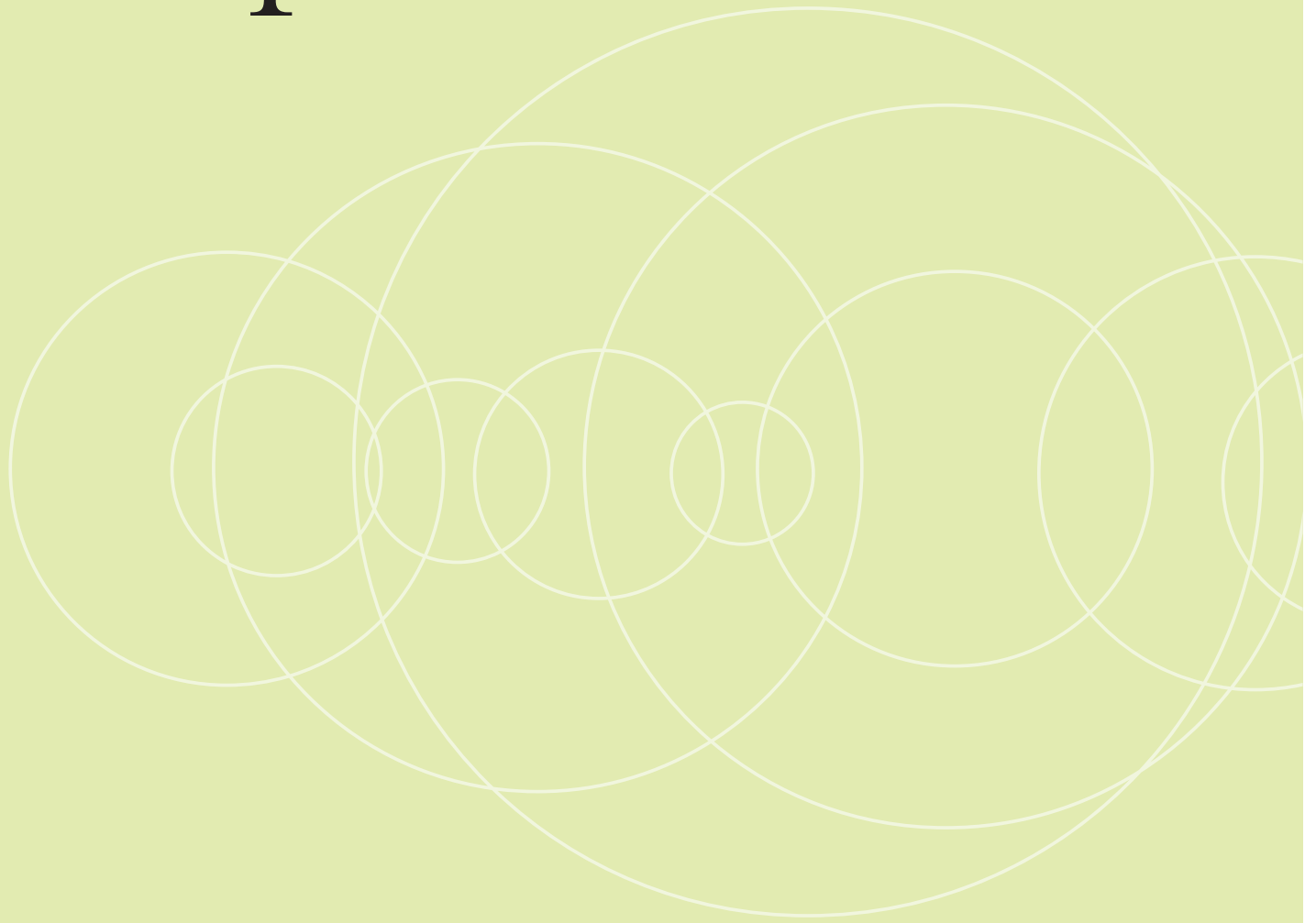


Perspectives



New ideas to reward sustained performance



New ideas to reward sustained performance

There is growing pressure on boards to rethink executive incentive packages. Not only has there been much public and shareholder comment on the potential adverse impact of financial incentives, the UK Corporate Governance Code now requires executive remuneration to focus on the long-term success of companies. Thoughtful stakeholders, including institutional shareholders, are thinking carefully about what companies should be paying for and are reviewing their guidelines on performance measures and pay design.

Nonetheless it is clear from the remuneration proposals that have been put to shareholders in the 2011 AGM season that there is no new emerging consensus about how to resolve longstanding problems with the UK executive remuneration model. This *Perspectives* considers how one emerging idea – career shares – may provide a partial answer to aligning executive rewards with sustained long-term performance.

The problems to solve

Several intractable problems have challenged remuneration committees and institutional shareholders on executive remuneration for some years. They include the following:

- Total executive remuneration potential for the average executive director has climbed steadily for at least the last ten years. Base salary increases have outstripped those for other employees, and incentive opportunities (particularly for short-term performance) have increased. Average realised remuneration of executives fell in 2009 as a result of the economic crisis, but the indications are that it is rising again in 2011. Shareholders are concerned about the behaviour that these incentives encourage, and politicians and the press have built up a head of steam about the 'fairness' of executive rewards.
- Too much of the executive remuneration package is linked to a multiple of salary – a £1,000 increase in base salary (which is small as a percentage) can result in a total increase in pay opportunity of £5,000 or more.
- While the newspaper headlines suggest share awards are worth millions for most executives, the reality is that many executives heavily discount their performance share awards, and probably rightly so when the pattern of payments is reviewed. Most executive share awards are subject to performance conditions measured over at least three years before they can vest; over the last decade or so, shareholders have effectively imposed stretching relative total shareholder return performance conditions on the majority of plans that have created both volatility in payment and lack of line of sight in operation. In our view, this has contributed to the increased emphasis on, and increased value of, annual incentives. Deferral of annual bonus into shares has become majority practice. With claw back provisions and/or additional performance criteria, deferral can help to mitigate the emphasis on short-term performance in determining the initial award. However boards and shareholders alike are right to ask whether this still places too much weight on short-term rather than long-term success in the total remuneration package.
- The well-established practice of a fixed three-year performance period between initial award and vesting is a 'one size fits all' answer. It means that outcomes are too often a product of performance at the end of the third year, or, in respect of relative Total Shareholder Return (TSR), the product of rankings over short time periods at the beginning and end of a performance period which are subject to a large number of exogenous factors. This can encourage risky behaviour to increase the prospects of reaching performance targets at the end of the year. This is exacerbated by the parcelling of performance periods into fixed one-year and three-year periods. The incentive to do this is further boosted when the value of the shares at stake is substantial.
- Executive shareholdings are too low in many companies relative to the level of remuneration realised from incentive arrangements.

Is simplification or rebalancing the answer?

It is dangerous to conclude that there is a quick 'fix' to rectify these problems. The favoured approach in the banking sector of de-risking pay is set to continue with annual bonus payments based on risk-adjusted short-term performance measures accompanied with three-year deferral periods and weak 'malus' (or claw back) provisions. In our view this is unlikely to fit a pharmaceutical or oil exploration business with long investment cycles. This approach has, incidentally, shown little impact on overall remuneration levels, and in many banks has significantly increased the proportion of fixed remuneration. However, there are some common threads:

- Increasing executive 'line of sight' to performance measures increases the perceived value of the package which should in turn allow for a reduction in pay potential.
- Using a balanced range of performance measures reflecting both short-term results and longer-term strategic investment aligns better with long-term sustained performance.
- Requiring executives to hold a reasonable proportion of their realised remuneration in shares increases their long-term interests with the company. The value of owned shares needs to be large enough to be a significant proportion of an executive's net worth but not so large as to deter executives from taking reasonable risks (within the risk policy of the board), or to create an incentive to leave and realise gains if the future looks uncertain.

These common threads might point the way to a win for all stakeholders in executive remuneration. Levels of highly-g geared, and

poorly aligned, long-term incentives and high short-term bonuses could be replaced with lower levels of longer-term shares with lower gearing, linked to a more balanced view of performance.

'Career' remuneration ... and beyond

If shareholders, and other stakeholders, are interested in long-term success and in encouraging the stewardship of their assets, then the acid test for executive remuneration should be not only whether it aligns with performance over an executive's career, but also after they have left.

Towers Watson's research with Professor Brian Main from the University of Edinburgh (see page 7) suggests that, over the long term, performance share plans with relative TSR measures theoretically produce a good alignment, but the 'error rate' is significant. That is to say, the payouts year by year based on relative TSR were volatile even in companies that performed well in the long term and some executives escaped subsequent poor performance by 'cashing in' as they left on the brink of a performance downturn.

An alternative approach we modelled was to make smaller annual awards of shares with no performance conditions attached to vesting, other than continued employment and a requirement for the shares to be held for the long term. We have called this approach 'career shares'. This approach resulted in an alignment with performance that was nearly as good as relative TSR, but which gave executives a more consistent reward for their performance as it built over the years and beyond into retirement. In our view, these could replace an element of performance-related shares and an element of deferred bonuses.



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How career shares could work

Career shares would work through an annual award of shares with retention requirements linked to an overall shareholding requirement which would operate until two years after the executive leaves the organisation.

- The number of shares in each annual award would be determined at the start (probably as part of a ‘trade’ for a reduction in the value of awards under the existing long-term share plan and annual bonus shares), but recognising that the performance hurdles on these share awards are low and value is more certain. In subsequent years, the number of shares could remain the same or be reduced or increased as a result of an assessment of performance, but with the link to annual salary dropped. Holding the number of shares constant could allow higher value awards in good years and automatically reduce the value of the award in poor years.
- At the end of the five years, if the executive is still in employment (or is a ‘good leaver’), the awards would vest subject to a modest performance hurdle or hurdles – AstraZeneca chose dividend and dividend cover and HSBC has adopted a range of non-financial measures on which to base the vesting of awards. A minimum return measure could be appropriate in other circumstances. The measures would be designed as a ‘stop loss’ or ‘malus’ mechanism.
- The after-tax vested shares would then be subject to a further holding period linked to achievement of a shareholding requirement which builds over time to a higher maximum than is currently the norm for UK companies. This could be calculated as a set number of shares per years of service, a proportion of the career

shares awarded each year, or a multiple of gross earnings. As the shareholding builds year by year to the total requirement, the vested shares in this ‘career share account’ would not be capable of being sold until at least two years after the individual left the company.

What are the advantages of this approach?

- The time scale is long, so the value of realised incentive earnings is less influenced by short-term performance spikes or troughs. By requiring retention beyond the executive’s date of departure, it provides an incentive to ensure strong succession planning and reduces the ability to time a departure at the top in a manner which maximises executive reward but not long-term company performance.
- Because of the increase in perceived value, it may be possible to reduce the maximum level of executive remuneration opportunity. It can be designed to break the link with base salary, thus reducing the potential impact of the ‘ratcheting up’ of base pay.

What are the disadvantages?

This approach would require rethinking of some ‘articles of faith’ for all parties as career shares would change the performance leverage in the package.

- Since awards would be in whole shares without tough performance conditions, there may be some value in the shares to executives even if performance has not been strong – in a rising market the indifferent performer may still make some money. However, if performance is indifferent for some years, the total amount the executive would make would be considerably less than the high performer, or indeed the average performer. It is possible to stop loss for the really poor performer by the operation of the minimal performance threshold at the end of five years.
- This is not a full blooded incentive plan – it is designed to reward rather than offer a route to quick riches. However, research clearly shows that, for high performing CEOs (who, as a result of their performance, often tend to be longer-serving CEOs as well), this will provide high differential rewards over time. In particular it allows rewards to ‘make up’ after the odd bad year, particularly at the start of a term in office. Similarly, this approach can penalise the short-serving CEO where performance fades after the illusion of a good start.

- The risk that the long-term executive has too much in shares towards the end of his or her career, and thus may manage the company in a risk-averse way as retirement approaches, is offset by capping the total shareholding requirement and also delaying final sale until beyond the end of employment.
- This plan is seriously long term. There is research evidence that the perceived value to executives may be diminished by this. However, there are two reasons for optimism that the value may not be diminished too much. First, in our experience it is the roulette wheel effect of performance conditions that causes most of the drop in perceived value of long-term incentives. Second, this type of plan can be used to accumulate wealth for individuals at a time when the scope for accumulation of wealth in tax-effective pensions is reduced.

Therefore, our proposal is not that performance shares or deferred bonuses in shares should be abandoned. Our view is that, by introducing career shares into the mix, a focus on sustained performance and stewardship over a career as an executive could be achieved.

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Conclusion

The concept of career shares is not new. It is not a panacea for all companies, or a total replacement for more sharply designed incentives, but it can provide a moderator to short-term focus and risky long-term incentives for organisations that value sustained performance from their executives and wish to retain their talent for the long term.



Vesting of long-term incentives and CEOs' careers: holding their feet to the fire

The University of Edinburgh's study reviewed the careers of 1,292 CEOs leaving FTSE350 companies between 1992 and 2006. Their typical career length is remarkably brief with an overall median of 4.3 years and a mean of 5.7 years. The longest career was 34 years and in no year did the maximum fall below 16 years. For each CEO the performance of the company over their careers was measured using information from the London Share Price Database, as was the performance of the company up to four years after their departure.

The first finding from the study was that the longer serving executives on average claimed superior performance relative to their shorter serving colleagues (with the top decile recording a median annual TSR growth of 18% per annum); but the statistical relationship was far from straightforward. Some shorter serving high performers are found, possibly lured away early in their careers by other companies.

The research looked at two alternative incentive approaches – the first was the use of a classic performance share plan with a relative TSR measure using the FTSE350 as a comparator group. Vesting was at the end of three years and the individual was assumed to either take the shares and invest them at a risk free rate of return or invest them in the FTSE350. The alternative was the award of a career share that the individual had to hold until the end of their tenure as CEO or for one, two or four years after they left.

The results are clear. The total of the performance share plan awards correlated well with overall performance, but the vesting each year (assumed to be on a threshold vesting at median and a maximum vesting at upper

quartile) was erratic, and there were a few cases when there was a very poor correlation as a result of the timing of awards or vesting.

The career shares were marginally less well correlated overall, but there was still a strong match to performance. There were also two advantages – those executives who made a relatively poor start but then produced strong performance were able to benefit from the good performance in later years through superior share price growth on their early awards, similarly those who started strongly but then turned in some indifferent years were penalised.

The delay in vesting for two to four years also yielded some interesting results. Those executives who left their company on a downward trajectory, or whose company collapsed shortly after their departure, were generally penalised quite heavily. Those who left their company on an upward path gained in similar measure. The research indicated that a two year term was on average all that was needed to ensure that a legacy was counted into the realisation of performance for a departing executive – although this will in part depend on the time horizons of the business.

Further information

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