Event Report: ‘Market or Racket: do we need a new approach to executive pay?’

Process and implementation – Practitioner discussion

Moderator: Stephen Cahill, Vice Chairman and Partner at Deloitte  
Panellist: Tom Gosling, Executive Fellow, London Business School and Partner at PwC  
Panellist: Jessica Ground, Global Head of Stewardship at Schroders  
Panellist: Kalina Lazarova, Director, Responsible Business at BMO Global Asset Management (EMEA)

Stephen Cahill led a panel with practitioners looking at the process and implementation of executive pay from a commercial perspective. He was joined by Tom Gosling, Jessica Ground, and Kalina Lazarova.

Cahill opened the panel discussion on the topic of restricted stock, asking Gosling why if it is such a good idea, only 5% of public limited companies have it. Gosling said that although one size does not fit all, he thinks a model based on restricted stock would be better than what most companies currently have. He said that his research with The Purposeful Company suggests that around half of companies would probably like to move to a restricted stock model and that a consensus across the market showed that this could work for about a quarter of companies. Gosling said the current gap is due to a mismatch in expectations between what companies and executives would like to get out of it, and what investors would like to, and that there are even mismatches between investors themselves. Ground said Schroders had done back testing analysis which showed a strong alignment between CEOs owning stakes in their companies which she called “having skin in the game” and pay being linked to total shareholder return, which she said is much stronger than when you have links to earnings per share (EPS). She noted that EPS can be manipulated, whereas total shareholder return is more transparent. Ground said her firm is keen to explore this issue and encourage long termism rather than a short term view on beating targets. She said the key question now is not so much about whether restricted stock is a good idea, but how we get there.

Lazarova shared Ground’s view that companies benefit from their CEOs owning stock. However, she warned practitioners to also consider potential unintended consequences of a public market transition to a restricted share model. Lazarova said that BMO undertook research in 2017 examining several companies, which were not performing well at the time, that had adopted the restricted share model. She said the analysis found that the quantum delivered in three years for the companies’ existing long-term incentive plan (LTIP) were much lower compared to the payout of a hypothetical restricted share scheme. They therefore felt that poorly performing companies were introducing restricted stock to improve their pay levels. Gosling said that this finding is partly a consequence of the historic vesting profile of companies adopting restricted stock being lower than average, which he argues is an inevitable consequence of the constraints placed around the system. In his view, too much of the thought process around restricted stock has been as a way of driving down quantum, rather than as a different and better way of paying people.

A member of the audience asked if there is an incompatibility with seeking to reward CEOs like company owners, when most CEOs have never been an owner. Ground replied that this is something she had considered and while the approach is not perfect, she believes it is the best one. Ground reiterated that she prefers for CEOs to have to invest and put some of their own money in as well as being rewarded for shares. Lazarova agreed with the preference for CEOs to buy shares, and said it is best when this is done early on at the start of the CEO’s tenure. Gosling said he finds it odd that companies are paying CEOs broadly in the same way regardless of their characteristics, and whether they have an entrepreneurial attitude or not.
Gosling argued that it is necessary to take a broader view on the whole compensation model, rather than whether LTIPs should become restricted shares. Reform also needed to take into account annual bonuses and that a move to restricted stock which involved a more radical restructuring of executive pay packages may get more investor support. Ground echoed this sentiment and said it is worth going back to thinking about what LTIPs were originally designed to do. She gave the analogy where pay is the cake, bonus is the icing and LTIPs were designed to be the cherry on top. She said practitioners should be thinking about whether they need three things in the cake or two. Cahill asked why companies have moved away from options. Ground said there is hesitancy to incorporate options due to ‘hangovers’ from problems with how they were historically represented in accounting. Gosling said there were also backdating issues in the US. Rather than bringing options back into compensation packages, he argued that it would be better to look at deeper restructuring of packages based on restricted shares to get the same kind of impact. He also warned that performance targets built into executive pay can sometimes have perverse consequences that are destructive to companies’ long term value. However, Gosling said it is clear that significant levels of equity ownership on the whole are a strong supporter of better performance, probably with a causal connection. He said he would rather be paying people the majority of what they are going to earn as CEO in stock, with the stock released over a long period of time. Gosling emphasised that it is not about getting LTIPs to pay out but changing the model to deliver better performance outcomes, a longer term mindset, and be more manageable in the context of the inevitable limitations on governance structures in listed companies.

Lazarova said that investors like BMO regularly meet with remuneration committee chairmen who are very comfortable with the schemes that they have in place and value the LTIPs they have structured. She said that performance targets can deliver good outcomes. Ground challenged Lazarova by saying that often performance targets as part of LTIPs are not tough enough, and CEOs should be stretched further. Lazarova said there are systems in place to check whether targets are met or not. She also stressed the value of remuneration committees in helping to set these targets. Lazarova shared that her firm has been encouraging the boards of companies in their investment portfolios in other markets to introduce performance targets. She said that as a global investor it would feel odd to start rolling back these targets now. Gosling agreed that consistency across remuneration structures is important and also helps with recruitment.

Looking at bonuses, Cahill said that the typical bonus plan has paid out around 70 to 80% of its maximum of the past decade, compared to a typical LTIP plan paying out around 40 or 45% of its face value over the same period. He asked if the real problem is with bonuses or LTIPs. Gosling said that there is a problem with bonuses. He said over the past decade they have consistently paid 75% of the maximum on the average, with only around a quarter paying below 50% of the maximum in a bad year. He said that increasing bonus levels have made the stakes too high and governance processes are not always strong enough to manage the calibration issues associated with this. Gosling said there was a case for broadly halving the level of annual bonuses and putting that value into something more long term like restricted stock and not driven off short term bonus targets. Ground made the point that the quality of stakeholder metrics and how auditable they are can be an issue. She said it would be difficult to take away from bonuses with a drive for more ESG metrics without them being more robust. A practitioner in the audience said she would not take bonuses off the table. She said the banking sector model, where senior managers are subject to deferral of bonuses for three to seven years, plus a holding period, works well. She said they often do not have the long term incentive on top and have a long term shareholding, so it’s like a hybrid of a bonus or restricted stock model, and you can have a clawback. Another participant said this model could work more broadly but that it would depend on having a cadre of board members who are willing and able to make tough decisions.
Cahill raised the question of how often shareholders vote against the measures companies put forward on executive compensation and performance targets. Ground responded that Schroders typically votes against one management resolution at almost half of the annual general meetings, although admitted this includes resolutions on other matters too. Cahill said that over 80% of companies get 95% or more in voting support, less than 10% get below 80% support in any given year, and an average of two companies a year lose a vote. He indicated that this can make CEOs complacent. Ground drew Cahill’s attention to the public register started by the Investment Association, to highlight votes against or withdrawn from a resolution. She said that there are far higher levels of shareholder dissent on executive pay than ever before. Gosling gave his view that it would be a dangerous place if it were shareholders’ job to second guess all bonus decisions that companies make and to need to scrutinise all those decisions. In contrast he said that private equity has better resourced boards that are more committed and knowledgeable about the business, and have incentives that are entirely aligned and have concentrated investor bases. He said that asking shareholders to provide that much greater level of oversight in the public markets, where there is not the same level of company knowledge or involvement, is not realistic.

A participant in the room asked what one should think about in a long term share price. Gosling said that different types of action take different amounts of time to fully reflect themselves in market prices – for example research has shown that intangible factors can take five or more years to be fully reflected in share price and in long-horizon businesses such as natural resources or pharmaceuticals investment cycles could be even longer. He said he thinks about long term share prices as being a horizon between when one makes a decision and when one gets the reward. In practical terms Gosling said this is having remuneration set up so that at any point in time when a CEO makes a decision, they have a proportion of their reward dependent on what the share price could be five to eight years in the future. Alex Edmans, sitting in the audience, said that his work on employee satisfaction shows that it can take four to five years before manifesting in a stock price, or even longer. He said another factor might be how long a business cycle is, so for example with Exxon half the shares vest after five years and half after ten. He also said that the perspective of long term differs company to company depending on how long term the impact of the CEO’s decisions are.

The balance of power between the remuneration committee, investors and the CEO was a theme that ran throughout the panel. A member of the audience said it is flawed to assume that there is equal power between these parties. She made the point that CEOs have a huge amount of bargaining power. She said if CEOs are not happy they can threaten to walk, which puts boards in a difficult spot if they do not have strong succession planning. Cahill asked Ground whether investors would support a board calling a CEO’s bluff in a situation for instance where he or she wanted to be paid more, or whether investors would prefer the board to “pony up.” Ground said that she has never met a remuneration committee chair who did not think their CEO was capable of walking out and getting another job, and that she thought half of them were capable of this. She said there will always be people who will call executives’ bluff. Ground said, “sometimes we have to admit there are three of us in this marriage when it comes to pay.” Gosling agreed that it would be very difficult for the board and particularly tough for the chair to lose a CEO. However, he said that succession planning has greatly improved in the past decade and the number of CEOs who have a board ‘bent over a barrel’ has vastly reduced. Cahill added that there are some star CEOs who have public profile that are quite disconnected from how they are in reality, so in these situations do have much more power with their boards.

Another participant asked if too much is being asked of investors who are often under resourced, and how we can we create a safe space for investors and issuers to experiment. Gosling said it would be beneficial to have a more intensive engagement process by creating an environment, such as via
the Investment Association, where certain companies are identified as test companies. This could allow for intense engagement and more guidance given to proxy agencies, well before AGM season, and would require more investment and resources from all parties. Cahill argued that the investment management community make strong margins and if they wanted to choose to invest more in research on these areas, they could afford it.

A participant in the audience asked the panel what needs to change to improve the climate of trust between independent directors and investors. Ground said that say-on-pay has perhaps eroded some of that trust, becoming like a referendum on pay. She said it would be helpful to have more focus on the board’s fiduciary duty and responsibility for long term succession planning, in addition to encouraging the right behaviours. Lazarova said better coordination on the investor’s side can be helpful and that after many years of having a disconnect between investment managers and responsible investment teams, investors are now better placed to hold meetings to discuss pay, strategy and broader questions related to the board collectively.

A member of the audience asked if we should move away from incentives altogether and just pay salary. Gosling argued that there is a counterbalance between incentives and efficiency. He said that undoubtably as soon as you stop paying somebody short term in cash, you have to pay them more for the perceived value to the individual. If behaviourally you get a better outcome, Gosling said, this shouldn’t stop you from doing it. He added that the idea that pay doesn’t influence behaviour is “complete hogwash.” He said, “it absolutely influences behaviour, just not always exactly how you want.” Gosling added that he agreed with Ground that it is very important to get the right kind of long term orientation in companies to help them perform better for everybody, rather than having unintended consequences. Cahill said the debate brought through in the panel discussion has shown that we should not take anything off the table on executive pay and that there’s no one size fits all solution.