Response to FRC Consultation on Directors' Remuneration.*

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Abstract

This note reports findings relating to three issues raised in the recent FRC Consultation on Directors' Remuneration.

First, in terms of the scope for claw-back we demonstrate that for those companies where the executive leaves the company worse off than when they started their boardroom position, the bonus and long-term incentive pay-outs realised in the final three years of service amounted to some 38% of total reward earned during their time on the board. As such, the scope for claw-back serving as a deterrent is *significant*.

Second, we show that, not withstanding concerns expressed by many commentators, the practice of serving executives sitting on the remuneration committees of other large companies leads to no significant measurable impact on the level of pay at those companies on whose remuneration committees they serve. This finding holds both in terms of awarded pay and in terms of realised pay. Nor is there any discernible impact on the design of reward arrangements, as captured by the pay-performance sensitivity of executive pay at such companies.

Third, by analysing the level of shareholder dissent expressed in the vote on the Directors Remuneration Report, we show that in the lowest quintile of performance (judged by total shareholder return over the period 2003-2011) shareholder median dissent on the Remuneration Report advisory vote is 8%. The value in higher quintiles of career performance is not so very different. This suggests that it would be very difficult to define a 'significant percentage' or 'trigger percentage' for FRC purposes.

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I Introduction

This note will draw on recent evidence on executive pay and performance to address three specific issues that are identified in the Financial Reporting Council's (FRC) Consultation Document on Directors' Remuneration (FRC, 2013):

1. On the topic of claw-back, the Consultation is concerned with the potential scope for such recovery and the circumstances in which it should be enforced. These are matters for professional judgement that are difficult to derive solely from empirical data, but we can at least quantify the scope that has existed in the past for recovery through such a claw-back mechanism. We do this by presenting the amount of incentive payments (i.e., those of a discretionary nature and susceptible to claw-back arrangements) that are realised by executives in the final three years of their career with a company - all expressed as a percentage of the total reward received by such an individual during his or her time as an executive on the board. In the case of under-performing executives, the proportion is more substantial than many might suspect and suggests that the potential incentive effect of the prospect of such measures might be significant.

2. The FRC questions whether active executives contemporaneously serving as non-executives on the remuneration committee of another company may tend to be particularly generous in their pay awards - for example, on the basis that it is in their self-interest to see generally higher executive pay awards. We demonstrate that the presence of such executives on the remuneration committee plays no significant role in determining executive pay. This result holds whether we utilise a measure of pay that reflects the expected value of total pay awarded or whether we use total realised pay. In neither case is there any significant connection to the presence of these 'executive non-executives', labelled 'ENEDs' here. Nor is there any significant connection to the design of the executive pay package as awarded by these remuneration committees - gauged by the effective pay-performance relationship for each executive. Notwithstanding popular concern, therefore, the presence of 'ENEDs' on company boards seems to lead neither to more generous pay awards nor to 'softer', less performance-related pay arrangements. Consequently, the FRC's concerns are not warranted in this area.

3. Finally, the FRC raises the question of what level of shareholder dissent on a vote on a remuneration resolution should be recognised as a 'significant percentage' in terms of the 'substantial shareholder votes against the resolution' alluded to in the new Regulations:

'Statement of shareholder voting
23. The directors' remuneration report must contain a statement setting out in respect of the last general meeting at which such a resolution was put by the company

> (a) in respect of the resolution to approve the directors remuneration report, of the votes cast, the percentage of votes for, against and number of abstentions.
>
> (b) in respect of the resolution to approve the directors remuneration policy, of the votes cast, the percentage of votes for, against and number of abstentions.

(c) where in either (a) or (b) there were substantial shareholder votes against the resolution, where known to the company, the reasons for that vote and any actions taken by the directors in response to that.'

(BIS, 2013)

Using the accumulated history of the advisory vote on the adoption of the Directors Remuneration Report, we show that even in clearly poorly performing firms (where the performance is in the lower quintile) the level of dissent only averages 8%. The median level of dissent is seen to be not so very different at significantly better preforming companies. This is true whether we scrutinise the average level of dissent over the executive's career or simply over the final year of their career. We, therefore suggest that the FRC will find it difficult, if not impossible, to nominate a meaningful trigger-point percentage value. Of course, voting behaviour may well change were any such figure to be announced, but historic data seem to be of little help in guiding this decision.

II Data

The data used comprise all companies that that featured in the UK FTSE350 index of top companies between the years 2003 and 2012. Manifest Information Services Ltd, is the commercial provider of this proprietary data. The data contain details on the remuneration of each director (including base pay or salary, short-term bonuses and equity-linked long-term incentive awards). Importantly, the data also contain details of shareholder voting. Once a company enters the sample frame, Manifest continues to follow the company, even should it subsequently leave the FTSE350.

The broad measure of reward used here is labelled 'TDC' (total direct compensation). In addition to the executive's salary plus other cash payments, such as any annual bonus received during each year, this includes the value of share options, performance share plans, and other equity-based incentives available to the executive. These can be valued as awarded (to produce 'TDC_awarded') or as realised or cashed in (to produce 'TDC_realised'). In valuing long-term incentives at the point of award, executive share options are approximated at 0.30 of their face value and performance share plans at 0.70 of face value[1]. The use of the 'TDC_realised' measure, of course, allows us to avoid the ambiguities of such estimation. All remuneration data are expressed in £2011.

The level of dissent expressed in shareholder voting on the adoption of the Directors Remuneration Report is expressed as the number of votes cast as either 'against' or 'abstain' divided by the total

[1]The use of 30% of face value as an estimate of the actuarial value of share options follows the practice of the remuneration consultancy industry (MM & K Ltd, 2007). Checks performed in Gregory-Smith (2012) demonstrate that the approach is robust. Conyon and Murphy (2000) valued performance share plans at 80% of face value.

number of votes cast ('% Dissent'). Manifest also provides details regarding the board composition. From this it is possible to calculate for each company in each year the total board size ('Board Size'), the percentage of the board that is non-executive ('% NEDS'), the size of the Remuneration Committee ('Rem Co Size'), and, of course the number of non-executives who can be classed as executives in other FTSE350 companies ('No. ENEDs'). For each executive it is possible to describe their position on the board in any year by whether or not they are CEO ('CEO'). We also know the age ('Age') of each executive and what fraction of each financial year they served on the board ('Fraction of year served').

Additional company descriptive data are obtained from DataStream. As a control for company size, the logarithm of total sales is used ('Ln Sales'). Firm performance is primarily captured by total shareholder return ('TSR') over the period in question (capturing the return to holding the share that arises both from dividend payments and changes in the price of the share). This is available through the 'RI' index available in DataStream, where the start and end value of the index is defined by the start and end of the relevant financial year. All financial data are expressed in £2011.

III Results

Table 1 provides the median and mean values for the variables used in this analysis. These summary statistics are split between companies in which at least one 'ENED' serves on the remuneration committee. An ENED is defined as a non-executive director who also serves as an executive director at another company listed on the London Stock Exchange (LSE).

Total annual awarded pay for executive directors is marginally higher at companies with ENEDs, albeit these differences are not statically significant ($p<0.2850$). The two samples are also statistically equivalent in the other control variables other than turnover, with the median ENED company having being larger by 46% ($p<0.000$).

Using only executives whose boardroom careers are observed from their beginning (therefore commenced in 2003 or later), Table 2 classes executives into quintiles according to the performance achieved by their company over their entire observed career as an executive on the board. As can be seen by the quintile cut-off rates for 'TSR', the lower quintile ('Q1') reflects executives whose companies are on average worth less at the end of their observed career than when they started. The second and third rows of this table report the median total pay awarded over the career of the executives. It is noteworthy that only at 'Q2' and above is there a positive relationship observed between pay and performance. Row (4) reports the median amount of pay received by these individuals as

incentive pay in the final three years of their service (either as annual bonus and/or as pay-outs on long term incentive schemes). It is this incentive pay that might fall within the scope of any claw-back arrangements. Row (5) shows the median ratio of this payment as a fraction of the total reward received over the executive's observed total career realised reward as seen in row (3).

The key point of interest in row (5) of Table 2 is that it reveals the median claw-back potential for low performers to be of the order of 38%. This is, perhaps, a surprisingly high number given that these companies are failing companies. It does, however, give empirical weight to the argument that claw-back arrangements have the potential to better align incentives by restoring the link between pay and performance. What is, of course, surprising is that even executives whose companies fall in this low-performing class have significant amount of funds liable to claw-back. Furthermore, when the analysis is repeated in Table 3 for CEOs only, the results are essentially the same. In this case the median claw-back potential is almost 39%.

Table 4 aims to identify the impact of ENEDs on pay. In the multiple regressions if columns (2) (Awarded pay) and (4) (Realised pay) the estimated impact is in the region of 4% for each additional ENED serving on the board. With 95% of companies having fewer than 3 ENEDs, the results here suggest that appointing ENEDs to the remuneration committee is not an effective route by which executive director pay has come to be inflated. Furthermore, when an allowance is made for the unmeasured individual circumstances of each firm (by use of the company fixed-effects in the regressions in columns (3) and (6)), the coefficient on ENEDs is statistically insignificant. An additional ENED has no statistically significant impact on executive pay.

Table 5 focuses the analysis on pay-performance sensitivity. The presence of ENEDs on the remuneration committee neither strengthens nor diminishes the sensitivity of the executive directors' remuneration to company performance. The coefficient in row (3) describing the interaction between the presence of ENEDs and the performance measure (TSR) is insignificant when firm fixed effects are included.

IV Conclusion

In summary, the findings of this investigation demonstrate that based on evidence from FTSE350 companies over the 2003 - 2012 period:

1. There is ample scope for claw-back arrangements to effect an incentive effect, as some 38% of variable pay would be liable for claw-back even among the worse performing companies.

2. Executives contemporaneously serving as non-executives on the remuneration committee of another company do not influence in any significant way the pay of the executives in that company.

3. Recent voting records offer no reliable guidance as to what might constitute a ‘significant percentage’ for use by the FRC in reacting to shareholder dissent on a vote on a remuneration resolution.

Tables

Table 1: Summary Statistics

Companies with ENEDs				
	N	p50	mean	St. Dev
Executive Directors				
$TDC\ Awarded$ (£M)	4,863	1.033	1.558	4.321
$TDC\ Realised$ (£M)	4,863	0.835	1.330	2.438
Age	4,863	51.014	51.306	6.940
$3-Year\ Variable$ (£M)	933	1.011	2.076	5.273
$\%Clawback\ Potential$	933	0.429	0.431	0.221
Firm Level Variables				
$No.\ ENED$	1,098	1.000	1.462	0.814
TSR	1,098	0.121	0.090	0.328
$Ln\ Sales$	1,098	14.106	14.182	1.637
$Board\ Size$	1,098	10.000	10.656	3.122
$\%\ NEDs$	1,098	0.600	0.611	0.123
$Rem\ Co\ Size$	1,098	4.000	4.825	1.744
$\%Dissent\ on\ Rem\ Report$	1,098	0.050	0.084	0.097

Companies without ENEDs				
	N	p50	mean	St. Dev
Executive Directors				
$TDC\ Awarded$ (£M)	5,366	0.934	1.480	2.875
$TDC\ Realised$ (£M)	5,366	0.762	1.269	2.009
Age	5,366	50.723	51.238	7.061
$3-Year\ Variable$ (£M)	1,100	0.927	2.143	3.874
$\%Clawback\ Potential$	1,100	0.419	0.431	0.225
Firm Level Variables				
TSR	1,358	0.123	0.091	0.329
$Ln\ Sales$	1,358	13.651	13.802	1.692
$Board\ Size$	1,358	9.000	9.836	2.781
$\%\ NEDs$	1,358	0.625	0.620	0.126
$Rem\ Co\ Size$	1,358	4.000	4.042	1.328
$\%\ Dissent\ on\ Rem\ Report$	1,358	0.048	0.090	0.112

1. Sample comprises FTSE350 executive directors between 2003 and 2012.
2. $TDC\ Realised$ is total compensation realised over the year, in Dec 2011 £M. This includes salary, bonuses, perks and the *realised* values from share options, deferred bonuses and vested equity incentives. $TDC\ Awarded$ is the same as TDC realised other than grant date values of options, deferred bonuses and vested equity incentives are used instead of realised values.
3. $3-yearVariable$ is the aggregate of the realised values of bonuses and incentive payments in the final three years of the directors' tenure in an executive position. $\%\ Clawback\ Potential$ is this figure divided into the aggregate of total realised remuneration over the directors' tenure in an executive position. Directors remaining in post at the end of our sample period are excluded in the calculation of these variables.
4. $No.\ ENEDs$ counts the number of non-executive directors on the company's board, who are also serving as executive directors at other companies listed on the LSE. TSR is total shareholder return which measures firm performance in terms of the capital growth in the company's stock and the income from dividends over the financial year. ROE is the company's return on equity, $LnSales$ is the log of turnover, $Board\ Size$ is the number of directors (executive and non-executive) serving on the board at the financial year-end, $\%\ NEDs$ is the percentage of the board who are classified as non-executive directors at the financial year-end and $Rem\ Co\ Size$ is the number of directors serving on the remuneration committee as the financial year-end.
5. $\%DissentonRemReport$ is the aggregate of votes cast 'abstain' and votes cast 'against' as a percentage of the total votes cast on the annual advisory proposal to approve the directors' remuneration report.

Table 2: TSR Quintiles

	Career TSR Quintiles				
	Q1	Q2	Q3	Q4	Q5
Career Performance					
TSR	-0.454	-0.033	0.197	0.517	1.084
Executive Career Pay					
$Total\ Awarded$ (£M)	2.575	2.079	2.583	3.467	5.228
$Total\ Realised$ (£M)	2.019	1.579	2.012	3.016	5.490
Executive Variable					
$3-Year\ Variable$ (£M)	0.688	0.792	0.799	1.103	1.499
$\%Clawback\ Potential$	0.383	0.429	0.450	0.421	0.409
Career Medians					
$ENEDs$	0.500	0.600	0.500	0.500	0.500
$Ln\ Sales$	13.862	13.982	13.994	13.751	13.474
$Dissent\ on\ Rem\ Report$	0.086	0.076	0.082	0.069	0.064

1. The table above reports the median values of the key variables under analysis by each TSR quintile for all observed executive careers. Not until the 2nd quintile (20-40 percentile) is there a meaningful relationship between executive pay and shareholder returns.

Table 3: TSR Quintiles: CEOs only

	CEO Career TSR Quintiles				
	Q1	Q2	Q3	Q4	Q5
CEO Career Performance					
TSR	-0.476	-0.027	0.193	0.524	1.131
CEO Career Pay					
$Total\ Awarded$ (£M)	4.445	3.707	4.799	5.331	7.897
$Total\ Realised$ (£M)	3.638	2.712	3.997	4.652	7.582
CEO Variable					
$3-Year\ Variable$ (£M)	1.166	1.295	1.177	1.551	1.698
$\%Clawback\ Potential$	0.386	0.453	0.425	0.425	0.399
CEO Career Medians					
$ENEDs$	0.454	0.633	0.400	0.444	0.500
$Ln\ Sales$	13.795	14.172	13.747	13.604	13.547
$Dissent\ on\ Rem\ Report$	0.088	0.085	0.079	0.069	0.066

1. The table above reports the median values of the key variables under analysis by each TSR quintile for all observed executive careers by those ending up as CEOs only. Not until the 2nd quintile (20-40 percentile) is there a meaningful relationship between executive pay and shareholder returns.

Table 4: Impact of ENEDs on Executive Pay

	Awarded			Realised		
	(1)	(2)	(3)	(4)	(5)	(6)
$No.\ ENEDs$	0.023	0.042**	0.0065	0.025	0.044**	0.020
	(1.00)	(2.20)	(0.40)	(1.19)	(2.04)	(0.89)
Executive Controls						
CEO		0.59***	0.60***		0.56***	0.57***
		(30.3)	(31.4)		(26.7)	(27.5)
Age		0.11***	0.12***		0.12***	0.12***
		(5.27)	(5.99)		(5.16)	(5.92)
Age^2		-0.0012***	-0.0012***		-0.0010***	-0.0011***
		(-5.47)	(-6.28)		(-4.71)	(-5.57)
$Fraction\ of\ Year\ Served$		1.00***	1.11***		0.80***	0.87***
		(14.8)	(17.2)		(11.9)	(13.8)
Firm-level Controls						
TSR		0.20***	0.15***		0.40***	0.30***
		(4.97)	(4.61)		(7.30)	(6.06)
$Ln\ Sales$		0.21***	0.22***		0.16***	0.30***
		(13.0)	(4.46)		(8.43)	(5.18)
$Board\ Size$		0.029***	0.00054		0.026***	-0.0038
		(3.77)	(0.068)		(2.96)	(-0.43)
$\%\ NEDs$		1.08***	0.29		0.92***	0.26
		(6.14)	(1.61)		(4.65)	(1.30)
$Rem\ Co\ Size$		0.0063	-0.0031		-0.00056	-0.0086
		(0.42)	(-0.24)		(-0.033)	(-0.51)
$\%\ Dissent\ on\ Rem\ Report_{(t-1)}$		0.36**	0.078		0.22	-0.039
		(2.34)	(0.56)		(1.36)	(-0.26)
$Constant$	13.8***	6.20***	6.81***	13.6***	6.52***	5.14***
	(342)	(10.2)	(8.15)	(367)	(10.5)	(5.80)
Observations	10,231	8,141	8,141	10,231	8,141	8,141
Firm FE	No	No	Yes	No	No	Yes
R-squared	0.000	0.467	0.645	0.001	0.348	0.554

Robust t-statistics in parentheses
*** p<0.01, ** p<0.05, * p<0.1

1. The dependent variable is the natural logarithm of the Total Awarded Pay, $TDC\ Awarded$, in columns (1) through (3) and the natural logarithm of the Total Realised Pay, $TDC\ Realised$, in columns (4) through (6).
2. One ENED worth 4% on total pay, ceteris paribus in columns (2) and (4). However, this falls away with firm fixed effects.

Table 5: Impact of ENEDs on Pay-performance Sensitivity

	Awarded			Realised		
	(1)	(2)	(3)	(4)	(5)	(6)
TSR	-0.079	0.15***	0.12***	0.11*	0.37***	0.32***
	(-1.35)	(3.01)	(3.19)	(1.89)	(5.72)	(5.87)
$No.\ ENEDs$	0.017	0.033*	0.00087	0.022	0.038*	0.025
	(0.76)	(1.73)	(0.056)	(1.06)	(1.76)	(1.10)
$TSR.No.\ ENEDs$	0.061	0.088**	0.048	0.032	0.055	-0.044
	(1.07)	(2.09)	(1.15)	(0.58)	(0.95)	(-0.89)
Executive Controls						
CEO		0.59***	0.60***		0.56***	0.57***
		(30.4)	(31.4)		(26.7)	(27.5)
Age		0.11***	0.12***		0.12***	0.12***
		(5.26)	(5.99)		(5.16)	(5.92)
Age^2		-0.0012***	-0.0012***		-0.0010***	-0.0011***
		(-5.46)	(-6.28)		(-4.71)	(-5.56)
$Fraction\ of\ Year\ Served$		1.00***	1.11***		0.80***	0.87***
		(14.9)	(17.2)		(11.9)	(13.7)
Firm-level Controls						
$Ln\ Sales$		0.21***	0.22***		0.16***	0.30***
		(13.0)	(4.44)		(8.43)	(5.20)
$Board\ Size$		0.029***	0.00066		0.026***	-0.0039
		(3.79)	(0.083)		(2.97)	(-0.44)
$\%\ NEDs$		1.09***	0.29		0.92***	0.26
		(6.15)	(1.64)		(4.66)	(1.28)
$Rem\ Co\ Size$		0.0062	-0.0030		-0.00064	-0.0087
		(0.41)	(-0.24)		(-0.038)	(-0.51)
$\%\ Dissent\ on\ Rem\ Report_{(t-1)}$		0.36**	0.081		0.22	-0.042
		(2.34)	(0.58)		(1.36)	(-0.27)
Constant	13.8***	6.21***	6.83***	13.6***	6.53***	5.12***
	(337)	(10.2)	(8.17)	(364)	(10.6)	(5.76)
Observations	10,231	8,141	8,141	10,231	8,141	8,141
Firm FE	No	No	Yes	No	No	Yes
R-squared	0.001	0.468	0.645	0.003	0.349	0.554

Robust t-statistics in parentheses
*** p<0.01, ** p<0.05, * p<0.1

1. The dependent variable is the natural logarithm of the Total Awarded Pay, $TDC\ Awarded$, in columns (1) through (3) and the natural logarithm of the Total Realised Pay, $TDC\ Realised$, in columns (4) through (6).
2. No measurable impact of ENEDs on pay-performance sensitivity when firm fixed effects are included.

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