Getting executive incentive pay right

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Introduction

When it comes to executive incentive plans, it seems that these days there are as many detractors as there are advocates. Even many of those who support the principle of incentivising executives find shortcomings in popular incentive plan arrangements. So how can organisations find the right way to motivate their executives?

In this paper we highlight some of the common problems with executive short-term incentive (STI) and long-term incentive (LTI) plans and outline a potentially more effective approach than the current mainstream offering.

What do plan participants say?

Many executives themselves make comments such as:

- **STI largely rewards performance measures that I have some control over, and pays something most years, while LTI is a game of chance with a tendency to get all or nothing: this is a mixed message.**
- **Even if I have a great year, I may not get any STI or my LTI may not vest if the company underperforms: incentives are weighted too heavily toward corporate performance or negative board discretion.**
- **I have no control over how other companies perform, as reflected in relative performance measures: hence I prefer absolute performance standards set within our specific operating environment.**
- **Even absolute measures represent a challenge as LTI hurdles: no-one can predict the right level of threshold performance 3-4 years from now.**
- **The number of performance rights awarded for LTI should be grossed up to factor in the punishing vesting impact of hurdles, i.e. the notional value of each right should be discounted for the performance conditions.**
- **Overall I don’t find our incentive plans and their excessive external factor risk, especially in LTI, motivating: they have little impact on how I perform.**

What do business owners say?

Many shareholders and proxy advisers express a different view to executives:

- **STI is too generous, paying out even when shareholders have experienced a year of pain, on performance goals that may be too soft or not transparent enough or otherwise difficult to assess.**
- **STI has too many performance measures, especially non-financial objectives representing what managers are paid (via their fixed pay) to do their job.**
- **The impact of having so many measures is that the ‘law of averages’ keeps overall STI pay-outs in many companies within a narrow range of target incentives: there is not enough pay-out variation.**
- **Executives should be rewarded only when they out-perform competitors or provide returns superior to my prospective investment alternatives: hence the need to reflect relative performance at a stringent level.**
- **The number of performance rights awarded for LTI should be based on each right attaining its face value at grant (share price); there shouldn’t be extra rights awarded to offset failure to perform.**
Overall I don’t find the incentive plans in many companies, especially STI, sufficiently aligned with the shareholder experience.

What do all stakeholders say?

Executives, boards and shareholders alike agree on one thing: executive pay is far too complex and difficult to comprehend. There is a pressing need to simplify and streamline the incentive framework.

A particular aspect of complexity concerns how to value performance-hurdled LTI at the time of grant, for purposes of determining the number of LTI instruments to award. One company director has referred to the face value versus fair value debate in this context as an exercise in alchemy, while many others remain puzzled by the mathematical intricacy of option pricing models, Monte Carlo simulations and the like.

What does Aon Hewitt say?

There are numerous contrasts between typical executive STI and LTI plans, as summarised below.

<table>
<thead>
<tr>
<th>Plan element</th>
<th>STI</th>
<th>LTI</th>
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<tbody>
<tr>
<td><strong>Type of performance rewarded</strong></td>
<td>Amalgam of company and individual/divisional performance</td>
<td>Company performance only in most cases; individual/divisional performance has little impact</td>
</tr>
<tr>
<td><strong>Form of payment</strong></td>
<td>Mostly cash, with residue in deferred shares or rights</td>
<td>Performance rights and/or performance options the most common forms</td>
</tr>
<tr>
<td><strong>Link between recent performance and award size</strong></td>
<td>Past year’s performance has a significant bearing, though many pay-out schedules are quite flat, ie do not display much variation</td>
<td>In most companies recent performance has no bearing on size of grant; its value is usually a set percentage of fixed pay</td>
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<tr>
<td><strong>Link between performance subsequent to award and vesting outcome</strong></td>
<td>The portion in deferred shares or rights is aligned with vesting period share price movements</td>
<td>Vesting outcomes reflect share price movements magnified by steep performance vesting scales</td>
</tr>
<tr>
<td><strong>Independence of year-to-year pay outcomes</strong></td>
<td>Highly independent, with each year’s pay-out determined independently of previous year’s</td>
<td>Highly dependent, with significant overlap of performance vesting periods over 3-4 years resulting in long runs of low or high outcomes</td>
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<tr>
<td><strong>Number of performance measures</strong></td>
<td>Numerous; in many cases diluting the impact of the most critical results</td>
<td>Few (1-2); usually reflecting a narrow view of sustained performance</td>
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<tr>
<td><strong>Degree of difficulty – threshold</strong></td>
<td>Often set at a low level which is achieved or exceeded most of the time</td>
<td>Difficult; 50th percentile or more is achieved only 50% of the time over the long run</td>
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<td><strong>Degree of difficulty – target</strong></td>
<td>Average actual pay-out often in the vicinity of target, though some studies suggest performance targets achieved more often than justified</td>
<td>Unclear what target performance is, though threshold performance often yields mid-range pay-outs similar to grant date fair value</td>
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<tr>
<td><strong>Degree of difficulty – stretch</strong></td>
<td>Capacity to attain maximum pay-out varies widely with plan designs; some studies suggest ‘stretch’ should be more stretching in many companies</td>
<td>Attainment of grant date face value typically requires stretch performance close to 75th percentile (near full vesting) with moderate share price growth</td>
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In summary, STI and LTI plans are not on a level playing field, carrying ambiguous messages concerning the relative importance of short-term and long-term goals. To unravel this mess and take large strides towards improving executive incentive plans, a good starting point is to get back to basics and remind ourselves of the core aims of these plans:

- From a participant perspective, motivation by being rewarded for performance over which executives have reasonable control is a critical purpose.
- For shareholders, aligning executive incentives with the shareholder experience is paramount.

To the extent that these aims may be in conflict, incentive design is a balancing act in which the plan structure and outcomes should go some way toward satisfying both parties’ expectations, but realistically neither party can have it all their way.

This means incentive arrangements need to contain an appropriate blend of:

- **Financial and non-financial goals** which reflect executive key performance indicators, though generally with financial goals comprising the majority of weighting.
- **Absolute performance measures** over which executives have more control and some relative performance measures over which they have less control.
- **Financial and operational criteria** (e.g., revenue growth, cash flow, profit, productivity ratios) which are lead indicators of shareholder prosperity, along with share market criteria (e.g., total shareholder return) which directly track shareholder experience.
- **Payments linked to recent company and individual performance** validated by sustained company performance over the long term.
- **Performance thresholds, targets and stretch levels** with associated incentive pay-outs carefully attuned to their comparative performance degree of difficulty.

On the last point an ideal pay-out arrangement, with a long-run average pay-out in the vicinity of target incentive, has the following features for each performance metric:

- **Pay variation over a wide range of performance scenarios**, from zero pay-out below specified ‘threshold’ performance, through to maximum pay-out at or above ‘stretch’ performance.
- **‘Threshold’ performance** set at a level of difficulty expected to be achieved or exceeded about 70-80% of the time (lower in this range if the threshold pay-out is high, e.g., 50% or more of target pay-out; higher in this range if the pay-out is low, e.g., less than 50% of target pay-out).
- **‘Target’ performance** set at a level expected to be achieved or exceeded about 50-60% of the time, with corresponding pay-out in the vicinity of target incentive.
- **‘Stretch’ performance** set at a high level expected to be achieved or exceeded about 10-20% of the time (lower in this range if the maximum pay-out is high, e.g., 200% or more of target pay-out; higher in this range if the pay-out is low, e.g., 150% or less of target pay-out).

Contrast this guidance with widespread current STI and LTI practice:

- **STI plans** perceived by many shareholders to pay out more often and in larger amounts than the company’s financial performance warrants (though our own experience is that there are as many STI plans which under-pay persistently, especially those with a funding gate, as there are that over-pay).
- **LTI plans** which deliver zero vesting about 50% of the time over the long run (whenever relative performance is below the peer group 50th percentile), so the lower half of the performance range exhibits no variation in pay-out (1st percentile and 49th percentile earn the same vesting: zero).
Instead of having STI plans that are perceived by shareholders to be ‘too soft’ or with pay-out schedules that are too flat, and LTI plans that are considered by executives to be ‘too hard’ or too random in their outcomes, we need incentive plans that are ‘just right’.

The icing on the cake would be significant plan simplification, for example by condensing separate STI and LTI plans into a single plan containing the best features and eliminating the worst features of each.

**An integrated, balanced incentive plan example**

Consider an integrated plan formulation along the following lines:

- **Determine size of incentive pool**
  - Based on company scorecard performance over one year leading up to award.
  - Comprises a profit measure, relative TSR and other key financial metrics (60-70%).
  - May include 2-3 other/non-financial measures of strategic significance, some of which may be relative to peers (30-40%).
  - Each measure has stringent threshold, target and stretch levels and an associated fairly steep pay-out schedule consistent with above guidance model.
  - The actual pool relative to target pool reflects a roll-up of weighted scorecard measure pay-outs.

- **Distribute the pool among participants**
  - The incentive pool is distributed in proportion to individual target incentives, moderated up or down via assessment of individual performance contributions.
  - The moderation process could include the use of target incentive multipliers, e.g. 0-150% of target, though the aggregate effect of their application is constrained within the size of the available pool.
  - Performance assessments may draw on individual performance ratings or scores or may be based on judgements or evidence in a ratings-free environment.

- **Deliver incentive amounts**
  - Individual incentive amounts are delivered partly in cash paid soon after the financial year end.
  - The residual amount is delivered in shares or share rights which vest, subject to continuing service, over 3-5 years (with no further performance vesting condition).
  - The split between cash and equity may vary by role/level, e.g. CEO 20/80, CEO direct reports 30/70, other executives 40/60, most other employees 100/0.
  - These splits are intended to favour higher equity-based proportions of total incentives than is currently the case in many companies.

Key features to note from this example are:

- The incentive pool formation process resembles many existing STI pool formation conventions, though in this case also applies to that part of the incentive budget that would otherwise be allocated to LTI awards.
- This subsumes and changes the nature of LTI awards, which in most cases currently have no performance test up front, thereby strengthening the connection between recent performance and variations in total incentive expenditure.
• The company scorecard includes relative TSR (measured over one year prior), we suggest with at least 20-25% weighting, and the model encourages greater inclusion of other relative performance measures than is existing STI practice.

• The framework surrounding the development of threshold, target and stretch performance values for each measure is more rigorous than at present and may imply more challenging and more transparent goals for an equivalent pay-out, compared with many existing STI schemes.

• If applied in a company which previously had limited incentive upside (above target) for outstanding performance, the potentially sharper pay-out downside for sub-target performance should perhaps be counter-balanced by greater reward for above-target performance.

• Compared with the current crude LTI vesting scales, we advocate incentive outcome variation over a much wider performance scale than just 50th to 75th percentile relative performance. We would see the threshold for relative TSR in the incentive scorecard as being somewhat below 50th percentile (with pay-out substantially below target), offset by stretch for maximum pay-out being considerably higher than 75th percentile (perhaps 90th percentile).

• Similarly, incentive pay-outs should vary over a quite wide range of performance on profit or other key financial indicators, in contrast to common LTI vesting scales based on measures such as EPS growth, in which vesting ranges from zero to 100% over a tight performance range and results in all or no vesting most years.

• Unlike existing LTI plans, this model has no overlapping multi-year performance periods which constrain the reaction time of reward to changing performance. Under this proposal all incentive rewards are tied to immediately prior one-year performance, so performance hurdles have already been tested at the time of award and subsequent performance hurdles into the distant future should not be necessary.

On the last point, this does not mean that the integrated incentive lacks alignment with sustained performance. On the contrary, our model proposes that a higher proportion of executive incentives than at present be delivered in equity over a lengthy holding period, thereby mirroring the experience of shareholders over this period. Its equity focus is also more long-term oriented than current deferred STI, which typically vests over 1-2 years; here we have suggested a vesting period of 3-5 years.

The most obvious aspect of simplification comes from the absorption of two incentive plans into one, with one award per executive each year and significantly reduced administrative requirements.

A further element of simplification arises from the elimination of complex equity valuation methods to estimate the number of performance-hurdled LTI instruments to award. Following the removal of post-award performance vesting conditions, calculation of the number of equity units to award would be much more straightforward and comprehensible to all:

• For awards in shares with dividends during the vesting period, the number of shares to allocate may be determined by simply dividing the intended equity-based remuneration value by the prevailing share price.

• For awards in share rights with no dividends during the vesting period, the number of rights may be determined by dividing the intended equity-based remuneration value by the prevailing share price discounted for the absence of vesting period dividends (typically a discount in the vicinity of 10% over a 3-year vesting period).
Why hasn’t this type of approach already become more prevalent?

Numerous boards and management teams have discussed ideas similar to those presented here, based on perceptions that:

- STI is a little broken and is coming under increasing shareholder scrutiny, with minor amendment perhaps required.
- LTI is very broken and needs major amendment or assimilation into a simpler, more cohesive incentive plan framework that delivers more consistent and motivating messages than the present paradigm.

So what are the barriers to reinventing executive incentive plans on this ‘back to basics’ approach?

Firstly, there is a fear of departing from the prevailing norm and potentially inviting more ‘against’ votes in relation to the remuneration report. Doing something radical, yet elegantly simpler, may invite proxy adviser suspicion and objection. There is a natural tendency to perpetuate standard incentive templates, even though doing the same as everyone else provides little – if any – competitive advantage.

Companies prepared to break away from the pack will need a dose of courage, backed by a well-orchestrated investor relations program, targeted at key proxy advisers and influential shareholders.

Many companies also struggle with the notion that in a bad year there may be little or no incentive awarded, if it is all contingent on recent performance. This is perceived as potentially weakening the executive retention hold, compared to always granting LTI as a set percentage of fixed pay, including years when STI is well below target or even zero.

Our response to this retention argument is to say that it is largely an exaggerated concern. Most executives assign little value to current LTI awards and their prospective retention hold is minimal. Even with the more highly-valued STI awards, the tendency for executives to leave a company after one or two years of low pay-outs is less evident than many companies assume. Further, if there is a sequence of poor company results followed by low incentive pool pay-outs, maybe it’s time for executive team changes. Preoccupation with retention should not override strong alignment with results.

In summary

In this paper we have noted common limitations of conventional STI and LTI plans, from a range of stakeholder and observer perspectives. We have concluded that performance-hurdled LTI, in particular, frequently has almost zero influence on executive behaviour and performance, as participants place little value on these awards in their most popular forms.

We have described ways that STI and LTI expectations are almost polar opposites and have advocated a more even-handed approach with greater consistency of messaging for participating executives. In particular, we have outlined a way of merging the two plans into one, while retaining a balanced approach to rewarding both short-term and long-term performance.

If your company is struggling with these issues and would like to explore an alternative path to getting executive incentives just right, get in touch with Peter Ryan at Aon Hewitt for assistance.
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