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Position Paper - Remunerating Executives for Shareholder Value

Executive Summary

A commercial, evidence-based approach sees executive remuneration as one among many components of talent management. The most important consideration when formulating and evaluating a remuneration plan should be how well it fits its purpose. In practice, this is likely to mean pay arrangements can and should differ according to organisational circumstances and the specific requirements of the role.

A common approach - causing pay to vary with shareholder returns - is based on fallacies about attribution of performance, alignment of interests, and the psychology of incentives. In many cases this will not only be ineffective, but counterproductive for shareholders.

Restraint, simplicity and transparency are key to ensuring the acceptability of remuneration arrangements to long term investors. We encourage companies to discuss remuneration matters of interest or concern with investors well before a remuneration plan is finalised.

Regnan believes informed and empowered board members are best placed to determine appropriate executive remuneration arrangements. We therefore provide no prescription, but provide context and general guidelines on what we consider necessary inputs for determining such arrangements.

Introduction

Since 2007, Regnan has argued for a fresh approach to executive remuneration; an approach that:

- Gives primacy to the talent management objective of remuneration, and reports the rationale for each pay element in the context of this purpose;
- Recognises that executives are employees of the company and treats any moves to pay them otherwise (eg as entrepreneurs) as exceptions requiring a specific and compelling rationale;
- Eschews complexity, which often leads to plan components being devalued or disregarded by executives, and misunderstood by stakeholders;
- Recognises that the talent management purposes of pay may require standardised incentive plan structures, in recognition that each package element has a different value to an individual, and that this may vary with their personal circumstances or goals;
- Recognises that many apparent constraints on the senior executive labour market are attributable to conventions rather than reality, and that this has led to disproportionate growth in executive pay;
- Recognises that overall quantum paid can send a material signal to the market, other executives, employees, and other stakeholders, with potential unintended consequences;
- Accepts that executives for whom pay is the primary driver are often ill-suited to leadership, and recognises that pay is not the only manner in which esteem can be communicated.

Most controversially however, Regnan challenges the orthodoxy that the executive pay experience should directly parallel the shareholder experience. We view this belief as instrumental in the design of remuneration plans that have delivered windfalls or shortfalls due to unforseen circumstances outside the executive's control, sometimes to the consternation of boards, shareholders *and* executives. Regnan accepts considerable research showing that it is very rare that company performance over a predetermined period can be directly attributed to an individual's performance over a specific timeframe.

We therefore propose some modest principles to guide pay design, in order that pay support (not hinder) business strategy, while taking into account the real and pressing challenges publicly-listed companies must tackle.

Overview

The financial crisis highlighted numerous examples of listed companies' senior executives being handsomely rewarded despite decisions and behaviours demonstrably damaging to company value longer terms. Understandably, concerned investors have sought ways to correct the misalignment between executive reward and enduring enterprise value.

Preventing inappropriate outcomes remains important. However, attempts to address these concerns have relied on payments that amplify the correlation between executive reward and financial measures such as shareholder returns. This simplified understanding of "alignment" overestimates the extent to which strong performance can be effected by an individual. It is also based on erroneous assumptions about the impact of variable rewards on individual performance and motivation.

Allowing executive pay practices to depart from the talent management frameworks and principles underpinning pay arrangement for other employees is not justified by evidence on company and executive performance. Of greater concern is that it produces unintended consequences that operate to the detriment of value. As institutional investors with a long term interest in company value, we call on directors to redress this progressively as opportunities arise.

The attribution fallacy

CEO pay often departs significantly from the principles that guide pay for other employees, both in structure and quantum, a circumstance often unchallenged on the basis that this role is uniquely positioned to create or destroy value.

Yet although CEOs do have greater responsibility for deploying appropriate human, financial, technical and physical resources in pursuit of the business strategy, the effectiveness of their execution relies on factors beyond their control, including resources inherited from predecessors (human and intellectual capital, technology, organisational culture and initiatives already in train) and factors that are entirely external to the business (competitor decisions, macro-economic conditions, regulatory and socio-political constraints). The role a leader plays and their ability to influence corporate performance also varies with industry, business maturity, and market dynamics.[1]

These factors make it unfeasible to estimate an individual's contribution ahead of time. Even after the fact, it is rarely possible to measure an individual's performance against the relevant benchmark: the performance that would have occurred under the same business circumstances with *a different CEO*.[2] When appraising the performance of employees, line managers are often trained to recognise and transcend well-researched cognitive biases that lead to false attribution (such as the tendency to underestimate the role of external or system factors on performance). Yet such over-attribution pervades pay arrangements at the most senior levels, where performance relies at least equally on myriad factors outside the individual's control.

The alignment fallacy

Linking significant proportions of total executive remuneration to shareholder returns and other financial measures is generally explained as "aligning" executive interests with those of shareholders to reduce agency issues. A common practice is to base long-term incentive payments (LTIs) at least in part on total shareholder returns relative to other companies (relative TSR).

[1] Daines, Robert, Nair, Vinay B. and Kornhauser, Lewis A., The Good, the Bad and the Lucky: CEO Pay and Skill (August 2005). U of Penn, Inst for Law & Econ Research Paper 05-07; NYU, Law and Economics Research Paper No. 04-035. Available at SSRN: http://ssrn.com/abstract=622223 or http://dx.doi.org/10.2139/ssrn.622223

[2] See, for example, Rosenzweig, P. (2008), *The Halo Effect*, Pocket Books.

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In practice, alignment of this kind is uncertain. The extent to which an instrument of this type causes an executive to feel they have "skin in the game" will vary with such factors as their absolute level of fixed pay, life stage and existing personal wealth. Continued employment or future prospects (reputation) may be of greater significance in some cases.

In the service of alignment, there has been effort to use a variety of quantitative inputs to gain the desired "aligned" result for executives. This adds complexity, frequently distorts the intended outcome, and can deliver unintended (windfall) gains or unexpected losses. Pay elements that produce a distortive effect on reporting should be challenged, for instance those that pronounce a target pay backed by requiring fair value calculations. Acceptance of increasingly complex remuneration practices over time entrench systemic agency issues. Long term, only a proper functioning board making targeted and restrained remuneration policies can negate systemic agency risk for an individual company.

Amplifying the correlation between executive rewards and shareholder returns is in any case a haphazard means to reward executive efforts, owing to the many external factors that drive corporate performance, as discussed above. It produces windfalls when the stars align, and short-changes executives (in relative terms) when as-great talents and efforts are applied to steering a company through tougher periods, or to important initiatives that bear fruit years or decades afterwards.[3] In so doing, such pay arrangements add to pro-cyclical pressures, increasing retention challenges in more difficult times.[4] In such times, standalone retention payments are often made to compensate, undermining even the superficial alignment and consequently calling into question the value of these elements within a pay plan.

The incentive fallacy

The idea that payments can incentivise executives to deliver better financial returns is at odds with one of the most robust findings in the social sciences. Unlike unanticipated rewards delivered after the fact in a discretionary manner, rewards known in advance to be conditional on performance have been shown repeatedly to be counterproductive for all but routine tasks; eroding intrinsic motivation, inappropriately narrowing the focus and limiting creative thinking, promoting short-termism, and increasing risk-taking.[5] These drawbacks combine with the problems of attribution and alignment to make many conventional incentive payments counterproductive in promoting shareholder returns.

In practice, the uncertain relationship between an executive's efforts and expected rewards results in the value of variable remuneration being discounted. Many executives report that it is demotivating when there is a disconnect between their efforts and their rewards.[6] Perhaps partly in response to this, fixed pay has continued to increase despite the growth of these "at risk" elements, in turn inflating "at risk" elements that are calculated as a percentage (or multiple) of fixed pay. The result is a ballooning of overall pay for executives, with a growing gap between executive pay and that of ordinary employees – and between the CEO and other executives.

[3] Eg Jan du Plessis, Chairman of Rio Tinto, during an address to an AICD luncheon in 2011 stated that the company does not reap the rewards of its investments for thirty to forty years.

[4] A report from Goldman Sachs early in 2012 found the median length of service for chief executives of the top 100 Australian listed corporates had declined to 3.9 years since 2007.

[5] Many of these studies are summarised in Pink, Daniel 2010; *Drive, the surprising truth of what motivates us;* See also Pfeffer, J, *Myths about Pay,* Stanford University Press.

[6] Pepper, S., Senior Executive Reward – Key Models and Practices, Gower, UK, 2007.

The fallacy of "buying the best"

We do not believe that boards have no choice but to acquiesce to inflationary expectations from executives; paying the most to get "the best". Aside from the issues with assessing (and predicting) what will lead to strong performance, the evidence is that well-selected executives apply proven talents and appropriate discretionary effort to pursuing corporate objectives even when remuneration resembles more closely that of other employees in both structure and quantum.[7] This is evident from pay practices in other markets; other sectors within the economy; past practices in the private sector (including in publicly quoted companies) and from the reports of former executives.

Beyond a certain threshold, quantum of pay appears to function for both executives and for boards as a marker of esteem rather than as compensation *per se*. However such pre-emptive esteem (along with over-attribution) can damage the way the CEO role is understood. Pay structures and quanta that differ significantly from that of their reports can for instance exaggerate hierarchical distance between the CEO and other executives, impairing team function, subduing contributions from others and clouding succession planning. It can also contribute to a bias towards visible action from the CEO that may be at odds with the needs of the business.[8]

Remuneration need not and should not carry the burden of communicating positive regard; other components of the contract between shareholders and executives should not be discounted. For other roles, it is a rarely challenged research finding that non-financial factors play a significant role in attracting, retaining and motivating talent, including satisfactions inherent in the performance of the roles.[9] Similarly, the well-recognised benefits associated with Australia's major cities should not be underestimated when determining remuneration arrangements for expatriates or returning residents. In fact, of ASX100 chiefs in 2012, 77 have worked or studied overseas, the majority in either the United Kingdom or America. It would be hard to argue that most of them have been lured back to Australia by potential financial reward above what is available internationally.

Bridging the gap

We urge boards to review pay practices in light of the research that fails to find a link between corporate performance and overall quantum or "incentive pay".

We recognise that fortitude and concerted effort will be required in many cases to restore simpler pay practices founded in demonstrable value. Reforms can be implemented when opportunities arise (such as when determining the arrangements for a new CEO). Where by exception, incentive payments are indicated, these should be carefully tailored to the specific challenges of the role and fully explained with reference to these considerations. Replication of approaches by peer companies would not be adequate.

The following are among the considerations that should guide board deliberations on executive pay.

[7] "Making Executive Pay Work: The Psychology of Incentives", PwC, http://www.pwc.com/en_GX/gx/hr-management-services/publications/assets/making-executive-pay-work.pdf
[8] Eg Khurana, Rakesh (2002) *The Curse of the Superstar CEO.*
[9] Eg Pink, *Ibid*, PWC report on executive remuneration, Pepper, Sandy, 2008.

1. Executives as employees

Executive pay arrangements should default to consistency with the pay principles that underpin that of other employees within the organisation. If job evaluation is used to determine pay levels for roles beneath executive level, clear explainable relativities between those levels and KMPs should be evident.

2. Business strategy

Where pay structure or quantum departs from consistency with that of other employees, it is necessary to ensure it does so in a manner consistent with the business strategy and the executive's specific role in this.

- What are the goals for the company? What kind of growth? What is the risk appetite? Will the CEO be leading wholly new endeavours – expansion into foreign markets, development of completely different income streams? Effecting a turnaround or integration?
- Alternatively, is the CEO taking the reins of a mature, stable company, with limited opportunity for growth?

3. Internal resources and external circumstances

Performance hurdles for variable or "performance" pay should reflect factors that are genuinely within the power of executives to affect, with proper attention to preventing windfall gains or dramatic drops in income due to external influences.

- What are the resources on which the CEO can draw? Is there a strong and well-functioning team or will they be acting largely alone? How will company performance during and following their tenure benefit from pre-existing or external circumstances? How do market position, macroeconomic drivers, regulatory and social circumstances benefit (or hinder) corporate perfomance? What initiatives (underway or completed) may have an impact on value during or immediately following their tenure?
- How might these dynamics change during their tenure for reasons outside their control?

4. Acknowledgement of known unknowns

Evidence is clear that biases cause us to overemphasise the causal role played by visible factors, and ignore less visible factors (even when they play a more significant role).[10] Caution is therefore required in assessing what causes strong (or weak) performance, particularly when attempting to predict this in advance.

[10] Eg "What you see is all there is" as described by Kahneman, Daniel (2011) *Thinking Fast and Slow*.

- What evidence exists to support the case that one individual can drive performance (good or bad) in like circumstances? Is this evidence robust or anecdotal? How consistent is any such evidence through time and under varying business conditions? How do the remuneration arrangements play out in a range of scenarios? If external factors cause a bear market, making threshold performance targets unattainable, what approach to remuneration would ensure the retention of executives?

- Is it preferable to retain the ability to exercise discretion after the fact?

5. The individual

A substantial body of research[11] shows that appropriate recruits to senior executive positions are by definition already motivated. We encourage boards to communicate openly with executives about the need to maintain appropriate internal pay ratios throughout the organisation, and we suggest robust review of the validity and relevance of market comparisons to securing the commitment of a given individual. All-market comparisons are at risk of being inflated by stakeholders with vested interests.

- What will secure the commitment of this particular individual? What are their motivations, personal circumstances, or life stage factors that may affect how they value ready cash versus other or more distant incentives? Whilst in many cases perquisites may be a relevant way to address individual interests, care should be taken as they can also diminish the transparency of the total remuneration package.

6. The wider context

Prevailing socio-economic conditions, and the potential impact of pay outcomes on the organisation's social licence to operate should also be costed when determining pay arrangements.

- How defensible is the ratio between CEO pay and that of median employees in the organisation? What risks might it promote with respect to labour relations? Could it undermine employee engagement? Fuel industrial action? Constrain public support for business initiatives (eg backlash for price increases to consumers)?

- What is an appropriate ratio between the pay of the CEO and their executives that reflects their role within the team? Is a great or a lesser hierarchical distance appropriate to the circumstances? How are executive team dynamics influenced by the hierarchical distance communicated by pay?

7. Alignment with shareholders to the extent possible

All else being equal, it is preferable for executives to hold shares in the company over a reasonable period. However evidence from behavioural economics indicates that alignment is likely to be more complex.

[11] See, for example, Kohn, Alfie (1999) *Punished by Rewards.*

- How material is a given shareholdering within an executive's overall personal income or assets?[12] How do features like loss aversion and mental accounting operate differently for share grants versus shares purchased with personal funds?[13]
- How might intended alignment be circumvented? Can retention arrangements be simply bought out by another employer?
- What are the systemic effects of pay practices? Does paying at a given percentile, resulting in an overall "racheting" effect on pay, deliver the intended competitive advantage?

8. A rational view of the labour market

We encourage boards to adopt a wider view of the market for well-qualified executives. The lack of diversity suggests that the executive labour market is rife with artificial barriers to entry and promotion, and this contributes to keeping executive pay artificially high.

Moreover the evidence does not support the case that the highest paid executives deliver the best performance.[14]

- Which are the truly necessary skills for this role at this time, and which are merely conventions? How are we ensuring that it is a truly competitive recruitment process? What unconventional pools of talent might we look to for competitive tension? Are any unwarranted assumptions being made about what effective leadership would look like?

Summary

Any remuneration plan should be fit for purpose, and should be established on the basis of a clear understanding of what it can – and what it cannot – achieve. It should strike a balance between shareholder and executive expectations, in particular with respect to determining the overall amount of company profits that should be allocated to total executive remuneration.

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[12] See, for example, Panousi & Panikolou, *Investment, Idiosyncratic Risk and Ownership,* March 2011.
[13] Eg Disposition effect, mental accounting as described in Kahneman, Daniel (2011) *Thinking Fast and Slow.*
[14] See, for example, Bebchuk, Lucian and Fried, Jesse M., "Pay Without Performance: Overview of the Issues" (2005). Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series. Paper 528. http://lsr.nellco.org/harvard_olin/528 Also "Making Executive Pay Work: The Psychology of Incentives", PwC, http://www.pwc.com/en_GX/gx/hr-management-services/publications/assets/making-executive-pay-work.pdf

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The remuneration report

Remuneration reports should demonstrate transparency not only about the mechanisms employed but also the reasons for their selection. They should comprehensively describe to investors the details of fixed remuneration, bonuses, incentives and share scheme arrangements, but also should include the rationale for their inclusion and decisions about each.

This disclosure must be valued and expensed in accordance with regulatory requirements, but we also encourage companies to be as descriptive as possible. In addition to providing the rationale for the approach taken, investors should be able to see context where relevant to the decisions. Simplicity and brevity are worthwhile objectives, but should not come at the expense of disclosures that illuminate the board's deliberations.

Table 1 - demonstrates examples of restricted and fuller disclosures.

Restricted description	Fuller description
To avoid perceptions of conflict, the CRO is not eligible for incentive pay	The Chief Risk Officer is not eligible for incentive pay as he is charged with ensuring all business operates within our agreed risk parameters. Providing incentive pay which largely depends on short term financial results (at the divisional or group level) may result in real or perceived conflict of interest. We therefore provide the CRO (and his team) with a level of fixed remuneration to compensate for this lack of upside, so they may focus exclusively on the risk function.
The board will assess performance based on a balanced scorecard over the year, and determine bonuses taking exogenous factors into account	Given the volatility in the external market, and the varying degrees of impact executives may have in the context, we have elected to provide bonuses on a discretionary basis rather than predetermine metrics as these may produce unintended consequences (either windfall gains, or no payout whatsoever) consequently eroding their effectiveness as incentives. All bonus decisions will be based on a balanced scorecard assessment carefully explained to investors, with 50% of any payments being deferred in shares for two years.
[no explanation for the absence of an LTI]	Despite prevailing market practice, the board has elected not to implement an LTI plan at all. This is because the investment time horizon is so long as to make any such plan unworkable, i.e., we will not see the results of our investment decisions for many decades. We further believe that the widely used measure for LTI – relative TSR – is virtually impossible to implement in a manner that is meaningful, given the dearth of comparable companies, and the incompatibility of our business with a wider index. We will implement an STI plan encompassing key financial and non-financial measures, and will defer [a portion] of that into shares to vest over 3 years, with appropriate clawback provisions. We will hold executives to account for what is within their span of control, and will fully explain STI hurdles and outcomes".

Further, we believe that significantly damaging negative attention on executive pay can be avoided if pay is explained clearly with reference to the needs of all stakeholders, rather than being confined to the executives and shareholders. Table 2 offers examples of key stakeholder interests and concerns.

Table 2 - explaining remuneration with reference to legitimate stakeholder interests

Stakeholder	Expectation	Variables	Key points
The executive	Fair, market competitive pay. Line of sight. Span of control.	Competitive position (skill, experience and effort). Stage of life/existing wealth. Intrinsic/extrinsic motivation. Expected tenure and implications for pay throughout the business cycle.	Avoid "deification" of executives. Simplicity, clarity of the link between contribution and reward.
The shareholder	Preserve/grow value. Pay should not promote actions/decisions inconsistent with long term value. Cost constraint (particularly with consideration to flow on effects of CEO pay).	Different shareholder preferences (short term, long term); different risk appetites.	The long term shareholders' interests should be prioritised. Resist systematically inflationary practices, eg paying at the 75th percentile or in accordance with market capitalisation; sign-on bonuses to neutralise loss of retention payments elsewhere (or expect your retention elements to be worthless also).
Stakeholders/ community	Pay should reflect the contribution and relative competence level of the exec. Pay practices should not promote disregard for externalities, or for other stakeholders.	Subjectivity on competence and contribution. Corporate citizenship, including cognisance of issues of social cohesion / social justice.	Consider role and reputation of company within the community.
The employees	Fair for skills and effort. Internal ratios matter.	Employee demographics. Size, nature, geographic spread of business. State of workplace relations. Security of employment.	Explain pay differentials in realistic, commercial language.