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Agenda

Advancing economics in business

What's wrong with directors' pay?

When compared with the depressed national economic situation, it is perhaps not surprising that the large bonuses paid to directors and other executives of public companies are hotly debated in the UK press. Jonathan Hutchings, Principal at remuneration advisers New Bridge Street, examines the current state of affairs regarding executive pay and incentives in the UK. He discusses some of the reasons behind the current situation, and suggests some ways to improve the pay-setting process

John Smith is the chief executive officer (CEO) of a fictional company with the characteristics of the median of the FTSE 250: 4,000 employees, an annual revenue of £760m and a market value of £1 billion. For this he receives the average pay package: a basic salary of about £500,000, an annual bonus of up to 120% of basic salary (with a payout of 60% at target performance levels), and a long-term incentives scheme award of shares worth 150% of basic salary, released after three years if long-term performance targets are met. He also gets pension contributions of 15% of salary, a luxury car, and private healthcare.

The theory behind the current executive pay model is that the most talented capitalists leading our major businesses should be incentivised and rewarded through performance-linked pay for creating growth and prosperity in the private sector—one of the cornerstones of the UK government's policy to take up the slack from a slimmed-down public sector. If John Smith performs badly, he makes £575,000, but if he performs well he can make £1,925,000, or more if the company's share price rises. To achieve this outcome, Mr Smith will have to have met stretching financial and stock market-based targets, typically involving a measure of total relative shareholder return (TSR). Employees will also have benefited, through increased job security, and through their own employee share plans.

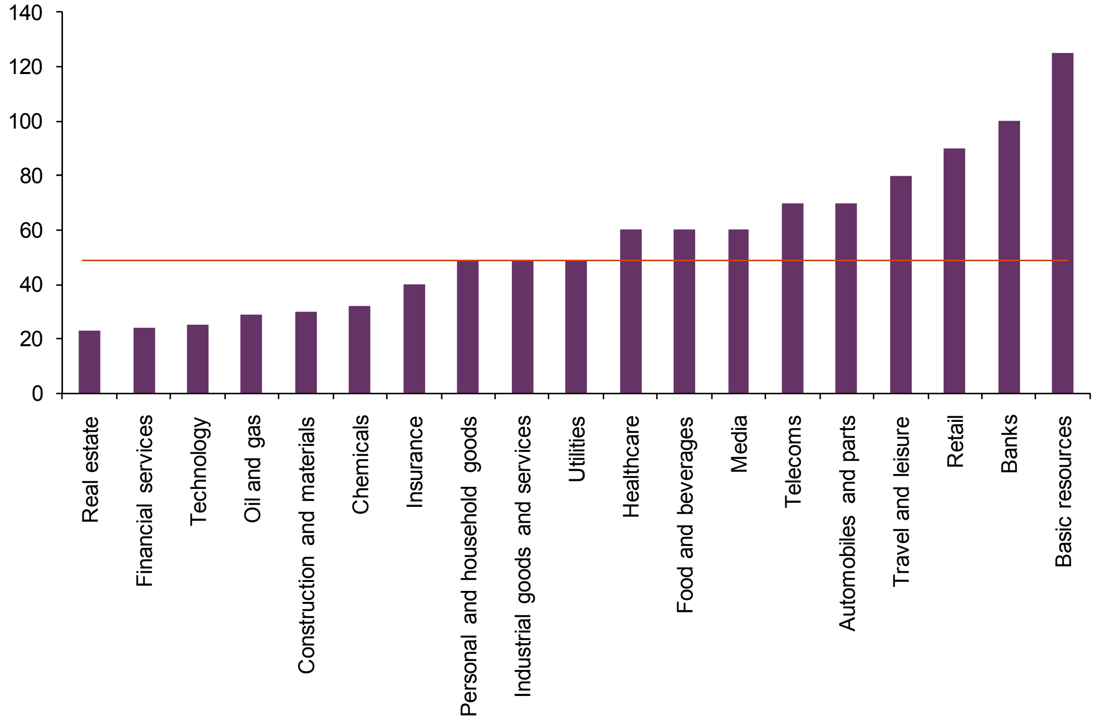
All this while Middle Britain is being fiscally squeezed, and anti-capitalist protestors camp outside St Paul's Cathedral in London. With broader European economic woes, there is a gloomy outlook for growth and prosperity. Yet, in the world of executive pay, seldom a week passes without yet another new headline or 'report'. While there is often more heat than light in much of the debate, this much is clear: it is unfathomable to all rational thinkers that directors' pay increased by an average of 49% last year, a statistic produced by Incomes Data Services (IDS) recently.[1] Even the most ardent capitalist would consider that there is something wrong with a pay model for our top executives that can be so out of touch with reality for 99% of the population.

But, before we join the anti fat-cat bandwagon, let's look at some of the facts. New Bridge Street advises a third of all FTSE 100 companies in the UK on remuneration issues, and our 2011 survey of all FTSE companies revealed some key numbers:[2]

- median basic pay of directors ranged from £1,035,000 for FTSE top 30 CEOs down to £240,000 for other executive directors in the FTSE 226 to 350 size range. Median pay levels had risen by 4% over the previous year;
- median bonus payouts for all directors stood at 85% of basic salary. Interestingly, these payouts had remained as high as 58% even in the depths of the 2009 crash;
- median remuneration, including all variable elements, ranged from £4,760,000 for CEOs at the top of the FTSE 30 down to £620,000 for other directors at the bottom end of the FTSE 350;
- there was a wide range in the multiples of chief executive remuneration to average employee pay,

The views expressed in this article are those of the author.

Figure 1 FTSE 350 companies: ratio of chief executive to average employee pay (median ratio per sector)



Source: Hewitt New Bridge Street (2011), 'The Current Executive Pay Landscape', presentation by David Tuch to the Hewitt New Bridge Street annual conference, July 5th.

from less than 20 times in the real estate sector to over 120 times average pay in the mining sector (see Figure 1 above).

Some of these numbers are very large, but in considering them we have to bear in mind that chief executives are, in the main, very good at what they do, having proved themselves at every stage of seniority as they have climbed the corporate ladder. While luck plays a part, they will have had plenty of opportunity to slip up over a 20- or 30-year executive career in front of a host of senior people, so, in most cases, their success is not due to chance. And they are responsible for the livelihoods of thousands of employees and billions of pounds of shareholders' funds.

It is a big job with a relatively poor work–life balance. The average length of time at the top is, at most, three to four years—little more than a Premiership football manager. If the results go against them, even through no fault of their own, the most talented executives will be fired with little chance of landing the top job somewhere else. There are plenty of other highly paid professions that still seem to rub along okay, with significantly less responsibility in many respects and certainly a lot less public transparency about what they are paid.

This pay model means that, year on year, take-home pay can change significantly, and in a bad year, the total remuneration shrinks by approximately two-thirds of the maximum (in the example above).

The process for determining pay

Pay is set by a remuneration committee comprising non-executive board directors at the company. They are appointed by a nominations committee and elected to the board by shareholders. They are paid a flat fee as directors and do not participate in any bonus plans. These are senior and successful individuals who can stand up to executives and have reputations that they do not wish to see tarnished by a public executive pay spat.

Transparency

By law, there is a full disclosure of every detail of executive pay in a Directors' Remuneration Report, contained in each company annual report. While there is room for improvement, the reader of the accounts can see clearly what has been paid for the previous year and the policy for the basis of what might be paid in the future.

Accountability

At each annual general meeting, there is a shareholder vote on the adoption of the Directors' Remuneration Report, and all directors of FTSE 350 companies stand for re-election each year. If the owners of the business (the shareholders) do not like what they see, they can vote against the Remuneration Report, and if they do not like the process by which pay is determined, they can vote against those non-executive directors who sit on the remuneration committee.

This all sounds fine in theory, so what is going wrong in practice? Having been involved at the sharp end of the executive pay debate for over 15 years—five years on the 'investor side', and the last 12 advising remuneration committees—I have seen the pay debate through these different lenses. Here are my thoughts on the fault lines.

Disinterested shareholders

Many of the largest institutional shareholders are also international public companies, so there is a natural conflict of interest. There have been some examples of the fund management arm of an institution voting against its own company's remuneration policy, but the instances are rare. More fundamentally, for executives at the top of those investment businesses it is not in their (personal) interests to take a robust line on restraining executive pay—what goes around comes around. This is likely to change only if underlying fund- and policyholders make it clear that they will move their money elsewhere unless their stance changes, but would they choose between placing our investment with a lower-performing fund that is hawkish on executive pay, or a better-performing fund that is more relaxed?

Even though UK and some European institutional shareholders have upped their game recently, they account for less than 30% of the shares in our typical FTSE 250 company. US investors and hedge funds account for an increasingly larger stock-market share, and their track record in voting wisely on pay issues is poor.

Accordingly, the first and most important force to determine the right outcome on executive pay is the remuneration committee, but there could be problems here too.

Ineffective non-executive directors

Despite the welcome increase in the number of women serving on boards (in a non-executive capacity at least), the profile of a typical non-executive director from the FTSE 50 down is still a British ex-businessman. In some cases, the relationship with their executive counterparts is still too cosy—shared interests and, in some cases, friendships, with many reluctant to 'rock the boat' on a pay issue at board level.

Many non-executives are used to seeing high numbers in remuneration and are sometimes unable to think laterally, having been in the system themselves too long. Generally speaking, I have often been impressed with the wider perspective brought to bear by European non-executives.

Outgunned non-executive directors sitting on the remuneration committee

Even the most diverse, engaged and robust remuneration committee members typically spend no more than 25 days a year working at that company. They may have a good working knowledge of the company's operations and finances, but when management presents financial numbers around which performance targets are set for annual bonus and long-term incentives, there is an information imbalance. Non-executives ask the challenging questions, but are they really in a position to second-guess the management's proposal? Do they know whether the numbers have been deliberately aimed low to maximise the chances of a payout a year later? Even with independent advice for non-executives, management holds all the cards.

Overbearing chief executives and HR directors

In a minority of cases, the chief executive can hold a gun to the head of the non-executives and shareholders and make unreasonable pay demands. There has emerged a star culture in many companies around the role of CEO. In a few cases, the CEO is a key profit and loss (P&L) contributor and irreplaceable, but, in my experience, the genuine star performers are often more relaxed about their own pay. Succession plans here are critical, as the pay for a CEO sets the tone for the rest of the management population.

The role of the company chairman here is critical too. If he or she is also in thrall to the chief executive, it is very difficult for a remuneration committee chairman to be robust.

Sometimes there is also an overpowerful HR director, who reports to the chief executive and does his or her bidding, filtering the information that goes to the remuneration committee and steering the committee towards choosing remuneration-friendly advisers. HR directors are conflicted, and the process of setting executive pay in many companies might work better if they could be removed from the direct process of determining the quantum and structure of executive pay, leaving it to the committee only—alternatively, the HR director could be paid a base pay only to mitigate any conflict, and report directly to the chairman of the remuneration committee.

Over-reliance on external benchmarking data

External comparative pay data needs to be used intelligently, with sensible comparators. Ten to 15 years ago, UK multinationals started using US companies in comparator data, which has led to an explosion of pay at the top of the FTSE. In practice, this idea of the transferability of UK executives to the USA has proved a myth, so these are not relevant benchmarks. Separately, there is an obsession still with 'chasing the median' of any remuneration data, which leads to an inevitable upward ratchet, as few companies will admit to an objective of paying below the median.

One of the unintended consequences of better pay disclosure has been a dramatic increase in pay levels. Remuneration committees are becoming much more circumspect in the use of comparative pay data. Instead of this, they are using internal relativities (to less senior executives) and pay and conditions in the workforce generally as the primary benchmark.

Weak bonus plan design

Annual bonuses are determined by reference to performance against budget, with a sliding scale from a beginning payment for a 'near miss' to a full payment for outperformance by a margin above budget. Even if the non-executives do have a feel for the achievability of the budget figure (which is often backed up by board financial forecasts), it is very difficult to determine the appropriate degree of stretch for the top end of a sliding scale, and the maximum payout. In my experience, the level of the top end of a sliding scale is often set too low to merit a maximum payout. In some cases, non-executives have felt 'mugged' by being required to pay out a full bonus on a formulaic basis.

The rise of non-financial performance metrics

There has been a noticeable increase in the use of non-financial performance conditions in annual bonus plans (and also long-term incentive plans). While non-financial metrics can be more meaningful for executives and, in some respects, can provide a better link between reward and performance, executives are naturally high achievers and are adept at achieving milestones set for them. Remuneration committees find it difficult to set an objective framework for assessing, in a qualitative fashion, the *degree* of achievement of non-financial metrics. This leads to the metric being more likely to be simply paid out in full. In my view, the efforts of executives are better judged by the outputs of a business strategy, namely achieving a sustained improvement in financial performance and delivering superior long-term shareholder returns.

The role of remuneration advisers

I must declare an interest here as an adviser to remuneration committees. Advisers are in the business of maximising fees for their firm and there have been instances where advisers have sought to make themselves indispensable to remuneration committees and companies by devising pay schemes so fiendishly complex that only they can understand the policy. They may also be looking to cross-sell the firm's other services. In some cases, some individual advisers at the top end of the FTSE have built a reputation for being the 'go-to' person for selling an egregious pay policy to company shareholders—they are obviously very popular people with executives.

Remuneration committees are nowadays much more engaged and accountable for their actions, and we are seeing the direct influence of remuneration advisers on the wane. It is important that advisers on executive remuneration are appointed by and report directly to the remuneration committee.

The solution

There will never be a panacea as far as executive pay is concerned, but I take issue with those who say that it is the British 'way' to be slightly resentful of those 'lucky enough' to have enjoyed business success. In the era of the BBC's *Dragons' Den*, the achievements of Sir James Dyson, Sir Alan Sugar and Charles Dunstone are widely applauded, and there is increasing celebration of business heads who are not self-made but have nonetheless been long-term leaders of highly successful British companies—Sir Terry Leahy at Tesco and Sir John Rose at Rolls Royce spring to mind.

What needs to happen is for the process to be tightened in some companies. We are where we are with quantum and there is no appetite to roll this back—but there is a concerted will to avoid the level of increases we have seen in the recent past. The process needs to start by existing non-executives becoming fully engaged on the company's remuneration policy and for remuneration committees to take the upper hand in a polite but firm way and, if necessary, facing down management on one or more issues.

Setting pay levels must be done in a considered way, looking at internal pay relativities and only very carefully at pay in other companies. Increases should be restrained, using the average increase for the workforce as the benchmark where any increases are needed (recognising that the concept of a cost-of-living increase is less relevant for the most senior roles).

Next, the target-setting process for annual bonuses needs to be examined. Non-executives should seek to ensure that bonuses should be paid at a maximum level only for exceptional performance (a two/three in ten years' occurrence), where all stakeholders must be delighted with performance significantly exceeding their expectations, and executives should get used to no bonus being paid when times are tough. Greater discretion should be built into the plan to ensure that this is the case and that executives do not receive a bonus in some years.

Of course, there needs to be a concerted will across a high majority of companies for this to happen. There are well-known companies which appear to flout investor guidelines shamelessly year after year, and pay their executives too much. At one level I can understand the 'me too' argument from executives pointing to other companies in their sector receiving more. However, not surprisingly the instances of a chief executive leaving one company to be chief executive at a direct competitor are extremely rare. So, non-executives, be fair but firm!

Jonathan Hutchings

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[1] IDS (2011), 'FTSE 100 Directors get 49% Increase in Total Earnings', press release, October 26th.
[2] Hewitt New Bridge Street (2011), 'The Current Executive Pay Landscape', presentation by David Tuch to the Hewitt New Bridge Street annual conference, July 5th.

If you have any questions regarding the issues raised in this article, please contact the editor, Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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