Simplifying executive reward:

what's your best route?

How to simplify executive reward in your organisation

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Introduction

There is little doubt that all involved in executive reward – investors, remuneration committees and executives themselves – are calling for pay to be made simpler.

But the road to simplification isn't an easy one, not least because simplicity means different things to different organisations.

So how do we get there?

It's a journey that entails addressing several questions. What is driving complexity in the first place? How do firms tackle the causes? What practical steps can be taken to simplify packages? What will this look like in practice? And how do you find the right route for your firm?

This guide presents a roadmap to simpler executive pay, by examining the following.

- **Drivers of complexity:** what causes complexity in executive reward?
- **Pointing the way:** creating the right conditions.
- **Routes to simplification:** what steps can companies implement?
- **A simplification dashboard:** simplification in action.
- **On the right road:** what is the right simplicity for your organisation?
- **Simplicity matrix.**

Drivers of complexity: what causes complexity in executive reward?

In our experience, when executive reward becomes overly complex, the reasons are largely behavioural. Certain embedded habits, mindsets and thought processes among remuneration committees are what tend to drive complexity.

1. Committees have unclear aims

As a result, pay policy is set out in general terms, providing little or no direction.

For instance, firms want pay to drive performance, but are not always clear about what that means in reality. Is it a 20 per cent variation in bonuses above or below the on-target level? Or significant fluctuations from year to year, and/or between individual executives?

This lack of clarity damages the quality of debate in the committee. Taking the time to develop a shared understanding of what pay needs to achieve, and agree decision-making principles, makes for a more effective discussion.

2. A lack of clear aims and principles results in a failure to make choices

For example, what is the main purpose of the long term incentive? Retention, alignment with shareholder interests or to incentivise delivery of the strategic plan? Similarly, what purpose does the annual bonus serve? Is it a profit share, an incentive to execute strategy or a mechanism to ensure competitive pay?

Unfortunately, for many companies, the answer is "all of the above". But trying to be all things to all people often leads to over-complicated plans with too many objectives.

3. Committees rely too heavily on benchmarks and precedents

To an extent, this is understandable. Remuneration committee members are non-executive directors, not technical reward experts, so tend to fall back on tried and tested paths. And after all, pay needs to be competitive within the market.

However, replicating existing plans is unlikely to prove effective in the face of investor discontent over pay.

4. Pay is often designed in silos

Each element of pay is typically considered independently of the others, resulting in missed opportunities to understand, evaluate and therefore simplify packages.

5. Committees and shareholders typically suffer dysfunctional relationships

Shareholder engagement can feel like a negotiation between opposing and mutually-suspicious interests – when in fact, both sides are attempting to act in the best interests of the company.

Remuneration committees are right to recognise shareholder opinion. But when respect turns to fear, it can result in additional complexity, as members try to keep as many investors as possible onside.

So how do remuneration committees move on from the behaviours that lead to complexity? >>

Pointing the way: creating the right conditions

The first stage in the simplification process is to foster the right conditions. Remuneration committees can go about achieving this by implementing six key steps.

1. Be clear about what simplification means for the business

Simplification can take many forms – it is essential to understand what is needed in your organisation.

- **Simpler structures.** This may mean fewer plans, or less complex plan design. Recent ABI guidelines recommend reducing variable plans to an annual bonus and a single long term incentive scheme. The ABI describes approaches such as bonus-matching and co-investment plans as "unnecessary complexity".
- **Fewer metrics.** There is a temptation to carry every scorecard metric over into the short term incentive. This convolutes bonus plans, making them difficult to operate and communicate. It also means that payments rarely stray far from on-target levels.
- **Fewer legacy plans.** An executive might typically be participating in three long term incentive cycles at any given time, each with its own financial targets, and sometimes even based on different metrics.
- **Faster decision-making.** Pleas for simplicity from NEDs often stem from frustration with the amount of time and energy they spend on remuneration issues.
- **More transparency, disclosure and communication.** Sometimes, the problem lies not with plan design, but with how pay is communicated to stakeholders and the outside world.

2. Accept trade-offs between simplicity and effectiveness

Incentive design should be seen as a cost-benefit analysis. Do the merits of each package element or design feature ultimately outweigh the disadvantage of added complexity?

3. Set clear, specific aims and principles about how pay should operate

As we've seen, unclear objectives often lead to a lack of direction.

Remuneration committees need to invest time in agreeing the following questions.

- Should pay vary substantially with performance, or be more stable over time?
- To what extent should long term incentives emphasise pay for performance as opposed to retention?
- Should this vary by role – and how?
- Should annual bonuses mirror eventual financial outcomes, or encourage people to do the right thing now?

Clear, specific aims and principles will help committees to make choices rather than compromises. This is because they offer a basis for decision-making, making it easier to identify the right course of action.

Achieving this clarity means taking a step back. For example, by holding a meeting once a year that is focused purely on the big picture, rather than day-to-day decisions.

4. Focus on the business

In addition to the behaviours already outlined, complexity in executive reward can arise from external factors such as inherited structures, market practice and real or perceived investor requirements.

By contrast, designing pay to suit your business – for example, by considering organisational culture and the nature of the workforce – leads to simpler structures. For example, if certain behaviours are deeply ingrained, such as a focus on quality, there may be no need to incentivise these.

Any remaining complexities will tend to reflect those of the business itself, and so be much more palatable to executives, NEDs and shareholders.

5. Don't cascade complexity

Simplification may be easier to achieve in some parts of the business than others.

For example, there is no need to extend reward features that are mandatory on the Main Board or ExCo (due to governance or regulation) to the whole executive population.

6. Be honest with investors

Explain what you're doing and why. Most importantly, help shareholders understand the trade-offs between simplicity and alignment with performance.

Having fostered the right climate, what practical measures should remuneration committees put in place to achieve simplification? >>

Routes to simplification: what steps can companies implement?

There are several approaches organisations can take to simplifying executive reward. These differ between the broader executive population and roles that are on Main Board or Executive Committee.

1. Roles below the Main Board and Executive Committee

The greatest scope to simplify pay lies with these roles, for three reasons:

1. shareholder approval is not needed
2. pay practices are not disclosed
3. governance requirements are less onerous.

Hay Group has been working with a number of companies to implement the following highly practical steps at these levels.

Reduce the number of LTIP participants
Many larger listed companies have more than 100 executives in their LTIP programmes. High numbers of equity participants may be a market necessity in some sectors and geographies. But in many cases, it is driven simply by historical custom and practice, rather than any strategic reward imperative.

By contrast, many private equity-backed companies limit LTI participation to just a few strategic roles.

Remove or simplify LTI performance hurdles
In our view, there is a clear case to do this below the Main Board and ExCo.

UK investors routinely demand LTIP performance conditions for top executives, but are much more relaxed where other roles are concerned. What's more, simplifying performance conditions increases the value that participants place on their plan.

Stop cascading
When designing performance scorecards for roles below ExCo level, objectives are usually cascaded top-down.

Adding a bottom-up review, based on what the role is actually required to do, can significantly reduce the number of objectives.

2. Main Board and Executive Committee roles

At Main Board level, pay is generally subject to investor approval. This inhibits simplification to a degree, as greater numbers of stakeholders are involved.

Reward is also subject to public disclosure, which means that remuneration committees need to focus on external perceptions as well as the actual substance of reward proposals.

However, there are four key areas where simplification remains possible.

(i) Package restructuring

An obvious way to reduce complexity is to create simpler structures, by removing package elements. As noted, the ABI has advised companies to pare down variable plans to a bonus and just one LTIP.

(ii) Changes to performance metrics

Some incentive plans simply contain too many metrics. Psychologically, however, it can be disconcerting to move from, say, ten bonus measures to just six, for fear of finishing up with a less complete view of performance.

In this case, a cost-benefit analysis is helpful. Weighing the benefits of each metric against its 'complexity cost' will make for a healthier debate.

Plans may also feature some metrics that are themselves inherently complex. Again, a cost-benefit analysis will be useful.

– It may be better to forgo metrics implemented for external rather than business-related reasons: Relative TSR, for instance, is popular with investors. But in less mature, less cyclical firms, or those without a clear set of comparators, its other benefits are modest compared to its high complexity cost.
– But when metrics are intrinsic to how the organisation is managed, they should be retained, however complicated they may be: For example, some companies use economic profit (EP) as a metric to underpin all business planning and monitoring. In this case, the complexity cost is minimal, as executives need to get to grips with EP anyway; and there is a clear benefit in aligning pay to how the company is run.

(iii) Changes to incentive vehicles

Most UK companies have a reasonably simple set of incentive vehicles: cash bonus, deferred bonus and performance shares. Where more complicated arrangements exist, they tend to serve a specific purpose.

Nevertheless, it is useful to consider whether incentive vehicles can be rationalised. As noted, the ABI has counselled against complex arrangements like bonus matching and co-investment plans.

(iv) Harmonisation of LTIP cycles
There is increasing realisation that multiple LTIP cycles result in excessive complexity.

In the short term, consolidating open plan cycles raises issues of fairness for shareholders and executives. That said, performance conditions can be successfully amended mid-cycle: Hay Group has helped clients to achieve this following major strategic change.

And over the longer term, we see two main approaches to rationalising plan cycles.

1. Recent commentary from the National Association of Pension Funds (NAPF) and others suggests that a scorecard-based annual bonus, with significant deferral and claw-back provisions, might be a valid alternative to a traditional, performance-vested LTIP.
2. Some Hay Group clients outside the UK operate LTIPs that replace the multi-year target with a series of harmonised annual targets, set at the beginning of the applicable year.

So what would these approaches look like in practice? >>

A simplification dashboard: simplification in action

This section illustrates eight example simplification measures. Each dashboard sets out the roles for which the approach might be suitable along with the associated implications and trade-offs.

1 **Replace LTIP with deferred bonus and clawback**

2 Remove LTIP and increased fixed pay

3 No bonus deferral

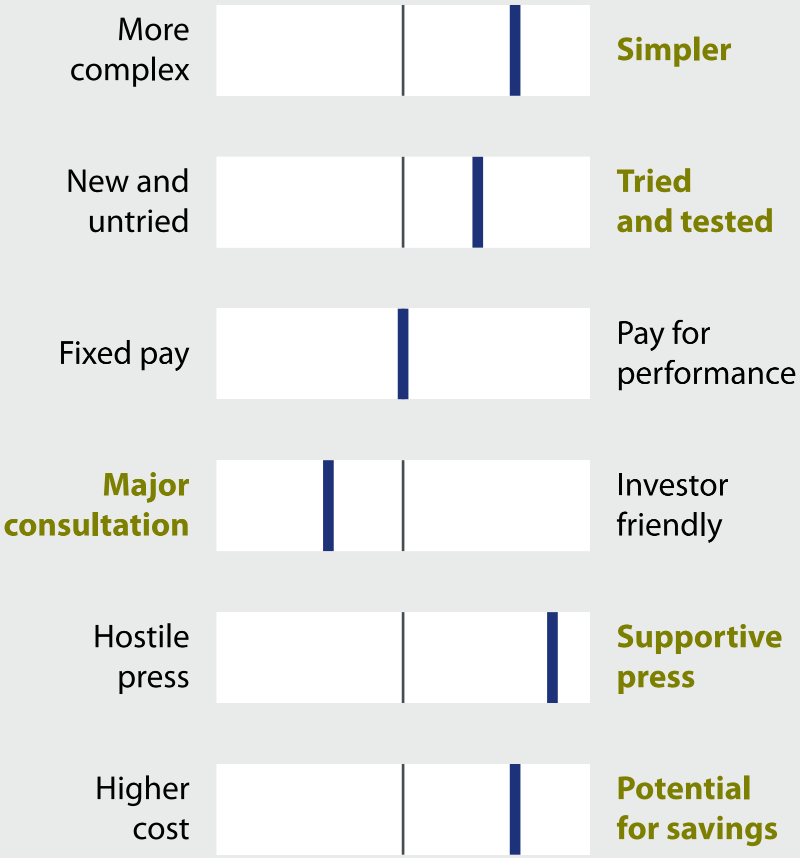
4 Convert bonus into quasi-profit share

5 Remove relative TSR condition from LTIP

6 Reset metrics for in-flight LTIP cycles

7 LTIP based on a series of annual targets

8 Reduce LTIP participation



Suitability

Executive directors and ExCo

Other executives

Considerations

- Suitable if short-term focus
- Suitable if largely non-cyclical
- Bonus should include lead indicators and / or strategic milestones to mitigate risk of short-termism
- Executive friendly but zero bonus years could cause retention risks.

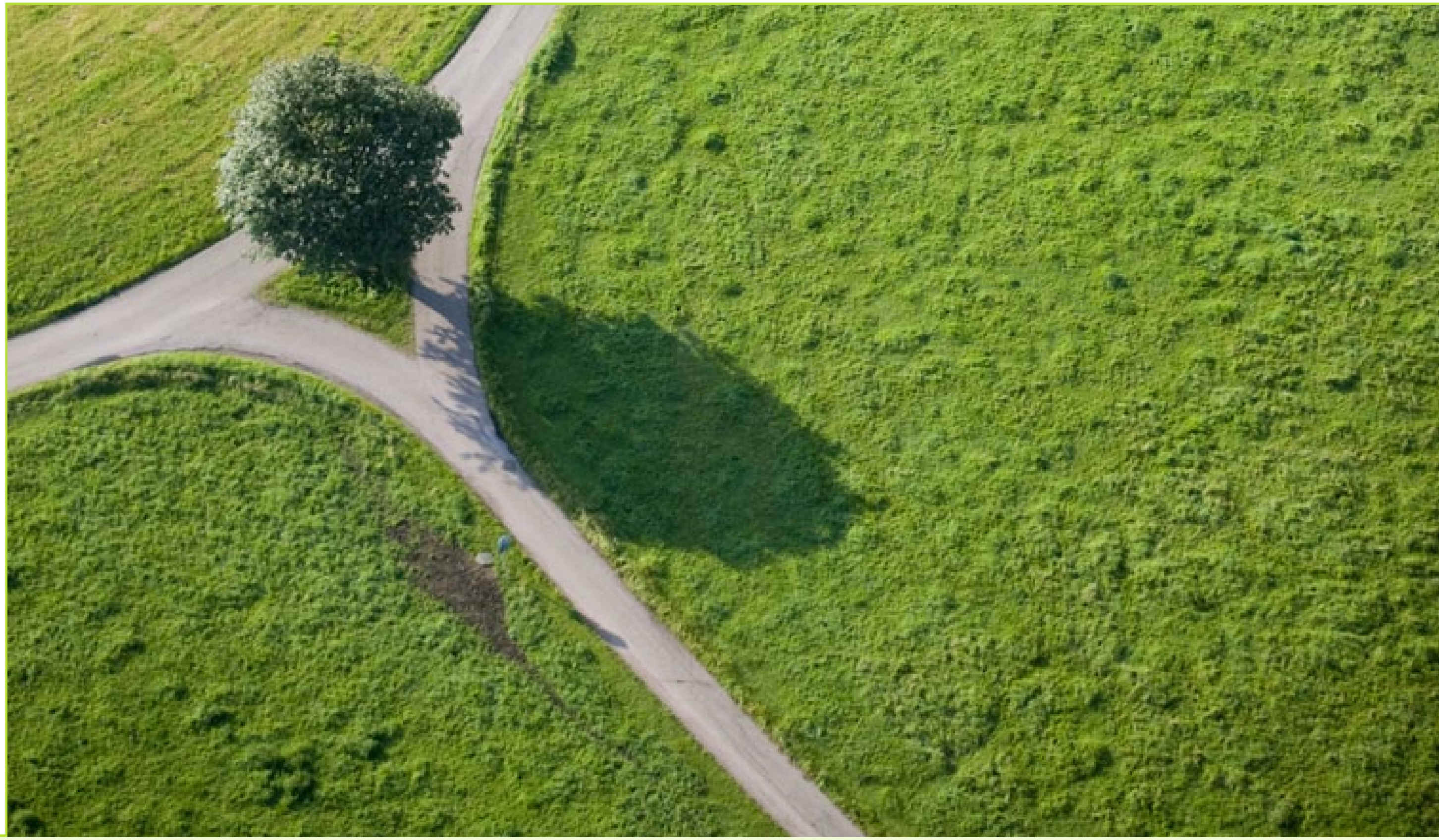
On the right road: what is the 'right' simplicity for your organisation?

Getting simplification right for your business is no easy task.

That's because simpler isn't always better. The iPod usurped the Mini-Disc because it is simpler to use and still offers good sound; yet few would willingly choose a basic 1960s Ford Anglia over the superior performance and comfort of a complex, modern-day BMW.

Consumers routinely make sophisticated trade-offs of this sort between simplicity and complexity. Remuneration committees need to make similar judgements when it comes to executive pay.

It may be relatively easy to remove elements of pay that have been designed for tactical rather than strategic reasons, or have outlived their usefulness. But the case is less clear when a feature has clear merits but increases complexity.



Simplicity matrix

On balance, though, we would argue that simplicity is generally better when it comes to executive reward – providing that firms take the right route, and that simplification is not achieved at the expense of effectiveness.

With this in mind, Hay Group has developed a matrix to help analyse the complexity and effectiveness of pay policies.

High

Complexity

Low

Complexity diagnosis

Complexity is driven by **extraneous, non business-related elements and features.**

Simplicity solution

Remove extraneous, non-business related elements and features and **reassess new position in matrix.**

Complexity diagnosis

1. Complexity driven by the need to get a **full and sophisticated view of organisational performance.**
2. **Failure to make choices.**

Simplicity solution

1. Consider **costs/benefits of current position** compared to a bottom-left approach that is less well aligned but simpler. If the current, top-right position remains optimal, **improve communications.**
2. **Make cost/benefit choices** on which elements and features can be removed and reassess what new position in matrix would be.

Complexity diagnosis

1. **Simplicity is chosen at expense of alignment**.
2. **Failure to tailor pay** adequately to the organisation.

Simplicity solution

Consider what a **more tailored, better aligned design might look like.** Then consider costs / benefits of the change and reassess what new position in matrix would be.

Ideal positioning if achievable

Relatively few companies here in part due to **actual and perceived investor requirements.**

Low | **Performance alignment** | High

Contact us

Hay Group advises on all areas of executive reward, including policy, strategy and design.

Our approach uses unique tools, techniques, research and expertise that enable us to consider the bigger picture for your organisation. We help clients to get the best from their executive reward by developing approaches that are instinctively understood by executives and investors alike.

To find out more about Hay Group's approach to Executive reward visit our website.

If you would like to discuss simplifying your executive pay arrangements, or would value a wider conversation about any other aspect of executive remuneration, please contact:

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About Hay Group

Hay Group is a global management consulting firm that works with leaders to transform strategy into reality. We develop talent, organise people to be more effective and motivate them to perform at their best. Our focus is on making change happen and helping people and organisations realise their potential.

With over 2,600 employees in 86 offices in 48 countries, our teams are chosen for their ability to connect business and people issues, and deliver workable solutions via original insights. Our clients are from the private, public and not-for-profit sectors across every major industry. For more information please contact your local office through **www.haygroup.co.uk**