Universe
Scientific Publishing

Long-Term Incentive Plans: Towards to Be Reformed Rather than Being Removed

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Abstract: In 1995, the Greenbury Report introduced the performance-related long-term incentive plans (“LTPs”) to the UK corporations and advised that the proposed new LTIPs should replace the previous schemes. LTIPs as a tool to motivate employees, not only to reduce agency costs, but also to help companies retain talent and maximise performance. However, the results of adopting LTIPs did not reach the expectations, since the original purpose has been damaged. Based on the poor state of affairs, some have proposed the use of deferred shares or cash as an alternative to LTIPs. Unfortunately, these alternatives cannot fundamentally solve the problems on LTIPs. Because of these issues, introducing a new payment scheme is impartial. Therefore, it is more efficient and effective to reform the LTIPs. Currently, the core of the major challenges with LTIPs is the complexity and lesser transparency, and the correct explanation of LTIPs and the usage of remuneration committee can contribute to a more acceptable payment structure.

Keywords: LTIPs; Deferred Shares; Cash; Reform

1. The advantages of LTIPS

1.1 Aligning the executives' interests with those of shareholders

After carrying out share options for several years, the practical evidence demonstrated that too many options are granted to too many peoples. Most options are granted below the top-executive level. According to Economic Research, approximately ninety per cent of share options were not issued to the top-executive level. Thus, the stock options truly could not incentivise any talents as what the executives received was not particularly motivating. Also, the top-executive level was not encouraged to accumulate substantial shareholdings so that there was not a direct link between the interests of executives and shareholders.

LTIPs eliminate the aforesaid concerns of employees sharing options from some aspects. For one thing, participation in an LTIP is generally limited to senior executives who can influence the success of the company, which plays a psychological incentive role for executives. Intrinsic motives, such as the sense of achievement or being a successful leader of a team of a firm, can push most CEOs to generate great profits for their company. For another, executives who have participated in LTIPs would focus on growing share price for a longer term by seeking a higher performance since it is the key basis for measuring their pay. Combining the share value with executives' salary is akin to matching the interests of the upper-executive level with those of shareholders to a certain extent.

1.2 Recruiting and retaining talents

Traditional stock options supplied the retention and attraction incentives via granting the rights of realising the shares to its executives. However, they did so in the most effective manner. When in the bull market, the executives might exercise their rights at a cheaper price than the present market value. On the contrary, if the stock prices fall below the exercise price, which is also called "underwater", the option is regarded as worthless, and the option holder will tend to leave this company to join the competing company offering a better compensation. Under the risk of decreasing the remuneration, executives are likely to focus on the short-term share price and switch their jobs.

Differently, companies that have embraced LTIPs often give their leaders' free shares, prior or after satisfying specific requirements. The example is as follow:

When managers are granted three hundred shares with a three-year vesting schedule, they will typically own one hundred shares if they stay with the company for at least one year, another hundred shares if they stay in office for at least two years, and the remaining hundred shares only if they remain with the company for at least three years.

In addition, according to the UK Corporate Governance Code 2018, share awards should be subject to a total vesting and holding period of five years or more. Since then, the executives will achieve their performance over time and these vesting schedules support the retention.

LTIPs not only target the existing employees of the firm, but also reserve the same incentive conditions for drawing fresh talents in the future. This commitment has given considerable interest expectations to incoming directors. Highly motivated new senior executives would believe that they can boost the share prices of the firm by accomplishing the performance requirements.

1.3 Lowering the monitoring agency costs

This advantage is derived from the first one. Agency costs, particularly the monitoring costs, will be minimized by integrating the interests of shareholders and executives.

The theory is as follows:

The manager-controllers of the firm are likely to have tastes and preferences that are different from those of the common shareholder-owners of the firm ... Unless there is some compelling means of causing the managers to act solely in the interests of the owners, there is likely to be some efficiency loss ...

Accordingly, if the interests of shareholders and executives are more tightly aligned, the monitoring expenses will be reduced. LTIPs, as a kind of equity pay, cause the executives to promote the shareholders' interests instead of the total employees' interests to reduce the agency costs.

2. The troubles with ltips

2.1 Complexity of LTIPs

The intricacy of LTIPs has been the most visible difficulty, which has puzzled both the corporations and executives. Performance is the key criterion for evaluating the executives' salaries. However, the goals of long-term rewards are questionable since some organizations have picked measures that are too complicated. According to the BEIS, the metrics of performance are various,[3] and different companies in different industries tend to choose different evaluation methods.

The most typical financial measure related to performance is total shareholder return ("TSR"), which is always tested from the value of shares. Besides this technique, some firms are likely to utilize earnings per share ("EPS") and return on equity ("ROE") as the metrics. Although these strategies include precise formulas, they are tough for executives who have little expertise of economics.

In addition to financial measures, there are non-financial key performance indicators ("KPIs") such as environmental effect, actions of workers, the satisfaction of interested parties and social concerns.[1] Non-financial KPIs, as the principal metrics that integrate social responsibility into the LTIPs of companies. According to the ICGN viewpoint published in November 2020, sustainability issues by definition focus on the long term, and the non-financial metrics are considered an important element of LTIPs. The advantages of these ESG metrics, which refer to the 'environmental, social and governance' pointed out by the ICGN, are obvious. First, the companies will adopt greater social duties, which oversees them to prevent CEOs from increasing the economy at the expense of the public interest. Second, the ESG metrics pushes directors to accomplish the sustainable growth of the firm. On the other hand, the negatives are as evident. The non-financial indicators are difficult to be monitored since developing a clear formula of ESG is unattainable, consequently it adds complexity to the structure of LTIPs. Furthermore, because every company will create their own measurement based on the current demands, the complexity and uncertainty have aggravated.

2.2 Undue peer comparison

The benchmark of executive compensation is difficult to be defined as it should balance the demands of the general workforce and the top. If the salary of executives is excessively high, the ranks will be disgruntled with their directors and vice versa. Therefore, corporations tend to refer to the norms of other companies. Similarly, CEOs also have strong criteria for fairness, thus they desire remunerations equivalent to those of their counterparts.

Benchmarking the compensation offers corporations with a more appriate LTIP, the executives, however, desire to obtain a greater income than their peers. If their salary is lower than others, they will be not incentivised. Because of this reason, corporations will be obliged to enhance CEO compensation, which disturbs the other employees, and the internal conflicts of the company will be reinforced.

2.3 Excessive ultimate pay

According to the report published by the High Pay Center in 2021, during 2017—2019, the mean proportion of LTIP of the average FTSE 100 CEO's remuneration was around 50%, while the base salary accounted for only 2%. This evidence showed that most of the remuneration of the CEO was not the base salary.

Exorbitant ultimate pay makes the other employees feel unfair, and this situation will cause the contradiction between CEOs and the ranks and investors. For example, shareholders mobbed executives of Royal Mail in July 2018, voting against the company's remuneration report. Even in the period of the COVID-19 pandemic, 77 per cent of LTIPs paid out to FTSE executives.

One of the most major reasons is the "superstar CEO" theory. This theory implies that it is customary for corporations to pay large compensation to CEOs since seeking skills in the market is tough. However, there are a rising number of talents in the contemporary human resource market, such that this notion is unworkable.

3. Why are alternatives not desirable?

3.1 Why cannot deferred shares replace LTIPs?

Deferred shares are the shares that are not entitled to dividends within a specified period or until certain conditions, e.g., a certain level of profitability, are met. They have a simpler and more transparent framework, which improves the alignment of compensation with corporate strategy and long-term performance. Also, the maximum pay levels will be lower since the vesting schedule is longer.

However, deferred share compensation is also questioned in some ways. First, restricted shares are an award without referring to the performance target, so the maximum value is lower than LTIPs while the vesting period is longer. The performance-on-grant has similar attributes to restricted shares except for the performance conditions, and the maximum value of it is between the maximum values of restricted shares and LTIPs. Since then, the risk-averse executives will not fully be motivated by these time-consuming and low reward methods. In addition, if the company goes bankrupt, the longer-period incentive schemes will force executives to lose all their money, although the failure of the company may not be caused by the executives themselves, but by the market or unforeseen circumstances.

Changing the remuneration structure is not easy for both companies and investors. The investigation of the report indicated that almost half of the companies either rejected deferred shares after considering them or do not consider deferred shares at all — usually because they think LTIPs are effective for them. The shareholders' approval about LTIPs will be substituted by deferred shares is hard to get since the consequences of reforms are unpredictable.

3.2 Why are cash-for-performance schemes unacceptable?

As the scholar said, cash-for-performance schemes use cash as a vehicle to motivate executives to achieve performance metrics. There are three key advantages of cash compensation. First, the final amount of pay will be scaled down as the expansion space of cash rewards is limited. Second, equity compensation will dilute investors' shareholdings even if many

companies have diluted limits. Third, this compensation structure will provide a more explicit measurement for performance as the money is easier to be quantified.

The cash-for-performance schemes, however, are not suitable for an alternative to LTIPs. The biggest problem is that the cash incentive plans are short-term, which is easy to cause executives' short-sighted behaviours.[2] The other is that the declining effectiveness of monetary reward incentives. For example, when the monthly compensation is only 100 pounds, executives will enjoy an increase of 20 or 30 pounds, but when the monthly income of executives climbs to 4000 or 5000 pounds, they will not feel much about an increase of 200 0r 300 pounds. Hence the incentive impact of cash would be decreased. Thirdly, monitoring expenses will be greater since tracking the programs and ensuring that cash incentives are appropriately delivered to executives are a tremendous drain on time and people.

4. Conclusion

After introducing LTIPs, most of the companies have embraced these strategies to motivate executives to achieve a greater performance objective to serve the shareholders' interests. There are certain advantages of LTIPs. However, the LTIPs are opposed by a rising number of researchers and critics, and BEIS suggested rejecting LTIPs and embracing other options in their report issued in 2017.[3] They referred to many reasons why companies should stop using LTIPs.

Although LTIPs are flawed, these alternatives—deferred shares and cash-for-performance-schemes cannot replace LTIPs since alternatives have certain drawbacks and inadequacies of LTIPs can be surmounted by suitable methods. Also, during this tough moment, recuperating and rebuilding the economy of a firm is vital and adopting a new pay system is surely challenging. Since then, giving up LTIPs is not a smart idea and corporations can carry out them through a more effective reform.

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