Making bonus plans more effective

MM&K Remuneration Committee Dinner

11 June 2018

On 11 June 2018, MM&K held one of its regular Remuneration Dinners for CEOs and Non-Executive Directors. On this occasion, the theme for discussion was: how companies can make their executive bonus plans more effective. The discussion was chaired by Stuart James.

The theme was introduced by Nigel Mills, who summarised the findings of some new research, carried out by MM&K, into bonus design practice in Main Board listed companies, AIM companies and private companies. Dinner participants were given a copy of the report, which also contained a methodology for designing plans.

Nigel said that an effective bonus plan is one that best meets it objectives. Since these objectives will vary from company to company, we would expect the design to vary widely. In practice, however, listed companies have similar plans. For example all but one in the research sample paid bonuses as a percentage of salary – only one distributed a pool based on profit. The picture is more varied in AIM-listed and private companies.

It is fair to say that over recent years, institutional shareholders have taken an increasing interest in bonus plans and the level of pay-outs under them. Historically it seemed that they were really only interested in long term equity based incentive plans.

The Investment Association Remuneration Principles, directed predominantly towards larger listed companies, say:

"Annual bonuses exist to reward contribution to the business during the year above the level expected for being in receipt of a salary."

They should be clearly linked to business targets, ideally through the KPIs reported in the Strategic Report. Where other measures are chosen, these should be explained and justified. The KPIs can be both financial and non-financial.

Companies should clearly disclose and justify the performance measures chosen and the related targets.

Following payment of the bonus, companies should provide a full analysis of the performance relative to the targets in the Remuneration Report. Maximum participation levels should be disclosed and any changes in the maximum from one year to the next should be explicitly justified.

Deferring a portion of the bonus into shares is expected for bonus opportunity of greater than 100% of salary. However, this should not result in an increase in the overall quantum of the bonus.

Discretion should be retained by the Remuneration Committee to ensure that a payment that is inappropriate in all the company's circumstances is not made."

Nigel went on to quote the remuneration committee guide published by the Quoted Companies Alliance (QCA). The QCA serves the interests of smaller companies – mid and small cap and AIM-listed.

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The QCA guidance says that annual bonuses should be capped and threshold and maximum targets should be stretching. Where base salaries are high, annual bonuses should be paid in shares. Deferral of part should be considered. Linking bonus targets too closely to the budget may distort the budgeting process – budgets should not be the only metrics for incentivising good performance.

We looked at a sample of Large, Mid-Cap and Small-Cap companies. We also looked at the AIM market and a small sample of larger private companies. All of the Large and Mid-Cap companies disclosed an annual bonus plan of some sort for their executive directors. However one Small-Cap company had no annual bonus plan in place, with all of its variable pay focused on performance related nil priced options that vested over three, four and five years.

One of the most interesting observations that came out of our analysis was that all of the bonus plan designs were very "samey" in listed companies, with only one of the listed companies in the sample basing their executive bonus amounts on something other than a percentage of salary. This was a FTSE 250 Company that had a profit share based bonus in place. In contrast, when we looked at the private companies' sample, they were much more varied with three out of the five operating some sort of profit sharing bonus for their senior executives.

In the larger companies the CEO tends to have a larger percentage bonus opportunity than other executive directors whereas in the Small Cap and AIM markets this is not so common.

79% of the Large and Mid-Cap Companies had compulsory bonus deferral of some sort, whereas only 40% of the Small-Cap companies required it. And in AIM Companies, only 20% of the top AIM Companies disclosed that they had a deferred element to their annual bonus plan.

Annual bonus only for outperformance

First there was a discussion about whether bonuses should be for outperformance only. The meeting was split on this. A number of guests felt that bonuses needed to be considered in the context of total remuneration. A company needs to consider how much of that total remuneration should be related to performance. With this perspective a bonus is not for outperformance. It is about delivering a competitive package in an efficient way.

This led to a debate on whether a company's budget should represent a minimum requirement or be aspirational.

One participant said: we have a budget plus a separate contingency. Another said budget is target and threshold is below budget… Our promise to shareholders sits between threshold and target so we feel confident we can deliver. Beyond target we set a stretch goal for bonus maximum.

Over-performance in one year creates an expectation in shareholders for the following year.

Purpose of a bonus plan

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The chairman asked dinner guests what they considered to be the principal purpose of a bonus plan. Responses varied and included the following:

We have to be careful about confusing short and long term performance.

We need to reward underlying management performance if the incentive is to be effective. But there is a problem trying to measure performance, stripping out the circumstances of the company. This led to a discussion about the application of discretion by the Committee.

The principal purpose is to incentivise performance (this view was different from that expressed earlier). The formula of the bonus plan should not get in the way of providing this incentive.

It is also important to bear in mind that different executives have very different personal needs in respect of their quantum of reward and the timing of payments It is about individuals, who will react to incentive opportunity in different ways.

I agree that the principal purpose of annual bonuses is to be an incentive – it's about this year and the three things we really have to do. It helps us stick to the guns.

But is it really a motivational incentive? If executives are going to over-achieve they will do so anyway, whether or not there is a bonus attached to success.

I used to work for a family office. Bonuses there are mostly for recognition for what they have done.

Isn't the purpose of a bonus to help make the firm better?

London Business School research has flagged up the dangers of incentivising the wrong behaviours – the unintended consequences of incentive plans.

Are we using incentive plans and money to save having to manage people?

The BBC is parsimonious with bonuses. The incentive is making your way up the career ladder; although the BBC has two cultures, the editorial culture and the administration/business culture.

The effect of institutional investors

In a PLC it is very public. Institutional investors want a formula – at the beginning of the year. And afterwards they want to know the exact targets and how the company did. Disclosure causes a distortion in the incentive plan – better if it were not disclosed. The chairman of the large private company corporate governance working group, David Wates, has said that the new code will not cover remuneration. In private companies this is a private matter and part of a company's competitive advantage.

The culture of bonuses is not going to change until the institutional investors themselves get a grip. And they don't want to change the status quo because that is how they get rewarded themselves.

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They are rewarded for increasing funds under management through improving fund performance in the short term. This leads to a culture of short term performance. Bonuses can be as high as 600% of salary. There is no transparency around the way asset managers are rewarded.

Dealing with a greedy CEO

If a chief executive is being greedy, what do you do? Move them to a three-month contract and be prepared to fire them after that. So why don't boards fire executives more? Because it takes 9 months to find a replacement. Smaller companies do not find it possible to carry a "bench" of substitutes. The better players will leave for another club who will give them playing time and pay them.

But large companies should be managing careers. The CEO should be grooming his or her successor from day one.

I do not think that many CEOs are greedy. I have found they are driven by the desire to make the company successful. Reward for them is important in the context of wanting to have people around them who are good at what they do. CEOs don't resent paying more to good people.

Would the problem of greed be cured by capping bonuses? But they are capped – the research report shows practically every listed company plan has a limit of payment defined as a percentage of salary.

Company values

Culture and values are very important – the CEO you want to hire and maintain is the one who takes the employees with him or her. Another guest agreed – you can go into a company and feel it when the CEO does that. Employee engagement is a vital measure – but it is not a matter of asking people "how do you feel about your company". It has to be judged in the reality of employee leadership and engagement.

The prime aim of the CEO is to create value in the company. But he or she can only do this over time: engage with employees, develop succession, win customers, bring shareholders with you. You need a three to five year timescale of measurement for senior members of the senior team.

But there still needs to be an annual incentive plan.

When CEOs leave a company – how long a tail (of damage) do they leave behind them? Two years – it takes two years for the worms to come out of the woodwork.

We have 5000 committees looking at different aspects of governance. We don't need another committee (the Wates committee) telling us how to run things.

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The private equity reward model

Nigel was asked if there is scope for public companies to move closer to the private equity model. Nigel replied that he feels the private equity incentive model is very effective both in terms of the incentive effect and the economic justification for reward. However, it is normally dependent on having an exit event, which is not the case with a listed company. Annual bonuses in PE companies are relatively much lower compared with PLCs.

The model would not work for a utility – it is not a panacea. There was some disagreement about this – there are infrastructure funds that pay out incentives based on long-term yields, and these can be effective. Utility investments can be part of such a portfolio.

Employee engagement

In the draft new UK Corporate Governance Code, the FRC is suggesting ways in which the Board might engage better with employees. A participant said that it is really important to manage the message to employees, not just have a "chitty chat"! But you are dead in the water if you try to explain away the pay difference between the CEO and the average employee – you cannot win that argument, you should just get on with it.

There is also a requirement in the new UK Code for the remuneration committee to "oversee remuneration and workforce policies and practices, taking these into account when setting the policy for director remuneration". There is a problem defining "oversight" and what the remuneration committee needs to know about. What does oversight mean? What can it mean in a large international group with many subsidiary divisions and businesses? But it cannot mean that the committee makes the decisions

It is more of a problem if people are being paid out of different companies within the group. One participant suggested it principally means remaining aware of group remuneration practices and establishing the values within which pay is managed (eg paying the living wage).

There is no reason why a board of directors should not be interested in remuneration across the company. How it does so is a function of company size; but the board should want to apply similar principles to all.

Remuneration committee courage

Shareholders try to write rules to cover every company. Remuneration committees should have the backbone to say what they want – it is up to the board of the company to decide how to reward, not the institutional shareholders. It is only going to work if companies are prepared to say no. The remuneration committee has the opportunity to do what is in the interests of the company.

In my experience remuneration committees are reasonable, objective and try to do the right thing.

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I disagree. Too many companies have remuneration committees who follow the lead of the CEO. They are not sufficiently challenging and take the soft route. We have NEDs who drop in and out – and shareholders who want or don't want a solution. Too many committees hide behind the governance rules. They need to move away from the rules and challenge the likes of PIRC.

We end up oiling the squeaky wheel. The remuneration committee too often is reactive.

But remuneration committees often lack competence in remuneration issues. They are not viewed with the same respect as audit committees.

It will be a massive task if we have to have an overview of the whole company. But does this mean more time commitment for the committee? Not necessarily. Probably more than one day a month.

Summary

Conclusion – in answer to how to make bonus schemes better, it would appear from the discussion that the answer is totally dependent on the industry or more specifically the company and its business circumstances.

Research in bonus design practice

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