

# Adopting a Career Perspective on both reporting and incentive design to improve the efficiency of Executive Director Remuneration: A response to BIS.\*

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## Abstract

This paper was written as a response to the BIS “Executive Remuneration” discussion paper (BIS, 2011a) and “The Future of Narrative Reporting” consultation paper (BIS, 2011b). First, we utilise a career perspective to outline the apparent disconnect between executive directors’ pay and company performance. Second, we explain why this disconnect emerges despite the fact that current contracts specify a very high proportion of ‘at-risk’ remuneration for directors in the form of bonuses, share options and long-term equity-based incentives. Last, we propose two items for reform that we believe will improve the efficiency of executive director remuneration: a) that companies report the total remuneration realised to date by each director, juxtaposed against the change in shareholder wealth over the same period; and b) that ‘at-risk’ remuneration is delivered through the vehicle of “career shares” which vest on, or after, the date that a director exits the company.

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# 1 The Problem

1. Currently there is a disconnect between career pay and performance in UK boardrooms. While the public in general and business analysts in particular express concern regarding the level of executive remuneration, it is the apparent disconnect between company performance delivered and remuneration received that provokes most concern regarding the effectiveness of remuneration committees in securing value for money from executive directors.

2. Table 1 illustrates just why some concern might well be justified. Using all executive director careers in the FTSE350 starting and ending between 1996 and 2008, the top panel reports the distribution of total remuneration realised over these careers (in £m) - through both direct cash payments and gains realised on equity-linked long term incentives (options, performance share plans, etc.). Directors are then grouped according to whether their shareholders were better off (value creators) or worse off (value destroyers) at the end of the career period in question. It can be seen that the upper quartile of value destroyers receive a reward at least as great as the typical (median) value creating executive (£2.4m versus £2.0m). 1% of directors in our sample (21 directors) left their companies in a worse state than when they started and yet took home in excess of £14.6m each.

3. The lower panel in Table 1 presents the pay-performance sensitivity that is estimated both across the whole sample and separately by value creators and value destroyers. Higher estimates describe a stronger link between directors' pay and company performance. The difference in treatment between the two categories is again clear, with the value-creators being subject to a pay-performance elasticity of 0.182 compared with the much lower sensitivity of 0.048 for the value destroyers.

4. The benefit of adopting a career perspective can be seen in the final part of the Table 1 by contrasting these career-based elasticities with those which result from a year-on-year approach. Under the latter approach, the estimated pay-performance sensitivity appears as 0.143 (versus 0.069 in the career estimates). The difference is almost entirely due to the annual estimates allowing under-performers to appear more reasonable than they otherwise might, by occasional less bad years offsetting poor years. Thus, for value creators the annual observations produce an elasticity of 0.187 (versus 0.182), as opposed to 0.0928 (versus 0.0484) for value destroyers.

5. It is also known that there is a clear disconnect at the market level. The BIS (2011a) discussion paper, “Executive Remuneration”, highlights this by comparing the mean total CEO pay in the FTSE 100 versus the annual variation in the FTSE 100 performance index over last 10 years (BIS, 2011a, Fig 3, p11).

6. Yet there is ample evidence that contracts have a very high proportion of at-risk or performance-dependent pay (BIS, 2011a, Fig 2, p9). Indeed, qualitative studies of the decision processes within remuneration committees generally paint a picture of well intentioned independent directors striving to craft remuneration arrangements that are both competitive in the executive market place and stretching in terms of performance linkages, e.g., Main et al. (2008), Main (2011), Main et al. (2011).

7. So where does the relationship break down? It could be that there is indeed a strong linkage between performance and remuneration, but that commentators observe and compare the outcomes in a way that masks this relationship. For example, when pay is observed in a particular year but the total remuneration realised in that year pertains

to performance over not only the current year but also (thanks to long-term incentives) to performance over the past three years. Similarly, total remuneration awarded is, in part, contingent on performance over the coming three years. However, the career perspective analysis, as presented in Table 1 and discussed above, avoids such timing pitfalls and, nevertheless, continues to reveal a major disconnect. The reason, we believe, lies in long term incentives belying their name and not, in fact, being sufficiently long term. This is compounded by an approach to reporting that focuses on the current year and fails to hold executives to account for their cumulative performance to date.

## 2 The Reason

1. The histogram in Figure 1 below uses the data introduced above, on FTSE 350 executive careers starting and ending between 1995 and 2008. It contrasts the distribution of total remuneration enjoyed over each of these careers (in 2008£m) with the performance of each executive's respective company over the same period (measured as total shareholder return). There is an unambiguous "heads-I-win" and "tails-you-lose" aspect (Sanders, 2001) about these results. Pay is right skewed - at worst, the career is brief and only moderately rewarding, but at best it can be long and richly rewarding. Shareholder returns over these same careers, on the other hand, are markedly more symmetric - while shareholders can gain much, they also stand to lose it all, with past gains being easily swept away.

2. The emphasis over recent years on designing executive remuneration arrangements that are characterised by high pay-performance-sensitivity (PPS) serves to skew pay further to the right. This has enhanced the potential for a big disconnect between an

executive director's experience over his or her career and the long-term outcome for the shareholder. An argument could be made that in extreme circumstances the PPS aspect as currently implemented may impart a further increase in the left skew in shareholder returns by encouraging CEOs to "bet the house" (Bebchuk and Spamann, 2010).

3. Hitherto, most research in this area has been structured around the connection between the expected value of the observed annual award of executive pay and the performance of the company in that year or in the previous year. While expected value has the advantage of being forward looking, hence relevant for decision making, its calculation on an annual basis can hide the career pay-performance sensitivity (or lack thereof) - so-called long term incentives notwithstanding. Just one terrible year can destroy the pay-performance sensitivity link on a career basis. In the Figure 1 below, "Banker 1" and "Banker 2" are highlighted as illustrations of this phenomenon.

4. To reduce this potential disconnect, it is argued here that long-term incentives should not permit executives to cash-out the rewards of early success (after three years, say) before shareholders can be assured that the improvement in performance is not transient. To this end we argue that all vested long term incentive rewards should be held in company shares ("Career Shares") until the executive leaves the board - or, possibly for a year or so longer.

5. To illustrate the effectiveness of such a Career Shares approach in focusing executives on the long term, Figure 2 uses the actual reward from long-term incentives as earned by one executive director during his time on the board ("Banker 3"). At each point where the annual Directors Remuneration report recorded a payout (vesting) of long term incentive (either through a deferred bonus scheme or a performance share plan) that

cash amount is contrasted with what would have been resulted had the proceeds been used to purchase company shares which are held through to the end of the executive's boardroom career with the company. It can be seen that the ability to take money out of the company (as under current arrangements) leaves the executive markedly better off. "Banker 3" was a value destroying executive and the consequence of being forced to share the shareholder experience has a negative impact on the executive's wealth - as previous gains are automatically clawed back with the falling share price.

6. To a certain extent, Figure 2 compares apples and pears, as the value realised at each point in the career is contrasted with the worth of the shares at career end. If, however, the proceeds of the realised "long-term" incentives are assumed invested in the FTSE-All-Share index over the remaining part of the career, then the comparison can be made in £2009. Were the executive to behave opportunistically and take realised gains out of the company to invest elsewhere, the resulting end of career wealth is some £7,161,076. This contrasts with the share valuation at career end of £672,082 had Career Shares arrangements been in place. If the executive had been even more prudent and invested realised gains in government bonds, the present value in 2009 would have been £10,243,208. Of course, under current arrangements executives such as "Banker 3" may voluntarily refrain from cashing out their vested long term incentives and elect to continue to hold company shares. The contractual nature of a Career Shares arrangement, however, clearly provides a much more robust long-term incentive.

7. As mentioned above, one reason why remuneration committees end up with such inefficient outcomes in terms of the pay received by executives and company performance delivered is that the committees' focus is largely on the current year - both in terms of awards vesting and awards being made. Current Directors Remuneration Report

Regulations (DTI, 2002) require a five-year graph of company performance versus a comparator group (e.g. FTSE100), but no effort is made to report cumulative executive reward versus performance. The power of such an approach is revealed in Figure 3.

8. In Figure 3, the information available on our sample of executive directors is used to estimate the pay-performance-sensitivity (PPS) This is done at each year of an executive's tenure: for everyone at the one year anniversary of appointment; at the second-year anniversary; at the third-year anniversary (for those who survive that long); and so on, up to a maximum of the ninth-year anniversary of appointment. As before, the sample is split into value-creators and value-destroyers. The upper part estimates the PPS using the cumulative information available to date. The lower part adopts a year-by-year approach. It is noticeable that in the upper half of the diagram the difference between the two groups quickly emerges with the PPS rising with passing years for value creators, and the estimated PPS for the value destroyers (on the right-hand-side) falling away (and actually becoming negative!).

8. The lower part of Figure 3, reflects our current year-by-year approach and the difference between the two groups is less clear and slow to emerge. In all cases the diminishing number of observations with the longer tenures means that the estimated confidence intervals expand with tenure. Nevertheless, the message seems clear. There is much to be gained by reporting (and analysing) cumulative reward against cumulative performance to date for executives. It is more difficult to hide inefficient remuneration arrangements using cumulative career reporting.

### 3 The Solution

Pointers to a possible solution are present in the recent ABI Guidelines (2011):

“To avoid payment for failure and promote a long-term focus, remuneration structures should contain a careful balance of fixed and variable pay. They should include a high degree of deferral and measurement of performance over the long-term. Structures should also include provisions that allow the company to implement malus or claw-back arrangements.” (ABI, 2011, v(d))

Our recommendation is that remuneration committees be encouraged to put these principles into practice through the adoption of two key changes in current practice:

1. The Directors Remuneration Report should record a single figure for the remuneration realised by each director in that year. Furthermore, it should contain a report for each executive director of both cumulative realised pay and cumulative company performance over each year spanning the period of office to date. This captures the total amount of pay the executive has received against the delivered performance over the equivalent period, and so prevents one-off periods of under-performance being forgotten. Failure to adopt this perspective makes the process vulnerable to a form of ratcheting wherein the executive gains when the company prospers and fails to lose when the company’s performance falters or reverses. The scope here is demonstrated in Figure 3 which contrasts the cumulative versus annual PPS for executives found at their first, second, third, etc. year of tenure on the board. The cumulative approach more effectively reveals value destroyers (upper-right quadrant of Figure 3). [Response to “The Future of Narrative Reporting” consultation paper (BIS, 2011b), question 17].



2. To reinforce the diagnostic tool of reporting over the cumulative career of each executive, companies should be encouraged to move away from incentive programmes that are reliant on annual bonuses, or three-year-vesting option and performance share plans, towards career shares (Bebchuk and Fried, 2010, Main et al., 2011) which lock the executive's reward into the truly long term performance of the company by inhibiting the cashing in of any vested option and performance share rewards until the end of the executive's career - indeed, preferably until a year or so after the executive has left office. In this way there is an automatic claw-back of any reward delivered for early promise that was subsequently unfulfilled. The introduction of cumulative reporting would naturally encourage this and the two go naturally hand in hand. [Response to "Executive Remuneration Discussion Paper" (BIS, 2011a) questions: 10; 12; 13; and 14].

Table 1: Career Pay &amp; Performance

	N	p1	p25	p50	p75	p99	Mean	St. Dev	skew
Pay	6251	.1002	.8181	1.676	3.387	20.04	2.967	4.344	5.949
TSR	6251	-3.918	-.2877	.2782	.7891	2.417	.1313	1.159	-1.408
$\Delta$ SW	6251	-4485	-55.05	74.63	493.8	31393	1238	7950	7.8
<i>Value Creators</i>									
Pay	4057	.1253	.9442	2.013	3.991	22.21	3.454	4.859	5.606
TSR	4057	.002471	.299	.6139	1.048	2.562	.7432	.5822	1.259
$\Delta$ SW	4057	.4545	83.11	299.1	1067	41540	2377	9068	8.711
<i>Value Destroyers</i>									
Pay	2194	.06689	.6851	1.267	2.404	14.64	2.066	2.98	6.111
TSR	2194	-5.168	-1.355	-.599	-.2351	-.005897	-1	1.109	-1.953
$\Delta$ SW	2194	-11430	-398.8	-131.1	-44.41	-1.507	-868.6	4605	-12.52
<i>Elasticity of Pay and Performance</i>									
	N	$\beta$	St. Error	Lower 95%	Upper 95%	R-Squared			
<i>Career Elasticity</i>									
Full Sample	6251	0.0686***	0.008	0.053	0.084	0.647			
Value Creators	4057	0.1818***	0.021	0.141	0.223	0.659			
Value Destroyers	2194	0.0484***	0.013	0.022	0.074	0.599			
<i>Annual Elasticity</i>									
Full Sample	32862	0.1436***	0.009	0.127	0.160	0.435			
Value Creators	22680	0.1867***	0.013	0.161	0.212	0.448			
Value Destroyers	10182	0.0928***	0.012	0.069	0.116	0.389			

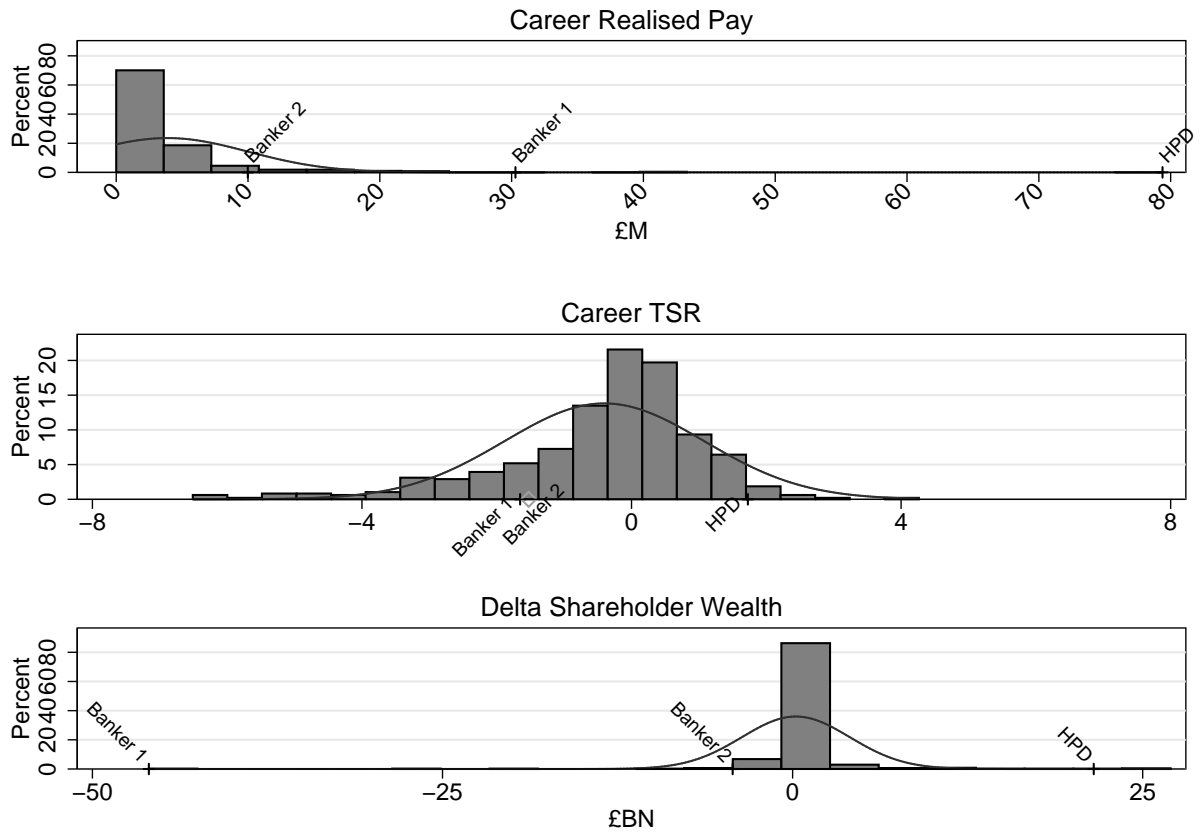
1. Sample comprises FTSE350 executive directors serving between 1996 and 2008. *Value Creators* are directors who's total shareholder return (TSR) is positive over their career. *TSR* is measured as the difference in the logged Datastream return index. *TSR* is multiplied by the average Market Capitalisation over the director's career to give  $\Delta$  *Shareholder Wealth (SW)*. The sample excludes careers less than 2 years.

2. Pay is total compensation realised over the whole career, in Dec 2008 £M. This includes salary, bonuses, perks and the realised values from share options, deferred bonuses and vested equity incentives.

3. The estimated pay-performance elasticities  $\beta$ , describe the percentage change in pay, arising from a 100% increase in TSR. *Career Elasticities* calculate pay and performance over the director career, *Post Career Elasticities* extend the performance period to one year post the director's exit from the company and *Annual Elasticities* pool all director-year observations and estimate calculate pay and performance on an annual basis.

4. The pay-performance elasticities were recovered from OLS regressions using a vector of control variables. These were board size, age and the proportion of Non-Executive Directors, averaged over the director's tenure, as well as director tenure itself, company size (measured by turnover), industry and year categorical variables. Full estimated results are available on request.

Figure 1: Distribution of Career Pay and Performance



1. Distribution of CEO pay and returns
2. Excludes careers commencing prior to 1st January 1996
3. Careers less than 2 years dropped
4. HPD signifies the Highest Paid Director observed

Figure 2: Banker 3: Realised Reward from Share Options and LTIPs vs Career Shares

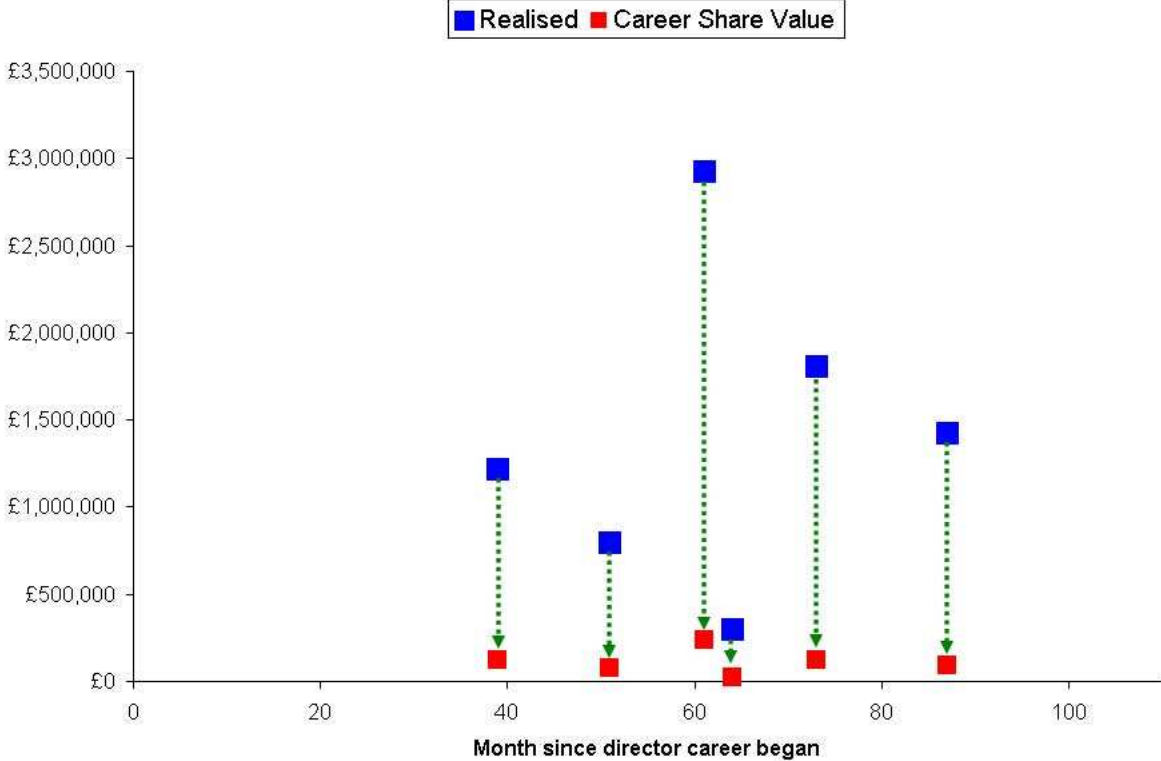
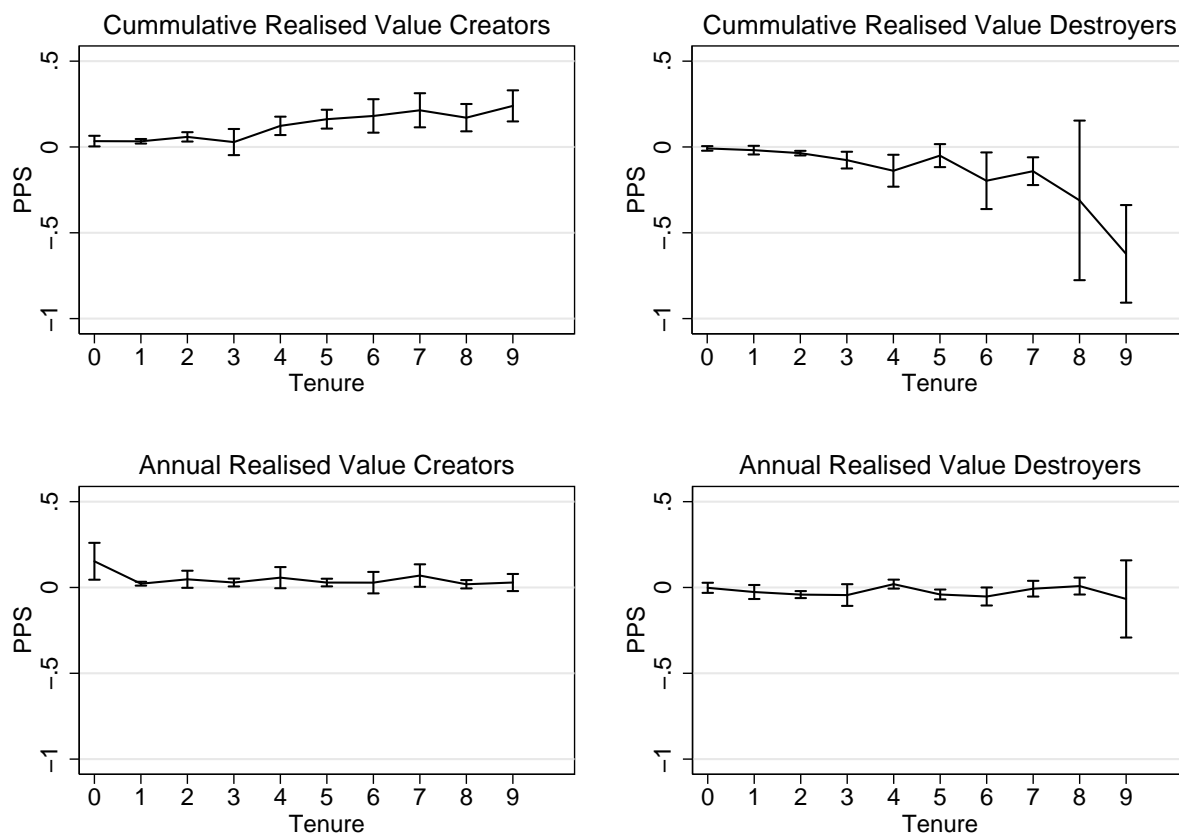


Figure 3: Cummulative vs Annual Pay-Performance Sensitivity



1. *Pay – Performance Sensitivity (PPS)* is recovered as the estimated coefficient on the performance variable under nine separate OLS regressions of executive directors’ pay, by their rolling tenure. They describe the £M increase in pay from a £100M increase in  $\Delta Shareholder Wealth$ . *Value Creators* are directors who’s TSR is positive over their career. *Annual Pay* is total compensation realised during the financial year in Dec 2008 £M. *Cummulative Pay* aggregates *Annual Pay* from appointment to date. *Annual Performance* is  $\Delta Shareholder Wealth$  as defined by TSR multiplied by the firm’s year-end market capitalisation. *Cummulative Performance* captures  $\Delta Shareholder Wealth$  from appointment to date, multiplied by the firm’s average market capitalisation over this period.
2. Excludes careers commencing prior to 1st January 1996 and executive’s with less than two years.
3. Tenure rounded up or down to the nearest year.

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