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Freedom with responsibility

Approaching the simplification of executive pay

February 2016

Input for the Investor Association Simplification Working Party

This input has been inspired by a series of discussions with Remuneration Committee chairs on the simplification agenda. We believe the views contained herein are close to the centre of gravity of sentiment in that community. But the views are our own and do not represent an agreed collective input.

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What's the problem?

30 years ago executive pay was relatively simple. A typical package would have been made up in broadly equal parts of a salary, pension (a generous final salary plan in those days), and incentives. The incentives would have been a cash bonus, probably just based on a profit target, and an award of share options. With two thirds of the package being fixed, executives could take the rough with the smooth on pay-outs, and the plans were simple.

Fast forward to today. Quantum has risen, and over three quarters of the package in large companies is incentive pay. An agency model view of the world has dominated governance thinking, leading to the concept that executives can only be aligned with shareholders through highly incentivized contracts. The market has largely converged on a single model. The vast majority of FTSE350 companies operate a salary, bonus and performance share framework regardless of the relevance of this construct to their strategy and business model.

With the growth of incentive pay has come complexity. With the stakes raised, shareholders are no longer prepared to accept simplistic single-measure incentives. Indeed, with much higher incentives there could be significant potential unintended behavioural consequences of an excessive focus on one or two measures. Multiple measures and balanced scorecards are now common features of bonus plans and long-term incentives.

Coupled with a period of rising executive pay and the financial crisis, pressure from shareholders and elsewhere has resulted in a plethora of bolt-ons, bells and whistles being attached to this model – deferral, holding periods, malus and clawback, underpins, and so on.

The result is that there are now few people who wouldn't agree that executive pay is just too complicated.

But companies feel boxed in. Fixing the problem would require that a number of remuneration committees take a different approach. The main areas in which committees may want to go outside the norm include:

- *Changing the balance between fixed and variable pay to make packages less excessively leveraged;*
- *Focusing incentives on bonus or an annual assessment of performance (which is more motivating than long-term incentives in many cases);*
- *Or even doing away with the long-term incentive altogether, replacing it with restricted stock.*

However, the rigidity of investor and proxy agency guidelines is rendering the use of these structures impossible in most instances. The result is that a significant proportion of companies have simply converged on the common model which is widely felt to be less than ideal.

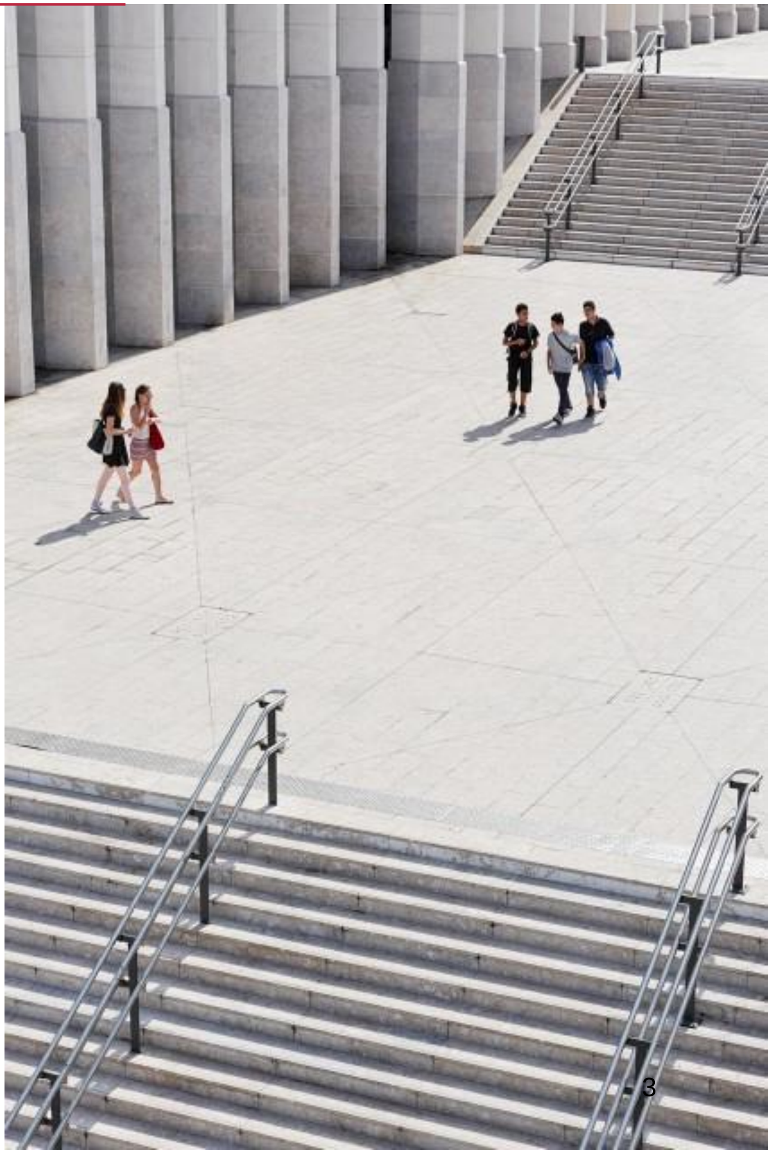
The call for simplicity

In response to the growing feeling that committees are being stifled, the Investor Association has established a Simplification Working Group, with a remit to look at ways in which the executive pay model can be simplified.

Some investors have been leading the process. M&G CEO Michael McKlintock has been reported as advocating doing away with long-term incentives altogether, and replacing them with an award of restricted stock, subject to long holding periods. Old Mutual Global Investors went a step further, and issued a detailed positioning piece advocating a restricted stock model, with deferral periods of up to seven years and shorter contract periods. Other investors have privately advocated a similar approach.

But building consensus won't be easy. Some investors think that executive pay is broadly on the right track and that the combination of salary, bonus, and long-term incentives work well. Their primary gripe has been multiple long-term incentive plans, but the vast majority of companies now operate just one. Indeed some investors (and notably the proxy voting agency ISS) have resisted the notion that long-term shareholding can replace multi-year performance conditions. Companies seeking to adopt a "performance-on-grant" model, similar to a restricted stock model but with performance conditions determining the level of grant, have come under pressure to change to a more conventional model or to introduce underpins to the grant (adding yet more complexity).

Also, there's an irony that elements of UK opinion are moving away from the model pioneered here just as its ascendancy seems assured in the rest of the world. US and European practice is increasingly reflecting that adopted in the UK, albeit with some variations. Global companies headquartered in the UK are unlikely to be receptive to adopting a uniquely UK approach that flies in the face of market practice elsewhere.



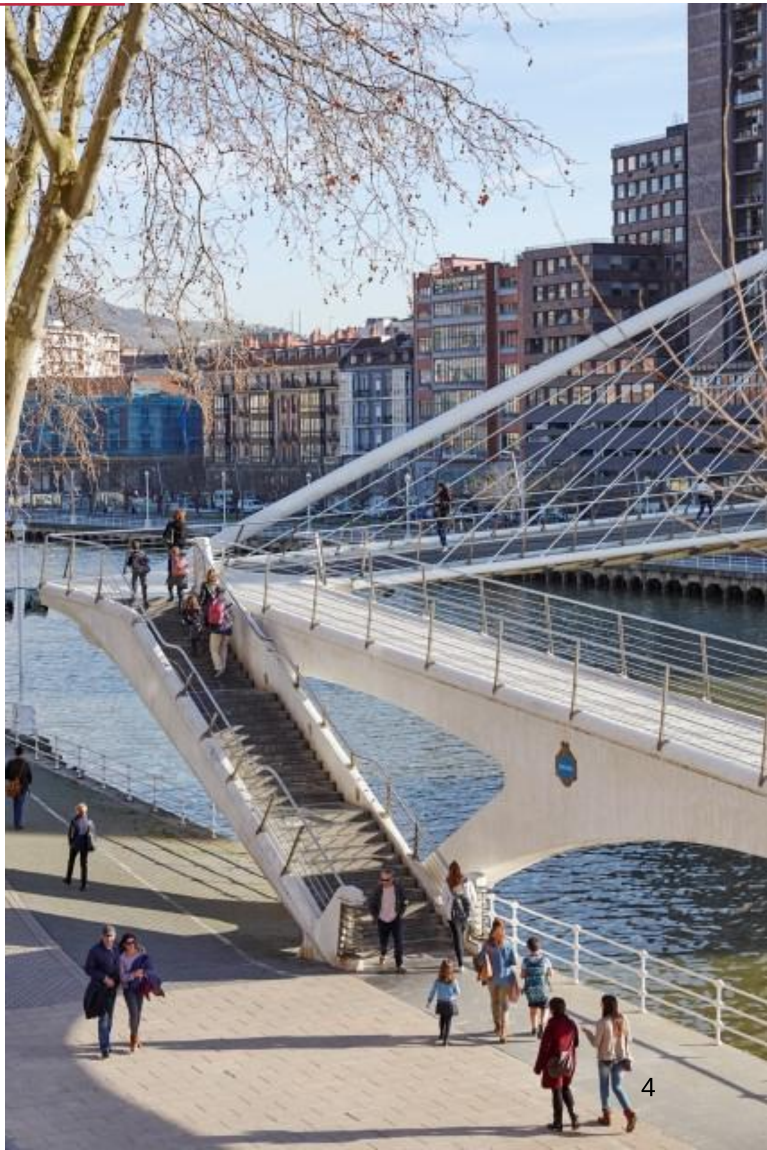
Responsibility not prescription

We've been arguing for simpler executive pay since 2007, when our research first showed that long-term shareholding could create better alignment with long-term shareholder returns than conventional incentive plans. We also provided evidence for the discount that many executives apply to complex deferred pay schemes in our Psychology of Incentives research conducted with the London School of Economics and Political Science.

However, we're cautious about the idea of jumping to an alternative prescribed model (or set of such models). Certainly a restricted stock based arrangement may be the best approach in some circumstances – it may even be a better norm than the status quo. But we wouldn't support one size fitting all. Remuneration models must be driven by a range of factors including strategy, maturity and the challenges faced by the business. For example, although most executives are risk averse and discount incentives heavily, our research also finds that over a quarter are risk-seeking and may be highly motivated by leveraged incentives. Private equity type schemes can work well in turnaround situations. Bonus-driven models can harness the power of short-term incentives to drive performance, if balanced by long-term shareholdings. For some companies operating in a global environment, a conventional model of base, bonus, and performance shares may be the best way of balancing internal consistency and external competitiveness.

There must be benefits in enabling companies to develop pay plans that are best aligned to their circumstances, culture and strategy – "situational reward" if you like.

As important as simplicity is relevance. Simple approaches can become simplistic if they are not directly aligned to a company's strategic circumstances. By contrast, plans that are directly linked to the direction and strategy of a company may be less complex than they seem. The market should be allowed to operate freely and allow all these approaches to be possible. Yet companies feel ever more tied in by seemingly increasingly prescriptive shareholder guidelines and voting policies.



What does freedom mean?

An ideal outcome from the Simplification Working Group would be greater freedom for companies to design reward programmes that fit their situation.

In practice the key freedoms some companies seek that are not currently available are to, in certain situations:

1. Use annual bonuses with deferral in place of long-term incentives
2. Use restricted stock with long holding periods, again in place of long-term incentives
3. Reduce leverage to provide a package with higher fixed pay but lower quantum

The largest obstacle is a lack of confidence and trust in what companies would do with any new-found freedoms. The public believes that executive pay is too high, too easy to get, and that it's not clear what it's earned for. This public mood is reflected in shareholder attitudes, and in the fear that greater freedoms would be abused.

The challenge then is to provide reassurance to investors that executives are being rewarded for good performance – and not for failure. Rather than providing an alternative template design, it should be possible to establish underlying guidance that, if adhered to, would give respected companies greater room for manoeuvre. Freedom yes. But freedom responsibly applied.

In the remainder of this paper we present some trade-offs that balance the concerns of the investor with the need for freedom. They indicate appropriate compromises for the flexibilities that committees may require to truly align pay with strategy. Compromises which, if applied, should reassure investors that the committee has acted responsibly with their new–found freedom.

Different situations, different reward

- In a long-term business with a **clear vision for the future but an unclear path to that goal,** an annual share grant model (without performance measures but with long holding periods) could fit. Shares will grow in value as the company moves towards its ambition, but the unintended consequences of short-term performance measures are avoided.
- In a business with **an unclear future outlook, or with a requirement to bring about rapid change**, reward focussed on the short term is more incentivising and motivational. In this scenario a performance-on-grant model might well be the best fit – long-term share awards based only on the performance of the company in the year before grant.
- In a business undergoing **a time-bound transformation**, a one-off long-term incentive plan could work.

Or combinations of the above. But what concessions would make the use of these, oft frowned upon, remuneration vehicles acceptable to the shareholder?

1. Investing in flexibility

A core element of executive–shareholder alignment is the acquisition of a significant personal investment in the company's shares. Shareholders will be more inclined to support a relevant and strategically aligned structure veering outside the traditional norm if executives are able to demonstrate a powerful alignment with investors.

But just how big should this holding be?

A finger in the air assumption might be that a material shareholding is one for which a typical annual change in the share price has an impact on executive wealth equivalent to what can be earned through the annual bonus. Taking a realistic but significant share price movement of 20% to 25% and a net of tax bonus opportunity of around 100% of pre-tax salary, a back of the envelope calculation therefore suggests a shareholding level of 400% to 500% of salary – roughly double the median requirement today.

But this isn't as onerous a demand as you might think. The median actual shareholding of a FTSE100 CEO is now 472% of salary – with the upper quartile a much larger 972%.

Codifying this existing unwritten custom would support a case for freedom from companies. Within reason, a higher requirement means greater alignment and therefore stronger reassurance.

Executives should also hold part of their shareholding beyond retirement. If a company collapses in the years immediately after a CEO leaves, should they not be exposed to this in some way? The UK corporate governance code has said that remuneration committees should consider this feature. Companies seeking greater freedom should adopt it.

For companies seeking greater freedom, executive directors should have a substantial shareholding guideline well above current norms, with a structured retention programme to operate until this requirement is met.

The shareholding requirement should apply, for example, in full for the first year after leaving the business and at half of the full level for a further year after that.

2. Trading certainty for opportunity – and time

The quantum balance

Performance-on-grant or stock grant models raise a question of quantum. As we reduce the variability in the package so certainty increases. And the shareholder's instinctive redress for increased certainty is reduced quantum.

But how much should quantum fall?

There's a natural discount for absence of performance conditions. Average bonus and performance share plan pay-outs are around 70% of the maximum. Therefore a discount of around 30% for removing performance conditions is reasonable.

But what about a further discount for certainty? Evidence from practice in introducing more certain plans suggests a further discount of around 30% should apply giving a total discount of around 50% for restricted stock.

The time balance

Increased certainty should also be counterbalanced by longer deferral and holding periods. Investment theory supports the notion that an executive would reasonably apply a 5% p.a. discount to the market return to compensate for enforced exposure to a single company's stock. If malus also applies over the lengthened period, this discount will be higher.

A common theme is that the timeframes for reward, whether through performance measures or deferral, should be long enough to ensure that reward is truly aligned with long-term success. But what is long-term? Fidelity have suggested 5 years; the NAPF-Hermes Principles suggested 10 years or to retirement; financial regulators in the UK have settled on 7 years, as have Old Mutual Global Investors.

Companies should discount awards to reflect the increased certainty of performance-on-grant or restricted stock models, or similar. The discount should reflect the expected vesting due to performance conditions but also a further discount for certainty.

Longer deferral and holding periods should be considered, including over 5 years or more in combination, where companies seek to replace long-term incentives with performance-on-grant or restricted stock plans. Deferral and holding periods may be taken into account when considering the discount to quantum that is appropriate, and so may offset to a degree the discounts for performance conditions and certainty.

Companies should be able to demonstrate clearly how they have traded risk for certainty and time.

Indicative guidance suggests a discount of 30% for the certainty of moving from long-term performance conditions to annual assessment of performance and a further discount of 30% for removing performance conditions altogether, with every year's increase in deferral or holding period reducing the discount required by 10% and 5% respectively.

3. Addressing payment for failure

Shareholders are unlikely to ever be accepting of the freedoms we are debating if committees cannot provide an underlying assurance that payments won't be made for failure. Of course this creates substantial challenges. Defining failure is tough, and attributing blame even more so.

A common criticism of restricted stock or performance-on-grant type arrangements is that the shares are earned whatever the subsequent performance, and that the absence of long-term performance measures increases the possibility that an executive will be overpaid in an unjustifiable way. The prospect of a failed executive leaving without penalty will not pass muster with a sceptical public.

Remuneration must go beyond just giving comfort to shareholders but also reflect the need to restore public trust in executive pay. The awarding of large pay-outs when an executive has done a poor job is bad for shareholders, bad for the organisation, and bad for public trust in business.

One route to tackling this is an escrow account of shares that is held until departure, or just after. The pool would be forfeited unless the remuneration committee can demonstrate that the CEO's tenure was a success – using a holistic assessment of the performance of the business.

This wouldn't just apply to performance on grant type plans. There's probably a case to apply this across the board to provide all investors – and the public at large – with some comfort that executives will be held to account even when they have moved on to new pastures.

How much could be held in this way? An executive with a traditional deferred bonus and LTIP plan operating over 3 years would typically have 3 unvested cycles when they leave the business. That means around 2x variable pay (pre tax) would be available for the exercise of Remuneration Committee discretion – a reasonable starting point.

Companies should show how much is available for exercise of discretion and how that would be applied.

Whatever share reward system is used, Remuneration Committees must clearly articulate how they will deal with payment for failure. Restricted stock and bonus deferral arrangements provide natural alignment through share price. But they should also provide the ability for the Remuneration Committee to reduce the number of shares earned by a substantial proportion through exercise of discretion or underpinning conditions. The remuneration report should clearly set out the quantum of award available for exercise of Remuneration Committee discretion in case of poor performance and how that discretion would be exercised.

4. Transparency rules

A commitment to comprehensive disclosure will go a long way towards allaying shareholder reluctance around non-standard plans. But transparency is not just about providing reassurance – our recent research report ('Sunlight is the Best Disinfectant') showed that full retrospective bonus disclosure is strengthening the link between pay and performance.

The reality is that we're inevitably heading down a road of increased transparency – which is no bad thing. But this means that shareholders are unlikely to be comfortable with anything less than complete retrospective disclosure of performance targets and the associated adjustments and decisions that have been made by committees. Pay-outs and vesting outcomes should be easily derivable from the financial statements – ideally using no more than a calculator.

But disclosure goes beyond targets and pay-outs. If companies want the freedom to design reward that fits their situation, then the onus is on them to describe how this is the case.

The link between reward and strategy is an area where investors have for some time complained that companies aren't doing enough. For companies wanting the freedom to do something different, boiler-plate statements about alignment are not enough. There needs to be a clear story linking strategy and situation to the proposed reward design.

As well as describing the theory it will be important to described the practice, and to answer clearly the four fundamental questions that the regulations ask Remuneration Committees to address.

Four key questions

- How does the way you pay executives align with the strategy and situation of your company?
- How can you justify what you have paid by reference to the performance achieved?
- How do you think about fairness in terms of the relationship between executive pay and the wider workforce?
- How do you consider the balance of interests between different stakeholder groups in managing the design and total quantum of pay?

The remuneration report should clearly set out how pay is aligned to strategy and whey the proposed approach is superior to a conventional model. Remuneration Committees should clearly disclose definitions of all incentive metrics and explain how they align with the strategy and situation of the business. There should be the fullest possible disclosure of bonuses – metrics and weighitngs disclosed at the start of the year and full retrospective disclosure of targets and outcomes. Remuneration Committees should show full transparency in relation to any adjustments made.

Building momentum

Remuneration Committees want greater freedom in how they design pay. Shareholders should grant it to them, but it's unrealistic that there should be no strings attached.

In this paper we've set out some tangible guidance for companies wishing to break from the norm while retaining shareholder trust. It need not be absolutely necessary to follow these as prescriptions, but a company following the spirit of these trade-offs should in our view be given the benefit of the doubt by investors to try something different that they feel better fits their business.

We believe that a principles based approach (as opposed to a prescribed model) - but one with clear practical guidance, is the best way to enable change to happen while giving shareholders confidence that they won't be letting any genies out of the bottle. Investors should give this a chance, and we hope that a critical mass well.

Let's hope that remuneration committees and shareholders alike are able to come together to make progress on the simplification agenda. If a small number of influential shareholders and respected businesses embrace these themes then we won't be left with companies shuffling around the edge of the dancefloor waiting for someone else to take the first step.

In previous years the opportunity to make this change has been missed, and if action isn't taken then the possibility remains that it will be missed again and we'll repeat the same debates in years to come.

Just don't say we didn't warn you.