The Psychology of Incentives 2024

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Our new Psychology of Incentives research

In 2012 our Psychology of Incentives survey, conducted with the London School of Economics and Political Science (LSE), sought to gain a better understanding of the perceived value of incentive awards based on the responses of executives themselves. The findings showed that many individuals are likely to discount long-term incentive plans (LTIPs) significantly compared to their economic value and to a fraction of their cost to the employer.

Since this research, shareholder and broader stakeholder sentiment has evolved and scrutiny in relation to executive pay has continued to grow. Further governance mechanisms have been incorporated within UK executive remuneration incentive structures, some in response to corporate governance concerns and others in response to shareholder views.

Our new Psychology of Incentives research explores whether our original findings on the views of executives still hold true, or if attitudes have changed, and it examines how companies can consider this in the context of the views of broader stakeholders and amid the ongoing debate on the competitiveness of UK companies competing for talent in international markets.

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We would like to thank the participants of this study for taking the time to complete our survey and for sharing their views, as well as the Heads of Reward who supported with the distribution of the survey amongst their teams, without whom this research would not have been possible.

We are also grateful to Professor Alexander Pepper, a co-author of the 2012 research, for his helpful input and review.

Key findings and implications for consideration

1 For many, long-term incentives are not working effectively

Executives believe strongly in the importance of remuneration to attract and retain talent.

But only 41% think their company's long-term incentive plan is an effective incentive.

There may be opportunities for companies to improve the efficiency of their remuneration spend from the perspective of participants, whilst recognising broader expectations.

2 Like the general population, executives are risk averse

Most executives choose fixed pay over a bonus of a higher value - only 30% choose the higher risk bonus.

There is evidence of risk aversion amongst executives…but it depends on the circumstances.

Many executives are willing to risk an uncertain outcome provided that grants are annual and there is the potential for upside.

One solution could be for companies to offer greater flexibility for employees to choose how they are remunerated - but clearly the views of other stakeholders should be taken into account.

3 Discounting of deferred remuneration is high

Greater familiarity with deferred compensation structures - which have become the norm in the UK over the last 15 years - has not led to executives valuing them more highly.

Executives continue to value deferred pay significantly below its economic value - a deferred bonus is typically discounted by almost 50% over three years.

Higher levels of deferral than peers creates a greater competitive disadvantage than a conventional view on the time value of money might suggest.

Companies could consider removal of non-mandatory deferral or holding periods but would also have to consider the broader reasons for these mechanisms.

4 Executives prefer multiple performance metrics to one

Executives prefer to be assessed against a balanced scorecard of metrics, rather than on a single metric such as profit or relative TSR.

Many would even choose a smaller, fixed amount over a bonus assessed on a single profit or relative TSR metric.

Greater segmentation in the operation of incentives (e.g. reduction to weighting of TSR for roles less able to influence the outcome) could improve the perceived value albeit in practice changes would need to take into account the views of the Board and investors.

Some companies could consider re-calibration of TSR metrics to align with approaches taken in other countries.

Key findings and implications for consideration

5 Pay positioning is important…

Most executives would choose to be paid less in absolute terms if it was more than their colleagues, rather than more in absolute terms but less than their colleagues.

But it is more important to be paid more than peers in the market.

Pay positioning is important - and therefore well-considered benchmarking against relevant comparators has its place…

6 …but recognition is a stronger motivator

But above all that, recognition of performance (e.g. through a pay increase) is considered more important than absolute pay level or positioning relative to peers.

…but it isn't everything. Executives are motivated by recognition - regular, smaller awards may have more impact than infrequent, larger awards.

7 It's about more than money

Executives would take a 20% pay cut for their ideal job. And they would even take a 10% pay cut to perform their current job if it was at an employer that more closely shares their values.

But when it comes to working abroad or taking on a Board role at a listed company, most would expect at least a 25% pay increase.

It may be difficult to offer individuals their ideal job but creating a strong culture built around shared values can have a meaningful impact on how employees value their job.

When determining remuneration packages, Remuneration Committees should be guided first and foremost on the market rate of pay for the role and the candidate's experience, and avoid making assumptions about a candidate's remuneration expectations compared to their current role.

Key lessons

Aim for simplicity and explain residual complexity

Consider whether design features which may impact the perceived value remain appropriate, and ensure detailed explanation of performance metrics to participants and how they influence them.

Consider a range of incentive structures and use these selectively

Combinations of different types of incentives may provide "something for everyone", or Boards may vary their approach year-on-year depending on business circumstances.

Operate a more segmented approach to incentives…

…or allow employees more flexibility to choose the remuneration structure that they value the most (noting that the appropriateness of choice may vary with seniority).

Introduction

Remuneration governance a decade later

Employers across the UK spend over a trillion pounds on pay each year and there is a clear commercial rationale for getting reward right at all levels of the organisation. For most employees, the financial element of pay largely comprises fixed elements including salary, pension and benefits. However, for senior employees, a higher proportion of pay is typically delivered through short and long-term incentive plans. Indeed, at the very top of the house, of the total amount paid to executive directors at FTSE 100 companies last year, around 73% was in the form of incentive plan payments.

And yet, despite this outlay, comparatively little detailed research had been conducted to test the extent to which executives value and feel motivated by these structures. So, in 2012, in conjunction with Professor Alexander Pepper of The London School of Economics and Political Science, we launched our Psychology of Incentives survey to gain a better understanding of the perceived value of these awards based on the responses of executives themselves. The findings showed that executives tend to view some often-used remuneration structures - especially long-term incentive plans (LTIPs) - in a rather unflattering light.

Some of the potential characteristics of LTIPs – complex performance conditions, arbitrary outcomes and perceived unfairness in outcomes, multi-year deferral – suggested that many individuals are likely to discount LTIPs significantly compared to their economic value (and to a fraction of their cost to the employer).

But clearly the views of executives are only part of the picture; the effectiveness of incentives and the views of other stakeholders should also be taken into account. In the decade or so since this research, shareholder and broader stakeholder sentiment has evolved and scrutiny has continued to grow. Executive pay has been under the spotlight in a range of scenarios, including payments in the context of corporate failures, the impact of high inflation on different earning levels and the overall fairness agenda.

In this context, it is perhaps unsurprising that further governance mechanisms have been incorporated within UK executive remuneration incentive structures, some in response to corporate governance concerns and others in response to shareholder views:

- Malus and clawback provisions, which give remuneration committees power to withhold and reclaim incentive payments, are now widespread.
- A form of compulsory deferral of part of the annual bonus now applies to executive directors of around 95% of FTSE 100 companies (compared to around 60% in 2010), in part as a mechanism to enforce the malus provisions above.
- Post-vesting holding periods on long-term incentive plan awards have become the norm, reinforced by the 2018 UK Corporate Governance Code requirement for a minimum five year vesting and holding term, providing further alignment with shareholders.
- The governance environment has evolved to permit restricted stock awards (i.e. awards without performance conditions that avoid the potential pitfalls of complexity and ambiguity) but these are typically only accepted if an underpin applies and the opportunity level represents a 50% discount to an equivalent performance share plan.
- Shareholding requirements have become commonplace and, in response to the 2018 UK Corporate Governance Code, now apply post-employment.

We therefore took the decision to revisit this topic to explore whether our original findings on the views of executives still hold true, or if attitudes have changed, and how companies can consider this in the context of the views of broader stakeholders. We were particularly keen to explore what conclusions we can draw as UK investors undertake a review of listed-company pay governance in the context of concerns about global competitiveness and in light of other developments such as the removal of the bonus cap in the banking sector.

> “In the decade since our original research, further governance mechanisms have been incorporated within UK executive remuneration incentive structures, some in response to corporate governance concerns and others in response to shareholder views.”

“Overall, it’s clear that both the context in which remuneration is paid and how it is paid have changed since 2012. But have the attitudes of executives changed?”

Different context, similar challenges

The original research was conducted in the aftermath of the 2008 financial crisis: the UK government was focused on deficit reduction, wage growth was below inflation and financial markets had not returned to their pre-crisis highs. Fast forward to recent years and COVID-19 and other geopolitical events have caused high inflation and created a cost of living squeeze. Yet in parallel, global equity markets have experienced one of their longest bull runs in living memory and, despite the interruptions of COVID-19, records continue to be broken.

Within the UK there is an ongoing debate over the effectiveness of executive pay in the global market for senior talent. Both incentive models and quantum have been highlighted as limiting the competitiveness of UK companies, with implications for the health of the UK’s business sector. It is clear that there are a range of views on this topic, which will continue to evolve over the coming months and years.

This debate tends to focus on market benchmarks which highlight disparities in pay quantum and differences in pay models. To date, most companies seeking to address this have done so through increases to opportunity levels under existing incentive structures.

A much smaller number of companies have introduced so-called “hybrid” long-term incentive structures, combining performance-based and time-based shares to more closely align with US practices.

But there are a number of factors to consider beyond quantum and incentive models. The precise structure of incentives evidently affects the level of discounting that executives apply, for example due to deferral or performance conditions. Non-monetary factors, such as recognition and job satisfaction, may also affect how motivated an executive feels to perform their role - since our original research, many companies have reviewed their employee value proposition, encompassing both financial and non-financial reward, and the conversation on quantum should not ignore the value that an employee (senior executive or otherwise) may place on having an employer that offers fulfilling work, provides development opportunities and shares common values with its employees. Indeed, our previous research indicated that companies using a “Total Wellness” approach to total reward (one that focuses on physical, emotional, mental, social, career and financial aspects, including employee incentives) could see an improvement in financial results.

This is not to overlook the importance of quantum. However, there may be opportunities to structure reward in a way that is more highly valued by participants and therefore more efficient and cost effective for employers and so address the competitiveness point without necessarily increasing quantum, a key area of concern for many stakeholders.

Overall, it’s clear that both the context in which remuneration is paid and how it is paid have changed since 2012. But have the attitudes of executives changed? And what does this mean in the context of broader stakeholder views?

Incentives are still not working effectively - what can be done?

Our new Psychology of Incentives research surveys executives of UK listed companies. When it comes to executive views on incentives, there are two primary lenses: the perceived value of the award (which is a purely economic judgement) and its importance (which takes into account a wider range of motivations and preferences).

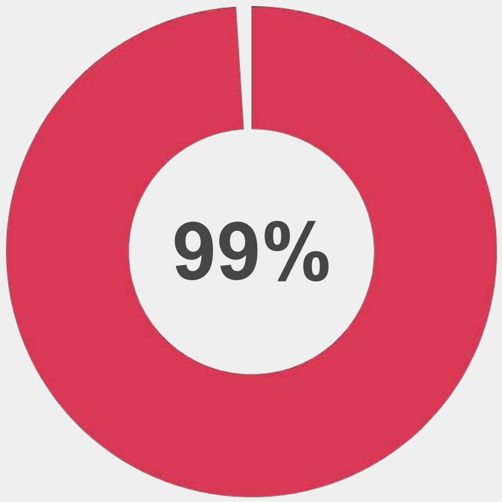
Based on their responses, there is little doubt that remuneration remains an important factor in attracting and retaining talent - 99% of participants agreed with this statement. However, only 41% of participants think that their company's long-term incentive plan is an effective incentive.

This figure has decreased from 60% in 2012 and it's hard not to suspect that the deterioration in sentiment towards LTIPs could be linked to the governance-driven complexity of the current LTIP model.

The remainder of the research explores the perceived value angle further, considering how attitudes of executives towards pay have evolved over the last 12 years with a view to taking an evidence-based approach to respond to the questions that the current debate on UK competitiveness raises, such as:

- What is the perceived value of an incentive based on certain design features (e.g. performance conditions, deferral/holding periods, vesting periods, shareholding requirements)?
- Which, if any, performance measures are most motivating to executives? And how does this align with the views of shareholders and other stakeholders?
- To what extent are executives motivated by factors other than the quantum of their package or their pay positioning relative to peers? What about status, job satisfaction or working abroad?

The importance of remuneration



Of executives agreed that remuneration is an important factor in attracting and retaining talent.

> "41% of participants think that their company's long-term incentive plan is an effective incentive. This figure has decreased from 60% in 2012."

Key findings

“If incentives are set in a way where there is a high risk of not obtaining them, this can be discouraging.”

Survey Participant

Executives are risk averse

The majority of executive remuneration packages are linked to short and/or long-term variable remuneration schemes. The outcomes under such plans are, by definition, variable or “at risk” - the amount an executive receives is typically subject to performance and/or share price movements. There is no guarantee that they will receive anything, let alone the full amount. A risk averse executive may value their variable remuneration below its expected value - for these individuals, fixed pay (even if lower overall) could be more motivating and offer better value to the employer. So how do executives view the risk associated with variable pay schemes?

In our 2012 research, we asked a series of questions in which executives were given a choice between receiving a certain amount and an amount which could be higher or lower than the certain amount. A risk neutral individual should, in theory, calculate the expected value of the gamble based on its probability of paying out (in our case, a 50% chance), compare this to the certain amount, and choose the higher option.

Like much of the general population, we found that most executives were risk averse and demanded a premium in excess of 10% for variable pay compared to fixed pay. This meant that variable pay was a relatively expensive way of paying them and so companies would need to assess whether the benefits – e.g. improved performance or greater flexibility to manage costs – were worth the additional cost.

This time, our questions followed a similar format. In each case the expected value of the gamble was higher than the certain amount. For example, a participant who takes the gamble in the first question is expected to be £375 better off (a 17% premium) than one who takes the certain amount.

Q1

Which would you prefer as a one-off gamble?

a. **50% chance of £5,250 (or nothing).**
b. **£2,250 for certain.**
c. **Indifferent to a) or b).**

Q2

Given that the annual bonus of a senior executive of a large company is around £45,000, which would you prefer?

a. **50% chance of receiving a bonus of £90,000 (or nothing).**
b. **£41,250 for certain.**
c. **Indifferent to a) or b).**

Consistent with our 2012 findings, the majority of participants chose a smaller, certain amount. Although there were some small movements in the proportions selecting each answer compared to our 2012 research, there has been no material change in the overall outcome suggesting that these behaviours are reasonably consistent over time.

However, this level of risk aversion was not remarkable when compared to our previous research on a global basis. The UK participants in 2012 were amongst the most risk averse of any country. When we compare the UK sample in 2024 to the results from all countries in 2012, our UK participants today would be more in line with the risk appetite levels seen in the US and Switzerland but still substantially below the levels seen in other countries such as Brazil and China at the time. Of course, levels of risk appetite may have changed in those countries in the intervening years.

This provides insight into participants' attitudes towards risk in a one-off gamble scenario, but the nature of incentive plans is that they often comprise annual awards which effectively means there are multiple throws of the dice. We therefore presented participants with a similar gamble, but with three independent attempts.

Q3

You are invited to have three attempts at a gamble with a maximum win of £5,250 at each attempt, i.e. a maximum of £15,750 over three attempts. Which of the following choices would you prefer?

a. **Go for the three attempts to win a maximum of £5,250 at each attempt knowing there is a 50% chance of winning £5,250 at each attempt, otherwise nothing.**
b. **£6,750 for certain.**
c. **Indifferent to a) or b).**

Despite the expected value under the single and triple attempts being the same on a "per-gamble" basis, the proportion of participants taking the gamble increased from 30% to 48% (higher than the 46% that opted for the certain amount). This makes sense as the distribution of the pay-offs from the three gambles will be different to the single gamble - for example, there is a much lower chance of getting nothing at all.

We were also curious to understand whether an individual's attitude to risk would be impacted by the choices of another person. We therefore presented the same three-attempt gamble, but this time indicating that a peer has decided to take the gamble. If the peer is successful in all three gambles, they would end up £9,000 better off than an individual who takes the certain amount. Would fear of missing out influence our participants' attitude to risk?

Q4

A peer you compete with takes the gamble in Q3. Which of the following choices would you prefer?

a. **The same gamble as your peer.**
b. **£6,750 for certain.**
c. **Indifferent to a) or b).**

It seems not - only 2% of participants who previously selected the certain amount then changed their answer to follow their peer in taking the gamble.

Although the overall headline remains true that executives are risk averse, the 30% who took the single-gamble opportunity is a meaningful minority. Put another way, most executives require a premium for variable pay but some do not.

Looking at the data based on sex also revealed some insights. Overall the men in our sample were more risk averse when presented with the lower value, one-off gamble. When the stakes rose for the higher value one-off gamble, the men were (narrowly) more risk seeking than the women. It was only when offered the three attempts that the men in our sample were notably more risk seeking. In summary, the one-off nature of the gamble inspired more risk aversion in the men whereas the size of the gamble inspired more risk aversion in the women. Neither men nor women were significantly influenced by the choice of a peer, consistent with the overall findings above.

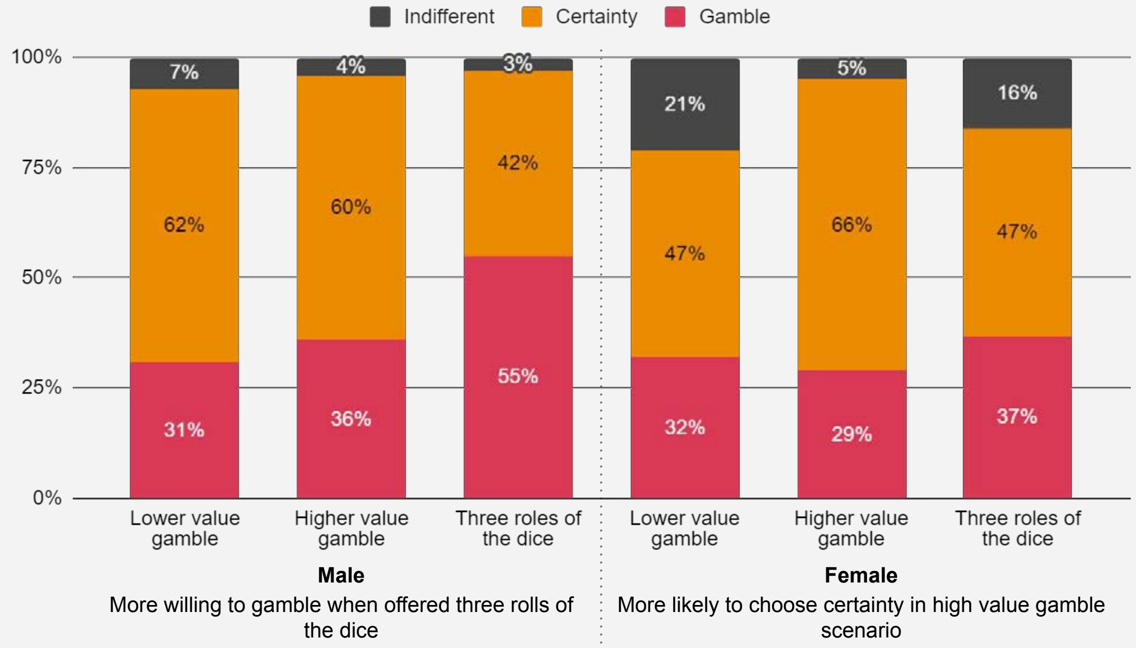
The results serve as a reminder that one size does not fit all (at least from the perspective of participants) and highlights the challenge in designing a single incentive for a large population of employees whose attitudes to risk may vary. Indeed, 13% of participants took the gamble in all four questions and 23% of participants opted for certainty every time. One solution for companies could be to offer greater flexibility for employees to choose how they are remunerated - clearly the views of other stakeholders should be taken into account, and such choice comes with some potential trade offs, such as increased administration and the risk of “gaming” their reward, and is unlikely to be appropriate for the most senior executives. We explore this further on page 27.

Our research suggests that executives may prefer incentive plans under which they know they will receive rolling annual grants, with each grant providing a chance to realise a higher value but with a lower certainty, rather than a one-off LTIP or a LTIP with lower opportunity but higher certainty of payouts. This approach is consistent with typical market practice in UK plcs. By extension, companies considering a move away from fixed annual LTIP awards (e.g. where all employees at a certain level receive an award each year) to a system of discretionary annual grants should consider how this may devalue the LTIP, even amongst those who are selected to participate - they may then be unsure whether they will be invited to participate in future years (with the accompanying award documentation often stating explicitly that there is no such entitlement!).

In recent years, some UK companies have moved away from performance share plans (PSPs) in favour of restricted stock plans (RSPs), one benefit of which is to offer more certain payouts whilst continuing to align participants with the company’s share price. Assuming repeated cycles and a potential for upside, our research suggests that 48% of executives are willing to risk an uncertain outcome (akin to annual grants of PSP awards) over a certain one (akin to annual grants of RSP awards).

However, the extent of this preference is likely to depend on the chance of a zero outcome on the variable LTIP. Nevertheless, those companies that proceed with the introduction of the RSP may take comfort from the fact that individuals may be willing to participate in a RSP, even if peers participate in a PSP. Of course, these views could change once the plans pay out!

Risk aversion - male and female responses



“

Long-term incentives are largely discounted, as are deferred sums.”

Survey Participant

Discounting of deferred remuneration is high

It is a fundamental assumption of economic theory that money today is worth more than money tomorrow, next week or next year (at least in normal times!), but how much more? What discount rate do executives apply?

Individuals placing “psychological discounts” on incentive plan awards, such that the perceived value is that much lower than the actual value, can take a few forms - there can be discounting for time (what is something in the future worth today?), for performance (what’s the likelihood that any performance conditions will be met?) and, in the case of share awards, share price volatility (how does the volatility of the share price affect the value an individual places on a share in the future?).

We therefore asked participants a series of questions focused on time discounting. In theory, participants should apply a discount rate consistent with the return on a comparably risky cash flow. For the purposes of our scenario where recipients receive cash in the future subject only to time, this should be close to the risk-free rate of interest.

Q1

If we assume that the average long-term incentive award of a senior executive of a large company is around £67,500 per year, which of the following choices would you prefer?

a. A chance of receiving £37,500 tomorrow with a probability of 75%, otherwise nothing.

b. A chance of receiving £90,000 in three years’ time with a probability of 75%, otherwise nothing.

c. I am indifferent between A and B.

In 2012, our results showed that the perceived value executives place on delayed or deferred awards reflects discount rates far greater than economic discount rates. The risk-free rate of interest at the time was about 5% p.a. but the discount applied by executives globally was 31% p.a.. Executives in Western Europe applied the lowest discount and yet this was still 20% p.a..

Q2

If we assume that the average long-term incentive award of a senior executive of a large company is around £67,500 per year, which of the following choices would you prefer?

a. A chance of receiving £56,250 tomorrow with a probability of 75%, otherwise nothing.

b. A chance of receiving £90,000 in three years’ time with a probability of 75%, otherwise nothing.

c. I am indifferent between A and B.

The risk-free rate today is comparable to 2012 and executives continue to apply much higher discount rates. The median in our sample was 18% p.a..

We explored reasons why this might be the case by looking at the recent share price performance of the companies where our participants work. Although our survey questions referred to cash awards and therefore we would not expect recent share price performance to have a direct impact on responses, there was evidence that it had some impact on the discount rates that participants applied. The median discount rate applied by participants at the company with the best share price performance over the last three years was less than 15% compared to a discount rate of over 25% applied by participants at the company with the worst share price performance over the same period.

The low performing company's share price had decreased by 80% over the last three years. This is not so different from the 25% discount rate per annum which is equivalent to 60% over the 3 years.

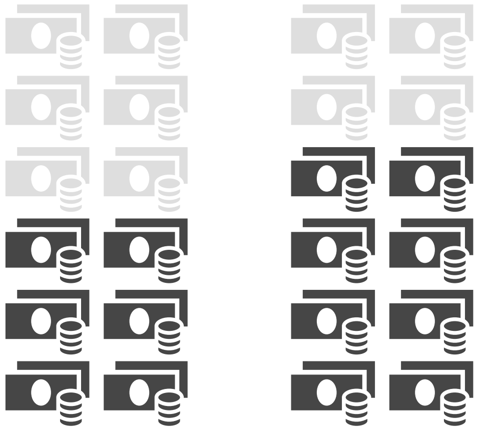
It is more difficult to explain the discount rate of under 15% which was applied by participants at the strongest performing company (whose share price had risen by 50% over the same period). It suggests that discounting for time remains materially above economic levels (and cannot be wholly explained by the individual's recent share price experience).

If there was a hope that familiarity with executive incentive plans would, over time, result in executives applying a more economically rational discount, this does not appear to be the case (at least not in a meaningful way).

Or alternatively, if familiarity has resulted in executives applying a more rational discount, this effect has been offset by other factors, such as malus and clawback provisions which may impact an executive's perceived value and are now more prevalent than in 2012.

Our original conclusion remains valid - as deferral increases, we should expect upward pressure on the level of compensation. Companies that defer where others don't create a greater competitive disadvantage for themselves than a conventional view on the time value of money might suggest. However, companies also have to consider broader reasons for remuneration deferral, including to enhance alignment with shareholders (if deferral is in shares), provide a further lock-in mechanism for executives or act as a mechanism to enforce malus provisions.

Executives discount deferred remuneration by 18% per annum



3 year deferred bonus shares - c.50% discount

Shares subject to 2 year holding period - c.33% discount

“Ability to influence outcomes…is key to enable variable remuneration to be a motivator.”

Survey Participant

Executives prefer multiple performance metrics to one

Performance metrics in incentive plans serve as a fundamental component in aligning the interests of employees with the objectives of an organisation. They are designed to quantify the level of achievement or progress towards key business goals and are used as a basis for rewarding employees. The integration of performance metrics into incentive plans can, in theory, facilitate strategic alignment, drive performance and enhance motivation.

From an external perspective, some shareholders have strong views over which performance metrics should and shouldn’t be included in incentive plans. However, performance is also another type of psychological discount. Each participant in an incentive plan will also have their own view of the likelihood that the targets for a performance metric will be met, the extent to which they can influence this outcome, and therefore how motivated they feel by the target. In turn, this will affect the value they place on the award. We therefore wanted to explore the extent to which participants in our survey value one type of performance metric over another.

In 2012 there was a clear preference for metrics that were internal to the participant’s organisation (e.g. earnings per share) over external conditions (e.g. relative total shareholder return (TSR)). Personal experience appeared to shape the responses. Dislike of relative TSR was most pronounced in those countries in which it had been used the longest.

This time we took a more direct approach to ask participants to rank their order of preference for a single financial metric, a scorecard of financial and non-financial metrics, a relative TSR metric or a certain amount.

Q1

If we assume that the annual bonus of a senior executive of a large company is around £45,000, rank your order of preference for the following:

a. Maximum bonus of £90,000, with a single financial metric (the main KPI for your company) calibrated to pay out 50% of maximum at target.
b. Maximum bonus of £90,000, with a scorecard of numerous financial and non-financial metrics, each calibrated to pay out 50% of maximum at target.
c. Maximum bonus of £90,000, with a relative total shareholder return measure that pays out 25% of maximum for performing in line with the median of peers, 100% of maximum for performing at upper quartile of peers, with straight line vesting in between.
d. £41,250 for certain.

Overall, the scorecard ranked highest on average followed by the certain amount, then the single financial metric, and then the relative TSR metric. Executives may feel that the balance of the scorecard offers the best chance of an outcome that fairly reflects their performance. A cynic might note that there is evidence that non-financial metrics, which form part of the scorecard, tend to pay out higher than financial metrics.

But the prevalence of scorecards in incentive plans today reflects the evolution of stakeholder capitalism over the last decade: profit is only one of a number of metrics that external stakeholders use to assess a company's performance - a scorecard measures performance across this broader spectrum of KPIs and, by taking into account a mixture of financial and non-financial metrics, it also avoids the boom or bust risk of the single financial metric.

The remaining choices divided opinions, but relative TSR was narrowly the least popular option.

We compared each participant's view against the TSR performance of their employer - unsurprisingly, participants from the company with the worst TSR performance ranked it last on average by some distance. More surprisingly, participants from the company with the best TSR performance over the last 3 years also ranked it last.

The willingness of participants from the high performing company to take the risk with the scorecard and the single financial metric but desire to avoid the relative TSR metric may reflect a feeling that relative TSR outcomes are inherently difficult to influence (and/or that high historical performance is unlikely to be repeated). We might expect this view to be particularly prevalent for lower seniority tiers in the organisation, where roles may be less able to have a direct impact on the company's share price. Yet even at the Group Board level, views were mixed - only a narrow majority favoured relative TSR above the certain amount on average.

A better indicator of whether an individual favours relative TSR appears to be the individual's attitude towards risk. Amongst those who consistently took the gamble in our earlier risk aversion questions, relative TSR was most commonly ranked as the number one performance metric. In contrast, amongst those who consistently preferred the certain amount in our risk aversion questions, the certain amount was most commonly ranked as the number one performance metric and relative TSR was the most likely to be ranked as the least preferred.

Nevertheless, the majority of investors have a strong preference for relative TSR metrics. Remuneration Committees continue to take this preference into account, with around two thirds of FTSE 100 companies using relative TSR in their LTIP. Although the potential theoretical flaws with relative TSR are well documented, the use of an objective metric which assesses relative performance introduces a degree of diversification within the performance assessment, and the market standard "median to upper quartile" vesting schedule also avoids the complexities of target calibration. So despite the preferences of executives, it's likely that relative TSR is here to stay.

However, given the wide range of opinions on relative TSR (and other performance metrics), as well as broader risk appetite, one solution could be for companies to apply greater segmentation to the structure of their incentives and how they are assessed. However, any such segmentation needs to be carefully balanced, taking into account the views of the Board and investors so that the interests of participants are not misaligned with the objectives of the company and its shareholders. We discuss flexibility as a solution in more detail on page 26.

Alternatively, companies could review the calibration of their relative TSR metric. Executives may understandably see the typical construct of the relative TSR metric - where the payout is 25% of maximum (i.e. threshold) for achieving median (i.e. 50th percentile) of a peer group - as more stretching than a financial metric that pays out a higher amount for achieving budget. A potential change to increase the competitiveness of UK executive remuneration packages without increasing maximum remuneration would be to pay out a higher amount for achieving the median of the peer group. Similar approaches to calibration are seen in other countries - so perhaps this is something for companies who compete for talent in those markets to consider in the first instance.

Average rank of performance metrics

Performance metrics	Rank
Scorecard of financial & non-financial metrics	1
£41,250 for certain	2
Single financial metric	3
Relative total shareholder return metric	4

Pay positioning is important…

“I am motivated by knowing that my pay compares well with others externally in similar roles.”

Survey Participant

One of the strongest messages to come out of our 2012 research was the importance that executives place on being paid comparably to whom they perceive to be their peers. This seems particularly relevant in the debate on the competitiveness of UK companies competing for talent in international markets, where pay benchmarking is frequently referenced to highlight the difference in pay levels between the UK and other countries (often the US).

This time, we explored the importance of pay positioning for motivation through two lenses: comparison to internal peers and comparison to external peers.

a) Pay positioning relative to peers in the same company

We asked survey participants who would be more motivated: Alex, who is paid less in absolute terms but more than peers in her company, or Bobby, who is paid more in absolute terms but less than peers in his company?

Q1

Alex is invited to join the senior management team of Company A with a total reward package worth £180,000. Bobby, a contemporary of Alex’s with comparable expertise and experience, is invited to join the senior management team of Company B with a total reward package of £195,000.

Subsequently Alex discovers that the average total reward package of her peers in company A’s management team is £175,000. Bobby discovers that the average total reward package of his peers in Company B’s management team is £200,000. All other things being equal, who do you think is likely to be more highly motivated?

Most participants agreed that Alex would be more motivated on the basis that she is paid less in absolute terms than Bobby but higher than the peers in her company. This response was similar in our previous research.

The expansion of directors’ remuneration reporting regulations and the introduction of mandatory gender pay gap reporting since 2012 have contributed towards greater pay transparency in the UK. Executive directors are accustomed to being able to see exactly how much listed peers are paid. Crowdsourced online platforms offer the public simple access to market salary information. And under the EU Pay Transparency Directive, many EU workers will soon have a right to request average pay levels at their company for work of equal value.

On the one hand, transparency enables stakeholders to hold companies to account over their pay practices. On the other, our results suggest that the more information that is available, the more likely it is that employees will cross-compare and expect parity (or more).

b) Pay positioning relative to peers in the market

When stakeholders express concern over these risks of "pay ratcheting", they tend to be referring to increases in pay levels driven by market benchmarking of multiple companies in a peer group, rather than pay levels within a single company. We therefore asked participants to consider a similar question, but this time with respect to Alex and Bobby's pay positioning relative to peers in the market.

Q2

Alex and Bobby subsequently learn that the average total reward package for equivalent roles in their sector is £187,500. Who do you think is now likely to be more highly motivated?

The response was even clearer. 71% of participants think that Bobby would now be the more motivated, since he is paid more than his peers in the market (even though he is paid less than his peers in his own company).

It is possible that participants who answered Bobby when considering internal pay relativity think that he is also likely to be more motivated based on external pay relativity due to his higher absolute level of pay, regardless of his market positioning. If we exclude these participants from our analysis, the conclusion remains. Positioning relative to peers in the market appears to be an even stronger motivation than positioning relative to peers in the same company.

Benchmarking as a rationale for pay increases has been maligned in recent years, in part because of concerns over pay ratcheting. But ignoring it altogether risks overlooking the importance that individuals place on their pay positioning (not to mention the company's ability to attract and retain talent, which is clearly in the interests of a far broader range of stakeholders). Individuals will find a way to compare their pay to the market. It is therefore surely better to conduct a thorough and thoughtful exercise based on a peer group of relevant comparators than to act on sentiment alone.

Alex and Bobby

Alex	Bobby
Total reward £180,000	Total reward £195,000
Market average £187,500	Market average £187,500
Company average £175,000	Company average £200,000
Alex salary increase +3%	Bobby salary increase 0%

Most participants agreed that Alex was better motivated than Bobby. In other words, getting paid more than their peers was more important than getting paid more in absolute terms.

…but recognition is a stronger motivating factor

> “The biggest motivator is feeling appreciated by the organisation for your contributions.”
>
> Survey Participant

But is pay positioning the be all and end all? Finally we asked who would be more motivated following a pay round in which Alex received a 3% increase and Bobby received a pay freeze.

Q3

At the next pay round, Alex gets a 3% pay rise as a result of her strong performance and Bobby receives a freeze. Assume inflation and wider workforce increase is 0%. Who do you think is now likely to be more highly motivated?

This was the strongest result of the three. 73% of participants felt that Alex would be the most motivated, despite her lower pay positioning relative to the market and lower absolute level of pay even after the salary increase.

It was striking that even amongst those participants who answered Bobby to the first <u>and</u> second question (i.e. those who favoured absolute levels of pay when considering both internal and external relativity), a majority still thought that Alex would be the more motivated following the salary increase despite her lower absolute level of pay.

In recent years, shareholders and their proxies have indicated a preference for executive director salary increases to be at or below the level of the workforce, noting the different absolute impact of (say) a 5% increase on an executive director salary compared to an average employee. Remuneration Committees have generally adopted this sentiment - 90% of FTSE 100 CEOs in the 2024 AGM season to date have received an increase at or below the level of the workforce. There have also been fewer salary freezes in the last two years compared to before the COVID-19 pandemic and the inflationary impact of the war in Ukraine, after which more formal expectations for salary increases being in line with or below the workforce were introduced.

Perhaps Remuneration Committees are playing catch up. Or they may be choosing to make more regular salary increases given the challenge of freezing pay in one year then making an above-workforce increase in the next. An unintended benefit of this new expectation, and the response of many Remuneration Committees to it, may be a cadre of more motivated executive directors as a result of perceiving greater recognition through annual inflationary increases.

“

The majority of people aren't motivated by money alone, for long-term success, work has to be interesting, challenging and… aligned with one's beliefs.”

Survey Participant

It’s about more than money

But for all the talk of pay positioning and salary increases, surely there is more to work than money? In our final section we sought to understand what motivates executives beyond financial reward. To what extent do executives value satisfaction, new experiences and status?

a) Ideal job discount

Many individuals have a strong desire to engage in work that they find personally rewarding or that aligns with their interests and values. For some, the sense of satisfaction and happiness that such work brings may be worth more than a higher paycheck. But how much of a pay cut would someone take to do their ideal job?

We asked participants to estimate the minimum salary that Francis, a senior executive at a large listed company, would be prepared to accept in his dream job, a senior management role at a music college. We then asked participants the maximum discount they would be prepared to accept on their own current pay, if they were offered their dream job.

Francis is a senior executive at a large listed company where, in a typical year, he expects to earn around £225,000. While he enjoys his job, he does not feel particularly fulfilled. Outside work his principal hobby is music – he is an accomplished clarinet player and competent singer. Francis is approached by a head-hunter and asked if he would be interested in taking on a senior management role at a prestigious music college, a dream job. However, he is told that it would mean a significant reduction in salary. Except for his employment income, Francis is of modest wealth but also has limited outgoings.

Q1

Other things being equal, what do you think is likely to be the minimum salary Francis would be prepared to accept if he were to take the new job?

Q2

Relative to your current total earnings, what is the maximum discount on your current level of employment income which you would be prepared to accept if you were offered your dream management job, like Francis?

Q3

Picture where you were 10 years ago. What is the maximum discount you would have accepted at that point in your life?

Participants were more idealistic when thinking about Francis than their own situation. They estimated that Francis would accept a 33% discount but would only accept a 20% discount themselves. These were noticeably smaller figures than last time when participants expected Franco (as he was then known) to accept over a 60% discount and were willing to accept a 25% discount themselves.

This result possibly reflects greater emphasis on pragmatism over idealism or is perhaps due to the cost of living pressures that have been at the forefront of mind in recent years. Financial considerations do appear to be influential - participants in the lowest earnings bracket were only willing to accept a 13% discount.

When participants were asked to consider their position 10 years ago and what discount they would have accepted for their dream job at that time (when presumably many were earning less), the discount fell from 20% to 10%.

The proportion of participants who were not willing to take any pay cut (14%) was higher than last time, which could also reflect financial considerations. These figures were also higher amongst the lower earners and when participants considered their position 10 years ago (20% and 38% respectively would not take any pay cut).

The 60-64s were willing to take the largest pay cut (30%). Is this the most idealistic age group or is it instead a function of them having the lowest present value of future earnings? At this age, a pay cut has less impact on cumulative future earnings. Either way, averages only tell us so much. For example, one participant in this age group would work for nothing at all if offered their ideal job.

b) Personal values

Our original research concluded that increased job satisfaction can be very valuable and that investment in making people's jobs more interesting and fulfilling means you can pay them less. The responses to our "ideal job" questions indicate that this remains true albeit not to the extent that we saw in 2012.

But it might be challenging in practice to make some jobs materially more interesting (without naming any specific examples). What can these employers do?

We asked what discount participants would accept to work for a company that aligns very closely with their personal values, compared to an employer that does not align closely.

Q4

You currently earn £200,000 per year working for an employer that doesn't align closely with your personal values. You have been offered the opportunity to perform a very similar role at a company that aligns very closely with your personal values.

What would be the minimum total remuneration you would accept to take the new job?

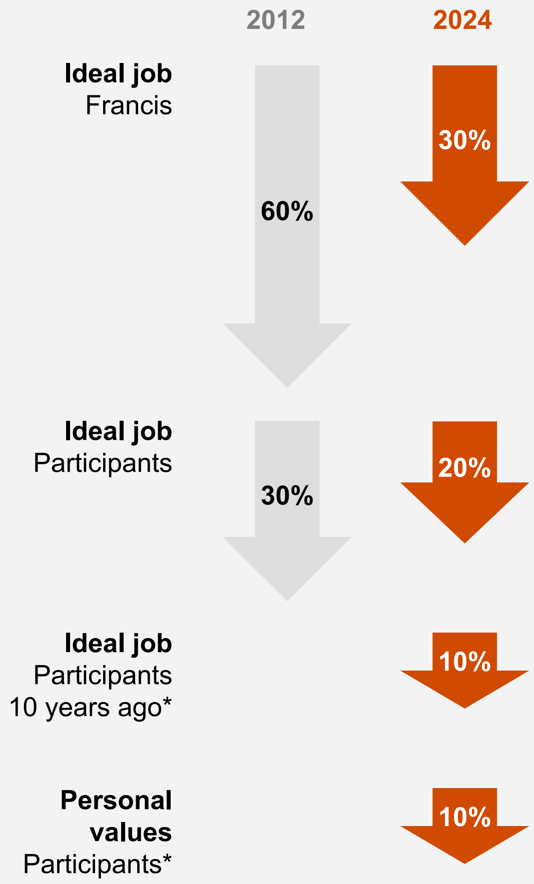
Participants were willing to accept a 10% discount to work for a company that aligns very closely with their personal values i.e. generally a lower discount than they would accept for their dream job. This held up consistently across age groups, gender and sector.

These new findings suggest that even if it is challenging to make individual roles more fulfilling, creating a strong culture built around shared values can have similar results. The discount our participants were prepared to accept to work for an employer with shared values (10%) was half that of an ideal job (20%), so not to be sniffed at.

That said, the margins are fine. Another way to look at this is that a 5% real pay cut could undo half of the benefit of a company that shares common values with its employees. Take note if we find ourselves in a high inflation environment again.

Job discounts

Participants are not willing to take as significant a pay cut for their ideal job as they were in 2012.



*New question for 2024

c) New experiences

If it's challenging to make a job more interesting, are there other ways to make it more appealing? One way could be to offer it to someone who finds the location of the job intrinsically attractive. New experiences can help one to learn and grow and provide a sense of accomplishment. We might expect an opportunity to work in a different environment to be appealing to individuals.

We therefore asked participants what would be the minimum total remuneration they would accept to take a new job in each of the UK, US, Germany and Singapore.

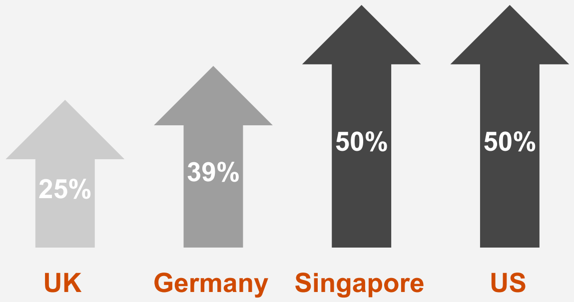
Q5

You currently earn £200,000 per year and enjoy your job. You have been offered the opportunity to perform a very similar role at a very similar company in each of the following locations. Assuming remuneration is adjusted for cost of living/differences in taxation, what would be the minimum total remuneration you would accept to take the new job in each location (UK, Germany, Singapore, US).

Only a very small proportion of participants were willing to pay for such experiences. For each of the four locations, we looked at responses from participants not currently based in that location. Based on this analysis, participants required a pay increase on average for all four locations (+25% to work in the UK coming from abroad, +39% in Germany, +50% in both Singapore and the US). This was despite the fact that the question asked participants to ignore cost of living and tax considerations.

Non-UK nationals required a smaller premium to come to the UK than UK nationals resident overseas required in order to return home, suggesting that perhaps there is some discount for experiences but it appears to be outweighed by other considerations - the disruption to family life perhaps.

Pay premiums to work overseas



d) Status

Humans have a natural tendency to compete with each other to move up the pecking order in a social hierarchy, for power often comes with status. Therefore, all other things being equal, we would expect executives to choose a higher status role within an organisation.

For the final question we asked participants to name their price to perform the role of a head of a listed company, rather than as the head of a division of the same size and complexity within a group. Would participants accept a discount given the higher status of the listed role or the career prospects it offers?

Q6

You are the CEO of a division of a Group. You have been offered the job of Group CEO of a listed Group in the same sector and geography. The listed Group is the same size as your current division. This would be your first Board level role in your career. The Group has £1bn revenue per year. All other things equal, what level of pay compared to your current role would you accept to perform the new role?

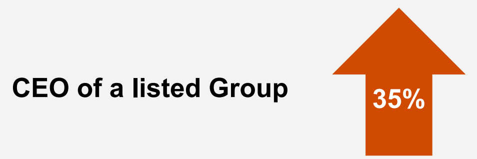
As expected, a majority of participants (76%) indicated they would require a pay increase to perform the listed company CEO role, with a median pay increase of 30% required amongst this population.

There are likely a range of factors that lead to this view, including the broader responsibilities and expectations of the role, a higher level of perceived risk and awareness of market pay rates (in part due to detailed disclosure requirements associated with listed company director pay).

However, surprisingly the remainder did not require a pay rise. 8% of participants were willing to take on the role for the same level of pay and 16% were willing to take a pay cut. The age group most likely to accept a pay cut was the under 39s, who were over twice as likely than any other age group to do so - perhaps those with more of their career ahead of them saw a long-term benefit in taking on a higher status role, even if it means a short-term pay cut.

The responses suggest that, when determining remuneration packages, Remuneration Committees should be guided first and foremost on the market rate of pay for the role and the candidate's experience, and avoid making assumptions about a candidate's remuneration expectations compared to their current role.

Pay premium for a higher status role



Key lessons

“There are three broad lessons:

A. Aim for simplicity;
B. Operate a wide range of structures;
C. Allow employees more choice.”

What does it mean in practice?

The responses to the questions on risk aversion, discounting and performance measures all suggest that the current model of pay may be inefficient in terms of the difference between the face value of remuneration and the perceived value in the eyes of employees.

Using assumptions based on our results, a few relatively simple changes to the structure of incentive plans could significantly increase the perceived value of a remuneration package and therefore the efficiency of a company’s remuneration spend.

That said, we need to be careful when extrapolating from our average results to understand the perceived value of a given remuneration package. The results of the survey show that individuals each have different attitudes towards risk, discounting and performance conditions. There is therefore no single, optimal incentive design. Moreover, these preferences may sometimes run contrary to the intent of the incentive or the views of various key stakeholders; and an effective incentive must be aligned with business strategy and match the business cycle. However, there are some broad lessons which could be considered by companies looking to improve the efficiency of their remuneration spend from the perspective of participants, whilst recognising these broader expectations.

A Aim for simplicity and explain residual complexity

For some roles, there will be regulatory requirements to structure remuneration in a certain way. Deferral of a portion of variable remuneration is a requirement for Persons Discharging Management Responsibilities (PDMRs) in the financial services sector. 5 year combined vesting and holding periods must be applied to executive directors in order to comply with the UK Corporate Governance Code.

For roles not subject to these requirements, and in particular roles below Board level, companies may wish to consider whether simplifying incentive designs would benefit both the perceived value of the scheme and its understanding, whilst still meeting the objectives of the Board and shareholders.

For example, our research suggests that reducing annual bonus deferral (either the proportion deferred or the period of deferral or some combination of both) or removing post-vesting holding periods (where they exist below Board level) are two relatively simple opportunities to improve the efficiency of the package from the perspective of the executive. Any decision, however, must consider the trade offs.

For example, reduced deferral lessens the alignment of an individual’s remuneration with the company’s share price - some companies have sought to balance these factors by adopting a structure where deferral is no longer required above a certain shareholding level.

Amendments to performance conditions could also be considered to improve the efficiency: for example, the reduction of the weighting of a relative TSR metric on a PSP award for roles below a certain level, on the basis that roles at these levels are less able to influence the outcome of the metric. Again, the trade offs would need to be considered - this approach could result in a different level of payout for one tier of the organisation compared to another which may not be desirable from the perspective of internal cohesion.

The importance of explaining performance measures and their key drivers should not be overlooked. For the reasons outlined above, it may not be appropriate to remove or simplify performance measures under incentive schemes.

But do participants truly understand the levers that can be pulled to drive performance outcomes? Metrics like TSR, earnings per share, return on equity or EBITDA may feel one (or more!) steps removed from the day-to-day roles and responsibilities of some participants. Breaking this down and ensuring everyone is on the same page is key - a reminder of this can be helpful even for the most well-seasoned executives. Whichever metrics are used, a transparent and consistent approach to target calibration and the assessment of outcomes also supports understanding and motivation.

B Consider a range of incentive structures and use these selectively

A company that is able to offer a wide range of incentive structures may be able to improve efficiency. A combination of performance-based shares, time-based shares and stock options, for example, could ensure that the remuneration package has “something for everyone”: certainty through the time-based shares, alignment to corporate results through the performance-based shares and further leverage through the stock options. Within these three types of awards, the use of different vesting and holding periods could achieve a balance between minimising the level of discount applied by participants and ensuring an appropriate level of long-term share price alignment.

Alternatively, a Board (or their Remuneration Committee) could use award structures selectively, making a judgement based on an assessment of the context at the time of grant to decide which might be the most effective incentive based on the views of both the participants and the company’s shareholders. During a period of uncertainty, an employer may take the view that employees will value a higher weighting of time-based awards, supporting the retention of key talent at a critical time. In a turnaround scenario, stock options may provide a simple incentive to grow the value of the business.

A company that wishes to achieve this level of flexibility may need to review its workforce remuneration policy, incentive plan rules, and grant documentation to ensure that they permit these approaches. A degree of realism may be required - proposals to operate multiple (or flexible) LTIP structures for executive directors were opposed by some proxy advisors and shareholders at UK AGMs this year. There is naturally a greater expectation of shareholder alignment with executive directors (and arguably their direct reports). It may therefore be appropriate to consider the approach to this flexibility amongst executives below the Board. Either way, communication will be important - with employees as well as shareholders and other stakeholders.

C Operate a more segmented approach to incentives or allow employees more flexibility to choose the remuneration structure that they value the most

The wide range of responses received to the questions in the survey from participants from the same company suggest that it could be challenging for a company to maximise the efficiency of its spend of incentives, even if it makes the changes set out in a) and b) above.

One approach to address this would be to operate a more segmented approach to incentive awards, with more differentiation between grades or geographies.

Another approach would be to depart from today's common, "top-down" approach to incentive awards whereby the Board and Management decides which incentive structures it will use each year and instead to take a more "bottom up" approach whereby employees have a degree of say in the incentive awards that they receive.

For example, a risk averse employee could opt for a smaller, more certain grant of time-based shares compared to a less risk averse colleague who might choose a grant of performance-based shares with a higher face value.

This approach clearly requires careful consideration - in the cases where companies have provided such choice, they have clearly done so within parameters with which the company is comfortable. A company could require a minimum percentage of an individual's variable remuneration to be subject to performance conditions or a minimum proportion to be deferred for a certain period of time. Furthermore, and as noted in b) above, such flexibility may be more appropriate for executives below the Board and executive committee. Ultimately it is for the Board and Management teams to set the intended direction of collective focus, and set the parameters of reward schemes in such a way that can drive the optimal approach to incentivising the right behaviours from the right people.

Personalisation of reward has become more familiar over the last 15 years as companies have introduced flexible benefits. A similar evolution for incentives may seem more challenging - but a bottom up approach is not so different from practices already in existence at some companies whereby employees are able to choose an exercise price for their stock option award, such that the higher the exercise price they choose, the greater the number of shares under their option (noting that such choice is not normally available to employees within the remit of the Remuneration Committee).

Care would also be needed so that the benefits of personalisation are not outweighed by other downsides. The results of our survey suggest that increased complexity can reduce the perceived value of reward and that individuals place a high level of importance on what their peers are paid - there is a risk of demotivation if outcomes differ significantly according to the choices that each employee makes.

Where next?

This conclusion focuses on the efficiency of spend on incentives. We should acknowledge that this is not the only goal of remuneration design. And whilst there are drawbacks to the current model - a deferred bonus and single long-term incentive based on 3 year targets - there are also benefits. It can support a performance culture and create a shared responsibility for meeting and exceeding business targets. There are, after all, good reasons why most companies continue to operate this model, which is supported by many shareholders.

However, our research shows that there are opportunities to improve the effectiveness of incentives based on a better understanding from executives themselves of what they find motivating. As the debate continues over how best to structure executive pay in the UK, we shouldn't forget this.

About our research

157
Executives participated in the research

73% Male

Female 27%

44% Earned £350,000 or under

31% Earned £350,000 - £725,000

25% Earned £725,000 or more

68% Report to Group Executive Committee Member

26% Group Executive Committee Member

6% Group Board

Data excludes participants who responded “prefer not to say” to these questions

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