Board Briefing

Fair or Unfair?
getting to grips with executive pay

By Peter Montagnon

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For two decades from 1980 Peter was a senior journalist on the Financial Times, including spells as Head of the Lex Column and in charge of coverage of the international capital markets. His last assignment, from 1994 to 2000, was as Asia Editor, responsible for the FT's coverage of a region stretching from Pakistan to New Zealand.

After graduating in Modern Languages from Cambridge University in 1972, he joined Reuters news agency as a financial journalist. At Reuters he completed assignments in Hong Kong, Zurich and Washington before joining the Financial Times.

Peter served on the European Commission's Corporate Governance Forum from 2005 - 2011. He is past Chairman of the Board of the International Corporate Governance Network and is also a visiting Professor in Corporate Governance at the Cass Business School of the City University, London, and a member of the Corporate Governance Advisory Board of the Norges Bank Investment Management and of the Board of the Hawkamah Institute for Corporate Governance, Dubai.

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Foreword

This is the third publication in the IBE's Board Briefing series, bringing to the attention of those in the boardroom a way of approaching ethical issues.

The focus of this Board Briefing is on UK executive pay, a topic which has been consistently rated as a top ethical concern in the IBE's annual survey of public perceptions of business behaviour.

Whilst many company stakeholders have an opinion and can influence or regulate executive pay, it is the company non-executive directors sitting on the remuneration committee (Remco) who are responsible for determining and setting it. This publication is for them, recognising that setting and negotiating pay levels is a tough and complex task.

The ethical issue at the heart of pay is fairness, to all parties concerned. The committee must not only be in listening mode but also have the courage to face their dilemma of achieving fairness to the company and its shareholders and stakeholders, and to the individual executive.

The issue is explored in this publication through the seven ethical challenges and the set of questions for the remuneration committee to ask itself.

Of course, executive pay is also an international issue given the global nature of business. Though the seven challenges are addressed from a UK standpoint, they are equally relevant to an international audience.

As ever, this publication is written to promote discussion of a difficult topic from an ethical perspective. Executive pay is of public concern, in part because it is not well understood, with attention concentrated on company headline numbers and not achieved performance. The issue has probably, along with the perceived non-payment of corporation tax, done the most to undermine public trust in business – something business needs urgently to address.

Philippa Foster Back

Philippa Foster Back CBE
Director
Institute of Business Ethics

Executive Summary

This Board Briefing is about executive remuneration. It picks up on the ideas expressed in the Institute of Business Ethic's initial Briefing on *Ethics, Risk and Governance* published in 2014.

That Briefing talked about the need for boards to ensure that the incentives they set were in line with the behaviour they wished to see throughout their organisation. Executive remuneration is an important part of this, but it is also very complex and difficult to manage. There is a widespread view that the present system in the UK does not really deliver the right incentives. Indeed, some would say it is fundamentally broken given the rapid increase in total pay over the past couple of decades, high levels of reward for average performance, and, even now, occasional examples of reward for failure.

This situation risks loss of trust among external stakeholders, including customers, saps employee morale and causes reputational damage with policy-makers, regulators and the broader public. Some boards might simply want to wait for the storm to pass, but this is also fraught with danger in today's social-media driven world. Besides, a system of rewarding executives that is fair, easy to explain and justifiable in terms of the interest of the company will make for a better and, in the end, more successful business.

This Briefing suggests some pointers to reform, but is mostly concerned with helping remuneration committees identify and respond to the particular challenges they face. The management of remuneration requires tough and difficult decisions and continuous judgement. Most remuneration committees take their task very seriously but the environment they face is difficult and the complexity is often not fully appreciated by the broader public. This Briefing aims to support them by suggesting ways in which challenges can be dealt with.

The main body of the Briefing sets out seven challenges:

Challenge 1	**Does the remuneration committee know the value of the rewards being delivered?**
Challenge 2	**Will the performance conditions really promote the desired behaviour?**
Challenge 3	**Who really sets the bonus and long-term performance targets?**
Challenge 4	**Does succession planning reduce the pressures?**
Challenge 5	**Should executives get a bonus for good management in a crisis or downturn where shareholders have lost money and jobs have been lost?**
Challenge 6	**What account should remuneration committees take of pay and conditions elsewhere in the company?**
Challenge 7	**Should remuneration be linked to culture and behaviour?**

At the heart of this is the need to have a clear vision of what remuneration committees are trying to achieve. Variable pay has its place in executive remuneration, but those responsible for allocating it must be clear whether the objective is to share out the rewards of success or to incentivise particular aspects of performance. If the latter is the objective, then performance targets need to work. There is little overall evidence that the market has yet found meaningful performance targets which really act positively as incentives.

Two requirements are paramount. First, remuneration committees must have a clear sense of the value of what is being awarded. There is substantial doubt whether this is the case at present, despite conscientious attempts to calculate the net present value of the packages they approve. Second, remuneration committees need to do more to justify the amount they have set. The new reporting regulations introduced by the UK government two years ago have created a much clearer picture of what happens and how the various components of remuneration are assembled, but this simply throws into stark relief the lack of argued rationale in remuneration reports for the quantum around which the remuneration committee has chosen to base the whole package.

> *The management of remuneration requires tough and difficult decisions and continuous judgement.*

Setting performance targets is a difficult process. Sometimes they simply reflect the budget, which may or may not be stretching. The more specific the targets, the more they will drive executives into certain types of behaviour regardless of the long term interests of the company. More general targets such as the widely used relative total shareholder return, leave the executive uncertain about exactly what he or she must do to deliver, and can lead to extreme and erratic outcomes. Remuneration committees must be very careful to ensure that the eventual targets, especially for bonuses, are not in practice set by executives who will make them too easy. A balanced scorecard approach may help to deliver a more rounded result.

Among the other challenges laid out in this Briefing is the need for remuneration committees to promote succession planning which will not force them to look outside the company to fill a gap. Hiring executives from outside can be the right thing for a company at a certain point in its history, but it is normally expensive, much more so than having a choice of well-qualified internal candidates which also limits vulnerability of remuneration committees to pressure from incumbent executives. The Briefing looks at how to reward executives in a downturn and suggests this might be time for greater emphasis on fixed pay with a long timescale for any variable element. At times of difficulty it is also particularly important that remuneration takes account of pay and conditions elsewhere in the company. Finally the Briefing suggests that culture and values should be factored into the equation.

Two guiding themes are fairness and simplicity. Fairness does not mean automatically keeping remuneration down. It means rewarding real contribution. Simplicity means that it is much easier for everybody to tell whether the reward received is really worth the effort delivered. A good test is whether the remuneration committee can explain outcomes in a way that ordinary people can understand, which will help business in the political debate and, more importantly, help restore public trust.

Introduction

There is a common view, not only among the broader public, [1] but also among many of those involved in the actual process, that our system of remunerating senior executives is in need of repair or even radical reform. Over the years it has appeared to reward lavishly executives whose performance has been mediocre, those whose performance might have appeared stellar but who left an impossible legacy, and those who failed to deliver at all. Since the financial crisis, the levels of executive pay have grown more slowly, thanks to the introduction of longer deferrals, claw back of remuneration in situations where the company has suffered a setback and tough performance metrics. Over the slightly longer term, however, they have risen much faster than the reward earned by the average employee. As the premium has grown, so has divisiveness – to the point where the social and political acceptability of the amounts earned by top executives has come into question. This then raises questions about whether the corporate world in general should be more tightly regulated.

This Board Briefing does not set out to offer prescriptive solutions or a radical blueprint for reform. That may be desirable but there are too many kneejerk recipes around for the Institute of Business Ethics (IBE) to add yet another patent proposal. The IBE's declared purpose is to promote high standards of business behaviour based on ethical values. Thus this publication, which follows on from earlier Board Briefings on Ethics, Risk and Governance and Internal Audit, [2] looks at the ethical challenges facing remuneration committees in the belief that a more considered approach will both help the system to operate better and ultimately suggest areas where fundamental reform or evolutionary change could help.

"Devising and implementing a sound system of remuneration requires the exercise of choice and judgement, and this is where ethics comes in.

Devising and implementing a sound system of remuneration requires the exercise of choice and judgement, and this is where ethics comes in. This is not a question of superimposing on remuneration policy a sense of what is absolutely right and what is absolutely wrong, but more a recognition that the choices and judgements that remuneration committees make will be better if they are informed by a clear set of positive values.

Take fairness, for example. Companies should want to espouse fairness in all their dealings because that will help build the trust and respect with their customers, employees and the outside world that secures their franchise. Fairness in executive pay does not necessarily mean that amounts should be low. Individual performance at the top does make a significant difference to a company's performance, and, when that performance is good, it is right that reward should be high, but in these cases reward has to be seen to have been earned and not creamed off at the expense of others.

[1] See IBE Survey *Attitudes of the British Public to Business Ethics 2015* which shows that remuneration remains the public's second largest concern about the behaviour of business after tax avoidance.

[2] IBE Board Briefing (2014) *Ethics, Risk and Governance* by Peter Montagnon and IBE Board Briefing (2015) *Checking Culture: a new role for internal audit* by Peter Montagnon.

Remuneration committees face enormous pressures, from executives wanting more, from shareholders threatening to oppose, from remuneration consultants pushing for new business, from the media and politicians upset at the amounts being paid out and from the sheer demands of a market which is used to paying executives very large amounts.

They need a clear sense of purpose and of what they want to achieve, once again informed by a set of values they are prepared to defend. That requires courage. Sometimes they will have to risk an executive's ire by refusing him or her. Sometimes they will have to defend before a sceptical and resentful public a policy which they believe to be right for their company.

> *"The problem is not simply about straightforward greed but also, and perhaps more importantly, risk aversion.*

It will be easier for them to respond to these challenges if they have developed from the outset a clear and concrete vision of what the concepts of fairness and excess (ie where the limit should lie) mean in the context of their own companies. They need to form and defend their own view, not just be driven by their assessment of whether shareholders will object or employees will be hard done by, or trends for remuneration in their sector. True, these factors cannot be ignored, but they need a clear view of what the job is worth and where the limits lie.

To the outside world the task seems easy – just say 'no' to excess – but remuneration committees must reconcile the objective of fairness with the requirement to pay the 'going rate' for good executives. The way in which the going rate is delivered, meaning the structure and conditions attached to the package, can make a big difference to the resolution of this dilemma.

Frequently the task involves making a judgement about risk, as well as recognising the executive's contractual rights which may have been negotiated in a different remuneration environment. Will the executive leave if he or she does not get the package they require? Will that destabilise the company and cause its share price to collapse by an amount far larger than the extra money being sought? The problem here is not simply about straightforward greed but also, and perhaps more importantly, risk aversion. The chance of the executive calling the remuneration committee's bluff cannot always be calculated in advance. It may be small but the damage from a wrong decision may be very large. So, while acquiescence has a cost, it is often perceived as less risky than confrontation.

Shareholders take a similar view, especially when things are going well. It is better to resist the temptation to interfere and, while they are often keen to tweak a proposal in the hope that it will serve their interests better, they prefer to reserve outright confrontation for extreme cases or cases where they have already lost confidence in the executive concerned.

> *…we are stuck in a world where there is a reluctance to innovate.*

Few companies want to pay their chief executive an amount that is seen to be paltry. That devalues both the individual and the company they serve. Can a remuneration committee be proud to have an executive paid in the lowest quartile? That might be an appropriate starting point for a less experienced individual whose contribution is expected to grow. But directors will worry that the markets will perceive them as stingy, hiring executives on the cheap. Being in the top quartile is a statement of confidence and prestige, but there will always be a ratchet effect if everybody wants to hit that level, or even if they all simply want to be paid at median.

Overcoming these pressures should require clarity and courage. Instead we have too often ducked the issue, opting instead for complication and obfuscation. Almost everybody involved in the process seems to yearn for less complexity. Yet we are stuck in a world where there is a reluctance to innovate, largely for fear on the corporate side that shareholders will object and on the investor side that new arrangements will always be an excuse for a larger payout. Somehow we need to inject some sense into the process. What follows is intended to help.

Getting it Right – the Context

There are three dimensions to decisions about executive remuneration. The first is the absolute amount which is handed over; the second concerns the conditions under which compensation is awarded, and the third is the degree of leverage or split between fixed and variable pay.

One pitfall is to design remuneration to meet the expectations of short term shareholders.

When amounts become large, boards naturally incline to set conditions relating to performance. As a result we have become used to the idea that reward for executives should vary according to what they deliver and leverage has increased in the process.

The theory of variable pay is hard to fault, but we are less certain about the underlying practice. Are we simply giving executives a chance to share in the success of the company after the event (which has traditionally been the rationale for bankers' bonuses), or are we conscientiously seeking to incentivise them to achieve the result that shareholders want? Most people would veer towards the latter choice, but the practice of linking remuneration meaningfully to performance is extremely difficult.

Under current practice good performance is often rewarded for a shorter period compared with the time horizons of many stakeholders, from employees to long term shareholders such as pension funds. One pitfall is to design remuneration to meet the expectations of short term shareholders such as hedge funds, or even mainstream portfolio managers worried about their short term fund performance. Such people have little interest in its long term implications.

The failure of boards to set effective performance conditions over the years has certainly undermined the integrity of the reward process and is arguably the single biggest problem facing the system. This section looks at the nature of the decisions that remuneration committees have to make.

There are two particular things to watch at the outset. First, the pace at which executives can earn their money should not be too fast. With a strong tail-wind in the stock market many current schemes at large companies would enable executives to earn as much in three years as would be needed to secure not only their future but also those of their children and grandchildren. By contrast a lack of tail-wind and a mediocre performance can leave the executive with only a fraction of the maximum. Too much is therefore at stake in the short term, and this can easily lead to short termism in corporate decision-making. Very large rewards should pay out only over an extended period.

...the pace at which executives can earn their money should not be too fast.

Second, there is a difference between variable pay and performance related pay. Given the responsibilities of top executives and their ability to affect the course of the businesses in their charge, there is a lot of sense in remuneration schemes whose outcomes can vary. But this does not necessarily mean imposing specific performance conditions, some of which can turn out to be perverse or irrelevant. A variable outcome can also be achieved simply by requiring executives to buy and hold shares over a very long period. This might seem to veer to the first of the choices mentioned above because it creates a mechanism for sharing in corporate success, but, if the executive concerned is entitled to a dividend flow, [3] it does generate a powerful incentive for long term sustainable cash generation.

Settling on an appropriate amount is one of the most important challenges for a remuneration committee. A number of elements normally come together in this, including the level of reward which is current in the sector, the performance of the company, its size, the experience of the executive concerned, and the complexity or otherwise of the strategic challenge he or she is facing.

> “ *The overwhelming majority of remuneration reports simply involve a post hoc justification of what has been paid out.*

The UK Corporate Governance Code says remuneration should be designed to promote the long term success of the company. [4] Boards should *“avoid paying more than is necessary”*, it continues, but, while this suggests a need for restraint, it is far from providing any clear yardstick. This is deliberate. The Code’s authors believe it is not up to outsiders to determine what is fair and appropriate. Only the board, through its remuneration committee, can do this, because only it has the inside knowledge needed to establish the right amount.

This puts a big onus on the committee to ensure it is comfortable with the eventual figure. Yet rare indeed is the remuneration report which tells the reader why the quantum was set at the level it was. The overwhelming majority of reports simply involve a post hoc justification of what has been paid out. It is very easy to hide behind bland statements about setting remuneration at a level which enables the company to compete for and retain talent. Once again, the temptation in confronting this challenge is to overpay, just to be sure the amount is competitive.

Yet sometimes this leads to poor quality decisions. Top executives are not just motivated by money. They like to compare their reward with those of their peers and feel inferior and unloved if it is noticeably less, but they are also driven to succeed and worried about their reputation if they do not.

[3] Such an arrangement would of course require some conditions around dividend cover.

[4] Published by the Financial Reporting Council, Section D.1, Main and Supporting Principles on Remuneration, p20.

John Cryan, the newly-installed co-chief executive of Deutsche Bank, caused a stir when he said he could not understand why he was offered a contract with a bonus in it. "*I promise you I will not work any harder or any less hard in any year, in any day, because someone is going to pay me more or less,*" he said. [5] He is not alone. Jeroen van der Veer, the former chief executive of Royal Dutch Shell, famously said at the time of his retirement in 2009 that he would have done the job for considerably less. [6]

More recently, the £43m annual remuneration of Sir Martin Sorrell, chief executive of WPP, the advertising concern, has attracted attention, mainly because of a large payout under the company's share scheme. The chairman of WPP's remuneration committee commented that *"the value of Sir Martin's award, while large by any standards, equates to approximately one third of 1% of the increase in value for shareholders"*. [7] Curiously, by using this yardstick, he seemed to be suggesting that the amount was in fact quite modest despite other analysis (see reference to the CEO Value Index on page 20) suggesting that his contribution exaggerated the value contributed.

Linking the amount an executive receives to the short or medium term performance of the share price appears to make sense. It is traditionally seen as aligning the interests of executives and shareholders, but simple use of the criterion begs a number of questions. How far was the share price movement down to one executive? What sort of risk was that executive running to generate the value recorded? How far was the executive facing a downside risk if the result were a fall in value? Was the executive able to influence the share price at critical moments, for example by announcing a share buy-back? How durable is the value purportedly created?

Thus, decisions on pay quantum can take account of supposedly objective indicators like share price developments, profits, and levels of pay earned by top executives in comparable organisations, but each of these are subject to interpretation and qualification. The Investment Association stresses the link to long term sustainable value creation in its Principles of Remuneration. [8] As points of reference, it suggests a policy that links aggregate remuneration to overall corporate performance, the pattern of employee remuneration throughout the company and a relevant and fairly constructed peer universe. It warns against using median pay as a benchmark since this, if used broadly, can lead to ratcheted increases in remuneration.

Separate principles developed by a group of asset owners and the National Association of Pension Funds [9] (now renamed the Pensions and Lifetime Savings Association) stress the alignment of pay to the desired corporate culture throughout the organisation. They also encourage remuneration committees to use the discretion afforded them by shareholders to ensure that rewards properly reflect business performance.

[5] Financial Times, 24 November 2015.

[6] Financial Times interview, 9 June 2009. *"You have to realise: if I had been paid 50% more, I would not have done it better. If I had been paid 50% less, then I would not have done it worse."*.

[7] WPP Annual Report 2014.

[8] Investment Association *Principles of Remuneration 2014* available on www.ivis.co.uk https://www.ivis.co.uk/media/10277/Principles-of-Remuneration-2014.pdf

[9] *Remuneration principles for building and reinforcing long-term business success* jointly produced by Hermes EOS, the NAPF, BT Pension Scheme, RPMI Railpen Investments and Universities Superannuation Scheme (November 2013). Available on www.plsa.co.uk

Ultimately, decisions on quantum are a matter of judgement. Remuneration committees need a firm view on what is appropriate and need to stick to it. Where their decision is informed by benchmarks or conditions elsewhere, they need to take a critical look to see that they are being used properly. And they need to consider whether the outcome is appropriate for the purposes of the company.

> *Remuneration committees need a firm view on what is appropriate and need to stick to it.*

As noted above, using median remuneration for the sector is unhelpful because of its ratchet implications and because it fails to recognise that each company is different. Equally, it is important to have the courage to say 'no' to amounts that are too high. The risk that executives will leave is mostly smaller than it appears, and it is worth considering that those who do flounce off in the face of a reasonable offer may well be the sort of executive the company could do without. Admittedly a refusal to pay what an executive asks can leave that person frustrated and more likely to listen to head-hunters when they call. Succession planning can help make dealing with this easier as the next chapter explores in more detail. The worst approach that a remuneration committee can take is to give in to an excessive demand from an executive and then devote all its effort as well as that of its consultant to the tactical task of getting the deal through the shareholders. This is an abdication of responsibility, but it happens from time to time.

> *Equally, it is important to have the courage to say 'no' to amounts that are too high.*

In practice, many committees settle on an amount they would like to pay their chief executive in conditions where he or she is performing on target, and then construct a set of performance criteria around this 'on-target' figure. The fact that these criteria are likely to include a short term bonus is one thing which baffles and even outrages the public, especially when it is paid for 'on-target' performance. Of course, the rarified world of executive remuneration adopts a different rationale for bonuses. When amounts are very large it is important that the board has significant discretionary powers to withhold payment. This is clear from what has happened to the banks. As they have been prevented by European law [10] from paying large bonuses, the fixed element of the reward package (salary) has grown, but this is paid automatically regardless of whether or not the bank is making losses. The way bankers are now remunerated guarantees them more money regardless of how they behave. It is doubtful if this was what legislators intended.

Nonetheless the subtlety of this argument is lost on the broader public. That in turn is an indication of how out of touch with most people's everyday reality the process of rewarding top executives has become.

[10] Capital Requirements Directive IV (CRD IV).

Bonuses, of course, are part of the effort to link reward to performance, and here a new set of challenges comes in. Commentators such as Anthony Hilton [11] have pointed out that executive remuneration has increased dramatically in real terms over recent years but without a corresponding improvement in corporate profitability. In other words remuneration and performance are effectively divorced. Shareholders generally do want to see a clear link between remuneration and delivery of the company's strategic objectives, but both they and companies themselves have found it hard to define precisely the performance conditions which would achieve this.

What is very apparent from accumulated experience is that remuneration committees need to have a clear sense of what they are there for, of what they want to achieve and of the values they intend to apply in doing so. The Performance & Reward Centre (PARC) sums up the purpose of the committee as being to:

- set and monitor fair and appropriate remuneration policy, structures and levels for the populations in its scope
- demonstrate that its policies and reward decisions align with business strategy
- support sustainable business performance (including mitigating risk and safeguarding reputation)
- show balanced attention to executive and shareholder interests; and
- support an effective and efficient talent management strategy. [12]

> *…a clear sense is needed of what they are there for, of what they want to achieve and of the values they intend to apply in doing so.*

None of this is possible if the committee is not driven by a clear set of values. These will obviously be a reflection of the company's broader values, but three qualities stand out as desirable: a clear determination to act fairly and a willingness to be judged on having done so; a strong commitment to independence even when this requires courage; and third, an open culture which is not afraid to communicate its decisions and explain why they were made.

[11] See for example: Evening Standard, 17 September 2015 'This executive pay farce will only end on the moral high ground'.

[12] PARC *The UK plc Remuneration Committee: its evolving purpose, effectiveness and challenges* (June 2015). http://www.parcentre.co.uk

Challenge 1

Does the remuneration committee know the value of the rewards being delivered?

The high degree of leverage in executive remuneration, meaning the proportion which is dependent on performance, and the timeframe over which it is earned, makes it hard to know the precise value of rewards being delivered to top executives. While remuneration committees do look at the net present value of the awards they are making, the calculation is at best a highly approximate central forecast of a wide range of possible outcomes. Yet conscientious remuneration committees need a clear understanding of the value of what they are approving. If the system currently makes that hard, then this is one of the strongest reasons for reforming it.

BHP Billiton's 2014 Annual Report contains a striking revelation about remuneration. Under UK regulations [13] the company is required to give a single figure for the compensation received by its chief executive, Andrew Mackenzie. Using the approach required by UK legislation the report calculates this as US$7.98m, but, a few pages further on, the report gives a different figure of US$7.12m. So just how much did Mr Mackenzie actually earn?

The difference is explained by the way in which remuneration based on long and short term share awards are treated in the calculation. Under UK rules, the relevant figure is the amount actually paid out during the year in question, including maturing schemes from prior years.

...the complexity of executive pay structures means there is no objective way of deciding what executives are actually earning.

Two views of pay at BHP Billiton

Chief executive's compensation in 2014 (US$'000) [14]

	UK rules	IFRS standard
Salary	1,700	1,700
Benefits	92	92
Short term plan	3,136	2,560
Long term plan	2,635	2,346
Pension	425	425
Total	**7,988**	**7,123**

[13] The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013.

[14] BHP Billiton Annual Report 2014.

For the other calculation, the company used the formula prescribed by the international accounting rules (IFRS) which requires companies to put a value on the new share awards made over during the year even though they have not vested. Basically this means ascribing a net present value to them, rather like the way in which corporate financiers put a value on options.

It is important to stress that this example should not be taken as a judgement on the level of remuneration at BHP Billiton, but more as evidence that we are often not at all sure how much an executive is actually being paid. Some would argue that these two figures are simply the result of different accounting conventions. This school would say that the critical question is whether remunerations in this range is more appropriate than say a range of $2m to $3m or $9m to $10m, and this is probably right.

Yet the BHP Billiton example is more than technical. It shows graphically how the complexity of executive pay structures means there is no objective way of deciding what executives are actually earning. This is all the more disconcerting when demanding executives will sometimes use a series of conflicting figures to justify a need for more remuneration. By using the UK approach based on outcomes, the company reaches a figure which actually includes remuneration earned in prior years because of the time it takes for awards to vest. Also the value of the awards received will have been influenced by the overall stock market performance during the reference period. This will normally have been heavily influenced by external factors such as the trend in interest rates which have nothing to do with the individual executive's performance. But if this means that the UK figure is rendered unreliable as a measure by the inclusion of remuneration effectively earned in prior years and by general stock market 'noise', the IFRS figure is also flawed.

The IFRS figure takes a logical approach in principle. It seeks to value what has actually been handed over by the company to the executive in the year in question, including grants of options and shares which will not be freely available to the executive until performance targets have been met some time in the future. This approach avoids the confusion created by the UK approach because it ignores the stock market noise mentioned above and narrows down the calculation to the value of new remuneration actually handed over in the year in question. In theory this prevents the calculation of a misleading single figure which actually includes remuneration received in previous years.

This approach seems more honest, but it only works if we are able to calculate reliably the value of what has been made available, and herein lies the problem. Almost nobody associated with the world of remuneration appears to believe the IFRS figure gives an accurate representation. The UK government certainly did not want to rely on it when requiring single figure disclosure; stock analysts do not regard it as relevant; remuneration consultants and shareholders dealing with remuneration issues at companies in which they invest do not refer to it. The reason is not necessarily because the IFRS has deliberately picked a flawed formula. It is more because nobody can really calculate the real value of these share-based payments in a way that everybody accepts is correct.

> “
> *...nobody can really calculate the real value of these share-based payments*

A figure built around option pricing is always likely to be flawed, not least because the incorporation of performance conditions into share schemes makes the value of the award almost impossibly difficult to calculate.

Yet the component of Mr Mackenzie's pay at BHP Billiton which is affected by this is rather large. Excluding the cash element of the annual bonus, long and short term share-related remuneration accounts for 47% of the total package, and the ratios are similar for many other companies. This points to the awkward conclusion that remuneration committees often do not really know the value of what they are handing over, not because they are lazy or don't care, but because it is impossible to work out.

"...the first big ethical challenge for remuneration committees. Do they know the value of what they are giving away?

This is the first big ethical challenge for remuneration committees. Do they know the value of what they are giving away? And, if they do not, should they be giving it at all? One answer to this question is that remuneration committees should be deeply suspicious of complex share schemes. It may be that they should be looking to rely more on cash payments and on shares bought in the market and handed over without performance conditions. It is always possible to tell what such compensation is worth when it is handed over. At the very least remuneration committees should not agree to share schemes unless they are absolutely confident that both they and the executives who receive them are able to value them accurately.

Under the current approach, however, valuation requires a lot of guess-work. Anecdotal evidence suggests that directors undervalue what they receive (which is one reason why they usually want more) and find it really difficult to know exactly what they are supposed to do to ensure the awards vest. It all seems too much like a high-stakes lottery. But if that is the case, the incentivisation element clearly cannot work. Sometimes big mistakes can be made which turn out to be expensive later, and some executives will in practice end up with too little reward.

Above all, an approach whereby remuneration committees do not know the value of what they are making over, fails the fairness test because they cannot really tell whether they are overpaying or underpaying. That is not fair to the executives who are employed to run the company or to the shareholders who ultimately have to foot the bill.

Challenge 2

Will the performance conditions really promote the desired behaviour?

An appropriate alignment of remuneration to performance is one of the main features used to justify the large amounts earned by executive directors. Often this means linking the reward received by directors to the returns received by shareholders. Yet, remuneration committees struggle to develop really meaningful performance conditions.

Traditionally remuneration committees fall back on the concept of total shareholder return. This is the return received by shareholders from dividends and from movements in the share price. Such is the importance of this indicator that UK companies are required to show it in their annual reports. [15] On its own total shareholder return is not, however, very meaningful because it is heavily affected by the general trend of the stock market. It becomes more helpful, however, when it is considered in comparison to the returns achieved by competitor companies and when this comparison is run over a long period. This is because a longer period of comparison tends to iron out blips that arise if the grant is made or the award vests at a time of unusual movement in the share price which would distort the result.

> *…the amounts received by executives vary widely when considered against the corporate value they have generated.*

In theory relative total shareholder return (TSR) is a good measure because it implicitly includes all the specific performance conditions that executives need to meet to deliver for their shareholders. Yet it can easily leave executives confused because they do not know exactly what they need to do to earn the rewards. Also, the comparator group of companies which is used to calculate relative return may not provide reliable comparisons.

According to one measure, the amounts received by executives vary widely when considered against the corporate value they have generated. Simon Patterson, a consultant who runs Pearl Meyer (London), has produced a CEO Value Index, which looks at the shareholder value generated by executives for each £1 paid in remuneration across the UK's leading quoted companies (the top 10 are listed on the next page). The measure is calculated using value achieved over a period of four years to avoid short term distortions. The latest Index [16] shows the best performer to be Dave Forsey of Sports Direct (incidentally a company that has been widely criticised for its corporate governance) [17] whose value added is three times that of the executive in tenth place, Steve Holliday of National Grid.

[15] Directors' Remuneration Report Regulations 2002.

[16] Sunday Times, 8 November 2015. The figure for Sports Direct reflects the unusual structure of its pay scheme whereby the chief executive's base pay is relatively low at £150k and the share awards only vest on outstanding performance and then only vest in their entirety. The condition has not been met in any of the last four years.

[17] See Financial Times, 7 September 2015, 'Royal London to vote against Mike Ashley at Sports Direct meeting'.

CEO Value Index – the ten best value executives

Position	Company	Chief executive	Value added
1	Sports Direct International	Dave Forsey	4,482
2	AstraZeneca	Pascal Soriot	3,103
3	GlaxoSmithKline	Sir Andrew Witty	2,827
4	BAT	Nicandro Durante	2,666
5	Imperial Tobacco Group	Alison Cooper	2,513
6	SABMiller	Alan Clark	2,477
7	BP	Robert Dudley	2,055
8	Aviva	Mark Wilson	1,799
9	Royal Dutch Shell	Ben van Beurden	1,565
10	National Grid	Steve Holliday	1,460

Those at the bottom of the overall list include Sir Martin Sorrell, ironically, given the justification advanced by the company's remuneration committee and quoted above (see page13), as well as Jeremy Darroch of Sky and successive chief executives of BHP Billiton.

The calculation is, nonetheless, only a rule of thumb. There is a bunching of sectors at the very top with pharmaceuticals, tobacco and oil companies figuring prominently. Sometimes the figure may be distorted by expectations of a takeover. At the time of writing a bid was on the table for SABMiller which seemed set to go through. Also Pearl Meyer has had to make its own judgement on what constitutes a definitive figure for each executive's pay. It includes, for example, the number of shares vesting in the final two years of the performance period. For all these reasons, it would be unwise to rely too directly on the CEO Index. What the differential result does show, however, is that the systems in place across the market do not consistently produce results objectively in line with performance.

If relative TSR is not a good measure, then the question arises as to what would be better. Ideally the performance criteria chosen by remuneration committees should be clearly aligned with delivery of the company's agreed strategy, only provide stellar rewards for delivery of stellar performance, and be difficult, or better still impossible, for the executives to manipulate.

HSBC has tried a different approach. [18] For two years from 2014, it abandoned medium term share plans which vest on maturity according to whether performance targets are met. Instead it allocated share awards based on criteria already achieved at the time of grant and which are closely related to the company's strategy. These included capital strength, the ability to make a progressive dividend pay-out, the cost-efficiency ratio, strategy execution, risk and compliance and people. Shares awarded under the scheme vest after five years and must then be held for the duration of the director's employment with the company. The company felt this created both a clear set of objectives for directors and a long run alignment with the interest of shareholders.

[18] See HSBC Annual Reports from 2013 onwards.

HSBC's policy, however, proved controversial with shareholders, partly because it included a substantial non-financial element where the remuneration committee is obliged to exercise judgement, for example on the execution of strategy.

Other objections were that the criteria represented things the executive should be doing anyway, that the actual targets were not stretching enough and that there were no continuing performance conditions attached to the share award and, finally, that the available amounts were too high.

In the event, the pressure was so great that HSBC felt obliged to abandon the experiment. Yet the shareholder response, which in part seems based on preference for doing things the familiar way and a gut resistance to innovation, is not particularly helpful because it pushes the market back to its old unsatisfactory ways. The underlying concept behind the HSBC approach seemed sensible, even if there are questions about the detail and the implementation. Importantly it met the first challenge set above, that remuneration committees should know the value of what they are handing over when they hand it over.

The company had also sought to identify a clear set of performance criteria which were directly related to the company's overall strategy. The executives were to be clear what they had to do to earn their reward. The five-year vesting period and subsequent holding obligation introduced a long term commitment which meant that executives could not bet the ranch successfully and walk off into the sunset. Finally, the remuneration committee had specific discretion to reduce the awards if targets had been met in a formal sense but the overall performance of the bank had been disappointing.

This analysis points to some clear lessons.

- First, it is very difficult to devise meaningful performance targets which bite. Relative TSR probably does not fit the bill because it is at one and the same time a lottery and because, at key moments in the cycle, it can be gamed. Some argue that a TSR approach which depends on the share price reduces the incentive to invest and encourages financial initiatives like share buybacks intended mainly to bolster the share price in the short term.
- It is important that targets are set in a way that does not encourage undesirable short term behaviour. Criteria based on return on equity have been criticised, especially for rewarding bank executives because they encourage excessive gearing.
- Instead executives need practical targets which they can clearly understand, which are difficult to game in the aggregate, and which they can reasonably be expected to achieve. Most importantly these should relate to the delivery of the agreed strategy.

> *…it is very difficult to devise meaningful performance targets which bite.*

- The time horizon for delivery of the award should be a long one as this is consistent with the need for the company to deliver sustainable returns.
- The mix of the package between fixed and variable pay matters. Given that companies will always have to take the market rate into account, a key decision is the proportion that should be variable. The larger the proportion which is performance related, the greater the strain on bonus targets and the greater the risk of inappropriate risk taking and short termism.
- Finally, and crucially, remuneration committees will always have to exercise a large amount of judgement. This starts with the choice of the actual amount to pay. It continues with the mix between fixed and variable pay and consideration around the possible introduction of softer values-based performance criteria that will promote long term success and mitigate risk of crisis or scandal that could damage the company's reputation and harm its franchise. This requires independence and courage, a sense of fairness, and a clear view of what constitutes an acceptable outcome that the committee would be happy to defend.

“ *…crucially, remuneration committees will always have to exercise a large amount of judgement.*

3

Challenge 3

Who really sets the bonus and long term performance targets?

Remuneration committees come under constant pressure from executives anxious to bolster their income and from shareholders anxious to ensure that they do not pay too much. The requirement for independence means that they should be able to stand aside from these pressures so as to produce a remuneration policy which is in the company's overall interest. A particularly hard task is the setting of bonus conditions.

Because the annual bonus is paid on the basis of achievements actually delivered during the year, the targets are normally quite granular. They may contain specific sales and margin targets, for example. In setting such targets, remuneration committees are vulnerable because the executives, notably the chief executive and finance director who have a close handle on the businesses, are in a much better position to know what is really stretching and what is easy to achieve.

“Remuneration committees need to be satisfied that they are not paying over the odds for a result that was going to be achieved anyway.

Executives thus have an incentive to push for targets that are not really as demanding as they look. This is a challenge that remuneration committees should resist. They need to be satisfied that they are not paying over the odds for a result that was going to be achieved anyway.

Obviously, the stronger the grasp that remuneration committee members have of the way the business is going, the easier it will be to detect and deal with self-interested pressure from the executives. They can enlist the help of the audit committee in looking at specific targets and determining whether they are suitably stretching, although, because the audit committee tends to look back more at what has happened rather than to the future, this may be a task for the full board.

Committees should also be able to rely on properly independent advice from their consultants. A step forward in recent years has been the adoption of best practice where these are normally appointed by the remuneration committee, report to the committee and are capable of being fired by the committee if they are not independent. The committee should authorise any work done by the consultants for other parts of the company in order to ensure that their independence is not compromised.

Similar arguments apply to the conditions for any longer term share-based schemes. Should these pay out automatically if the company simply delivers on its medium term plan, or should the executives actually exceed expectations before the schemes deliver? Remuneration committees must make an independent assessment of the degree of challenge in the plan before coming to a conclusion.

Getting the bonuses right, however, is particularly important because they are easier for the broader public to understand than long term share incentives and therefore attract a lot of public and press attention. The public, moreover, have a conventional view of bonuses, which are seen as a payment for extra effort. The arcane world of executive remuneration, however, will talk of on-target bonuses, prompting the question from intelligent lay observers as to why anyone should get a bonus for simply being on target. That does not happen for more junior employees who never expect a bonus, but simply earn their salary and run the risk of being fired if they do not perform. To them an on-target bonus looks like extra reward for simply turning up. Their scepticism is fuelled by the apparent inexorability of payouts. According to Deloitte's 2015 review of executive remuneration, median bonuses in the FTSE100 have only once fallen below 70% of their maximum potential in the past 10 years.

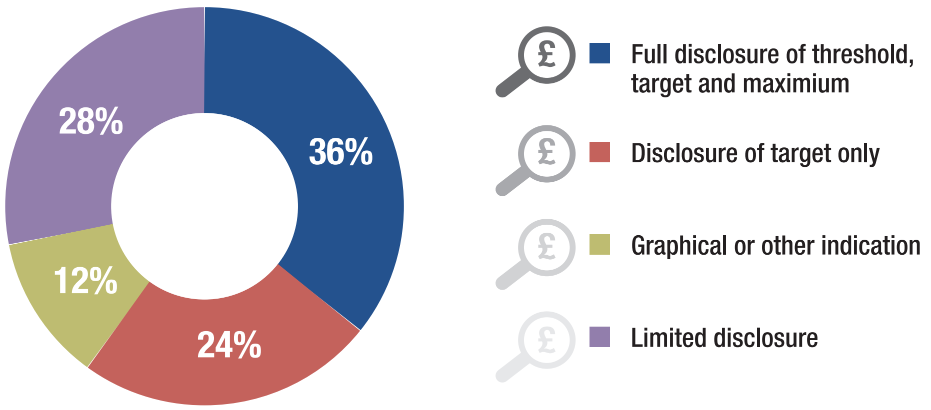
“ ...a bonus ...is actually better described as an amount of the salary which is at risk unless the recipient delivers as expected.

What are called bonuses play a significant role in executive pay because of the overall amounts involved. As these became large, it seemed sensible not to make the entire on-target package available automatically. Executives had to reach the target or forfeit some of the package. What is called a bonus for the purposes of executive remuneration is actually better described as an amount of the salary which is at risk unless the recipient delivers as expected. Thus, although it has now been complicated by the incorporation of a deferred element to the bonus and claw back, [19] the actual going rate for an executive job should probably be seen as the fixed remuneration plus the on-target bonus. While there is a rationale for this, however, the fact remains that bonuses are very sensitive in terms of public opinion.

Remuneration committees thus have to be particularly sensitive to the reputational impact of getting bonuses wrong. It is important for them to ask themselves who really sets the relevant targets. If they have simply rubber stamped a proposal from the executive, there is likely to be a problem. Also, UK government regulations (see footnote 13 on page 16 above) now require considerable disclosure around bonus conditions even though not all companies appear to be fully compliant yet.

[19] The term claw back refers to the ability of the remuneration committee to claw back part or all of the deferred bonus in the event of a problem arising during the deferral period. This has become a common part of bankers' remuneration after supervisors realised that in the run up to the financial crisis of 2008 bankers had been paid large bonuses for booking seemingly profitable deals that very quickly afterwards were revealed as loss-making. The concept is also now widely used in other sectors.

Levels of bonus disclosure by FTSE100 companies



Source: PwC

The more that remuneration committees disclose about their bonus conditions, the more they will have to justify them and the less likely they are to yield to pressure to make them too easy. A sensible policy is to be as open as possible about what conditions were set and how the final decision was made.

Critics will say that disclosure of bonus targets before the event is akin to making forecasts that are not allowed under stock market listing rules. Also some will point to the risk of giving away sensitive information to the firm's competitors. While these criticisms can easily be overdone, they have some merit. The problems are much smaller if detailed disclosure is made after the event so that shareholders can see why the eventual bonus was set at the level it was. This is also an important opportunity for the remuneration committee to justify any use of discretion in applying the targets.

4

Challenge 4

Does succession planning reduce the pressures?

Hiring a new chief executive is a big task for corporate boards. On each occasion they will have to consider whether to promote from within the organisation or look outside.

...if there is a need for a change in strategic direction, it will be sensible to look outside.

Quite often, if there is a need for a change in strategic direction, it will be sensible to look outside, but then the board will have to decide how far it is willing to pay up for a good recruit. In these circumstances, underpaying can be dangerous because the candidate may not be of the desired calibre. An added expense is likely to be the need to buy the successful candidate out of existing arrangements. All of this may make sense, provided the choice is a conscious one and not driven by a failure to nurture suitable candidates internally. Two contrasting examples of what can happen are the experience of BG Group and National Grid.

BG Group, the oil and gas exploration group, caused a storm when it announced the appointment of Helge Lund as its new chief executive in November 2014. [20] At one level Mr Lund, the very successful chief executive of Norway's Statoil, was a fine catch for a company which badly needed a strong new chief executive to restore its strategic direction. The difficulty was in the amount he was due to be paid. Including a £12m 'golden hello' paid in shares, the initial package was estimated to be worth somewhat more than £25m. This was not only vastly more than Mr Lund had been receiving from Statoil. It was also in breach of the company's remuneration policy which had been formally approved by shareholders only months before.

The company argued strongly that the package was necessary to secure the services of such an able executive. In the board's judgement, he might decline to sign on if not offered a generous inducement. Shareholders in contrast were worried not only about the size of the package, which was large even by oil company standards, but also about the precedent of allowing a company to breach its remuneration policy so soon after they had approved it. In the event the package was modified to bring it back in line with the policy, though it remained very generous.

One in five shareholders that voted at the subsequent general meeting failed to approve it and 15% voted against the re-election of the remuneration committee chairman, Sir John Hood.

[20] The Guardian, 26 November 2014, 'BG faces battle with shareholders over chief executive's pay'.

This is all in striking contrast with the experience of National Grid which announced about a year later that it was appointing a new chief executive. Steve Holliday was to step down after 10 years and be replaced by John Pettigrew. [21] Unlike Mr Lund at BG, Mr Pettigrew was an insider, having worked his entire career at the company. There was no need for a golden hello, and indeed his base pay is to be only £825,000, markedly lower than that of Mr Holliday whose salary is £1.6m, according to the company's annual report. This reflects the fact that Mr Pettigrew has to grow into a job which Mr Holliday has been doing for ten years.

Of course the background to the two situations is fundamentally different. Sometimes companies do need to recruit a strong new executive from outside to lead a strategic transformation. In those circumstances they will need to offer sufficient reward to attract the talent they need. In other cases, such as National Grid, the opportunity should be there to recruit from inside.

> *Where a company has a strong internal candidate or range of candidates to choose from, then the risk is much lower.*

The lesson for remuneration committees, however, is to keep abreast of succession planning. Where a company has a strong internal candidate or range of candidates to choose from, then the risk of negative remuneration consequences from succession is much lower. There is no need to buy an outside candidate out of benefits earned elsewhere and which would lapse in the event of a move. This is not to say that companies should always recruit internally, and they must be prepared to look outside if the need arises.

The remuneration committee should keep in touch with the nominations committee to ensure that succession planning is being carried out conscientiously. Many problems not only in remuneration but also in governance more generally arise from failed succession planning and from the tendency of strong chief executives to push the issue aside until they are about to leave, by which time it is often too late. A successor or a choice of successors have not been identified and groomed and the company faces a difficult recruitment problem.

[21] The Guardian, 3 November 2015, 'National Grid chief to step down'.

5

Challenge 5

Should executives get a bonus for good management in a crisis or downturn where shareholders have lost money and jobs have been lost?

Ensuring executives are properly rewarded for managing during a crisis is one of the hardest tasks for remuneration committees. This can be a time in a company's history when strong leadership is vital, but there are also important risks to reputation and to staff morale when a crisis leadership is well rewarded and, perhaps continues to receive bonuses, even while the company is making losses.

The situation facing the banks in the aftermath of the financial crisis provides a partial example of this. While the losses arose in particular divisions, others continued to operate profitably, and indeed their earnings were needed to cover the losses. Senior management feared that if they failed to pay bonuses to those working in profitable departments, their staff would simply leave and find jobs in other institutions where they would be able to earn bonuses. In many cases therefore they continued to pay bonuses, creating a storm of outrage among the public who could not understand why lavish bonuses were being paid to workers in banks that had required a high level of support from the taxpayer. In the end the politicians took over and the European Parliament enacted legislation severely limiting the ability of banks to pay bonuses.

Remuneration committees looking to reward executive directors charged with the job of turning a company round face a somewhat different problem. They will probably have fired the executives on whose watch the problem occurred and will need to recruit a new leadership whose job may be truly daunting. While it may involve laying off employees and closing down or selling parts of the business, there is also a high level of risk for the executive concerned. Failure to turn the company round could lead to a loss of reputation, and it is not always easy to tell from outside how deep-rooted the problems are. It is therefore difficult to attract strong executives without ensuring they are well-rewarded.

Sometimes new executives are blamed for the very problems they are trying to sort out. Stephen Hester was lambasted by the public for his pay at Royal Bank of Scotland, but the reason why the bank was declaring losses was because of the damage inflicted by the previous regime.

> *Sometimes new executives are blamed for the very problems they are trying to sort out.*

What is the right approach to this conundrum? Part of the answer lies in getting the mix of fixed and variable pay right. Part lies in ensuring that the variable element is deferred and conditional on long term success in turning the situation round. An annual bonus, which will grate with both staff and the public, fits badly into the equation. Instead, a relatively high fixed salary, presented as the amount being paid to take on the challenge is a useful starting point. On top of that the executive could be awarded a specific number of shares which would vest after the work is completed. That would create a variable reward, but only when success is assured.

> *…a relatively high fixed salary, presented as the amount being paid to take on the challenge is a useful starting point.*

One of the problems with giving executives shares with a market value of a given proportion of salary is that too many can be awarded when the share price is low and volatile. That can lead to excessive windfall gains later. This was the case at the height of the banking crisis when companies insisted on continuing to award shares based on a multiple of salary. Because of the volatility of the share price, the underlying value of these awards was very much higher than previously. In fact companies were paying a substantial pay increase which came back to haunt them later as the schemes matured and paid out.

Giving executives involved in turn round situations a specific number of shares takes away the element of windfall which could be all the greater given the need to pay a higher fixed salary. It still provides a strong incentive to the executive to manage the way out of crisis, though care needs to be exercised in setting the number to ensure the reward does properly reflect the effort committed and is not swollen by exaggerated market fluctuations. Some would argue that a fixed number of shares should be offered at a given strike price.

Sometimes incumbent executives have to work their way through a period of corporate or sectoral challenge. This is, for example, currently the case in the basic resources sector. At these points it is important to ensure that there is some correlation between the level of pay received by the top executives and the treatment of the broader workforce. It is difficult to justify continuing bonuses and pay increases when workers are being laid off and salaries are frozen.

6

Challenge 6

What account should remuneration committees take of pay and conditions elsewhere in the company?

The new UK reporting regulations mentioned above, and which have been in force since 2013, require companies to publish a percentage increase figure for the remuneration of the chief executive alongside a percentage increase in respect of employees of the company taken as a whole. [21] **They also require companies to publish a table setting out the amount spent on directors' remuneration, the amount spent on remuneration to all employees, the amount distributed to shareholders and any other significant distributions. However, these disclosures may be of limited value.**

The regulatory innovation is understandable given the deep public scepticism about directors' pay and the widespread belief that directors have been taking far more than they deserve out of the common pot. Yet the data revealed by these disclosures is of limited value for several reasons. First, if, as has been shown above, there is ample doubt about the exact amount executives are receiving, there is no solid base for comparison. The regulations get round this by limiting the type of remuneration to be disclosed for comparison purposes, but this simply distorts the result. Second, it is not clear who constitutes employees. A company which outsources a lot of work to low-paid employees in an overseas jurisdiction may come up with a markedly different result to one which does not. As to the sharing of the pot, this has been driven by the large amounts taken by bankers (not just directors) which have exceeded dividends paid to shareholders and amounts reinvested in the business. In non-banking sectors, the amount taken by directors, especially in larger companies may well be a very small proportion of the pot – a point made by the remuneration committee of WPP cited above.

“This unfortunate result should not be seen as… regulation gone mad.

This unfortunate result in terms of creating an unhelpful disclosure requirement should not be seen, however, just as regulation gone mad. It arose from a very real sense of public irritation at a time when wages and living standards were being depressed by the recession in the aftermath of the financial crisis. The lesson for remuneration committees is that they have to be sensitive to this. There are no formulaic rules which will give them an answer, but they must be conscientious and fair in their use of judgement. The UK Corporate Governance Code says simply that remuneration committees should be “*sensitive to pay and employment conditions elsewhere in the group*”.

[22] The new UK reporting regulations were referred to on pp16 and 24 above. The full citation here is the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendments) Regulations 2013 (SI 1981), reg 3 substituting Sched 8 (Quoted companies: Directors' Remuneration Report), Part 3, paras 19 and 20 of the 2008 Regulations (SI 410).

> *One important consideration is the level and structure of executive pay at levels immediately below the board.*

This is wise advice and should be followed. Remuneration committees do not need rules to tell them when executive remuneration is going too far for the company's own good. They do need the courage to act with fairness and determination in these circumstances, but it is not obvious that all companies recognise this. One important consideration is the level and structure of executive pay at levels immediately below the board. Because of the requirement to offer shareholders a vote on directors' remuneration, committees tend to spend a disproportionate amount of time on the remuneration of the few executives, usually only the chief executive and chief financial officer, who actually sit on the board. A more holistic approach may help, not least because remuneration committees should be aware of the risk of creating too big a gulf between the top paid directors and other senior executives. This can be bad for morale, undermine the collegiate approach and make succession planning more difficult.

In the immediate aftermath of the financial crisis, many companies froze the base pay of their top executives in line with the treatment of other employees. This was a sensible response. Now that the crisis has lifted somewhat and economic growth has returned, wages across the system have started to grow again. It is right that top management should share in this, but the share has to be proportionate. Anecdotal evidence from shareholders in the Autumn of 2015 suggested that a handful of companies were using the opportunity to propose a substantial double digit increase in their chief executive's pay on the grounds that, after a long period of restraint, there is a need to catch up.

This is curiously insensitive when the rest of the workforce has no such opportunity. If pay has been rebased across the whole economy there is no reason why top executives should claim to be exceptional. Nothing could be more calculated to forfeit trust and respect.

It should be noted also in the context of this discussion that gender discrimination in pay is coming under increasing scrutiny. Again, this runs directly counter to the concept of fairness, and remuneration committees will never find an acceptable justification for it.

7

Challenge 7

Should remuneration be linked to culture and behaviour?

Corporate culture has become an important agenda item in the debate on corporate governance. The emphasis is no longer just on what companies do, but also on how they do it. The system of remuneration is part of this.

A succession of corporate problems from Tesco to Volkswagen, Northern Rock and Toshiba have exposed how flawed culture played an important part in triggering eventual crisis. Small wonder, therefore, that financial regulators have begun to look more closely at culture. They have had to deal with the consequences of what happens when the culture within an organisation encourages short term risk taking, contempt for the interest of customers and sometimes outright deceit.

Financial regulators saw the system of remuneration as a major contributor to this. So it is no surprise that they have clamped down as described above. Bankers now face limits on their variable pay, more of the remuneration package must be paid in shares, performance horizons have become longer term and there is extensive application of claw back arrangements, so that banks can recover compensation paid to reward deals that, while apparently profitable in the short term, turned out to be loss-making in the longer term.

The supposed purpose of this is to discourage excessive risk taking in the interest of short term reward. One can quibble with the mechanisms introduced by the regulators – and banks have in any case found ways of getting round them. But it is hard to argue with the principle. The question is: should one go further and seek to positively reward a good culture rather than simply penalising a bad one? Or should one simply expect a good culture anyway?

It is clear that the way in which incentives are set drives behaviour. Academic research shows that top executives tend to cut back on research and development expenditure as well as other forms of investment in order to boost their short term returns at times when they need to bolster the share price to maximise the reward they can earn as share schemes vest. [23] The way in which incentives can encourage risk taking is less obvious but can be highly insidious. Long term horizons are a good response to this, but remuneration committees also need to pay close attention to the company's risk appetite and ensure that their policies are in line with this.

It is clear that the way in which incentives are set drives behaviour.

[23] See Alex Edmans and Xavier Gabaix *Executive Compensation – a Modern Primer* (May 2015). ECGI Finance Working Paper N° 450/2015 available on http://ssrn.com/abstract_id=2576707

Rewarding a positive contribution to culture is harder because culture is difficult to measure. Shareholders also sometimes resist non-financial performance criteria because their own focus is on financial returns and they are afraid that non-financial criteria are both a distraction from the task in hand and easy to manipulate. There are nonetheless some objective indicators which are worth considering.

One of these is customer satisfaction. A rapid increase in sales accompanied by a correlated increase in customer complaints is a clear indication of something being wrong. Another is staff turnover. When talented people are leaving an organisation, there is usually a cultural problem which can be traced back to management. Yet the reporting of human capital is seriously underdeveloped. Boards and shareholders therefore appear to pay too little attention to it. [24] A third indicator is the company's record on health and safety, including not just actual incidents but also near misses. A fourth is regulatory breaches, including the number of employment tribunal cases.

> *...it should be possible to compile a measurable indication of corporate culture.*

Using indicators such as these, it should be possible to compile a measurable indication of corporate culture, which might be incorporated into a balanced scorecard. Remuneration committees would then have to decide whether to reward executives for a positive culture alongside their other targets or to make the cultural indicators a threshold for all variable pay. Following the latter course would mean that no bonuses would be paid if minimum standards on the cultural indicators were not met. Some redlines are almost certainly desirable – a serious industrial accident, involving loss of life, for example, or a breach of law or regulation which led to large losses, or fines as in a bribery or corruption case.

In these cases, at the very least, the short term bonus should be entirely forfeit. Arguably also, bonuses should also be forfeit if minimum standards on the agreed indicators are not met. But the bonus could be increased if they are significantly exceeded and the financial targets are met. The key point for remuneration committees to recognise is that the chief executive whose reward is at stake in their deliberations is the very individual who by example, leadership and strategic responsibility sets the tone for the whole organisation. It is rare indeed for a corporate crisis to occur simply as a result of rogue behaviour among one or a handful of employees. The responsibility of top management may only be indirect but that responsibility exists and should be factored into the rewards they earn. [25]

[24] *Where is the workforce in corporate reporting?* NAPF/Pensions and Lifetime Savings Association, June 2015.

[25] For more general practical advice on how performance management can play a critical role in embedding values into business behaviour see IBE Good Practice Guide (No 7) (2014) *Performance Management for an Ethical Culture*.

Conclusions

Fairness and simplicity are two themes running through this IBE Board Briefing. One of the reasons why executive pay has become so problematic is that it is too complicated. The link between remuneration and performance is not clear, so nobody, including sometimes the recipients, can tell what they are really being paid for. A system that operates like that is bound to attract charges of unfairness and trust will ebb away.

One of the reasons why executive pay has become so problematic is that it is too complicated.

There are some pointers to reform. These would include greater reliance on cash as a starting point, even though some of it should then be used to buy shares in the market which would be held for the long term; greater scepticism towards dilutive use of shares; less emphasis on short term bonuses; and much longer time horizons than previously seen. The more remuneration committees try to manipulate short term behaviour, the less likely they are to succeed. If their focus is on long term and sustainable growth in cash generation, they will be setting their company and its executives on a course for success. That may mean encouraging executives to hold shares and, subject to cover limitations, allowing them to receive dividends which in turn would reduce reliance on bonuses.

The most difficult challenge of all is probably that there are no formulaic answers.

Reform needs to be urgently discussed, and it is good to see this starting to happen, but it will take a long time to implement. In the meantime this Board Briefing offers remuneration committees thoughts on how to make the system work better. The most difficult challenge of all is probably that there are no formulaic answers. All remuneration committees have to make judgements and choices all the time, most of which require a considerable amount of courage. This will be easier for them if they approach their task with a clear set of values, which should also be those espoused by the company they serve; a proper understanding of what they are trying to achieve; and a large measure of independence.

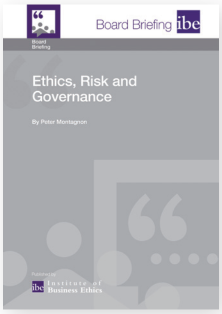
Appendix
Useful Questions for Remuneration Committees

1	What is the purpose of the package? Is it aimed at sharing success or at producing incentives to perform? If the latter, will the incentives work in the way the executives want?
2	Is the remuneration committee clear about why it has set a given quantum? What are the judgements that went in to this decision?
3	Will the executives' effort to maximise reward lead them to impose excessive risk on the company?
4	Can the remuneration committee really be confident that it understands the value of what it is handing over, especially the share-based element of the package? If not, why did it approve the package?
5	Who has set the comparator group of companies for pay benchmarking purposes? Was the process properly independent of the executive?
6	What was the direct or indirect role of the executives in setting bonus targets? Are these suitably stretching?
7	If the targets are not disclosed, are the reasons for this genuine?
8	Does the remuneration committee pay attention to succession planning so as to ensure that it has a range of options when a new chief executive is appointed?
9	Is the remuneration committee comfortable with the balance between fixed and variable pay, especially in situations where the company needs to be turned round?
10	Does the board question executives who fail to build up a significant holding of shares bought with their own money?
11	Is the remuneration committee sensitive to pay and conditions elsewhere in the company? In particular, are top executives receiving conspicuously preferential treatment at times of corporate or sectoral difficulty?
12	Are the executives rewarded for embedding a healthy culture which reduces corporate risk?

Related IBE Publications

IBE publications provide thought leadership and practical guidance to those involved in developing and promoting business ethics, including senior business people, corporate governance professionals and ethics and compliance practitioners.

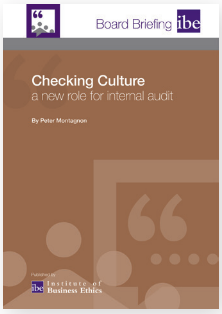
Some recent publications related to this topic which you might be interested in include:



Ethics, Risk and Governance

Peter Montagnon

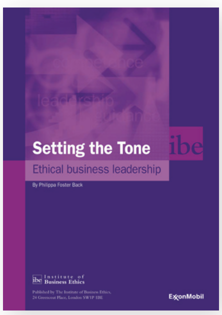
Setting the right values and culture is integral to a company's success and its ability to generate value over the longer term. The challenge for business is how to develop and embed real values. This requires leadership and is a core task for boards. Many boards acknowledge the importance of a healthy corporate culture, both because of the role this plays in mitigating risk and because of the value to their franchise of a sound reputation. This IBE Board Briefing sets out why directors need to be actively involved in setting and maintaining a company's ethical values and suggests some ways to approach it. It aims to help directors define their contribution to the maintenance of sound values and culture.



Checking Culture: a new role for internal audit

Peter Montagnon

Boards are increasingly concerned to embed a sound corporate culture. However the corporate leadership team need to know whether the culture they want is the one they have actually got. Internal audit can help through its work on assurance. This IBE Board Briefing, the second in the series, draws on the experience of those involved at a senior level in a range of organisations. Audit committee chairs, heads of internal audit and heads of ethics and compliance, give practical advice and explain in their own words how to approach the challenge of checking culture.



Setting the Tone: ethical business leadership

Philippa Foster Back CBE

Leadership is essential to business ethics, as ethical qualities are essential to good leadership. This IBE Report demonstrates that business leaders should consider ethical competence as a core part of their business acumen and provides guidance to those wishing to build a culture of trust and accountability and strengthen the ethical aspirations of their organisation. It includes interviews with business leaders offering practical insights into ethical leadership issues.

Other IBE Resources

Investing in Integrity Chartermark

How does your corporate integrity measure up?

The IBE has developed a chartermark in association with the Chartered Institute of Securities and Investment (CISI) to help businesses and organisations know if their ethics programme is embedded throughout their organisation.

The **Investing in Integrity** (IiI) Chartermark gives an assurance of trustworthiness to clients, customers, investors and other stakeholders doing business with the organisation. The real strength of the IiI framework is that it tests an organisation's ethical conduct against its statements of values to ensure those values are properly embedded. It can help them identify whether or not the company is truly living up to its values, from the boardroom to the shop floor.

The testing uses a self assessment management questionnaire and third party audit by IiI partner, **GoodCorporation**, whose methodology has been adapted for the IiI Chartermark.

To find out more visit **www.investinginintegrity.org.uk**

Say No Toolkit

The IBE Say No Toolkit is a decision making tool to help organisations encourage employees to make the right decision in difficult situations. The Say No Toolkit delivers immediate guidance to employees on a wide range of common business issues, especially those that could lead to accusations of bribery.

Employees tap through a series of questions about the situation they face and the tool will provide the right decision to take: Say No, Say Yes or Ask. The answer also makes it clear why it is important to make that decision so your employees can have the confidence and the knowledge to respond correctly.

Organisations can use both the IBE Say No Toolkit App and website for free. The App can be downloaded on to any smartphone or tablet. You can start using it for free now. Simply go to **www.saynotoolkit.net**

The Say No Toolkit can be customised and branded to suit your organisation's needs and detailed procedures. For more information email info@ibe.org.uk or call the IBE office on +44 20 7798 6040.

For details of all IBE publications and resources visit our website www.ibe.org.uk

Fair or Unfair?
getting to grips with executive pay

IBE Board Briefings aim to support board members by drawing their attention to and suggesting ways of approaching particular ethical issues.

Executive remuneration is an important driver of behaviour and therefore of the way values are perceived throughout the company. However, it is also very complicated and tough for boards to manage. There is a widespread view that the present system in the UK does not deliver the right incentives, and may even be fundamentally broken.

Fairness and simplicity are the two themes which run through this Board Briefing, the third in the series.

It looks at the difficult and complex task of the remuneration committee and aims to help them identify and respond to the ethical challenges they face. It explores seven challenges, and suggests practical ways in which they can be addressed.

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