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High Pay Centre discussion paper: Are bonus payments and Long Term Incentive Plans fair and proportionate rewards and incentives for business leaders?

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Background

So-called annual bonus payments and long-term incentive plans (LTIPs) form the largest component of listed companies' executive pay packages in the UK.

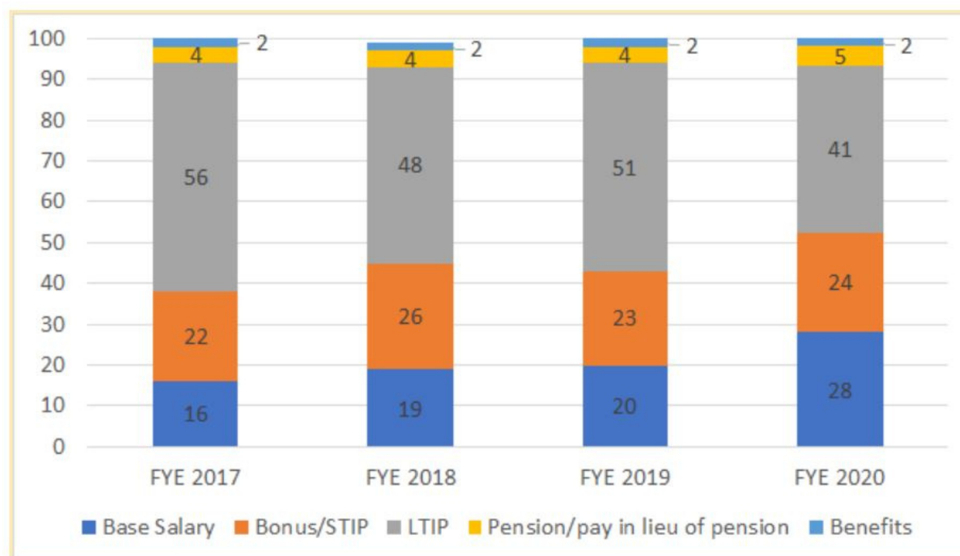
Bonuses take the form of payments related to performance over the previous year, tied to a range of metrics and paid in cash, shares or a mixture of the two. LTIPs are contingent on performance over a period of years, usually three, and are typically paid in shares.

The structure of these payments varies across companies and sectors but in general, bonuses are linked to a wider range of financial, operational and environmental, social and governance (ESG) measures, while LTIPs are predominantly linked to financial measures relating to the companies' earnings and returns to shareholders, such as 'earnings per share' (EPS) or 'total shareholder return'. Both bonuses and LTIPs 'pay out' once performance against these measures surpasses a threshold set by the pay policy, with the value of the pay-out rising up to a stated maximum.

The pay policy setting out the potential payments and performance conditions for the coming years, and the pay awards made based on performance in previous years, are detailed in annual reports and subject to shareholder votes, though while the vote on the pay policy is binding (and thus the policy must be amended if rejected by shareholders) the vote on pay awarded is advisory and cannot prevent payments being made.

In 2020, a year disrupted by the pandemic, 64% of FTSE 100 companies paid a bonus while 77% paid an LTIP.(1) In 2019, 89% of companies paid a bonus and 82% paid an LTIP. Bonuses have typically accounted for around a quarter of total executive pay awards, whereas LTIPs have accounted for somewhere between 40% and 60% in recent years.

Figure 1: Components of FTSE 100 CEO pay



As the biggest components of very high CEO pay awards, bonus and LTIPs have attracted significant public controversy. The UK is one of the most unequal high-income countries in the world, with higher levels of income inequality than any EU country except Bulgaria.(2)

As well as concerns about the impact of inequality on well-being and social cohesion, there is a risk that very high concentration of incomes amongst top earners has opportunity costs in terms of the pay of low and middle earners. Research estimates that the 18% of total incomes in the UK are now captured by the richest 1%.(3) A report by the Autonomy think tank in partnership with the High Pay Centre showed how a more even pay distribution across the UK could benefit lower-paid workers: if total earnings in the UK remained the same, but with all annual pay above the threshold of £200,000 redistributed to low and middle earners, this would result in an increase in pay for over 9 million workers, with a median increase of about £1,400 or 4.5% of annual pay per worker.(4)

The High Pay Centre has historically argued that the frequency of bonus and LTIP payments is suggestive of their limited value as drivers of better business performance. When payments are made more commonly than not, it is hard to believe they could be considered by recipients as rewards or incentives that would encourage greater effort as opposed to a guaranteed component of their pay package. When these payments are consistently awarded to a majority of CEOs every year, is seems unlikely that they reflect outperformance by the recipient.

Methodology

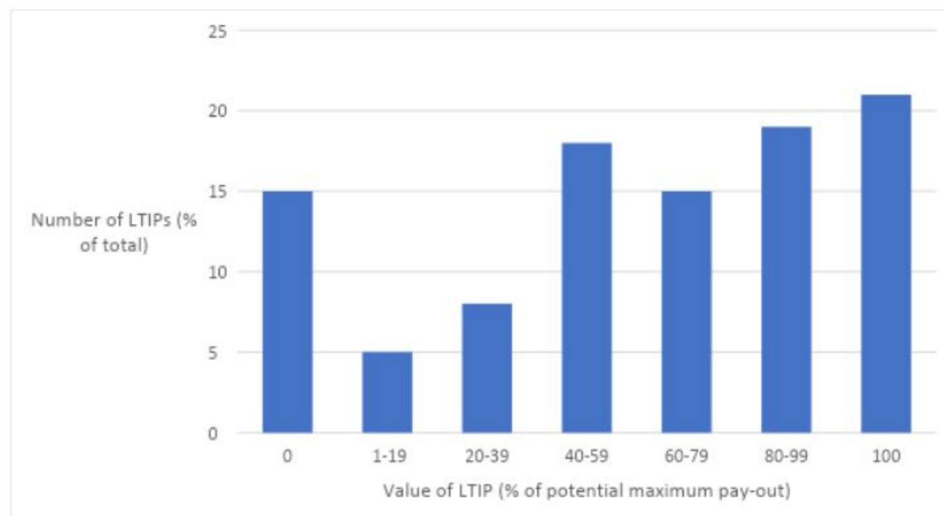
In the research for this discussion paper, we commissioned E-Reward to conduct a more detailed analysis of bonuses and LTIPs, examining payments at FTSE 100 companies (based on the index as constituted in Q1 2021) as a proportion of the maximum available under the terms of their pay policy for each year from 2009-2019, excluding 2020 because of the (hopefully one-off) effect of the Covid-19 pandemic. The analysis also discounts years in which there was a change of CEO because of the complexities in calculating and measuring the payments to each CEO in these years.

Our findings are intended to provide some insight into whether bonus plans and LTIPs are sufficiently stretching, and whether they serve as an effective incentive for exceptional leadership.

Findings

The distribution of the value of LTIPs, as a proportion of the potential maximum pay-out in accordance with the company's pay policy (as documented in their annual report) is detailed in figure 2, based on analysis of 746 FTSE 100 LTIPs from 2009-2019.

Figure 2: Value of FTSE 100 CEO LTIPs (2009-2019)

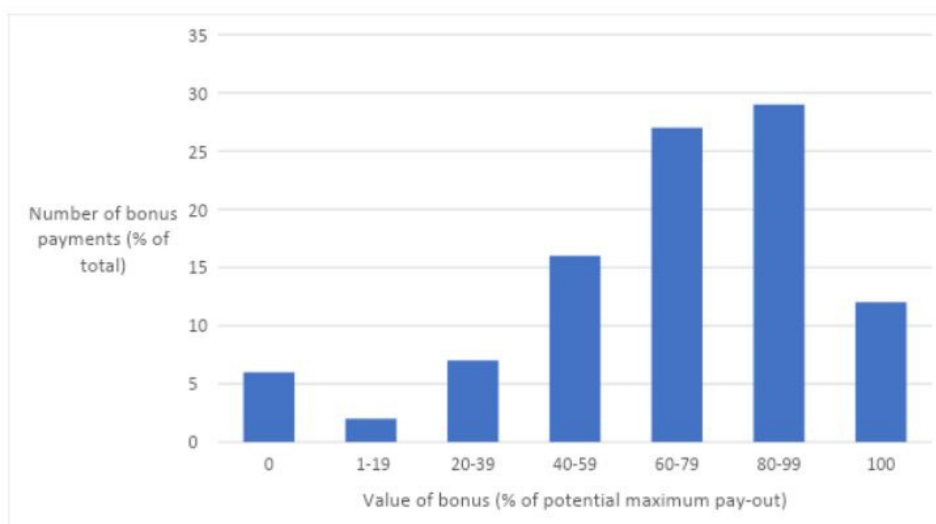


The figures show that:

- LTIPs almost always pay out – a payment was made in 85% of cases.
- Generally, they pay out a significant proportion of their potential value - half of LTIPs paid out at least two thirds of the potential maximum.
- Very high pay-outs are common. More than one in five LTIPs (21%) paid out their maximum potential value. Including those that paid out at least 90%, this figure rises to roughly one in three (32%).
- 36% of pay-outs are either at 0% or 100%, suggesting that in more than a third of cases performance was outside the range set, and presumably seen as realistic, by the remuneration committee - either below their minimum target or in excess of the maximum.

Figure 3 details the distribution of annual bonus payments over the same period on the same basis, based on analysis of 849 bonus plans.

Figure 3: Value of FTSE 100 CEO bonuses (2009-2019)



The figures show that:

- Bonuses are even more likely to pay out than LTIPs, with 94% of bonus plans paying out at least some proportion of the potential maximum over the period.
- They generally pay out a significant proportion of their value – half of bonus plans paid out at least three quarters of the potential maximum.
- Though the median bonus payment was higher, as a proportion of the potential maximum value, than the median LTIP payment (75% versus 66%), fewer bonuses paid out at 100% of their value (12% as opposed to 21%).
- Similarly, the number of bonus plans not paying out at all was lower at 6%, meaning that a smaller proportion fell outside the performance range set in the pay policy – i.e. 18% of bonus plans paid either 0% or 100% of their maximum value, compared to 36% of LTIPs.

Analysis

The findings raise some interesting insights about the value or effectiveness of bonus and LTIP payments, as well as their fairness and proportionality.

From a governance perspective, it is striking that both bonus plans and LTIPs almost always pay out, and very commonly pay out a high proportion of their potential maximum value. The number of LTIPs paying out at over 90 per cent of their potential value implies that in roughly a third of cases, CEOs are delivering close to the best possible performance for the company over the long term, with the absolute best possible performance being achieved in the 21 per cent of cases where 100 per cent of the LTIP paid out.

It would be fascinating to see whether these figures correlate with the perceptions of company investors, workers and even the executives themselves. From the High Pay Centre's perspective, given human fallibility and the potential for multiple different factors such as internal decision-making or contextual market developments to result in different

business outcomes, the number of companies confidently making these pay-outs on the assumption of optimum performance is surprisingly high.

It seems more likely that incentive payments are attached to insufficiently stretching targets and that more demanding requirements would lead to fewer and lower pay-outs, with only truly exceptional performance rewarded (and therefore more strongly incentivised). Given the controversies around high pay, it is entirely possible that this may be a deliberate strategy to deal with the conflicting pressures of public/stakeholder opinion and the pay demands of serving and prospective executives.

Bonuses and LTIPs create an ostensible link between pay and performance that can be used to defend the levels of pay that boards feel they need to pay in order to attract or retain the right candidate. However, undemanding targets ensure that those pay levels are effectively guaranteed. Notably, recent academic research has found that the directors responsible for setting executive pay perceive that the most important function of pay policies is to attract a strong candidate for the CEO's role, while shareholders feel that it should be to motivate the CEO.(4) Performance-related pay packages serve as motivation (thereby satisfying shareholder objectives), if taken at face value, but if they almost always pay out and effectively guarantee a pay award of a certain value, they might be more enticing to potential candidates (thereby helping boards to meet their objectives of a stronger candidate pool).

Whether or not this slightly conspiratorial view is justified, it is certainly harder to argue that bonus and LTIPs act as rewards and incentives, thereby delivering better outcomes for the companies' stakeholders, when they are a de facto component of guaranteed remuneration, reliably paying out on an annual basis.

Furthermore, the fact that 36% of LTIPs fall outside the anticipated performance range – either below the 'threshold' at which the plan begins to pay out or above the 'maximum' at which it pays 100% of its potential value - might again be considered to undermine their supposed function as incentives or rewards.

LTIP performance thresholds are not necessarily projections or forecasts, but logically the 'target' (usually 50% of the maximum) represents a realistic expectation of performance against a given metric that the remuneration committee believe the CEO (employed by the board on the basis that they can deliver a certain level of performance) should achieve. The 'maximum' ought to reflect the best performance (against the same metric) that the remuneration committee think possible. Therefore, the 'threshold' and 'maximum' can legitimately be interpreted as parameters of the remuneration committee's broad expectations of company performance.

The number of LTIPs paying 0% or 100% of their potential value suggests that, over the longer three-to-five year periods that LTIPs typically apply, remuneration committees struggle to make accurate estimates of company performance (keep in mind that in these 36% of cases, performance is not merely at odds with a precise target set by the remuneration committee, but falling outside the range between minimum expectation and maximum possibility).

Difficulties estimating company performance also highlight the challenges associated with influencing it. Targets ought to be set on the basis of the board and CEO’s strategic planning, with minimum and maximum pay-out levels reflecting the different potential levels of success executing plans and accounting for the risk and opportunity factors that might arise over the period of the LTIP. When CEOs deliver performance outside these parameters despite careful planning, it implies that (good or bad) luck has played a significant role.

The much lower proportion of bonus plans paying out at 0% or 100% supports this theory. Bonuses reflect performance over one year, a period over which it is much easier to identify external risks and opportunities. The immediate consequences of decisions can be easier to quantify than their long-term effects. They are also more commonly linked to operational measures such as business acquisitions or disposals, health and safety metrics or carbon emissions, over which the CEO is directly and wholly influential.

Financial metrics such as earnings per share or total shareholder returns form a much bigger element of LTIPs. These metrics are dependent not only on the CEO's decisions, but also how the market responds, as well as other factors over which the CEO has no control such as the global economic context or the fortunes of rival companies. Therefore, pay awards linked to these metrics have limited value as incentives or rewards.

Conclusions

The susceptibility of LTIP targets to being overtaken by events has implications for the structure of executive pay awards. It raises the question of whether LTIPs are a robust mechanism for incentivising and rewarding good leadership, or something of a lottery, hugely dependent on the external context in which the company operates.

Our findings also have potential ramifications for the value of pay awards. Firstly, the very high proportion of bonuses and LTIPs paying out suggests that if these mechanisms are maintained, targets should be more demanding, with fewer and lower pay-outs, resulting in lower average pay.

Secondly, the frequency with which performance outcomes deviate from the range of possibilities set out in LTIPs highlights the limitations of boards' and CEOs' abilities to forecast and determine business performance. This challenges the notion of the superstar CEO and the imperative to pay vast sums of money to attract or retain executives, creating huge divides within the workforce. It is something that remuneration committees should consider when contemplating the pay demands of their executives, and the pay gaps between high, middle and low earners throughout their organisation.

Endnotes

(1) High Pay Centre (2021) What happened to CEO pay in 2020? via https://highpaycentre.org/wp-content/uploads/2021/08/CEO-pay-report-2021-web-copy.pdf

(2) Resolution Foundation (2021) The UK's decisive decade: The launch report for The Economy 2030 Inquiry, via https://economy2030.resolutionfoundation.org/wp-content/uploads/2021/04/The-UKs-decisive-decade.pdf (2021)

(3) Resolution Foundation (2020) Who gains? The importance of accounting for capital gains, via https://www.resolutionfoundation.org/app/uploads/2020/05/Who-gains.pdf (2020)

(4) Autonomy and High Pay Centre (2020) Paying for Covid: capping excessive salaries to save industries, via https://highpaycentre.org/paying-for-covid-capping-excessive-salaries-to-save-industries/ (2020)

(5) Edmans, Alex; Gosling, Tom and Jenter, Dirk (2021) CEO Compensation: Evidence From the Field European Corporate Governance Institute – Finance Working Paper No. 771/2021, via https://ssrn.com/abstract=3877391 or http://dx.doi.org/10.2139/ssrn.3877391

The High Pay Centre is an independent, non-partisan think tank focused on the causes and consequences of economic inequality, with a particular interest in top pay. It runs a programme of research, events and policy analysis involving business, trade unions, investors and civil society focused on achieving an approach to pay practices that enjoys the confidence of all stakeholders.

Website: highpaycentre.org
Contact: info@highpaycentre.org
Twitter: @highpaycentre