Engendering Long-Term Decision Making by Using Truly Long-term Incentives: A Response to "The Kay Review of UK Equity Markets and Long-Term Decision Making"*

Ian Gregory-Smith†
Brian G. M. Main‡

November 2011

Abstract

This paper was written as a response to the "The Kay Review of UK Equity Markets and Long-Term Decision Making". 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 long-term decision making in the boardroom: 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.

*The authors have submitted a similar response to the Department for Business Innovation and Skills on "Executive Remuneration Discussion Paper" and "The Future of Narrative Reporting". Brian Main is grateful for research support under ESRC Grant: RES-062-23-0904.

†University of Edinburgh Business School

‡Address for correspondence: University of Edinburgh Business School, 29 Buccleuch Place, Edinburgh, EH8 9JS. Tel +44 (0) 131 6511375. E-mail: brian.main@ed.ac.uk

1 The Problem

1. Currently there's a disconnect between career pay and performance. While the public in general and business analysts in particular express concern regarding the level of executive remuneration in Britain's boardrooms, it is this apparent disconnect between company performance delivered and remuneration received that provokes most concern regarding the effective long-term outlook of executive directors [1].

2. Table 1 illustrates just why some concern might well be justified. Using all executive director careers starting and ending in the FTSE350 between 1996 and 2008, the top panel reports the distribution of total remuneration realised over these careers (in £m) - both through direct cash payments and gains realised on equity-linked long term incentives (options etc.). Individuals are grouped according to whether the 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 £2.1m). 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. 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.

3. The benefit of adopting a career perspective can be seen by contrasting these elastic-

[1] This is a footnote.

ities with those presented in the final part of the Table which result from a year-on-year approach. Here 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 might, as occasional less bad years offset poor years. Thus, for value creators it is 0.187 (versus 0.182), as opposed to 0.0928 (versus 0.0484) for value destroyers.

4. It is also known that there is a clear disconnect at the market level. The BIS (2011a) report, "Executive Remuneration", highlights the disconnect 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, 2011, Fig 3, p11).

5. Yet there is ample evidence that contracts have a very high proportion of at-risk or performance-dependent pay (see Fig 2, p9 in the BIS paper). 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).

6. 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 described 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.

2 The Reason

1. The histogram below uses data 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 measured 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 further increases 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. Figure 2 uses the actual reward from long-term incentives as received by one executive director during his time on the board ("Banker 3") to demonstrate the power of Career Shares to focus executives on the long term. 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. 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 many might think appropriate.

5. 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. Behaving opportunistically and taking realised gains out of the company to invest elsewhere results in a total of £7,161,076 compared to a share val-

uation at £672,082. Had the executive been even more prudent and invested realised gains in government bonds, the present value in 2009 would have been £10,243,208. 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.

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).

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), (**?**) 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.

Table 1: Career Pay & 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
Δ SW	6251	-4485	-55.05	74.63	493.8	31393	1238	7950	7.8
Value Creators									
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
Δ SW	4057	.4545	83.11	299.1	1067	41540	2377	9068	8.711
Value Destroyers									
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
Δ SW	2194	-11430	-398.8	-131.1	-44.41	-1.507	-868.6	4605	-12.52

Elasticity of Pay and Performance

	N	β	St. Error	Lower 95%	Upper 95%	R-Squared
Career Elasticity						
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
Annual Elasticity						
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 Δ *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 β, 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

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 seperate 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. $Cumulative\ Pay$ 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. $Cumulative\ Performance$ 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.

References

ABI (2011). Principles of remuneration. Technical report, Association of British Insurers.

Bebchuk, L. A. and J. M. Fried (2010). Paying for long-term performance. *University of Pennsylvania Law Review 158*, 1915–1959.

Bebchuk, L. A. and H. Spamann (2010). Regulating Bankers' Pay. *Georgetown Law Journal 98*(2), 247–287.

BIS (2011). Executive remuneration - discussion paper. Technical report, Department for Business Innovation & Skills.

Main, B. G. M. (2011). Executive pay - a career perspective. *Edinburgh: The David Hume Institute*.

Main, B. G. M., R. Belfield, and K. Turner (2011). Is there a negotiation process in uk remuneration committees? Technical report, University of Edinburgh Business School.

Main, B. G. M., C. Jackson, J. Pymn, and V. Wright (2008). The remuneration committee and strategic human resource management. *Corporate Governance: An International Review 16*, 225–238.

Sanders, W. G. (2001). Incentive alignment, ceo pay level, and firm performance: A case of heads i win, tails you lose? *Human Resource Management 40*(2), 159–170.