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Executive Pay In Lloyds Banking Group

In its recent Green Paper entitled 'Corporate Governance Reform', the Government says:

"... there is widespread perception that executive pay has become increasingly disconnected from both the pay of ordinary working people and the underlying long-term performance of companies. Executive pay is an issue of significant public concern ..."

The Prime Minister has said:

"It is clear that in recent years, the behaviour of a limited few has damaged the reputation of the many. It is clear that something has to change".

The Government's Green Paper quoted research which showed that in 1998 the ratio of average FTSE 100 CEO pay to the average pay of full-time employees in the UK was 47:1. This ratio increased to 132:1 in 2010 and stood at 128:1 in 2015.

Excessive CEO pay is also being criticised by some of the world's largest asset managers. "LTIPs are not fit for purpose any more. They're like any opiate. They have become an addiction" said one UK asset manger reported recently in the Financial Times.

Paul Lee, Head of Corporate Governance at Aberdeen Asset Management said: "A number of us are willing companies to think again about the structure of pay. We don't want them to be trapped in the structure of an annual bonus and a three-year LTIP. That structure probably does work for some but it can't be a one-size-fits-all approach. They need to break out of this box. It really isn't working".

Some of the more enlightened CEOs know that the writing is on the wall. The Chief Executive of Deutsche Bank, John Cryer, said in a recent interview: "I have no idea why I was offered a contract with a bonus in it because I promise you I will not work any harder or any less hard in any year, in any day because someone is going to pay me more or less." [1]

Academic Literature

Many commentators have questioned whether increases in the pay of CEOs have been matched by increases in the long-term value of the companies they manage. The research by Emmanuel Saez, Stefanie Stantcheva and Thomas Piketty [2] suggests that the increases in executive pay are fairly well explained by the bargaining model and does not have much to do with any hypothetical increase in managerial productivity.

Piketty et al also found that the elasticity of executive pay is greater with respect to "luck", that is, variations in earnings that cannot have been due to executive talent, because, for instance, other firms in the same sector did equally well [3] with respect to "talent", which drives a coach and horses through the argument that increases in executive pay is a reward for good performance.

More recently a study commissioned by the investment association CFA UK said the link between what CEOs are paid and companies financial performance is "negligible".

The median pay of chief executives at Britain's 350 largest companies was £1.9m in 2014, a rise of 82% in 11 years. However, performance as measured by return on capital invested was only 1%. Much of the increase in pay for CEOs was the result of performance-based pay.

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CEO of Deutsche Bank, John Cryer

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But the metrics used to assess performance – including total shareholder return – are unsophisticated and short-termist, which acts against the long-term interests of investors. According to Young and Li "the unrelenting focus on pay levels and the clamour for even-more sophisticated ways of aligning senior executive incentives with performance risks creating the illusion of pay-for-performance while failing to deliver the reality". [4]

However, that said, the evidence is not all one-way. There is a large amount of research which suggest that high pay differentials are associated with higher performance Faleye, Reis and Venkateswaran concluded in a recent paper in the Journal of Banking and Finance that "we do not find a negative relation between relative pay and employee productivity…. We also find that firm value and operating performance both increase with relative pay".

Executive Pensions In Lloyds Banking Group

Antonio Horta-Osorio receives a pension benefit worth 50% of his base pay. The research set out opposite shows that no other CEO gets the same pension benefit. In fact, HSBC announced last year that it was reducing the pension benefit of Stuart Gulliver, Chief Executive, from 50% to 30% of base pay because it said: "feedback from shareholders that cash in lieu of pension was higher relative to large FTSE 100 companies".

"LBG stands out as a laggard on this issue offering a pension benefit of 50% of base salary to the CEO."

Royal London Asset Management

Royal London Asset Management said last year "An area of concern is generous executive pension payments. Companies that grant executives cash payments, in lieu of pension, upwards of 30% or 40% are not uncommon in the FTSE 100.

This raises concerns and questions about pension fairness, with staff below executive level often receiving a fraction of this amount in their pension pots." It goes on to say "We do not think executives should receive preferential treatment with regards pension payments". In respect of Lloyds Banking Group, it says: "LBG stands out as a laggard on this issue offering a pension benefit of 50% of base salary to the CEO".

In January, it was confirmed that the major US investment firm Blackrock had become the largest shareholder in Lloyds Banking Group, following a further sale in the Government holding to below 5.95%. In its Executive Remuneration Guidelines, Blackrock says "We view pensions as being part of the benefits offered by a company and therefore we expect pension contributions for executives to be in line with the rest of the workforce…".

In its latest Report and Accounts, the Bank says that "No change to policy for existing Executive Directors. All future appointments as Executive Director will attract a maximum

Name	Company	Pension Allowance (% of Base Pay)
A Horto-Osario	LBG	50%
J Garner	Nationwide	40%
N Bostock	Santander	35%
R McEwan	RBS	35%
J Staley	Barclays	33%
S Gulliver	HSBC	30%
M Wilson	Aviva	28%
K Skeoch	Standard Life	25%
P Pester	TSB	20%
R Pennycock	Co-Op Group	10%

allowance of 25 per cent of base". Whilst we welcome the Bank's decision to introduce a maximum allowance for the future, it still doesn't deal with the fact that the GCE gets a pension benefit that is out of line with the rest of the staff in the Bank. HSBC reduced the pension benefit of its CEO, and LBG should have done the same.

The Bank's GCE is also entitled to a second pension which "provides benefits on a defined benefit basis at a normal retirement date of 65 … the maximum allowance over that period is 26.5% of the higher of the GCE's base pay and reference salary in the 12 months before retirement". The latest figures show that accrual at 31 December 2016 was a pension of 6% or £73,200. In 2014, the Bank imposed a pensionable pay freeze for all members of the Bank's final salary pension schemes.

According to Blackrock "Any downgrade of the workforce's pensions should be applied to executives". Antonio Horta-Osorio should be subject to the same pensionable pay freeze as everyone else in the Bank. We are disappointed that once again the Remuneration Committee has decided not to reduce the value of the GCE's second pension benefit.

Group Ownership Share Plan

The Chairman of the Remuneration Committee says in the Directors' Remuneration Report that "There are no significant changes to the remuneration policy for Executive Directors….". The new LTIP for Executive Directors, which is renamed the Group Ownership Share Plan (GOSP), seeks to reduce the weighting of financial performance measures from 70% of the 2014 plan (30% Economic Profit, 30% Absolute Total Shareholder Return and 10% Cost/Income ratio) to 65% of the 2017 plan (25% Economic Profit, 30% Absolute Total Shareholder Return, 10% Cost/Income ratio).

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The two new measures in the 2017 GOSP are the digital active customer base and the employee engagement index. The two main criticisms of LTIPs is that they lack transparency and it is often difficult to determine if the measures are sufficiently demanding. Let's look at the new plan.

Economic Profit

The threshold metric for economic profit in the new plan is £3,074m and the maximum is £3,769m. According to the Bank those are set relative to the 2019 target. The economic profit metric delivers 25% of the 2017 GOSP. At 31st December 2016, the Bank's economic profit was £3,377m, which is only £392m less than the maximum target for this metric. Is that a sufficiently demanding metric for an incentive plan that will deliver 300% of Mr Horta-Osorio's base salary?

Digital Active Customer Base

The weighting for this metric is 10% of the 2017 GOSP. The threshold metric is 14.3m and the maximum is 14.9m active digital customers. In a recent presentation, Antonio Horta-Osorio said the Bank already had 12.5m digital customers. When the Bank announced its last strategic plan it said that it would be investing £1bn into its digital propositions over three years. Since that time, the number of active digital customers has increased by 21%.

If we extrapolate that increase in digital use going forward, taking in to account that branch closures are going to increase year-on-year and the only way many customers will be able to interact with the bank is digitally, then we would expect the threshold target to be 15.1m and the maximum target to be 16m active digital customers. The current 2017 GOSP metric is not demanding enough given the amount of money the business has already invested in its digital propositions. The Group Chief Executive, Chief Financial Officer and Chief Risk Officer are going to achieve 7.5% of their GOSP awards for very little effort. Shareholders are entitled to demand more realistic and stretching targets.

Employee Engagement Score

The Bank's latest Employee Engagement Score is 71%, which is its highest score for many years. When reviewing Antonio Horta-Osorio's 2016 performance, the Remuneration Committee concluded in respect of employee engagement that: "Employee engagement survey results strengthened despite uncertain economic outlook and announcement of further role reductions – scores significantly higher than UK benchmark and close to UK high-performing benchmark".

Mr Horta-Osorio was given an individual performance rating of 'Strong plus' and was given a 2016 bonus award of £1,219,537. Under the 2017 GOSP scheme the minimum threshold for the Employee Engagement metric is 69% and the maximum is 73%. Given that Mr Horta-Osorio has already been adequately rewarded for achieving an employee engagement score of 71% one would expect the threshold metric for the 2017 scheme to be at least 72%, and we would argue that it should be higher, and the maximum 76%. The Bank is in danger of paying for the same level of performance twice, which doesn't seem to be a good use of shareholder resources.

Conclusion

Whilst we accept that the move towards the use of more non-financial metrics is consistent with a more balanced approach to performance management, it is nonetheless still important that those metrics are sufficiently stretching. In Lloyds Banking Group the new 2017 GOSP is anything but demanding. We calculate that the three Executive Directors could earn 40% of their total awards for very little effort. In the case of the GCE, that would be worth £1,475,842 (maximum award is £3,689,605).

> **"Any downgrade of the workforce's pensions should be applied to executives."**
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> Blackrock

Young and Li say of the balanced scorecard approach to performance management for CEOs that: "More cynically, a balanced scorecard approach could be used as a way of ensuring CEOs receive their targeted pay since the likelihood of identifying some positive aspect of performance increases as the number of aspects measured expands … Non-financial and executive-specific objectives are particularly problematic in this regard given their lack of transparency and difficulty determining if the target is sufficiently demanding".

The metrics being used by the Bank are simply too easy and seem to be designed to deliver a bonus for average performance. In the current climate, that is not acceptable. Asset Managers should insist that the Remuneration Committee looks at these metrics again and puts in place stretching targets that are going to deliver superior returns for shareholders.

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Acknowledgements:

[1] 'Stop Paying Executives for Performance', Harvard Business Review, Feb, 2016.

[2] 'Optimal Taxation of Top Labour Incomes: A Tale of Three Elasticities', American Economic Journal: Economic Policy, 2014.

[3] Marianne Bertrand and Sendhil Mullainathan, "Are CEOs Rewarded for Luck? The Ones without Principals Are", Quarterly Journal of Economic, 2001.

[4] An Analysis of CEO Pay Arrangements and Value Creation for FTSE -350 Companies, Weijia Li, Steven Young, Lancaster University Management School.