

# IT'S HOW YOU PAY IT

MAKING SENSE OF THE COMPLICATED  
WORLD OF EXECUTIVE PAY

## 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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complicated world  
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## Introduction

Earlier this year, when HSBC announced the pay award for their chief executive, Stuart Gulliver, it came out with three different figures – stretching from £4.2 million to £7.2 million. When Barclays announced its pay package for the CEO, Bob Diamond, the bank stated he would be receiving £6.3 million. Within hours the media was reporting that it would be more like £17 million, or even £27 million according to the *Daily Mail*.<sup>1</sup>

Ten years on from requiring executive pay in listed companies to be made public, how can it be that we simply do not know what the boss of a company is earning?

Over the last 30 years we have seen a dramatic shift in the structure of pay awards for those at the top. Executive pay packages have become increasingly complex. This growing complexity is driven by a desire to align executives' interests with shareholders' interests, to incentivise the executive and link pay to company performance.<sup>2</sup>

In the early 1990s, a series of articles appeared in academic journals calling for a greater link between pay and company performance in an attempt to manage the classic principal/agent problem experienced since the beginning of the 20th century.

The total pay package for the vast majority of executives is now made up of a number of different elements. These include but are not limited to basic pay, an annual bonus, a long-term incentive plan, share awards, share options, matched share awards, benefits and pension or payment in lieu of pension. In addition, in any one year a number of overlapping schemes can vest, creating an increasingly complicated mix.

This report looks at the current situation in regards to executive pay packages, the elements included in them and how they can be calculated.

This paper is part of a series which will explore issues relating to top pay, including remuneration consultants, shareholder engagement, and the role of other stakeholders in decision making.

<sup>1</sup> J Salmon and R Davies, 'Banks' day of shame: 238 millionaires and three fat cats walk away with £42m... but still they won't lend to small firms', *Daily Mail*, 9 March 2012, <http://m.dailymail.co.uk/news/article-2112677/Banks-day-shame-238-millionaires-fat-cats-walk-away-42m.html>.

<sup>2</sup> M.C. Jensen and K.J. Murphy, 'Performance pay and top-management incentives', *Journal of Political Economy*, 98 (2), 1990.

## What has happened to executive pay?

Over the last 30 years we have seen substantial changes in the role of executives and the way they are paid. The new bosses are seen as leaders of the company, and the individual in the position has come under greater public and media scrutiny. Increasingly there is a public demand for them to be held accountable for the decisions they make.

Alongside this shift in role we have seen a dramatic shift in pay. Between 1983 and 1986 the average annual pay package for an executive of a large public company was £77,000; by 1998 the annual pay package for an executive in the FTSE 100 was over £1 million. Since then the value of annual pay packages has increased by as much as 300% to reach £3.7 million in 2009 or £4.2 million, depending on the method of analysis used. Accurate data on executive pay before the late 1990s is limited, but the evidence suggests this trend emerged at the beginning of the 1980s. Between 1949 and 1979 executive pay packages grew by 0.8% per year on average.<sup>3</sup> It is this change in executive pay that is the focus here as we explore the complicated world of executive rewards.

The average worker receives a salary, sometimes a pension, possibly an annual bonus, and on occasion other benefits. For the vast majority the salary is the major component, the other elements combined rarely add up to more than 20% of the original salary, the major exception being employees who work in sales roles and finance, where the variable elements often make up significantly more than the base salary.

For the average executive of a large company a very different picture emerges. They often receive a basic salary, annual bonus, benefits, pension, long-term incentive plan, favourable loans, golden hellos, severance payments, merger bonuses, contractual notice periods, phantom options and share option grants. The variable elements as a rule account for three to four times the basic salary, but can be worth much more than that. An infamous example is that of Bart Becht, CEO of Reckitt Benckiser, whose total reward topped an estimated £90m in 2009. Becht received a salary of £987,000, a cash bonus of £3.5m and made £74m from exercising share options he had been granted as long ago as 2001, and a further £13m from cashing in free performance-related shares he had received in 1999 and 2005.<sup>4</sup>

A major driver in this growth in the variable element of executive pay is a desire to link executive rewards to the successes of the company. However, it is important to note that this growth in variable award has not come at the expense of basic salary, which over the last decade increased by 63%.<sup>5</sup>

The desire to link executive pay to performance, to tie the interests of the executive to that of the shareholder, sounds inherently sensible. However, what may have been a rational idea has now been pushed to an extreme, and appears to have had perverse consequences. It has spawned an entire industry of pay consultants, encouraged obfuscation, cost shareholders vast sums of money in attempting to calculate who is getting paid what in order to make an informed decision, and can be seen as contributing to the decline in public trust of business.

<sup>3</sup> C. Frydman and R. Saks, *Executive Compensation: a new view from a long-term perspective 1936–2005*, 2007.

<sup>4</sup> J Treanor, 'Cillit Bang boss Bart Becht takes home £90m', *Guardian*, 8 April 2010, [www.guardian.co.uk/business/2010/apr/07/reckitt-benckiser-bart-becht-pay](http://www.guardian.co.uk/business/2010/apr/07/reckitt-benckiser-bart-becht-pay).

<sup>5</sup> Incomes Data Services (2011) *What are we paying for: Exploring executive pay and performance*

## Calculating a single figure

As part of Rt Hon Vince Cable's reforms of executive pay he has stated that there should be one figure calculated and published by the company for the total remuneration received by the executive in any one year.

How this figure is calculated is a point of particular contention. Performance-based remuneration commonly takes the form of equity as well as cash bonuses. The equity element can be through share option grants, share appreciation rights and other stock-based compensation. This form of compensation makes evaluating the true costs and value of remuneration extremely difficult for the board or shareholders.

Given this inherent difficulty, the most straightforward way to work out pay is to calculate what has been received in any one year. This is to count the cash or cash equivalents handed to the executive. It means that share plans are not counted when they are awarded, but when they vest – when the shares are available for sale.

However, it is important to note that while this is straightforward in its simplicity, it does not show the whole picture. Counting pay received – rather than pay awarded – is a measure of decisions taken several years ago, maybe by a remuneration committee that is no longer in place, whereas pay awarded focuses on how the remuneration committee is choosing to incentivise the executive today.

For this reason it is arguable that not one but two figures should be produced by the company: the pay received in any one year by the executive and the pay awarded and the predicted payouts for the executive based on performance. When remuneration committees make a pay award, they should have a value in mind for the package, even if this means relying on hypothetical values for shares that will be received in several years' time. These can be expressed with a range of figures. For example, if executives reach all their performance targets, they will get the maximum award, but if only a few are met, they will get a percentage of their award.

Careful consideration should be paid to the risk of double counting. For example, if we have made the assumption that the previous year an executive could have cashed out his or her shares, then we should not be counting the dividend the executive receives on the shares he or she owns as part of his total pay package. However, where a company has granted or matched shares, and required the executive to hold them for a certain period, the dividend earned on these shares should be included in the total package.

The details of the executive pay award are in the remuneration report, which forms part of a company's annual report and is often extensive. While some companies produce clear and transparent reports, the norm is that these are complicated documents with the finer details and often large parts of the total award described in footnotes. The details of

the reports of even some companies with what would appear to be to be simple performance goals and business structures can throw up unexpected issues.

## What are the elements?

### Base salary

Average: among FTSE 100 companies the average base salary for a CEO is £600,000–1,000,000. The base salary is the easiest piece of information to find and is normally stated clearly in the remuneration report. It is invariably cash rather than share based compensation.

### Annual bonus

The annual bonus can be paid in cash or shares. The total amount potentially available is normally stated as a multiple of the basic salary. It is generally up to 200% of salary but can be considerably more. The total pay-out is based on performance related targets. These can be company specific targets, financial measures such as earnings per share (EPS) and total shareholder return (TSR), or relative targets based on a comparator group of companies.

At BP last year, for example, 50% of the top executive's bonus is related to financial measures such as operating cash flow and replacement cost profits, 30% to safety requirements being met and 20% to rebuilding BP's reputation and internal morale. The maximum bonus that can be achieved is 225% of salary.

If executives are encouraged to take their bonus in the form of shares, there is sometimes a holding period. It is probably clearest not to count the share value as part of pay received until the end of the holding period when the shares are available to sell.

Increasingly companies are paying part of the bonus today and deferring part to a later date. This is particularly the case at banks where the regulator has insisted that part of the bonus be paid in shares and part of it be deferred.

### Long-term incentive plan

The use of long-term incentive share plans has increased significantly in the last ten years. They usually last three years. Again these are typically measured as a multiple of salary and can be as much as 700% of salary.<sup>6</sup> They are also dependent on certain performance measures being met.

At GlaxoSmithKline, the pharmaceuticals company Andrew Witty is eligible for performance shares of up to 600% of salary in 2012, but is required to hold 25% of them for two years after vesting. At BP, chief executive Bob Dudley's incentive plan for 2012–2014 is worth up to 5.5 times salary and is related to total shareholder return compared to the other leading oil companies, operating cash flow and strategic objectives such as safety, rebuilding trust in the company and replacing oil reserves.

If the shares are to be added to the overall package as part of pay

<sup>6</sup> Incomes Data Services (2011) What are we paying for: Exploring executive pay and performance.

received, they should be added in the year they vest, which means they are available for sale, even if the executive has not actually sold them. To calculate the current value of the package, the share price at the time of vesting should be used if the company hasn't done it already.

### **Pension**

Most executives receive a generous pension provision, which vary in form, from final salary related schemes to defined contribution. However, increasingly payments are being made in lieu of pension. These are additional cash payments and there is no obligation to put them in a pension so they should be included in the total package as part of pay received – they are usually £100,000–200,000. They are normally stated as a percentage, for example 25%, of salary. They do not count as salary when working out a bonus payment, but should be considered as cash emoluments.

Additionally where the employer has made a contribution to a pension plan this should be included in the total figure for pay awarded in any one year.

If the payment is made into a pension it is not the equivalent of cash, but it is a valuable perk. It is worth looking at how much the pension pot is worth – anything up to £20m is not uncommon for executives who have been with a company over a long career.

### **Benefits**

These vary significantly. There is usually a figure given for the cash equivalent of benefits such as health or life insurance and a car allowance. This is often paid in cash and is a valuable addition to the package. Housing allowance is often a substantial part of the award, particularly if the executive is a foreign national, and can amount to several hundred thousand pounds a year. Some companies provide a chauffeur as well as a car for their chief executives.

In addition, there are often extra benefits; for example, Sam Laidlaw's £700 gas bill was paid by the company Centrica.

A driver and a car are included in the total benefit of the Marks & Spencer chief executive. However, the staff discount for goods he purchases from M&S is not counted as a benefit because it applies to all employees.

Bob Diamond at Barclays received benefits worth £474,000 in 2010/11. He is also having his tax bill paid by Barclays to avoid him paying double tax on the sale of some shares, after returning to the UK from the US. This is worth £5.75m.

### **Co-investment plans**

Some companies require executives to buy shares with their own money and then they grant matching shares. There is usually an obligation on executives to hold these shares for a certain period of time. The matching shares should be included in the value of the



package when the holding period is over. However, shares bought by executives should not be included as they have spent their own money on them rather than having them awarded by the company.

Some companies require executives to build up a certain shareholding in the firm and retain this over a period of time. BP demands that executives hold five times their salary in shares and maintain this holding while they are in the job.

### Share options

Again these are often awarded to the executives as part of pay received. To calculate the value of the total package the share value should be included in the package at the end of the option period, when the shares are received and they can be sold.

There are ways of valuing options and share awards before sale using mathematical valuation models such as Black Scholes.

### Valuation models

These are equations used to calculate the expected value of a share based award. The most commonly used is the Black Scholes model, and variations of it that include derivative payments. These models can only predict an estimated value and are based on a number of assumptions, chief among them that the market is efficient and that the price of the underlying stock increases or decreases smoothly. Although these models can be useful in predicting the potential value of a share based award, this can only ever be an estimate and can therefore paint a misleading picture about the actual value of the award.

### Currencies

Multinational companies such as BHP Billiton sometimes make payments in other currencies. It is important to check the currency referred to as the payments are often in dollars, pounds plus another local currency where the company has significant operations. The currency is specified at the beginning of the relevant table or in the footnotes. To calculate the total figure you should use the exchange rates for these currencies at the time of the report's publication to convert it into sterling.

## Do incentives really incentivise?

*Poorly-designed compensation policies can create perverse incentives... Management compensation policies should be aligned to the long-term prudential interests of the institution.*

Ben Bernanke, speech to the Independent Community Bankers of America, 2009

The pay of executives is now in the spotlight and there is an awareness that it is not just how much but how they are being paid that matters. It is popularly argued that a degree of complication in the awarding of pay packages is essential to incentivise executives. But when does an incentive become a disincentive?

Pay at the top, no matter how high, is often justified by linking it to company performance, which includes the executive's personal goals, company profits or more specifically long-term corporate performance. However, there is a growing scepticism among shareholders and corporate governance experts about the efficacy of the current model of linking executive pay to performance and the ongoing debate about rewards for failure.<sup>7</sup>

Most incentive plans are based on TSR as a measure of performance or EPS, or a combination of both. According to the corporate governance experts at PIRC, in 2010 33.5% of schemes used total shareholder return as a performance measure, 27.6% used earnings per share and a further 15.7% used a combination of both, but it is extremely difficult to demonstrate an individual's contribution to any of these measures.<sup>8</sup>

While businesses have embraced the link between pay and performance, there is limited academic agreement on the success or otherwise of these attempts.<sup>9</sup> Indeed Cliff Weight, a director at MM&K experts in corporate governance, argued: 'Many performance-related pay schemes appear designed to satisfy the chief executive and, in fact, offer little incentive for anything above just adequate performance.'<sup>10</sup>

This begs the question: can companies really design targets that accurately capture executive input? The executive at the top of the company is important – providing leadership and strategic direction – but measuring that person's value and input is an almost impossible task. This also forces us to ask whether performance-related pay is actually effective in motivating executives.

There is evidence that excessive compensation of directors and CEOs is associated with a firm's underperformance. In a study in the US in 2005, Brick, Palmon and Wald demonstrated that high director and CEO pay is positively correlated with poor governance, which is in turn related to poorer company performance.<sup>11</sup>

It is also demonstrated that highly paid CEOs are more skilled than their industry counterparts when they are in a small firm, especially where there is a large shareholder. In contrast, a study in the US showed that highly paid CEOs who operate in large firms perform worse than their more poorly paid peers – as a result of their leadership poor performance

<sup>7</sup> Directorbank Life in the Boardroom, 2012

<sup>8</sup> High Pay Commission, More for Less, 2011

<sup>9</sup> P. Gregg, S Jewell and I Tonks, Executive Pay and Performance in the UK, 2005.

<sup>10</sup> N. Fletcher, 'Executive pay rises while shareholder earnings fall, says MM&K survey', Guardian, 5 July 2010, [www.guardian.co.uk/business/2010/jul/05/executive-pay-rises-shares-fall](http://www.guardian.co.uk/business/2010/jul/05/executive-pay-rises-shares-fall).

<sup>11</sup> I.E. Brick, O. Palmon and J.K. Wald, 'CEO compensation, director compensation, and firm performance: evidence of cronyism?', Journal of Corporate Finance, 2006.

of their company is likely to continue and any good company performance may be reversed.<sup>12</sup>

The rise in equity-based performance-related compensation has also been accompanied by unforeseen side effects. It has recently been suggested in the US that manipulation of reported earnings is more pronounced at firms where CEO remuneration is more closely linked to the value of stock option holdings.<sup>13</sup> A study in the US demonstrates that earnings restatements are more common in firms where CEOs have a larger option portfolio.<sup>14</sup> Further questions are being raised about whether proliferation of share option schemes has contributed to aggressive accounting practices within firms.<sup>15</sup>

Academics are increasingly contesting the added value of share-based compensation as a whole.<sup>16</sup> It is argued that increasingly complex pay arrangements are not an efficient method of incentivising executives to behave in the interests of shareholders.

The growth in performance-related pay as a percentage of income raises the specific issue of 'gaming' the system. It may be that in the interests of maximising their personal rewards executives encourage the board and shareholders, who suffer from an information asymmetry, to set and accept less demanding performance targets in order to increase their pay. It is argued that it is for this reason that individual performance-related pay on the whole rarely delivers the performance boost it is designed to.<sup>17</sup>

Since the financial crisis, there has been significant debate about the issue of 'short-termism' in the corporate sector. It has been suggested that as a result of the rise in short-term shareholding it is optimal for shareholders to offer remuneration contracts under which CEOs can make early gains from a speculative stock price rise, even though at a later date the value may collapse.<sup>18</sup> Thus failure to maximise long-run firm value is not necessarily a symptom of weak corporate governance, but a reflection of a more short-term speculative interest among shareholders.<sup>19</sup>

A recent survey of financial executives also revealed that the majority of managers would avoid initiating a positive net present value (NPV) project – one that offers long-term value for money – if it meant falling short of the current quarter's consensus earnings; three-quarters (78%) of executives would give up long-term economic value for smooth earnings numbers.<sup>20</sup>

This certainly raises concerns over the creation of value-destroying perverse incentives.

<sup>12</sup> R. Daines, V.B. Nair and L.A. Kornhauser, *The Good, the Bad and the Lucky*, 2005, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=622223](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=622223).

<sup>13</sup> D. Bergstresser and T. Philippon, 'CEO incentives and earnings management', 2003, <http://pages.stern.nyu.edu/~tphilipp/papers/dbtp.pdf>.

<sup>14</sup> Bergstresser and Philippon, 'CEO incentives and earnings management'.

<sup>15</sup> S. Bell, 'Directors remuneration' in V. Younghusband (ed.) *Corporate Governance: the practical guide for directors*, 2003.

<sup>16</sup> B.S. Frey and M. Osterloh, *Yes, Managers Should Be Paid Like Bureaucrats*, CESifo, 2005, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=555697](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=555697).

<sup>17</sup> W. Hutton and P. Schneider, *The Failure of Market Failure: towards a 21st century Keynesianism*, NESTA, 2008.

<sup>18</sup> P. Bolton, J. Scheinkman and W. Xiong, 'Executive compensation and short-termist behaviour in speculative markets', *Review of Economic Studies*, 73 (3), 2006.

<sup>19</sup> Bolton, Scheinkman and Xiong, 'Executive compensation and short-termist behaviour in speculative markets'.

<sup>20</sup> J.R. Graham, R.H. Campbell and S. Rajgopal, 'The economic implications of corporate financial reporting', *Journal of Accounting and Economics*, 40 (1–3), 2005.

## Conclusion

Is it right that it continues to be extremely challenging to calculate what an executive is paid in any one year? Does it matter that executive pay is more closely aligned to the pay structure of the sales role than the pay of the average worker?

Levels of pay matter, and how we pay people matters too. While the corporate world has embraced wholeheartedly the idea that you can incentivise those at the top to act in the interests of shareholders, at best we can argue that evidence is unclear. At worst it is fair to say that the case against large variable awards is increasingly compelling.

Providing a single figure for the pay awarded in any one year is an essential step forward for businesses. However, even with this reform awards that are too complex may fail to incentivise executives who struggle to understand when or why an award will pay out. They create what may be unnecessary work for shareholders and investors, who must assess the levels of award and determine if they are justifiable. Finally they encourage obfuscation, which in turn damages

