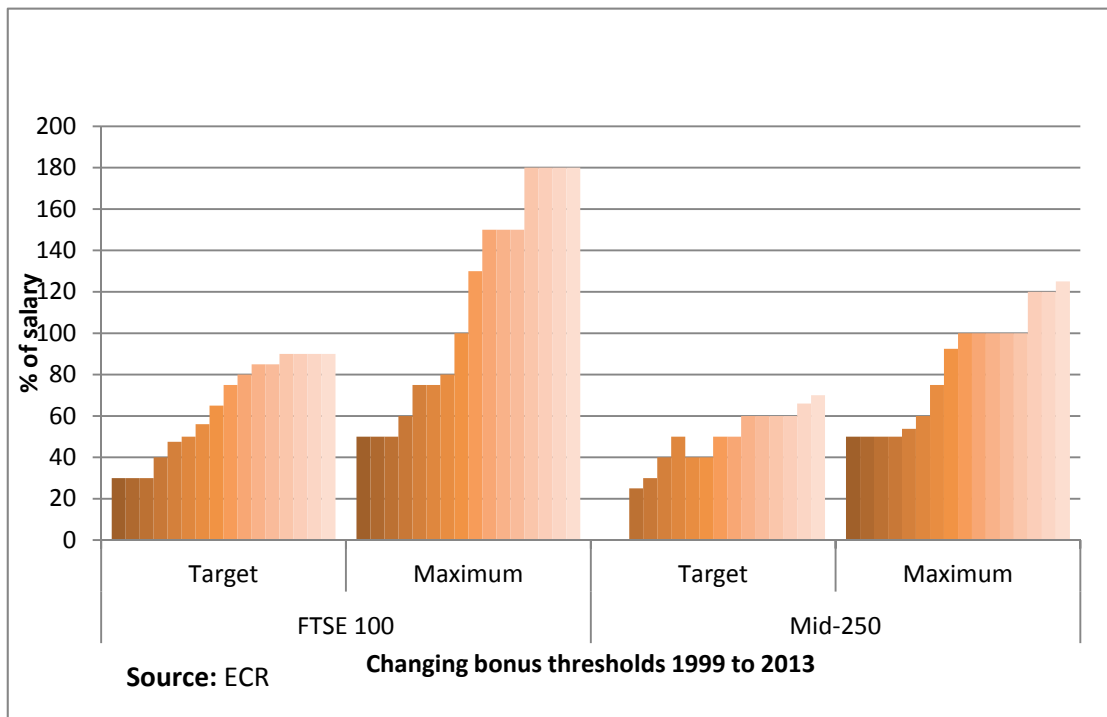
Graph 18 Incentive schemes in FTSE 100 companies 1994 to 2013



4.9 Rising incentive scheme maxima

Underlying this shift in practice has been an increase in incentive scheme maxima. A picture of how annual bonus on-target and maximum thresholds have increased for FTSE 100 and mid-250 lead executives since 1998 can be seen in Graph 19. The upturn in bonus scheme thresholds began in the early noughties and continued throughout the decade. The maximum bonus for FTSE 100 lead executives has gone up from 50 per cent of salary in 1998 to 180 per cent in 2013. The corresponding target threshold has risen from 30 per cent of salary to 90 per cent over the same period. Although less spectacular, similar increases in bonus thresholds took place for all FTSE 350 directors.

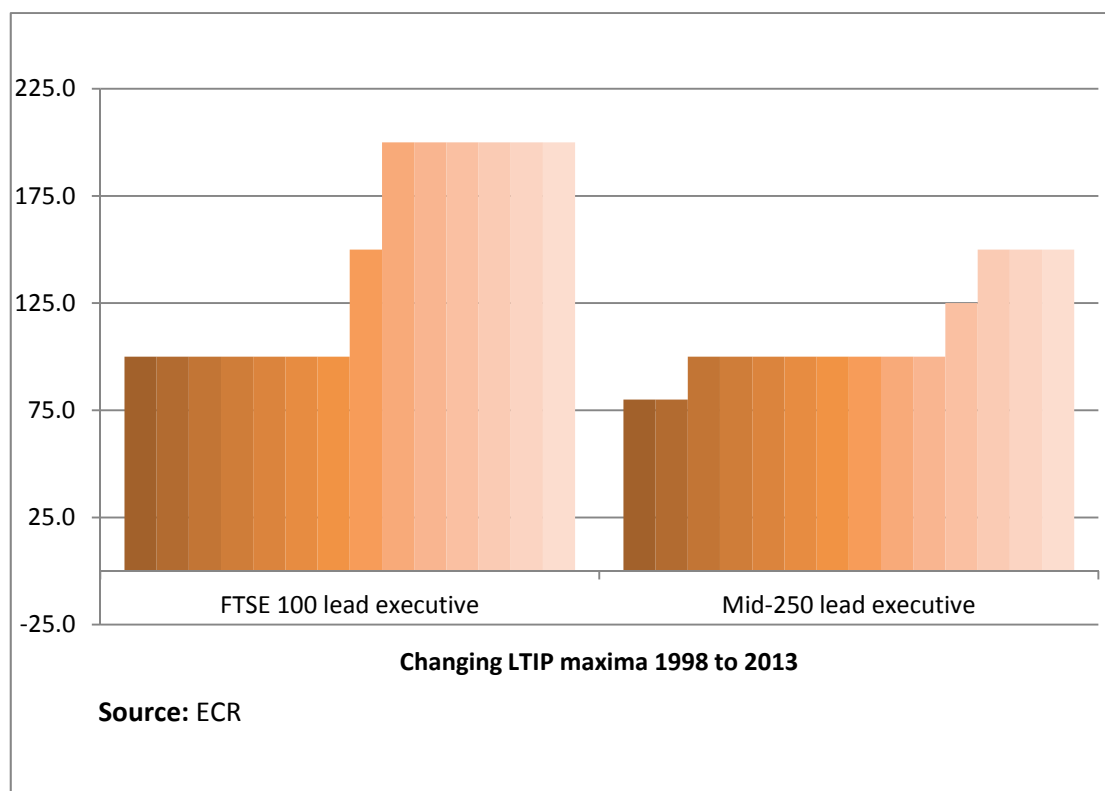
Graph 19 Change in FTSE 350 lead executive target and maximum bonus thresholds 1998 to 2013



A similar trend towards higher maxima was evident with LTIPs, as can be seen in Graph 20. The graph indicates there was a particularly sharp upturn from the mid-noughties that followed the bursting of the dot.com stock market bubble. By the middle of the decade share options had become even less popular with remuneration committees, in part because many went under water making them worthless as an incentive. Further, a new accounting rule, FRS20, was introduced requiring companies to recognise share-based payment transactions in their financial statements from 1 January 2005. Given that option grants tended to be higher than LTIP grants, this made them more 'costly' to companies. Added to the higher 'cost' of share options was growing shareholder concern about dilution. All these reasons accelerated the switch from share options to LTIPs as the main long-term incentive of choice.

Where options still existed, however, grant ceilings did increase during the period. The biggest innovation was the abandonment of the original tax privileged scheme grant limit of four times remuneration in favour of annual grant policies. Many of the original phased grants were worth one times salary or earnings, but by 2013 the median grant for FTSE 100 directors equalled 200 per cent and for their mid-250 counterparts 150 per cent.

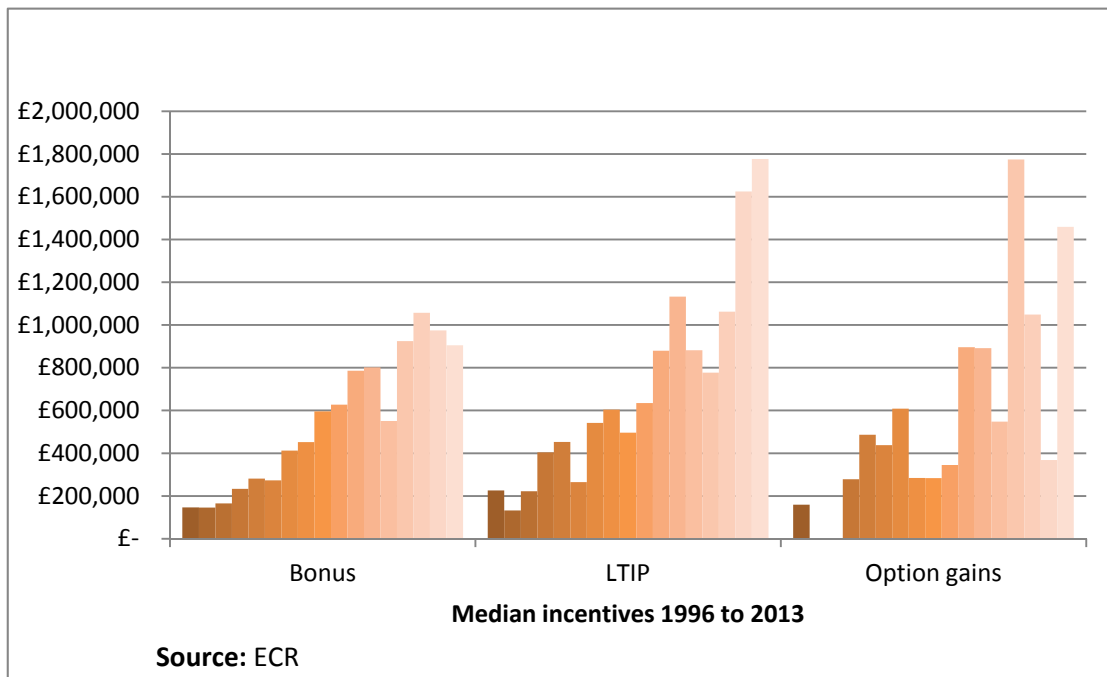
Graph 20 Median maximum LTIP grants for FTSE 350 lead executives 1998 to 2013



4.10 Rise in median value of awards from all incentives

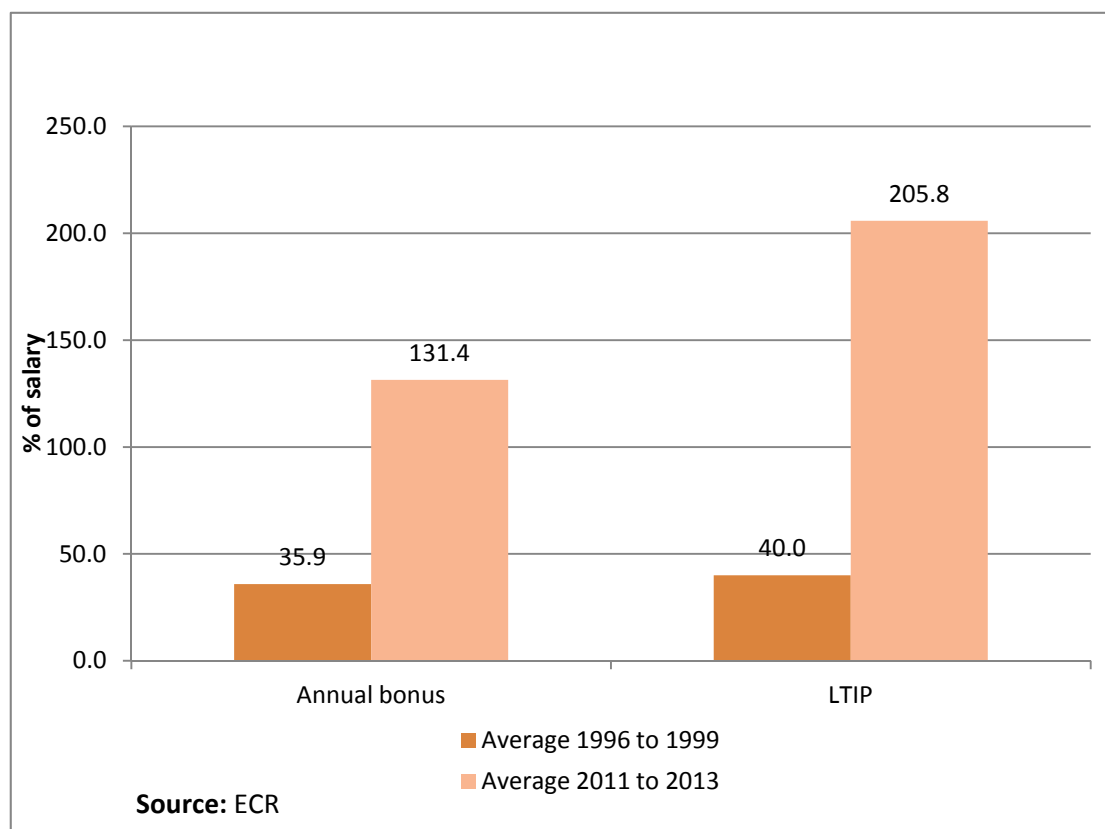
As a consequence of these trends, the value of incentive payouts received by FTSE 350 directors has increased over the last 15 years. This can be illustrated by looking at the median incentives received by FTSE 100 lead executives since 1996 as in Graph 21. The graph shows that over the period the median bonus of FTSE 100 lead executives has gone from around £150,000 to around £1 million, although there are fluctuations in the payouts. The rise in the cash value of the median vested LTIP awards is even starker, increasing from £226,000 in 1996 to £1,777,424 in 2013. In contrast, the median cash value of the share option gains is more volatile, but there is a detectable upward trend in the FTSE 100.

Graph 21 Median cash incentive payments received by FTSE 100 lead executives 1996 to 2013



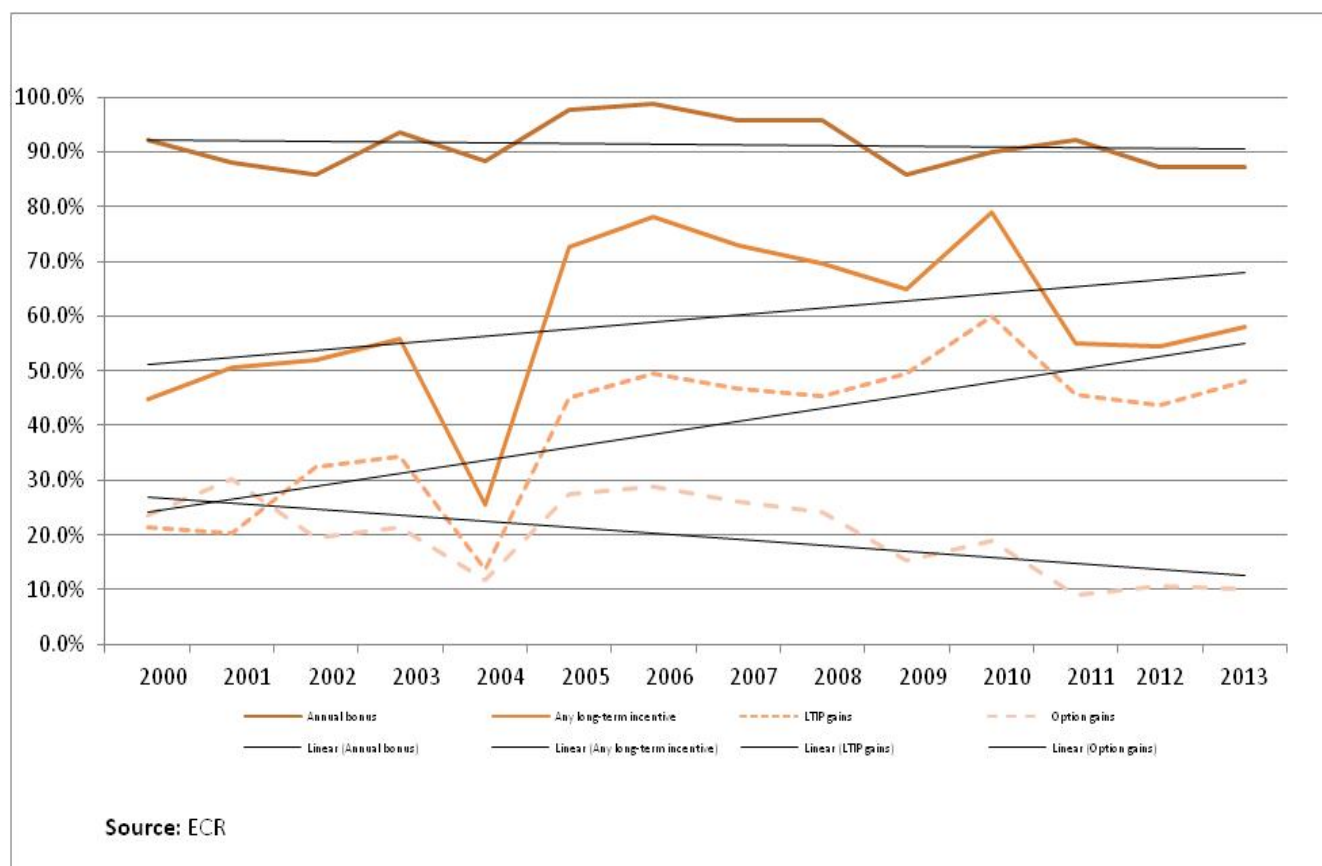
Given inflation and pay growth, some increase in cash incentives might be expected, but the period has also witnessed a relative rise compared with salaries. This is illustrated by Graph 22, which shows the value of annual bonus and LTIP awards as a percentage of salary averaged over two comparative three year periods, 1996 to 1999 and 2011 to 2013. The figures have been averaged to iron out any fluctuations in payouts over the two periods. As option gains tend to be extremely volatile they have been left out of the analysis.

Graph 22 FTSE 100 lead executive bonus and LTIP awards as percentage of salary averaged 1996 to 1999 and 2011 to 2013



Yet, the increase in both the cash and relative values of incentive payouts is only one side of the equation; the other is a rise in the numbers of directors receiving them. This can be seen in Graph 23, which shows the proportions of lead executives receiving each type of incentive. For ease of understanding, the graph adds in trend lines to smooth out year to year fluctuations.

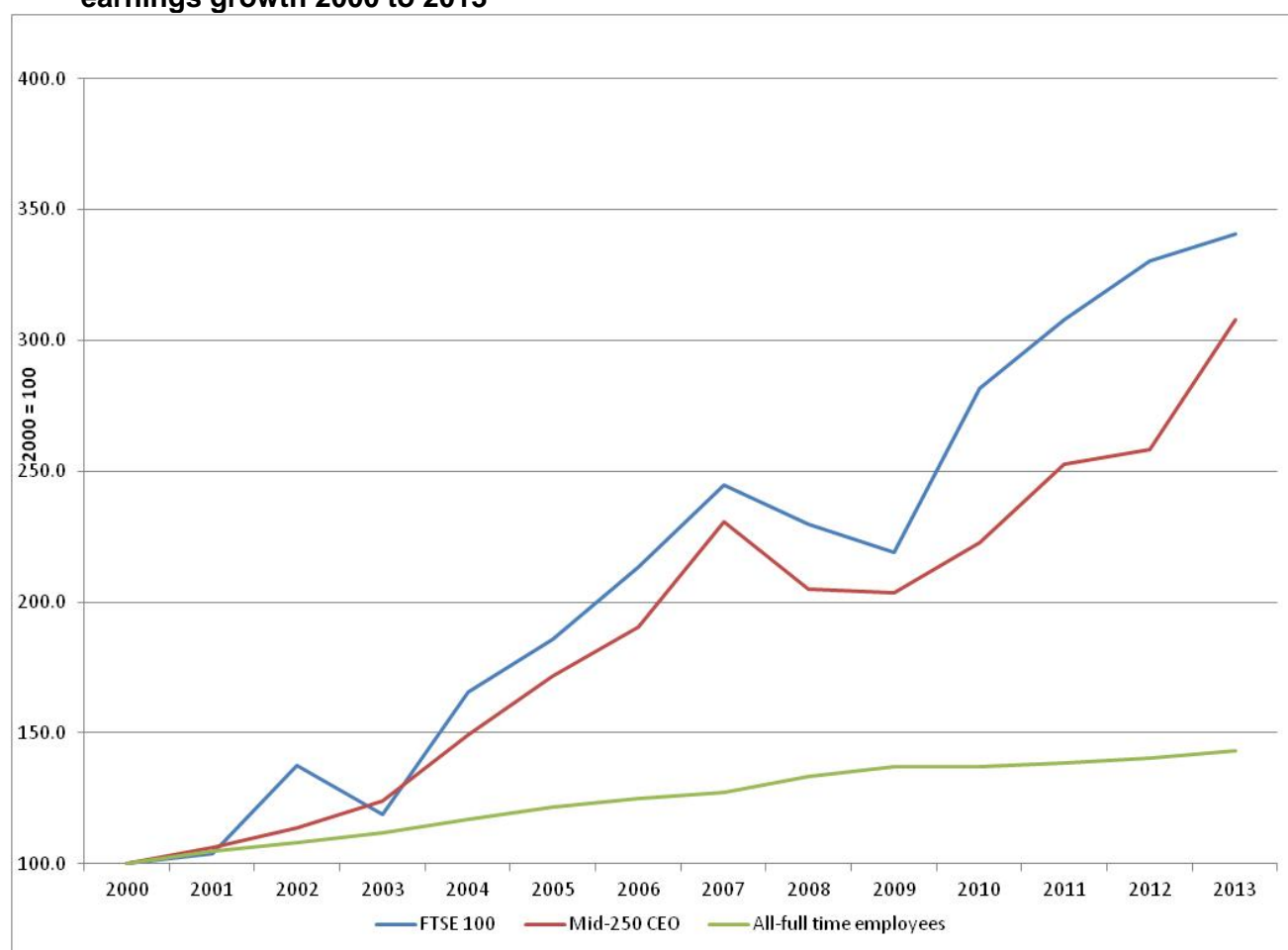
Graph 23 Proportion of FTSE 350 lead executives receiving an incentive 2000 to 2013



In the graph, the most notable trend is the rise in the proportion of lead executives benefiting from either an LTIP award or option gain. In 2000, for example, 44.9 per cent of all lead executives received either an LTIP or option, while by 2013 this had grown to 58.1 per cent. In some earlier years, the combined proportion was even higher, with numbers peaking at 78.9 per cent in 2010, two years after the onset of the recession. More notably, however, the graph shows that within the overall figures there was switch-over in the proportions gaining an LTIP award compared with those exercising share options.

This combination of more directors receiving higher incentive payouts alongside continuing rising salaries fuelled significant earnings growth throughout most of the noughties, as can be seen in Graph 24, which includes the face value of any share option gains.

Graph 24 Indexed FTSE 350 lead executive and full-time employee earnings growth 2000 to 2013



Over the whole period 2000 to 2013, the median earnings of FTSE 100 and mid-250 lead executives increased by 240.5 per cent and 207.9 per cent respectively, which compared with 43.3 per cent for all full-time employees. But as the graph indicates, the trajectory of pay growth for top directors was not steadily upwards. There were clear setbacks in certain years when recorded median total earnings were actually lower than the year before. These years coincided with major reverses in the economy such as the bursting of the dot.com bubble in the early noughties and the onset of the financial crisis in 2008. Yet, what is equally striking is just how short the setbacks were as it did not take long before directors' earnings resumed their growth path. As a result, by 2013 the median total earnings of FTSE 100 lead executives were nearly two-fifths higher than prior to financial crisis in 2007.

Speedy returns in total earnings growth are largely due to the way remuneration committees tend to react when incentives fail to pay out. When a scheme fails to pay out due to poor performance then it is working as it should, but a scheme that fails to pay out due to more difficult circumstances is failing to incentivise. As result, remuneration committees often

redesign or recalibrate incentive targets to make them more achievable and restore a realistic possibility of reward. This is what may be termed the paradox of pay for performance. Targets always need to be achievable if they are to act as a motivator so any failure to pay out can only ever be short-term.

5 Conclusion

If a point in time can be identified when the earnings of board directors started to outstrip those of the rest of the workforce then the year might be 1979. Freed from incomes policies and high taxation, companies steadily began to increase the remuneration levels of executives. As a consequence, the gap between top pay and the rest of the workforce increased steadily throughout the 1980s. In today's UK boardrooms executive remuneration policy is dominated by a pay for performance culture, with as little as a fifth of a top director's annual earnings paid as salary and the remainder made up of various incentive awards.

But our research suggests that there is either no relationship or at best a weak link between directors' pay and performance. In summary, we found that:

- the statistical correlations between changes in two key annual bonus performance metrics, pre-tax profit and earnings per share (EPS), and subsequent bonus payments were insignificant;
- 98.7 per cent of the change in annual bonuses could not be explained by changes in pre-tax profit;
- 99 per cent of the change in annual bonuses could not be explained by changes in EPS;
- there was no noticeable correlation between the relative ranking of long-term incentive plan (LTIP) share awards and the relative ranking of changes in total shareholder return over three years;
- there was no noticeable correlation between the relative ranking of long-term incentive plan (LTIP) share awards and the relative ranking of changes in EPS over three years;
- As Graph 3 on page 8 highlighted, total earnings for FTSE 350 directors increased by nearly 350% between 2000 and 2013 compared to indexed corporate performance metrics in the same companies that rose by between 140% (revenue) to 195% (pre-tax profit).

Acceptance of a pay for performance culture has spread beyond the boardroom, with investors and all the main political parties agreeing that generous rewards are justified where a company has shown strong long-term performance. Based on the research presented here, however, increases in all the key elements of FTSE 350 directors' remuneration have far outstripped a range of corporate metrics and there is little discernible link between directors' earnings and corporate performance.