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**Scope:** This submission draws on our significant body of published research in relation to the health of UK corporate governance in general and, more specifically, to the role of executive remuneration within the broader architecture of corporate governance. This submission addresses the following issues identified by the inquiry:

*Should additional duties be placed on companies to promote greater transparency?*

*What factors have influenced the steep rise in executive pay over the past 30 years relative to salaries of more junior employees?*

*How should executive pay take account of companies' long-term performance?*

*What evidence is there that executive pay is too high? How, if at all, should Government seek to influence or control executive pay.*

### **1. Executive summary**

- 1) We have evidence that CEO pay windfalls (pay unrelated to performance) are often concealed or 'camouflaged' behind a facade of complex incentive pay structures.
- 2) Empirical studies document a significant increase in the complexity of pay structures for UK executives since the mid-1980s.
- 3) Our research indicates that CEOs with more complex pay structures are paid more than the CEOs with relatively less complex pay arrangements that achieve similar levels of firm performance.
- 4) This effect manifests itself across a range of different pay elements such as annual bonus and equity-based compensation schemes.
- 5) The disclosure of pay structures that are arbitrarily complex is difficult if not impossible to standardise, i.e. excessively complex pay structures are never fully transparent to shareholders.
- 6) A reduction in complexity of incentive pay structures would facilitate more accurate scrutiny and evaluation of the effectiveness and desirability of alternative remuneration structures by institutional shareholders, investment analysts, and researchers, thereby promoting a more transparent and efficient labour market for top executives in the UK.

### **2. Context: The Researchers' Experience**

2.1 Our expertise in this area, in terms of publications in learned journals, dates back to the early 1990s, and is evidenced by a number of contributions published in highly rated international journals in the economics, management and business areas, including *Economic Journal*, *Journal of Management Studies*, *Long Range Planning*, *British Journal of Industrial Relations* and *Business History*. Throughout this period, our work has also been disseminated internationally via numerous conference contributions and we have engaged in dialogue with government departments (e.g. BIS as was) in the delivery of seminars and involvement in round table discussions regarding consultation exercises. We have also recently worked with the High Pay Centre in producing a synthesis of academic work in the area of executive reward and corporate performance. We believe that this close involvement with the field affords us a position from which to comment on aspects of

UK corporate governance, especially in connection with the contribution of pay structures to the wider architecture of governance.

2.2 Before we detail some aspects of the work we have undertaken, it may be useful first to set the context for this work in terms of the shifting patterns of executive pay in the UK and then to make some general observations about broad themes relating to executive pay which appear, to us, to be important features of the past three decades.

### **3. Context: Academic Interest in Remuneration and Governance**

3.1 The considerable increase in academic interest in various aspects of executive remuneration over the last three decades is in large part explained by the fact that since the mid-1980s the structure of, and processes associated with the setting, monitoring and reporting of executive pay arrangements, have been subject to very significant change, promoting a natural interest in the impact of change on areas such as absolute and relative pay levels and the relationship between pay and performance. Increased academic interest has been matched by interest from shareholder groups, the business community more generally and government, particularly in relation to the potential impact of new pay arrangements on the health of corporate governance in UK companies.

3.2 A key aspect of change since the mid-1980s has been the increased complexity of pay structures for UK executives. Pay structures had been relatively simple, stable and uniform prior to this, populated invariably by base salary, annual bonus, perks and pension entitlement, with established norms in relation to each element. The subsequent period has seen far greater complexity. In part this has occurred via the innovation and rapid uptake of new pay variants featuring much greater detail in terms of their design and specification and in terms of the uncertainty and diversity of impacts on aggregate pay. As well as the increased complexity associated with innovations in pay instruments per se, further complexity is associated with often quite significant changes in the way that established pay components are used and how such change impacts upon pay levels and the pay-performance relationship.

3.3 A perennial strand of research has involved the examination of whether pay innovations do, in practice, fulfil their theoretical promise in terms of sharpening the connection between reward levels and corporate performance or whether, alternatively, they serve mainly to increase aggregate pay, whether or not performance is enhanced. As pay schemes become more complex, via component innovation and/or changes in use of existing components, the link between pay and performance becomes less evident and less accessible to researchers, shareholders and even to eligible executives. Investigating any governance enhancing, or indeed governance-diluting, effects increasingly requires detailed assembly and interrogation of complex data sets.

3.4 We highlight below some of our work on the effects of changing structures and practices in pay on the levels of reward in UK corporations and the relationship between pay and performance. In each of these strands of research, the central importance of complexity in confounding 'easy' estimates of impact on the pay-performance relationship is evident. Where complexity is the result of the exercise of board discretion in the detailed design of reward schemes, this invites the suspicion that the complexity is designed to frustrate clear identification of any link between pay and performance by shareholders or other interested parties. It is, of course, equally the case that complexity could reflect a desire to maximise the positive effect of pay structures on performance and/or stakeholder alignment as captured by aspects of the detailed design.

3.5 Irrespective of the motivation for more complex pay structures, an implication, or recommendation, which flows from most of our work in this area is that a reduction in complexity would facilitate more accurate scrutiny and evaluation of the effectiveness and desirability of alternative remuneration structures in terms of their ability to incentivise stronger performance or to align more closely the interests of different stakeholders. Equally, a greater degree of simplification and standardisation of schemes would facilitate more effective cross-company comparison.

#### **4. Changes in Pay Structure and Practice in UK Companies: a brief chronology**

4.1 A very brief chronology of some of the main changes in approach to remuneration in the UK over the last three decades offers some context for the observations, based on our research and the work of others, which follow.

4.2 The era of significant change began in the mid-1980s as UK companies responded to the need to improve their competitiveness in the international executive labour market by introducing executive share options, an established feature of US boardroom pay (as 'stock options') and an instrument rendered more attractive via temporary tax advantages in the 1984 Finance Act. In an initially buoyant equity market ESOs delivered very significant enhancements to aggregate reward and raised concerns around equity dilution and appropriateness of reward among shareholders and the wider public.

4.3 As a consequence of a number of episodes of what were considered to be unwarranted and/or excessive awards, the Greenbury Report (1995) recommended that a more appropriate form of stock-based compensation was the Long-Term Incentive Plan (LTIP), where the principal difference from the ESO was the design of a much more bespoke yardstick, against which relative corporate performance could be measured. This led to some movement away from ESOs in favour of the LTIP, although the latter was an essentially untried instrument at the time, with similarly unknown consequences. By the early part of the following decade, with weaker equity markets meaning that stock-based compensation was becoming less favoured, there was a discernible re-emphasis on an established form of reward, the annual bonus, but with significant changes to the way that annual bonus schemes were designed.

4.4 To a degree, our own research into executive pay has mirrored these changes, so that an initial focus on the effects of the ESO gave way to greater concentration on the LTIP, which was in turn replaced by a focus on the more exotic forms of annual bonus scheme which emerged in the early 2000s. More recent work has returned to stock-based compensation, and LTIPs specifically, in probing more closely distinctions between the impact of comparator peer groups which rely, respectively, on independently determined or more bespoke and discretionary membership.

#### **5. Complexity in Annual Bonus Schemes**

5.1 We examine empirically the tendency towards less transparency through more complexity in bonus schemes in a series of academic papers published in *Long Range Planning* (2007), *British Journal of Industrial Relations* (2007), and *Business History* (2013). We define complex bonus schemes as those where bonus pay-outs are based on firm performance as measured by multiple performance targets in a single performance period (normally one year). For example, a typical annual bonus plan can generate bonus payments calculated by reference to a mix of accounting

performance targets (Earnings per Share, EBITA and others), cash flow, and personal undisclosed targets. Typically, in line with the current regulation, Directors' Remuneration Reports report the weights that are applied to individual performance targets and the pay-outs that are payable to the CEO if the targets are achieved. We define simple (in contrast with complex) bonus schemes as those that are based on a single performance condition/target.

5.2 Using data on FTSE 350 companies in financial years 2003-2004, we show that bonus scheme complexity tends to increase the odds of bonus pay-outs but without any associated increase in shareholder returns. On average, in a group of firms that have all achieved similar levels of shareholder return, complex bonus schemes that make use of multiple performance conditions have significantly higher (by 85%) odds of eliciting a bonus pay-out relative to those simple bonus schemes that are based on a single performance condition/target. Crucially, where bonus schemes elicited an award, the level of pay-out was unrelated to the total number of targets employed. This suggests that complex bonus structures, on average, are softer and pay more, *ceteris paribus*.

5.3 More recently, our analysis of UK financial sector bonus schemes in the years immediately prior to the financial crisis of 2008/09 reveals a significant increase in their complexity. A striking feature of financial sector bonus schemes is the upward drift in the mean number of targets employed as a basis for triggering an award. On average, financial sector firms reported 2.37 targets in 2001, whereas by 2007 this figure had risen to an average of 4.47. ***We present empirical evidence that suggests that an introduction of a new performance target has an independent effect of a 7% increase in bonus award in excess of the general trend for growth in bonus pay in the financial industry.*** Complex bonus structures are softer and pay more, yet again.

## **6. Complexity and peer selection bias in Long Term Incentive Plans (LTIPs)**

6.1 Restricted shares, granted under LTIPs, vest only to the extent that pre-determined performance targets are met over the relevant three-year (in some cases five-year) performance periods. According to our research, a significant proportion (45 to 55 %) of FTSE 100 firms use performance criteria that are measured relative to a 'bespoke' peer group of comparator companies, where peers are hand-picked by the board of directors. The composition of performance peer groups used for performance evaluation is subject to the board's discretion and is one of the least standardised elements of incentive plan design.

6.2 Our latest work examines empirically the use of LTIPs in FTSE 100 companies for a seven-year period (2005-2011) and suggests that peer group adjustments are used by (some) CEOs to extract income from their organisations: **firms keep their bespoke peer groups weak by excluding relatively stronger performing peers.**

6.3 The peer selection bias in bespoke peer groups and the resulting pay windfalls (pay unrelated to performance) help explain relatively low levels of pay-performance sensitivity in LTIPs observed in our early research, published in the *Journal of Management Studies* (2003). We find that, while increasing average total rewards, the presence of LTIPs is actually associated with reductions in the sensitivity of executives' total rewards to shareholder return.

6.4 In practical terms, these results suggest the need for stronger justification by remuneration committees and greater vigilance on the part of boards and shareholders in relation to changes in peer group composition. Performance criteria that are measured relative to broad indices ('index-

based' peer groups e.g. FTSE 100, FTSE World Media) are harder to obfuscate and might be preferable.

**Overall, empirical evidence suggests that complex pay structures, at least in some firms, are open to abuse.**

### ***7. Why does the apparent abuse of complex pay structures by a relative minority of corporate boards matter to the wider market for CEO talent? Competition for talent and asymmetric contagion effects.***

7.1 A clear and consistent theme which characterises the work described above is that discretion in the design of corporate remuneration arrangements has led to a significant increase in the complexity of those arrangements in a significant number of cases. In turn, complexity, defined in terms of both the range of pay instruments deployed and the detailed design of each instrument, tends to be associated with pay windfalls and with a weakening of the pay-performance relationship, suggesting that the principal motivation for designing complex pay models is a desire to increase aggregate reward rather than to strengthen the pay-performance link.

7.2 Of course, it is important to be clear that not all firms are motivated in this way. So long as some are, however, and so long as this translates into higher aggregate pay outcomes, there are likely to be significant spillover effects across the wider business community, as rival firms are required to compete for executive talent on similar terms.

7.3 In an influential study, Gabaix and Landier (2008) calibrate the hypothetical (in their study) effect of talent "mispricing" by a minority of firms using a large US dataset. Gabaix and Landier estimates suggest that **"...If 10% of firms want to pay their CEO only half as much as their competitors, then the compensation of all CEOs decreases by 9%. However, if 10% of firms want to pay their CEO twice as much as their competitors, then the compensation of all CEOs doubles."** This result highlights the asymmetric contagion effect that the rent-extraction by a relative minority of weakly governed boards might have on the general market price for CEO talent.

### ***8. Lessons from the Research: Regulatory /Policy Recommendations***

8.1 The trend towards ever-increasing complexity of bonus schemes and long-term incentive schemes should be acknowledged and the relevant risks should be contained. The discussion above suggests the need for stronger justification by remuneration committees and greater vigilance on the part of boards and shareholders in relation to changes in incentive schemes' complexity. Long-term relative performance criteria that are measured relative to relevant broad indices ('index-based' peer groups e.g. FTSE 100, FTSE 250) are harder to obfuscate and might be preferable.

8.2 At the moment, most firms employ remuneration consultants to recommend pay packages that they believe will not attract press outrage, and it is understood that these consultants, as part of their service, usually present remuneration committees with scenarios of what rewards the new package *would have been* expected to generate over the last three years, say. In order to provide relevant information to shareholders at little additional cost, Remuneration Committee Reports could be required to disclose this information.

8.3 Together, these modifications would serve to empower shareholders or other stakeholders in monitoring and comparing corporate performance, removing the burden of more direct policy or

regulatory intervention from government. The point here is that the current state of complexity and opacity in executive pay and its reporting simply adds to a reluctance on the part of shareholders to invest in effective monitoring, particularly where there is a limited incentive to engage in this activity, given its strong public good element.

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**References** (copies can be provided on request):

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