CEO REMUNERATION
Chairmen's views on current issues
2011

THE
Chairmen's
Research Group
The Board Advisory Partnership

DEDICATION
GEORGE BATTERSBY

The authors would like to dedicate this work to the memory of George Battersby who sadly died last year. As the Board member responsible for HR at Amersham International plc and Cable & Wireless Plc, George referred many of his colleagues to Manchester Square Partners for advice on the development of their careers. He had also given us the honour of agreeing to become an Advisor to the firm. Malcolm Saffin, our co-researcher on this project, worked directly for him at both companies and found George to be a superb boss and mentor, and a very good friend.

George will be sorely missed. His particular blend of human and commercial wisdom lives on with all of us who were lucky enough to have known him. We hope that he would have approved of this collaboration between us on a subject on which he was an outstanding thinker.

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INTRODUCTION

There is considerable scope for interpretation as to how to discharge one's role as a non-Executive member of the unitary board of a UK listed company. The Chairman in particular has to be guided by the same principle of adaptive flexibility which, on a larger scale, keeps our constitution unwritten and which shapes our common law. In asking members of the Chairmen's Research Group to share with us how they ensure that a board reaches the most appropriate remuneration framework for their CEO, the answer, almost always, was that it is a matter of context. Differing designs,processes and outcomes are appropriate in different companies at various points of the business cycle.

We undertook this study to explore the range of approaches taken, and current thinking on this issue. We did so because the reflections of leading Chairmen are seldom heard and are of great interest to the wider population of board members, prospective board members, investors and advisors.

Our co-researcher was Malcolm Saffin, an expert advisor on remuneration to Chairmen across sectors. We interviewed 25 Chairmen of FTSE 350 companies, with further input from a cross-section of Chairmen of Remuneration Committees. Many participants contributed from both perspectives. As one might expect from such a diverse group, a wide spectrum of views was expressed. On issues of how the development of plans is managed, and on the roles it is appropriate for Chairmen to take, many of the views expressed were diametrically opposed to those of other participants, yet a shared view on some major themes emerged.

The main point of wide agreement was that LTIPs are broadly not operating as envisaged – neither as incentives nor as tools of retention. Rather, because performance criteria are often finally determined by external factors outside of the control of the Executive, LTIPs are often given and received in the spirit of a lottery ticket, operating to the benefit only of the recipients of a windfall. The law of unintended consequences and 'capricious outcomes' were often referred to.

It is paradoxical that institutional investors rely on board members' flexibility in exercising their judgement in protecting shareholders' interests in so many respects, yet, on the question of executive remuneration, do not trust them to exercise it appropriately. One of the means of improving the appropriateness of outcomes suggested by the majority of participants to this study was for Remuneration Committees to have greater scope in which to exercise discretion. The veto on discretion, the mistrust and in many instances, the formulaic manner in which some shareholder decisions are made, are all felt to militate against shareholders interests.

On other counts, many participants are currently working with their Executive teams to refocus the design of packages to act (again) as incentives. They are refining their thinking around the balance of long and short term performance criteria and are seeking to simplify plans, amongst other changes. We hope that the airing of the issues and the ideas for change prompted by this study will be of value to those considering the challenge.

We are, as always, grateful to all participants for their contribution of time, insight and honesty.

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SECTION 1
SUMMARY FINDINGS

A. ON THE ROLE OF THE CHAIRMAN

1. Significance of the CEO's remuneration for the Chairman

It was clear for all participants that they regard having the right CEO at any point in the company's cycle as one of their primary tasks. To get his or her attention, the remuneration has to be right. Not excessive, just right. Consequently, many saw guiding the remuneration discussions as one of their key levers in driving accountability and performance management of the Executives.

2. CEOs work hard for many reasons, of which pay is only one

Participants all raised the point that pay is important, both to focus motivation and as a reward for good work done. However, in their experience, a fundamental level of drive and achievement orientation as well as the desire to do a good job are at least equal to pay as motivators for successful CEOs.

3. The role taken by Chairmen in design varies

Some participants carried it as an article of faith that the Chairman should be the primary architect of the structure of the CEO's remuneration, and others that he or she should be all but invisible in the process. The majority of participants held no over-riding philosophy about who should lead the design process, nor how they believe packages are best structured. Like so many aspects of Chairmanship, it is a classic 3-D chess game. Their objective is always to align the CEO's motivation, the strategy and performance. There was some discussion as to whether this alignment should be more with shareholders' interests, or the strategy, or with the company. A fine but significant point.

For the most part, participants emphasised the complexity of balancing interests and that their approach is driven by the context rather than dogma. In the words of one:

"Chairmanship is about empowering other people. If you have a good Chair of the Remuneration Committee ('RemCo'), let him or her do it. If you don't, you do it."

4. Consulting with the CEO

There was wide agreement that the CEO should be party to the design and formulation of his or her own remuneration. By this contributors were not suggesting that the CEO should primarily drive the process, but that, as Chairman, one should know the CEO well enough to make recommendations on the basis of what will motivate, or as suggested in the case of many CEOs not especially focused on pay, not de-motivate them. The rare practice, that of not consulting with the CEO before a recommendation is made to the RemCo, was held to herald only disaffection.

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5. The significance of the Chairman of RemCo's experience

The relative depth of experience and therefore robustness of the Chairman of the RemCo appears to be of significance relevant both to the conduct of the process and to the nature of outcomes. As represented in these conversations, the ideas of a highly experienced RemCo Chairman are likely to be as impactful as those of the Chairman. And the reverse must hold true. With the emphasis placed on remuneration in presenting to shareholders, the inexperienced Chair of RemCo is in an unenviable position. Many spoke of how, when there is a desire to adopt a practice outside of the ABI's guidelines, that this results in frequent reluctance to face the ire, and consequent reputational damage, of Governance Departments. The consequences of this run far. Participants were clear that in many instances, they believe that where a RemCo is not robust, packages can end up being designed more to fit the orthodoxy of common practice than to drive the business.

> Chairmanship is about empowering other people. If you have a good Chair of the Remuneration Committee ('RemCo'), let him or her do it. If you don't, you do it.

B. ON LTIPS

1. Variable pay has become too large a part of the package

LTIPs were discussed in the context of an overall discomfort that variable pay has become too large a part of all Executive pay. The question was often asked, "Will we ever be able to put that genie back in the bottle?" Chairmen can probably not lead this single-handedly, but, for this and a variety of other reasons, are considering making changes in line with those suggested below. (Section C).

2. A misnomer, and not working as intended

There was considerable scepticism about whether or not LTIPs are achieving their intended objectives. Over 80% of participants expressed reservations and many have begun to revise their approach to package design.

Several reasons for this scepticism were discussed. The general view was that, with a few exceptions, such plans may reward, but do not substantively motivate CEOs. The performance criteria are often in reality driven by extraneous factors and so Executives currently attach little belief that they will pay out. Without pleasure in describing them as such, plans were thought often to be given and received as something of a lottery ticket in addition to base salary and bonus. Given the factors considered below, when they pay out, which they seldom do currently, they are often viewed almost as a windfall, and timing often leads to capricious outcomes.

3. Their role in retention is overstated

CEOs and other Executives stay or go for a variety of reasons, of which pay is only one and candidates for roles elsewhere are frequently bought-out of existing schemes. Many participants did not consider that three years was 'long term' in a meaningful sense either. So the term behind the acronym LTIP seems to be something of a misnomer.

4. The role of shareholders' governance departments

Some participants spoke of the frustration caused when the Governance Departments of Institutional Shareholders have operated at variance with their own Fund Managers' views. Despite their Fund Managers having approved a plan after consultation, several instances were given of the Governance Departments explicitly ignoring those views and choosing to vote against plans.

5. Acceptable process can be a more significant driver than the intended commercial outcomes

Following on from this, many spoke of a culture of convergence prevailing in which conformity to the norm of current practice has become a powerful driver in itself. Plans can end up being driven more by market practice than by the specific needs of the company. As an important part of this, some participants described the opposition they face when departing from current practice to devise very context-specific elements of plans – such as the comparator group, or particular performance criteria. The suggestion is that 'acceptable process' can be seen to be more important than commercial outcomes.

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C. PROPOSALS FOR CHANGE

Where convergence and conformity have achieved such momentum, it is not easy to be a first-mover. The changes which some participants were already making, or considering included:

1. Reducing the scale of variable pay and returning to simpler packages and tools

About 80% of the participants expressed a desire to increase base salary and/or annual cash bonus while sometimes radically simplifying the long-term element of the CEO's package. This reflects the sense that LTIPs have gotten out of hand, both in terms of quantum and complexity. Share options were suggested by some as a tool that had died a premature death and could be revived as a simpler approach than that adopted by most current plans.

2. Increasing the Remuneration Committee's span of discretion

Discretion was seen as an important counterweight to the vagaries of the market, enabling the effects of rigid plan design or unexpected external developments to be offset. Paradoxically, it was felt that greater discretion might give Executives more confidence in fairer, less unpredictable outcomes, although it was also recognised that a breakdown in public trust makes the return of discretion problematic.

3. Different business models should be reflected more in the nature of incentive schemes, factoring-in a recognition of cyclicality.

In financial services, risk management has become the central theme in package design. Outside of financial services, one participant explicitly raised the point that companies could and should better manage risk by factoring greater consideration of the business cycle into remuneration. In a highly cyclical business, one invariably given to peaks and troughs, one participant reflected that they had not rewarded their people for balancing investment decisions with an awareness of the virtue of holding cash for the inevitable downswing, but would do so in future. Remuneration was seen as one of the many pro-cyclical factors.

4. A focus on value-based plans?

The possibility of adapting the features of private equity long-term reward plans into the quoted context was discussed by some. The attractions include the likely motivational effect of their potential for large scale pay-out triggered by the achievement of specific performance targets, as in a turnaround situation. The difficulties which emerge after a pay-out were also discussed – chiefly adjusting Executives' motivation from a high–octane package to a more 'normal' one if the Executive team continues in situ post the trigger event.

SECTION 2
THE FINDINGS

A. ON THE ROLE OF THE CHAIRMAN

1. Significance of remuneration within the role of Chairman

In terms of significance, the universal response was that the issue matters more than anyone would like, largely because of its innate complexity and the degree of external focus on it. The time spent on the issue varies considerably between 'all engulfing' (financial services) to, for the majority, about 20% of their time but considerably more at times of plan re-design. Despite this, all were clear that it is one of the most significant commercial levers available to a Chairman in his or her oversight of the CEO.

2. Who drives the process?

The Chairman as principal architect

Some had a clear view that,

"The Chairman should be the 'principal proposer' of reward for the CEO – in a sense he is the HR Director for the CEO."

"The RemCo Chairman and I will brainstorm the new scheme. He or she will take over the conversations when I have put the architecture in place. After the plan is outlined (and agreed in principle) we will populate it with figures. If the Chairman is not providing the client side input, who is? I propose and he (the Chairman of the RemCo) disposes."

One or two Chairmen declined to participate in this study as they were unsure as to why The Chairmen's Research Group was researching the subject as they were clear that the Chairman should take no lead in the remuneration of the CEO, i.e. that is solely the reserve of the Chairman of the RemCo. This is not a common stance. Per another participant:

"Why are we paying the Chairman? Other than looking at the overall strategy and performance of the business which is all driven by the CEO and the executive team, the single biggest thing is actually overseeing the CEO and making sure the CEO and the executive team are on the right track. In support of that is the remuneration. So how can some Chairmen sit back?"

The Chairman of the RemCo as principal architect

It was sometimes implicit, but sometimes made explicit, that it is an individual Chairman of RemCo's capability, interest in and experience around reward rather than the office itself, which determines the nature of the role they take.

In the words of one RemCo Chairman,

"In the boards I have been on, the Chairman has not been the big driver – if you did that you would be trampling straight on the feet of the RemCo Chairman. The process should not be led by the Executives – it must be led by the independent NEDs. The Executives have a stake in it but it takes an independent perspective to say 'Is this is in the interests of the company?'."

One view was that:

"The Chairman of the RemCo is responsible for the first level of management of the process so it is his or her responsibility to get a policy that works."

But others disagreed:

"It's unfair to expect the Chairman of RemCo to come up with schemes for Executives because, if you want a scheme to incentivise the Executives, they have to believe in it and people believe much more strongly in things that they have had a hand in creating – that's just the way of human beings."

"One viewpoint I really disagree with is that the Chairman of the RemCo actually designs the incentive schemes. That's like saying the Chair of the Audit Committee deals with auditors – that's an operating issue. The RemCo should be getting proposals which it can reject if necessary but to actually sit there and design smacks of NEDs doing exactly what you don't want. However I know at least one RemCo Chairman who actually thinks he should sit with advisers, design plans and then hand them to the Executives. You wouldn't ask the Board to do any other operating role."

Several participants spoke of a desire for RemCos to act 'with more courage':

"My experience of NEDs is that they aren't very brave. They don't say what they think when they see a very strong-willed CEO or, more often, when they think the ABI isn't going to like the suggested plan. I think that it is a major issue how people need to challenge the over-strong Executive and decide to be robust in the face of governance departments more than they do."

"NEDs are, maybe understandably, generally very focused on their reputations. I mean, there are even prizes now for being a good NED! Sadly they don't win prizes by standing up to institutions. I think that we need a lot more courage from NEDs, we need to help them act out of first principles in the company's interests rather than, dare I say it, their own."

The CEO as driver with the Chairman as arbiter

The great majority of participants believe that the Chairman's role is akin to that of arbiter between the various constituencies but that the CEO should be generating the initial proposal.

"In my view the best genesis for incentives is with the Executives because they're the ones who have to be incentivised by them so let them have a major influence on what it is."

But others felt that high levels of CEO involvement at the design stage are simply inappropriate:

"I think it's wrong that the Executives come up with the scheme. They have too much of a vested interest.

3. Influence of third parties

<u>Shareholders' representatives</u>

The role of the views and interests of shareholders was all pervasive throughout the interview conversations. The overall view is that the Stewardship Code is beginning to positively influence institutional shareholders to be more engaged with management. The major issue taken with some, not all, shareholders was the over-involvement, and 'box-ticking' approach of the governance departments of some such shareholders. The need for robustness in anyone wishing to depart from the guidance notes was mentioned by many, both from the perspectives of having had institutions vote against plans, and by those who had carried their shareholders with them on unusual plans. The desire for greater robustness by RemCos was urged by many.

"We have a good example in reward work of governance and process becoming, on occasion, more important than the outcome."

The unhelpful role often played by short-term holders of stock also got frequent mention, but the gulf between the governance departments and the Fund Managers was discussed with more heat:

"I sense a difference of attitude between institutional shareholders themselves and the bodies that represent them."

"It is difficult to talk about institutional shareholders as one entity. Some of their governance departments are completely disconnected from the Fund Managers, sometimes breathtakingly so. One such simply refused to join into a three-way conversation with us, the Fund Manager of their own institution, and themselves. Then they voted against us despite the Fund Manager endorsing us."

"The sclerotic effect that the ABI and others are having on the appropriate design of remuneration plans is an example of the operation of the law of unintended consequences. In the thinking about the exercise of discretion, for example, they aren't making organisations particularly safer for shareholders, they are just making it harder to drive and/or reward performance. Everything is based on mistrust of management. It's very unhelpful".

"Alignment with strategy and shareholders is important but market practice and comparability are the overriding drivers."

<u>Remuneration Advisors</u>

The specialist firms were generally held to be strong on technical input but to be guilty on two grounds: the first was making the plans more complicated than most numerate people find comprehensible, and secondly lacking originality in devising client solutions. A lack of true customisation was thought to be reinforcing current market practice.

Separately, one major financial services institution has initiated the involvement of a second set of advisors, specifically for the Executive.

"I believe both RemCos and the Executives should be independently advised. Management here now has a totally separate adviser. We ask management to come forward with their suggestions. The model comes from the CEO. Things are so complex now that they need expert help on design. A good adviser to each independently helps both."

In contrast to that rationale, several participants had reservations:

"I don't think there should be separate advisers. I look to the advisers for a sanity check on wider trends. Since they are not designing the plans, you shouldn't need separate advisers."

Things are so complex now that they need expert help on design. A good adviser to each independently helps both.

B. ON LTIPS

1. Pay as motivation for CEOs

Participants discussed the many reasons why they believe their CEOs work as hard as they do. Wealth creation as a dominant driver was believed to be relatively rare and, when it occurs, seldom constructive. CEOs are remarkably driven individuals and there are always many sources and factors making up that drive. A sentiment heard from many:

"I'm sceptical of the effectiveness of pay as an incentive. It works from the point of view of showing your appreciation of the individual and the team but I think people work because they like the team they are working with and the job they are set to do."

The range of individual CEOs' financial motivation was highlighted by one participant who indicated that, in two of the companies with which he is currently involved, one CEO will know to the decimal point where the LTIP is on a daily basis, while the other would be largely unaware. These are two very different individuals and yet both are amongst the highest performers in their respective sectors. There was some discussion of how too little interest in money was as problematic as too much, but that the former was a fairly rare phenomenon. Unsurprisingly, the greatest preoccupation that participants revealed in discussion was their focus on the complexity of the task:

"I'm interested in the CEO's pay structure as part of why they do the job – money is seldom the sole reason – though it certainly can have a positive or negative impact on their morale. Reward is important for the top team, of which the CEO is the most important member. As Chairman you should ensure that the reward is appropriate and encourages the right behaviour and that people are not rewarded for underperformance."

"Once upon a time, being head of a public company gave great kudos. Also, it gave access to capital markets. Now I don't believe people feel this way. The external obligations take about a third of your time. It's now harder to raise capital as a PLC rather than in private equity. And, finally, the press will kill you – very few people get out well. So why would anyone want to run a PLC now? The rewards are two to three times greater in private equity. So the equation has changed and as Chairman I have to spend a great deal of time on the issue."

A point made by many participants was that what is important to the CEO is generally not the absolute quantum of payment, but the amount relative to his or her peers. This is particularly true within financial services but still true for many people:

"If nobody had LTIPs but the CEO could earn, say, a 20% bonus on top of salary, you would probably get the same business outcomes, so a cynical shareholder would ask 'why pay so many people so much?'. The answer is that, as the owner of company X, I'll try to get my share of the best people. And to do this I'll pay 100% bonuses, not just 20%. What is the reaction? Top talent starts moving towards me."

2. Variable pay as a proportion of the package

When asked what they would change about packages, almost all participants volunteered that they would like to reduce the amount of variable pay as a percentage of the whole. The current structure of UK executive pay is remarkably uniform - the 'three-legged stool' of base salary, annual bonus and long-term incentives. However, it is clear from research by Towers Watson that the long-term incentive has grown dramatically over the last 30 years, and particularly in the last decade. In 1990, share options, a long-term incentive, dominated as the variable element of pay, whereas today only a quarter of companies use them and the proportion is still declining. Recent research from Hewitt New Bridge Street also highlights some significant changes within the last decade. For example:

- **The average annual bonus opportunity for FTSE 100 CEOs is 180% of base salary, compared to only 100% as recently as 2005**
- **The average annual bonus paid to a FTSE 100 CEO in 2010 was around 120% of base salary, compared to 50% a decade ago**
- **For FTSE 100 CEOs, long-term incentives now provide the largest leg of the stool, accounting for about 40% of the total package value (compared to less than 25% in 2003).**

3. Design insufficiently tailored to business needs

The declared intention of LTIPs as driving the creation of value by aligning the Executives with the strategy and with shareholders' interests would suggest that there would be as many types of plan as there are strategies and business models – but the evidence of how LTIPs are structured across companies and sectors suggests conformity rather than diversity. LTIPs of companies represented in this study are best described by their few differences, than by their many similarities.

For example, the ubiquitous three-year term (some now have an extra two years of deferral but the performance period is still almost universally three years) was invoked as an example of practices adopted because it is the norm to do so rather than the business case actually suggesting three years as a natural reward period.

"The length of the LTIP should depend on the cycle of the business. I'm using three years in relatively short-cycle businesses but, if you're in a business building a franchise over 20 years, say, you would do better having longer terms."

"Our market is very volatile, and that volatility is where you capture value. Remuneration swings around quite wildly. When the market goes up we pay big bonuses, but no bonuses on the down-swing. We also don't factor in any expectation that the inevitable downswing will happen and that we should think more about holding cash when the market is high. We don't and we get caught out. But this isn't like retail where I'm also involved, where you know by five o'clock how much you sold that day and how much money you made. These are two examples of different industries that need different structures of incentives."

"I used to scratch my head in the insurance sector as to what short-term profit had to do with management when an earthquake could wipe out all profit. There is a great focus on setting performance targets, particularly associated with the market. In rising markets people think they deserve bonuses just for keeping up with the pack."

4. More a lottery ticket than an incentive

Around 80% of participants were doubtful that LTIPs actually drive behaviour, but not always helpfully. Typical comments were:

"Yes incentives do change behaviour. For the first two to three years of my Chairmanship, the management were not getting paid on long-term incentives and therefore concentrated on short-term incentives. This made them go safe on budgeting. They set EPS targets they knew they could break - so it didn't optimise performance."

"LTIPs are not incentives, they are a reward for work done in the past. They are too much of a lottery to actually act as an incentive per se."

"I'm not sure if LTIPs change behaviour. The key is to have the right senior team – engaged, passionate, wanting to achieve something that's worthwhile. I can't remember them driving something just for one incentive. It doesn't make my CEO work harder or smarter but if the incentive were different, for example based on cash, then it would have a greater effect, as that's easier to control."

"We are using a strategic scorecard. Twenty-five per cent of the LTIP is based on economic profit – so that won't be out of his mind – but the wider, softer targets suffer simply by the sheer multiplicity."

5. Role in retention - a myth

"There is a fallacy that deferred compensation is a retention tool – good people get bought out. It's been true in banking for some time and it's increasingly the case elsewhere."

"If you are recruiting a new CEO then it's going to be the competitiveness of the package that you're thinking about. You'll find people coming from a highly geared background so they'll be looking for the same again."

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The implication in this last point has to be that if one is prepared to compensate a candidate for leaving a 'highly geared background', one should not be surprised by one's own efforts at retention being similarly confounded at a future date.

6. Alignment with shareholders interests

Alignment with shareholders was cited by almost all participants as a central thrust to remuneration packages, but how LTIPs achieve this was less certain:

"I worked in a bank and there was great emphasis on aligning with shareholders and rewarding in shares but that didn't stop a great amount of risk-taking. People will endeavour to earn rewards under any system and you have to manage risks separately to that."

"People forget that the company has an existence separate from the shareholders and people should be allied to the company. Shareholders could be shorting the stock or be very short-term holders or could be index trackers who don't understand or care about your business. If you try to focus on them, you come unstuck. You're missing an essential step in the process."

7. Capricious Outcomes

The frequency of 'capricious outcomes' was cited as a large part of why LTIPs do not actually drive behaviour, in alignment with shareholders or elsewhere.

Whether through design flaws or the vagaries of the market, there was common consent that an incentive plan drawn up to cover a period of several years often fails to deliver the predicted financial outcome and therefore inspires limited confidence or commitment on the part of the CEO and Executive team.

"I've seen people work very hard and succeed in changing the company, but if analysts prefer a different sector, the TSR will be down so they will be under-remunerated. Comparative TSR is a bit of a lottery. It doesn't make sense to compare my company to the whole FTSE 100 when there's nothing we can do in comparison to, for example, Russian mining companies."

"Since we brought in the performance conditions there has only been one payout – mainly because of the change in the value of sterling and our use of the TSR measure in constant currency. If it was in local currencies it would have paid out half of the time. That clearly demotivates management."

"Economic circumstances change and you can't alter the incentives. In a PLC rather than private equity, we make the rules rigid, but circumstances change all the time. The priority shouldn't be about setting a set of rules, preventing people fiddling, it should be about motivating performance."

"Financial performance of the company is largely driven by factors way outside management's control. No matter how well or badly management do, the long-term incentives vest or do not vest dependent on such things as fuel prices. Assessments of management performance over the past five years are that it has been extremely strong but every single one of the schemes is underwater; they pay out nothing. Has this led to departures from the company? No, but managers do question the validity of the plans."

8. TSR

Short-term

"I don't support TSR as a performance measure – it's a disaster and it doesn't incentivise. Just because it's how some fund managers are paid doesn't make it appropriate. Managers are paid to run the business and should be incentivised to do things in the short term that will produce results in the long term."

"Well-tailored short-term incentives do have a considerable impact on management behaviour well down into the organisation. For example, at one company we switched bonus from EPS to cashflow. We did that through the recession because getting cash out of the business at a time when stock was increasing and bank covenants were in danger of being breached was important. Lots of shareholders objected because they thought growth in underlying profits was better aligned to their interests but I thought it was exactly the right thing to do and we got fantastic performance out of it."

Longer term

The establishment of performance measures for long- rather than short-term incentives was an area of much greater debate, with a strong dividing line between those who support the use of TSR and those who definitely do not:

"I feel more in line with TSR and in the long run it's more about the value that shareholders receive and Executives' share in it. If I were the sole owner and I made £100 million out of the business I would be well disposed to sharing some of that with executives who created it but, if I made nothing out of it, I'd be pretty keen that they would get nothing out of it – long-term incentives should be based on that very simple premise."

"If you are in a sector with a lot of quoted competitors then TSR is a good way of linking to shareholders but that does not work if you link to TSR in companies in different sectors – and it is not an incentive for management as they think it is a lottery."

9. Comparability and Benchmarking

Benchmarking is key to comparability. Those who discussed the point discussed the need to be a great deal more specific about relevant benchmarks than people tend to be.

"One of the problems of focusing on benchmarking is in trying to get similar outcomes from very different circumstances."

"Benchmarking is fine; it's how mindlessly people apply it that can be a problem."

"One aspect often forgotten is the dark side, the non-quoted sector. This is often as great a competitor for your executives as quoted companies but data is much less readily available."

"The law of unintended consequences has seldom had greater effect than when the Greenbury Report recommended transparency of remuneration. It has driven the comparability factor almost to the point of absurdity. Everyone has to compete with everyone else on quantum, when their contribution and actual performance is hugely different, and everyone believes themselves to be in the top quartile. It's amazing."

One of the problems of focusing on benchmarking is in trying to get similar outcomes from very different circumstances.

10. A sense of entitlement by Executives

There was a clear sense amongst the participants, almost universally, that they are caught in a system from which it will be very difficult to escape. Although the focus of our questions was on LTIPs, similar sentiments emerged in respect of other elements of the CEO package.

"It's quite hard to get away from management's entitlement mentality."

"I hate the phrase 'target bonus'. The presumption has grown that the bonus is normal. I'd like to turn back to when you only got a bonus for exceptional performance. Our CEO's target bonus is 130% of his salary, so if you give him below that you're sending a huge message. The idea that it isn't base salary is nonsense."

"God help us if they (the executive team) didn't have one, but they have very low expectations of them paying out given when the scheme was set and where we are now."

C. PROPOSALS FOR CHANGE

We asked participants what they would like to change about pay structures. Their answers fell into two categories: tactical improvements and more fundamental redesign.

1. Tactical improvements

The watchwords were greater simplicity, visibility and relevance.

Making LTIP performance targets simpler and closer to the CEO's control

"Visibility of measurement targets is all important. Make your incentives simple and clean."

"We have tried to align to things that management can more readily influence e.g. ROCE. In the long run if you get such things right, TSR should follow."

"We are changing the plans to incorporate a balanced scorecard year-on-year rather than simply look at measures such as relative TSR. The scorecard contains more than just financial measures, for example, strategic milestones."

"In our company, the commodity prices dictate the share price – and the reality is whether or not the incentives pay out is just luck. That's why a large number of measures are now based on more manageable things such as cost."

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Limiting the effect of cyclicality, aligning LTIPs to the business cycle

"I'd pay people through the business cycle. Ours is a famously cyclical industry. I'd devise a way of paying them over the 7-8 year cycle, through the good and bad. It would change people's behaviour."

Better Communications

"To ensure that pay is a good motivational tool, it is not sufficient simply to have LTIPs in place. It is important to make sure that those who are to benefit from them understand them. It's easy to assume that high-performing people do understand it all but that's not always the case."

The greater use of options?

"I would like to go back to share options, a simple way of delivering potentially high reward. Changes in accounting rules stopped us but at my company we've gone back to plain vanilla options, with no performance conditions, unless forced to do so. The recipients are happy (the share price going up helps!), it's more easily understood and 10-year options can ride cycles of poor share price performance and still deliver value."

2. More fundamental re-design

"I would scrap long- and short-term incentives and pay a base salary and a short-term discretionary bonus. This doesn't give you retention but you could put in deferral for that."

"We are reducing the number of elements within the LTIPs performance criteria, taking it down from about 25 to 4, greatly reducing the part played by TSR."

"I think in getting the right balance between variable and fixed in general I would raise base salaries. On the other hand I'm in favour of putting more into long-term reward to get alignment with shareholders."

"I would try to simplify – often I think managers just know that there is a nice incentive out there but they're not really motivated apart from the people at the very top of the business. There could be a straightforward salary and annual bonus and then give a certain number of shares every year, with less demanding conditions. The Executive would have to stay with company for an extended period to benefit from the shares, giving a retention element here (though sometimes it might get people staying for too long)."

3. Restore discretion?

"We're going to have to move back to greater discretion but the guidelines advise strongly against discretion so how you do it is not clear – you would need a brave RemCo and I haven't got one!"

"The institutions don't like discretionary bonuses. Yes, this shows a lack of trust but that's not entirely unjustified. The metrics are largely to satisfy institutions. In a sales business, discretionary bonus gets you there… but in a more complex business you do need to break it down. Discretionary bonuses require trust between the employer and the employee. They eliminate gaming opportunities."

"I think allowing the RemCo to exercise judgement is important. That happens now at my company, with the assessment of performance against a balanced scorecard each year. That judgement also feeds through to the LTIP, which is now based on a rolling three-year look at the scorecards. Provided the Board, and within that RemCo, is credible in the eyes of shareholders, and remuneration judgements are explained, then this is fine."

"To exercise discretion, you need a brave RemCo, and you don't always have them. RemCos generally need to be helped to become a lot braver."

4. Adapting the PE model?

"The private equity model is better and it works because there is an event around which everything crystallises. Within PLCs, it's difficult to get people to think long term. People aren't getting up in the morning thinking, "How can I drive up my three-year LTIP?". The reward comes in the form of shares and there is little one can do to control the share price."

"The best LTIPs I've seen (but it doesn't fit all organisations or all circumstances) are when they are not annual grants, but one-off 4 or 5 year awards on a turnaround or corporate event. You need to be able to clearly see what good performance looks like several years out and not change that view. In those cases you can get an entire organisation focused – extremely motivating. You can't keep doing it, so what happens next is difficult."

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ABOUT THE AUTHORS

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