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REMUNERATION OF THE CEO

ASSET MANAGER PERSPECTIVE

CEO remuneration structures are a distinct issue of interest to shareholders, with likely implications for the well-functioning of financial markets. This note views remuneration as an expression of corporate governance and discusses commonly used incentive plans and alternative remuneration schemes.

Agency theory remains relevant to executive remuneration in listed companies because CEO incentives do not match those of shareholders. It is therefore in the interest of shareholders to better align the actions of the CEO with their interests.

Requiring the CEO to be a long-term shareholder seems to be an underutilised strategy for aligning the interests of the CEO with those of shareholders. This should supplement the promotion of a board of directors that effectively monitors management and is accountable to shareholders.

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Introduction

Remuneration of the Chief Executive Officer (CEO) plays a vital role in the functioning of limited companies. The purpose of remuneration is to attract and retain the right CEO, and to reinforce his or her intrinsic motivation for the job. The board, in setting remuneration structures, also needs to align the interests of the CEO with those of shareholders.[1] From this perspective, remuneration should seek to mobilise the capabilities and motivation of the CEO for the purpose of securing a competitive return on the capital invested.

The CEO's overall responsibility for the company makes the structure of his or her remuneration a distinct issue. It is related to, but different from, that of other employees. The CEO's role reflects the separation between management and the board in the modern company. The CEO is responsible for the executive leadership of the company, its managers and employees. This also includes broad authority over the financial resources of the enterprise. The CEO needs to be remunerated competitively for this complex assignment and responsibility.

Deciding on the best way to remunerate the CEO is an important duty of the board, and should be kept fully under the control of the board. This follows from the board's duty to choose and monitor the CEO and to administer a change of CEO when necessary. The board combines the roles of advisor, overseer, controller and approver, with a mandate from the shareholders who elected it.

Our perspective on CEO remuneration is driven by single-company considerations as well as the broader promotion of well-functioning markets. CEO remuneration is set by each company's board. It is not standardised across companies, but determined by market forces, corporate circumstances and the individual preferences of the CEO and the board. Remuneration is an important expression of corporate governance.

However, the expectations of the CEO, the remuneration actions of the board, and the voting behaviour of shareholders may best be understood in light of common practices in the market and the industry in which the company operates. There are differences between markets in terms of regulation, institutional and capital structures, and historical factors. The models that are commonly preferred may have implications for the well-functioning of markets. The scope of the discussion on remuneration models should therefore extend beyond the individual company.

Management Remuneration and Agency Problems

Current management remuneration models are a reflection of the agency problems embedded in public companies with dispersed ownership. The incentives of management may differ from the interests of shareholders.

1 We use the term "board" for the non-executive branch of the board of directors, recognising that across markets management is represented on boards to varying degrees. The usage of the term does not disregard that remuneration decisions are prepared by a remuneration subcommittee of non-executive board members in most developed markets.

Hence, remuneration of management should seek to better align management with shareholder interests.[2]

Executive remuneration practices have attracted considerable academic interest in recent decades.[3] Two contrasting schools dominate the discourse. The optimal contracting school maintains that observed remuneration is the result of an active market for executive talent. It is rational for shareholders to rely on management incentive programmes. The weaker the corporate governance system of the company, the more important the management incentive programme becomes.

The managerial power school, on the other hand, claims that rising pay levels are the result of inefficiencies in the market for executives. Weak corporate governance and information asymmetries allow managers to influence pay practices to their own benefit, even if pay practices are formally the remit of the board and must be approved by shareholders.[4]

Behavioural economics is a promising third strand of research into executive remuneration. Researchers focus on what happens to executive motivation as a result of the various incentives they are exposed to. Behavioural economics also provides insights into how executives and board members act in the process of developing and maintaining remuneration plans.

Alternative Remuneration Structures

The well-founded critique of pay practices in the 1970s and 1980s established an interest in different forms of incentives. An early example was the widespread introduction of management options. The purpose was to expose management to the effect that its decision making had on equity returns. Pure stock options gradually gave way to a wider set of equity-based models, including a range of different requirements for management to hold company shares, and to shareholding incentives such as matching share schemes. Table 1 lists alternative incentive remuneration approaches and their advantages and disadvantages.

Markets have modified remuneration structures over time, influenced by new academic insights, changing investor preferences and evolving best practices. The prevalent model in most developed markets combines three elements: a base cash salary (12 percent of total remuneration in the US, 22 percent in the UK), an annual cash bonus (76 percent of base salary in the UK), and an equity-based element usually referred to as a "long-term incentive plan"[5] (LTIP – 206 percent of base salary in the UK, 57 percent of the total

2 For influential early research on this topic, see Jensen, M. and Murphy, K. (1990) "CEO Incentives—It's Not How Much You Pay, But How", Harvard Business Review *69(3). See also Jensen, M. and Murphy, K. (1983) "Performance Pay and Top-Management Incentives",* Journal of Political Economy *98(2).*

3 For an overview and discussion, see Edmans, A. and Gabaix, X. (2016) "Executive Compensation: A Modern Primer", Journal of Economic Literature *54(4).*

4 See, for instance, Morse, A., Nanda, V. and Seru, A. (2011) "Are Incentive Contracts Rigged by Powerful CEOs?", Journal of Finance *66(5), and Bennett, B., Bettis, J., Gopalan, R. and Milbourn, T. (2016) "Compensation Goals and Firm Performance", working paper, forthcoming in* Journal of Financial Economics.

5 Long-term incentive plans (LTIPs, also referred to as "long-term incentives" – LTIs) generally take the form of an initial award of equity shares that will vest following the fulfilment of certain conditions. Vesting usually requires the achievement of a set of pre-defined performance targets by the company over a set period (for instance three years) as well as the continued employment of the recipient. Targets may be based on share price or total shareholder return (absolute or relative), earnings or other metrics. In some instances, LTIPs come without performance conditions, which means the primary condition is continued employment.

in the US including stock awards (42 percent) and stock options).[6] Remuneration packages may include requirements to hold company shares, either as a standalone requirement, as a requirement for shares that vest under the LTIP, or as a matching scheme for shares bought with bonus cash.

Pure share options and restricted share schemes have been on the decline but still exist (particularly in the US). Restricted shares do not have performance conditions but resemble other LTIPs in being conditioned on continuation in the CEO role. The primary focus of this paper, however, is on performance-based incentive plans as the most common framework today, and on approaches to mitigate their shortcomings.

Table 1: Remuneration Approaches

Approach	Intent	Advantages	Disadvantages
Options	Low capital commitment, upside exposure allows for diversification by CEO	Was considered "costless" at initiation even if it has shareholder dilution effects Performance-based by definition: allows for tax deduction (US)	CEO has strong incentive to manage share price down at award date, up at exercise date Asymmetrical
Shareholding requirements and matching shares	Symmetrical exposure, CEO has a stake in the company's performance during employment	Can be phased in as CEO wealth grows Allows for company matching – leverage Could be conditional – optionality	Behavioural factors – CEO discount factors Commitment is short term: Boards routinely waive requirement upon resignation
LTIP ("long-term incentive plan")	Incentives can be structured to match performance targets: equity is awarded and vests at a future date conditional on achievement of metrics (performance-based vesting vs time-based vesting)	Flexibility in contract design – performance criteria can be equity return driven or based on operational or financial criteria Vesting decision is taken by board – potential for discretion	Complexity leads to higher discounting by manager – greater expense Empirical correlation to equity returns is weak Asymmetrical Sensitive to practice
Settlement of pay in shares with long-term lock-in (beyond resignation)	Symmetrical exposure, CEO has a stake in the company's long-term performance	CEO is a shareholder and aligned with their interests Incentivised beyond own career Easy to administrate and fully transparent	Limited flexibility Difficult to provide competitive remuneration given flat structure and full transparency

6 *Median values in 2014 for the S&P 500 in the US and FTSE 350 in the UK. Sources: (1) Reda, J. and Tonello, M. (2015)* CEO and Executive Compensation Practices 2015 Edition Key Findings, *The Conference Board, 25 August 2015, (2) Li, W. and Young, S. (2016)* An Analysis of CEO Pay Arrangements and Value Creation for FTSE-350 Companies, *CFA Society of the United Kingdom, 2 December 2016, available from Lancaster University Management School. The UK LTIP figure is the average for the FTSE 100 in 2011-2013 as reported in High Pay Centre (2015)* No Routine Riches.

Stakeholder Objectives and Concerns

While the LTIP framework has been promoted by investors, companies and market standard setters, it is clear that current pay practices have not been able to resolve all agency problems. Observed practices raise serious issues with regard to their complexity, incentive paradigm, governance and misaligned time horizons.

Investors are increasingly concerned that remuneration practices do not work as intended. It is not clear that equity-based remuneration has achieved satisfactory alignment of CEO interests with those of shareholders. In particular, the current remuneration system might encourage short-term decision making. This has been suggested as one contributor to the reduced attractiveness of listing on public markets.[7] Data indicate that overall levels of remuneration do not clearly correlate with company performance. The need for shareholder approval of increasingly complex remuneration takes up considerable time and focus in the relationship between companies and institutional investors. Some investors are also uneasy with pay outcomes and the social legitimacy of increased income inequality.

Paradoxically, the current framework of performance-conditioned equity incentives has been largely driven by institutional investors; in particular through increasing voting rights on remuneration. The framework is to some extent codified as best practice recommendations in the voting guidelines of institutional investors and their agents, and in local corporate governance codes.

Company boards, while able to configure remuneration packages that appear to deliver competitive CEO pay, often feel that it is institutional investors and their agents who are making remuneration solutions complicated. Increasing requirements for shareholder approval of remuneration practices have been a growing trend over the last 15 years, making matters more difficult for boards that do not want to see low vote tallies for remuneration motions and motions to re-elect remuneration committee members on the board.

The public has at the same time become more critical of executive remuneration, especially in the aftermath of the 2008 financial crisis. Executive pay has also been drawn into the wider debate on income inequality. Proposals for a cap on executive pay have been launched, but not approved. In Switzerland, for instance, a proposal to cap executive pay at 12 times the minimum wage in the company was unsuccessfully brought to a referendum in 2013. It is clear that dissatisfaction with executive pay is on the rise.

Legislators and regulators are feeling compelled to respond to the public's concern over executive pay. In some markets, the law, corporate governance codes or best practice standards require that the board discloses executive remuneration to show the potential maximum amount executives can receive, either prospectively or retrospectively. A requirement to publish CEO

7 *We addressed this issue in "The Listings Ecosystem: Aligning Incentives",* Asset Manager Perspectives *1/2016, Norges Bank Investment Management (https://www.nbim.no/en/transparency/asset-manager-perspectives/2016/the-listings-ecosystem-aligning-incentives/).*

pay as a multiple of ordinary employee pay has been proposed in several markets. Shareholder votes on remuneration have been introduced in law or soft law on both sides of the North Atlantic. The corrective measures so far introduced by regulators, standard setters and institutional investors have not produced convincing results. At the same time, remuneration levels, the target for much of the public interest, have increased markedly.

CEOs have experienced significantly increased pay levels over the last three decades. The multiple of CEO pay to average employee pay in large US firms is currently between 140-1 and 335-1, depending on how it is measured. This represents an increase from about 40-1 in the 1980s.[8] In the UK, the average ratio is 129-1.[9] Levels are somewhat lower on the European Continent. Share awards represented almost three times the base salary on average for leading companies in the UK.[10]

At the same time, it appears that the average CEO tenure has declined over the past 15 years. For resigning CEOs, the average is reported to have decreased from about 8-10 years to 5-6.5 years today (depending on the study).[11] Data on tenure vary somewhat and may be sensitive to business cycles.

A 2013 academic paper took stock of the remuneration debate to date and argued for bringing regulatory forces into the discussion.[12] While the paper observes that researchers generally are divided in two camps – "efficient contracting" vs "managerial power" – it found that the debate tended to ignore that government intervention has been both a response to, and a major driver of, time trends in CEO pay.

Making progress towards a better-functioning remuneration paradigm, with broader support from stakeholders, will require action from all the above parties. Regulatory measures have so far not yielded satisfactory results. We believe that institutional investors, who depend on robust corporate governance to ensure long-term corporate viability, should take up the gauntlet by revisiting some of the assumptions boards rely on when setting CEO pay.[13]

8 *Source:* The Economist, *25 June 2016. The median pay for S&P 500 CEOs was 10.4 million dollars in 2015.*

9 *Source: High Pay Centre, 8 August 2016. The average pay rate of the UK's FTSE 100 CEOs was 5.5 million pounds in 2015.*

10 *Source:* Corporate Governance Review 2016, *Grant Thornton (*http://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/2016/2016-corporate-governance-review.pdf*). In FTSE 100 companies, share awards represented on average 284 percent of salary in 2016, which was an increase from 257 percent in 2015. During the same period, average salaries were down slightly.*

11 The Economist *reports that the average job tenure for the CEO of a Fortune 500 company has halved from 10 years in 2000 to less than five years (25 January 2015). Among the world's 2,500 biggest public companies, the average job tenure for departing CEOs has fallen from 8.1 years in 2000 to 6.6 years, according to consultancy Booz & Company, now PWC's consultancy arm Strategy& (*The Economist*, 21 January 2012). Strategy& reports (April 2016) that the median tenure for outgoing CEOs was 6.0 years in 2015 if the CEO came to the firm from the outside, and 5.0 years if the CEO was an insider.*

12 *See Murphy, K. (2013) "Executive Compensation: Where We Are, and How We Got There", in* Handbook of the Economics of Finance, *Elsevier Science, North Holland.*

13 *See the final report of the Executive Remuneration Working Group of the Investment Association in the UK for a discussion of possible investor-led reforms, July 2016 (*http://www.theinvestmentassociation.org/assets/files/press/2016/ERWG%20Final%20Report%20July%202016.pdf*) .*

Current Issues with CEO Remuneration

In our view, there are four main issues with current market practices. These could undermine the desired effect of CEO remuneration.

Complexity

Current remuneration practices have tended to become overly complex. This complexity is due to a number of design features of incentive plans:

- LTIPs typically rely on a set of metrics, not a single target.
- Metrics are often defined relative to an index or group of peer companies.
- LTIPs are often subject to annual changes in targets, choice of metrics, conditions, matching schemes, vesting schedules and holding requirements. Hence, in any given year a CEO may be exposed to multiple LTIP vintages with a complex, and at times divergent, set of performance criteria.
- Annual bonuses have their own criteria sets, adding further complexity.

Additional complexity comes from the interpretation of incentive plans during their life span. Each year, the board will consider to which degree LTIP targets (often from different vintages) have been met and should be honoured with vesting. The board relies on figures reported by staff reporting to the CEO. It has to interpret these figures, often using discretion, as permitted in many incentive plans. During the measurement period, the board sometimes adjusts targets, for instance following market events that make targets harder to achieve. This assessment goes on at the same time as the board and the CEO discuss the criteria sets for the next LTIP and bonus respectively. It is evident that the running application of incentive plans requires extensive interaction in an environment with information asymmetries.

As a result, boards, CEOs and shareholders tend to spend a disproportionate amount of time on remuneration, relative to other important topics in the relation between board and shareholders. Diversified investors holding shares in a high number of companies struggle to handle this complexity effectively. Despite lengthy disclosures, the underlying drivers of pay often remain opaque and non-transparent. The grant date value of share awards in this environment cannot be calculated authoritatively. Finally, this complexity exacerbates information asymmetries and weighs on the ability of the board to monitor management effectively.

Misplaced Belief in Incentives

The underlying belief that constructed incentives can effectively capture the conditions for corporate success is questionable. Research indicates that incentives work better for relatively simple, repetitive tasks than for complex undertakings such as managing a listed company. Designing a robust set of CEO targets is notoriously difficult on a multi-year horizon. This is reflected in the frequent changes and adjustments that boards make to incentives, as well as in their discretion during later vesting decisions. Market circumstances and corporate strategies may both evolve considerably during the measurement period. There is also a risk that engineered incentives crowd out the intrinsic motivation of the CEO to succeed and create value.[14]

Misaligned Interests

Empirical research on the relationship between aggregate pay and sustained performance offers mixed evidence.[15] Various studies indicate that realised remunerations have a clear correlation with firm size, geography and corporate governance structure, and a weaker correlation with company performance. In terms of structure, incentive plans have an asymmetrical pay-off profile, with exposure to the upside but not to the downside.

Typically, incentive plans' vesting conditions specify that the CEO must perform against chosen performance metrics. Shareholders prefer the CEO to be awarded shares, hence the board must calibrate the plan in such a way that it becomes likely that shares are awarded and vested. This means that there is a certain pressure on performance models to produce high performance achievement. For these reasons, shareholders can be conflicted about the ability of the incentive plans to offer reward commensurate to achievement. Variable pay elements appear to pay off more often at the high end than at the low end, driven partly by design, and partly by adjustments and discretion.

Short-Term Pressures

LTIPs and annual bonuses are criticised for over-relying on short-term CEO incentives. First, the measurement periods are generally between one and three years, which is shorter than the investment and business cycles in most industries. Second, during his or her term the CEO may take sub-optimal decisions to achieve near-term targets. The preparation of next-period targets, and the possibility of target adjustment during the measurement period, offer additional opportunities for narrowing management's focus.

The pay-off from achieving near-term targets can lead to operational sub-optimisation, management of earnings or opportunistic choice of benchmarks.[16] While many CEOs resist such temptations, academic research supports the notion that such behaviours exist, encouraged by incentive metrics. We believe many CEOs will welcome remuneration schemes that emphasise a longer time horizon aligned with investment cycles.

In reality, the equity time horizon for the CEO is even shorter than on paper, due to the way CEOs are compensated when they resign. As soon as the CEO leaves the company, the board needs to consider how to deal with agreed incentives. Holding requirements are routinely waived. Some-

14 For a discussion of how bankers' individual treats dominate performance incentives in explaining bank business models, see Hagendorff, J., Saunders, A., Steffen, S. and Vallascas, F. (2016) "The Wolves of Wall Street: Managerial Attributes and Bank Business Models", working paper, 20 April 2016.

15 See, for instance, Bruce, A. and Skovoroda, R. (2015) "The Empirical Literature on Executive Pay: Context, the Pay-Performance Issue and Future Directions", working paper, Nottingham University Business School, May 2015.

16 See, for instance, (1) Bennett, B., Bettis, J., Gopalan, R. and Milbourn, T. (2016), (2) Bizjak, J., Hayes, R. and Kalpathy, S. (2015) "Performance-Contingent Executive Compensation and Managerial Behavior", working paper, December 2015, and (3) Faulkender, M. and Yang, J. (2010) "Inside the black box: The role and composition of compensation peer groups", Journal of Financial Economics *96(2).*

times the board agrees to honour shares not fully earned through accelerated or pro-rated vesting decisions. Where the CEO can anticipate such an end-of-employment waiving of conditions, the practice will shorten the expected time horizon of the imposed equity exposure.

The economic importance of end-of-employment arrangements has increased as the average CEO tenure has shortened. These arrangements compound the time-limited payoff opportunities for a CEO at the end of his or her career, with a limited commitment to stay economically exposed to the company following departure.

Towards a Simpler and More Robust Remuneration Model

Our perspective is that of an asset manager seeking market-wide remuneration solutions that are efficient in fostering prosperous companies and thus strong returns for diversified shareholders over the long haul. Agency theory remains relevant to executive remuneration in listed stock companies. The CEO, whose primary relation with the company is an employment contract, cannot have exactly the same objectives as shareholders, the providers of equity capital. It is therefore in the interest of shareholders to better align the actions of the CEO with their interests.

Alignment of Interests

Three sets of measures can improve alignment. First, shareholders can ensure that the company has a board that effectively monitors the CEO, based on shareholder objectives. Second, the board can construct CEO incentives that seek to reproduce payoff to shareholders, or certain assumed drivers of such payoff, in line with currently prevalent incentive plans. Third, alignment can be secured by requiring that the CEO has a long-term shareholding that is substantial enough to align his or her long-term interests with those of shareholders.

Most shareholders would support the first measure – a board that effectively monitors management. This is the rationale behind the fundamental governance structure of limited companies observed across jurisdictions. The CEO is accountable to a board of directors. The board, in turn, is accountable to shareholders. In practice, effective board monitoring is regarded as necessary but not sufficient to ensure alignment.

The second measure, the construction of management incentives seeking to reproduce payoff to shareholders, has dominated the strong growth in pay levels over the last three decades. We have discussed a number of challenges with such constructed incentives, typically referred to as long-term incentive plans. The plans may have been supported with good intentions by boards and shareholders, but they appear to be ineffective and expensive, and put pressure on corporate governance.

The third measure, requiring the CEO to be a long-term shareholder, seems to be an underutilised strategy. There is growing empirical evidence that executive shareholding plays a positive role in corporate performance.[17] From an asset management practitioner's perspective, it seems intuitive that executives who are long-term shareholders would to a larger extent act in the interest of shareholders than executives who are not. This effect would be assumed to be particularly strong if the shareholding is substantial in relation to other financial incentives and resources, and is contractually and irrevocably long-term.

It is an interesting question why this simpler approach to interest alignment has not come to play a more prominent role in employment contracts with CEOs. Institutional aspects (e.g. inefficient shareholder monitoring), misconceived desires for more "high-powered" (i.e. option-like) incentives, executives' negotiating position, and behavioural mechanisms in the boardroom probably play supplementary roles in explaining the limited role of CEO shareholding as a solution for long-term alignment.

Board Accountability

For any given sum of remuneration, the recipient would generally prefer immediate settlement in cash. Hence, any settlement that involves involuntary deferral, conditionality or non-cash instruments would lead the recipient to discount the overall value. The beneficiary would rationally value such payments lower than immediate cash due to a time discount as well as a risk discount. Behavioural economics suggests that executives, due to bounded rationality, discount delayed, non-cash pay elements further than can be explained by economic rationality[18].

This does not necessarily mean that payment in shares that must be held for a number of years is inefficient. A certain gap between the cost to the company and the perceived value for the CEO is a necessary and known consequence of paying in equity. Hence, there is a first-order cost to providing remuneration in the form of equity. But the intention with payment in shares is aligning the CEO with shareholders and achieving a better long-term return on equity. If this succeeds, it may be highly efficient with respect to pursuing the ultimate goal of long-term commercial and financial success for the company.

In terms of governance, the introduction of shareholder voting on remuneration has occurred in parallel with a significant rise in remuneration levels, while proponents of shareholder voting had intended the opposite effect. In line with the general board duty to hire and monitor management, there are arguments in favour of the original delegation of remuneration authority from shareholders to the board, with a possible exception for measures that lead to shareholder dilution. Shareholders should rather hold the board accountable.

17 *See Lilienfeld-Toal, U. and Ruenzi, S. (2014) "CEO Ownership, Stock Market Performance, and Managerial Discretion"*, Journal of Finance *69(3).*

18 *See Pepper, A. (2015)* The Economic Psychology of Incentives, *Palgrave Macmillan.*

Conclusion

The three strands of research – optimal contracting, managerial power and behavioural economics – all provide insight into the complex issue of executive remuneration. There is reason to believe market forces are at play, partly evidenced by how the increasing pay packages are associated with increased company size. Shareholders have tried to link pay to performance. We question, however, whether investors have supported the right mechanisms for alignment via remuneration.

Based on research as well as our practical experience, there appears to be merit in the simpler solution – using a substantial portion of the annual pay to irrevocably expose executives to the long-term performance of the shares of the company. This would shift focus onto the impact that the *holding* of shares has on aligning incentives, rather than the *award* of shares. Remuneration would be less variable on paper, but the exposure to the long-term success of the company in the stock market would be less ambiguous.