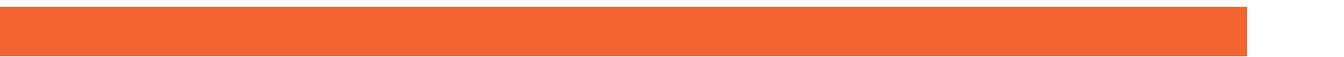


THE STATE OF PAY

ONE YEAR ON FROM THE HIGH PAY COMMISSION



About the High Pay Centre

The High Pay Centre is an independent non-party think tank established to monitor pay at the top of the income distribution and set out a road map towards better business and economic success.

We aim to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre is resolutely independent and strictly non-partisan. It is increasingly clear that there has been a policy and market failure in relation to pay at the top of companies and the structures of business over a period of years under all governments. It is now essential to persuade all parties that there is a better way.

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Forward

In the past year business behaviour has been under scrutiny as never before. Large-scale corporate scandals such as interest-rate rigging at Barclays, money laundering at HSBC and the latest alleged manipulation in the energy markets as well as some excessive pay awards, have undermined trust in business.

We need our business sector to be strong and healthy to return the economy to growth and innovation. Business also needs to foster more public understanding of what it does and why. Part of this involves responding to public concerns about excessive pay and corporate behaviour.

Shareholders have started to take a stand on rewards for failure. During the much-heralded shareholder spring there has been a flurry of protest votes over pay, although this has tended to reflect isolated cases of concern rather than a more general push-back over top pay awards.

The government wants to address concerns over pay by giving shareholders a binding vote on remuneration policy every three years. This is unlikely to be enough to arrest the trend for ever more complex and higher awards for top bosses.

Nevertheless, there has been a shift in the debate about top pay this year. While there has been broad condemnation of rewards for company failure, there have also been some moves against excessive awards for mediocre performance. Some prominent shareholders are even beginning

to question the effectiveness of performance-related pay altogether.

A year ago, the High Pay Commission called for companies to simplify their top pay packages. So far, little innovation has come from business itself. The High Pay Centre is now calling for a broad debate on pay at the top and for everyone else.

We need to ask why the gulf between average earnings and those at the top of the income scale continues to widen and what can be done about it? Performance-related pay has added to the complexity of executive income, but does it actually work? And why are our companies focused on short-term financial success at the expense of sustainable behaviour?

We need root and branch reform of corporate pay if we are to address rising inequality across society as a whole.

Deborah Hargreaves, Director of the High Pay Centre

Executive summary

In recent years, directors of some of Britain's top businesses have been roundly condemned by shareholders, politicians and the public for their burgeoning bonuses and expanding pay packets. Yet in the past twelve months executive rewards have increased well over the rate of inflation, in the midst of a stagnating economy.

Many of these companies have failed to increase profits – the standard measure of success – and yet directors have been rewarded handsomely. In the past year executive rewards for those running FTSE 100 companies have increased by 12%.

A year ago, in 2011, the High Pay Commission highlighted the excessive pay packages awarded to those at the top of British business, showing increases of more than 3000% in top pay over the past 30 years. The High Pay Commission called for a dramatic simplification and greater transparency in CEO pay packages. But in the vast majority of cases, the way leaders are rewarded remains complex and hidden from public scrutiny.

The High Pay Commission's report was timely. Employees, shareholders and the general public were confused and angry at the way pay packages for the country's bosses had increased so spectacularly when most of the population were enduring pay freezes, and even real-terms pay cuts. There existed an atmosphere of incredulity: how could CEO rewards be rising at the same time as the rest of society was

experiencing the direct pain of austerity, cuts, redundancy and unemployment, especially when, in the case of the bankers, CEOs have had a direct and causal effect on our shrinking economy? How could they pay themselves more, when they were failing to deliver?

This report finds that, despite promises of action, little has changed. And though some shareholders have sought to rein in executive excesses, they have been unable to enforce a change of culture on top pay. Individual shareholders and institutional investors, such as pension funds and insurance companies, comprise a diminishing proportion of UK shareholdings and they often find it difficult to work with other shareholders to tackle the problem of excess pay.

The situation is getting worse. Those at the top of the income scale are getting richer as the majority of British citizens are experiencing a squeeze in their standard of living:

- > Executive rewards in the FTSE 100 have risen 12%.
- > Shareholders have been unable to make their voices heard – only two FTSE 100 remuneration reports were voted down.

At the same time, in the past twelve months trust in British industry has been knocked, hard, again and again. There have been repeated large-scale corporate scandals, including:

- > interest-rate rigging at Barclays
- > money laundering at HSBC
- > the mis-selling of pharmaceutical products
- > the mis-selling of payment protection insurance across the banking industry.

Over the past ten years, pay at the top of our biggest companies has trebled while the FTSE 100 index is little changed, even though companies claim they are linking top pay to company performance.

The Government's response has not been ambitious enough. There is a danger that the proposed reforms will not deliver significant and needed change.

Empowering shareholders to veto executive pay increases was a step in the right direction, but the evidence shows that investors are not sufficiently engaged with this issue to represent the concerns of society as a whole. The government did not adopt the High Pay Commission's recommendation to open up remuneration committees to include a worker representative, and dramatically simplify executive pay. As a consequence executive pay continues to rise.

High pay with rewards that are out of kilter with results, is having a corrosive impact on our living standards, our

economy and our society. It damages public trust in businesses; it de-moralises employees whose rewards for their efforts are tiny in comparison with their bosses; and it creates a number of well-documented public health and social problems arising from soaring inequality.

It is no longer enough simply to hope that the issue of high pay resolves itself, and it is in the interest of business and wider society to settle growing pay inequality. For this reason the High Pay Centre is calling for a public debate on pay. This debate must bring together businesses, shareholders, trade unions, employees and civil society to debate what is fair pay in the 21st century. It must answer the following questions:

- > Who are the stakeholders in company success? Who creates wealth and how should they be rewarded?
- > What are we paying executives for? By what metrics should company success be measured, and who should decide them?
- > What are the long-term effects of unequal pay, and who has to bear their cost? How does executive pay in the UK compare to that in other countries, and what is its impact on employee relations, business ethics and levels of inequality?

Introduction

One year on from the High Pay Commission this report takes stock of the pay debate.

Over the last year there has been a dramatic shift in the discussion around top pay. This shift was led by the final report of the High Pay Commission (in November 2011), which called for a pragmatic policy response from government to start to put the brakes on the escalation of pay at the top with a twelve-point plan.

The report *Cheques with Balances* also recognised the overwhelming business case for reform and called on businesses, shareholders and business leaders to start to tackle pay inequalities within companies.

In 2012 business leaders and politicians from all parties have begun to talk about the need for action on executive pay, and growing pay inequality more generally. These discussions have resulted in a government policy response spearheaded by the Business Secretary, Vince Cable, and an outbreak of investor activism in the so called “shareholder spring”.

This report looks at the reality behind this rhetoric. Is this all just hot air or have we really reached a tipping point in executive pay? Is real reform taking place or is it all empty promises?

¹ David Cameron (2012) on The Andrew Marr Show http://news.bbc.co.uk/1/hi/programmes/andrew_marr_show/9673749.stm
² Nick Clegg (2011) on The Andrew Marr Show
³ Ed Miliband Labour party conference, Manchester October 2012

Party leaders advocate change

It's the excessive growth in payment unrelated to success that's frankly ripping off the shareholder and the customer and is crony capitalism and is wrong... There's been a bit of back scratching going on and a sort of circular process of rewards being pushed up across the board... I'm interested in what will actually work to correct this market failure.¹

David Cameron, Prime Minister

I think the revelation that top executives of some of our top companies were receiving up to 50 per cent pay increases even though their companies weren't doing any better was a real slap in the face for millions of people in this country who are struggling to make ends meet. I think we now need to call time on excessive and irresponsible behaviour.²

Nick Clegg, Deputy Prime Minister

Those with the broadest shoulders will always bear the greatest burden. I will never accept an economy where the gap between rich and poor just grows wider and wider. In one nation, in my faith, inequality matters. It matters to our country.³

Ed Miliband, Leader of the Labour Party



What is the state of pay?

This renewed interest in pay has occurred in an environment of heightened public sensitivity towards business behaviour. The interest-rate rigging Libor scandal followed on the heels of the phone hacking disclosures and the mis-selling of pharmaceutical products. Business behaviour is being scrutinised as never before. While this report looks at the pay debate, it does so in the context of what a good company is, and what is good business.

This report explores what has happened to pay at the top over the last year and discusses this in relation to broader pay trends over recent decades. It also offers an analysis of the business community reaction, the “shareholder spring”, and government action on executive pay and pay in the financial sector, particularly the Enterprise and Regulatory Reform Bill and recent proposed reforms to the UK Corporate Governance Code.

During this time of austerity who gets what matters more.

Who's getting what?

Over the last 30 years there has been a dramatic redistribution of rewards. A shift has occurred, and the lion's share of income now goes to those at the top of our biggest businesses. The promises of trickle down have not been delivered. This section draws together the recent data on pay and offers a new insight into the pay debate.

We look at pay at the top of businesses – executive pay generally across the FTSE 100 and 250 companies and more specifically at the formation of the £10 million pound club: a new group of super-paid executives.

We then explore the issue of pay in the City, looking at what has happened since the financial crisis.

One thing is clear. The brakes have not been put on the rapid rise in pay at the top.

What has happened to executive pay?

Pay at the top of our biggest companies has trebled in the past ten years (figure 1) while the FTSE 100 index is little changed, even though companies claim they are linking top pay to company performance.

⁴ Manifest and MM&K (2012) *Executive Director Total Remuneration Survey*

figure 1 Comparison of FTSE 100 index performance and average FTSE 100 CEO remuneration⁴

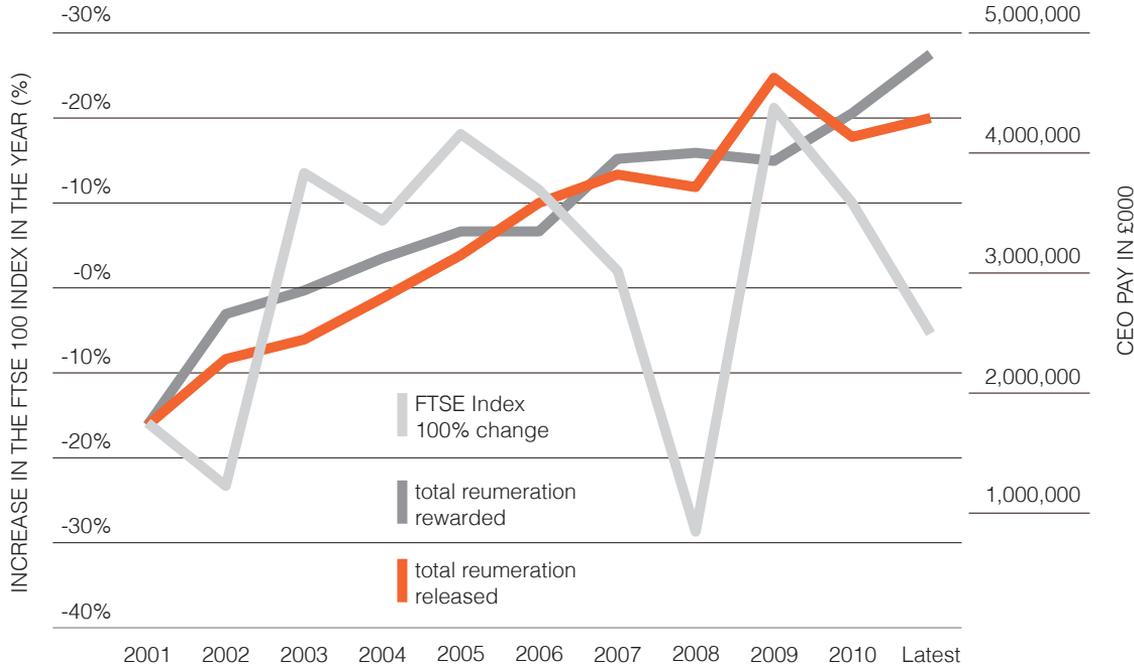


figure 2 Average pay of all FTSE 350 directors and average corporate performance measures, 2000–2010⁷

Remuneration Element	Change Over 10 Years		Corporate Performance Measure	Change Over 10 Years	
Salary	↑	63.9%	Pre Tax Profit	↑	50.5%
Bonus	↑	187.0%	EPS	↑	73.0%
Total Cash	↑	133.4%	Year-end share price	↓	-5.4%*
LTIP	↑	253.5%	EBITDA	↑	62.0%
Share Options	↓	-40.0%	Turnover	↑	80.4%
Total Earnings	↑	108.0%	Market cap	↑	8.0%

* Median used instead of Average to mitigate for the exaggerated impact of the dot com boom in the early 2000s

Sarah Wilson, managing director of Manifest, the proxy voting agency, says:

Regulators and investors have always known that the way directors are paid is a window on the soul of the company. But their attempts to control pay have not addressed this. Instead we have seen formulaic solutions, which in turn encourage box-ticking on both sides. In the meantime executive pay at the largest companies has continued to climb regardless of firm performance.⁵

The sharp rise in executive pay in the past 30 years has reversed earlier trends towards a more equal pay distribution. Between 1940 and 1979 the pay of the average

executive of a large UK company increased by just 0.8% per year.⁶ Pay at the top declined relative to average wages and a newly affluent middle class emerged.

Most of the growth in top pay in recent years has not been in salaries, but in bonuses, share option grants, long-term incentive plans (LTIPs) and a raft of new and innovative pay structures. These rewards were designed to tie the executive’s interests to those of the shareholder. Figure 2 shows the average pay of all FTSE 350 directors and average corporate performance measures between 2000 and 2010.

While company performance has gone up only modestly in the past 10 years, executive and boardroom rewards increased exponentially.

⁵ <http://www.mm-k.com/newsletter/online.aspx?n=844&s=58377&p=-1&id=197>

⁶ High Pay Commission (2011) *More for Less*

⁷ Incomes Data Services and High Pay Commission

figure 3 Average Pay For Full-time Workers Compared To FTSE 100 CEO Total Package in 2011



This rise has continued despite the recession. Between 2006 and 2010 executive pay continued its meteoric rise, almost unabated, despite a flat-lining economy and some record poor company performance:

- > In 2006 the average FTSE 100 total executive pay package was £3,309,000.
- > In 2011 the average FTSE 100 total executive pay package was £4,771,000.⁸

In 2011 alone the annual pay of the average FTSE 100 chief executive rose by 12% to an average of £4.8m, according to data from Manifest and MM&K.⁹ Meanwhile the pay of everyone else stagnated, rising just 2.8% across the economy – indeed only 12% of people experienced a pay rise of over 4%.¹⁰

If we take a closer look at what happened to executive pay in 2011, it is clear that this pay rise followed similar patterns to those that occurred in the last 20 years, albeit

with a slightly lower rate of return. The average executive annual salary of employees of companies in the FTSE 100 increased by a relatively modest 2.4% (to £856,000), which is arguably not out of line with national average pay increases, but the variable elements of the pay awards jumped significantly.¹¹

This average obscures significant variation within companies. For example, according to Deloitte Consulting the chief executives of 46% of FTSE 100 companies had their basic salary frozen, although MM&K found that the figure was closer to 21%.

At the top end pay packages increased dramatically. According to Incomes Data Services the lead or chief executives of the companies listed in Table 1 were awarded the top five highest pay increases in the UK in 2011.

table 1 Highest earnings increases of FTSE 100 lead or chief executives 2011¹²

Company	Total earnings movement (%)
International Power	189.5
Croda International	153.6
Amec	119.7
Arm Holdings	100.6
GlaxoSmithKline	67.9

⁸ MM&K/Manifest (2012) Executive Pay Data

⁹ MM&K and Manifest (2012) Executive Pay Data. Based on executive pay packages with year end before March 2012.

¹⁰ Incomes Data Services (2012) Pay Survey

¹¹ Ibid.

¹² Incomes Data Services (2012) Directors Pay Report

Table 2 lists the FTSE 100 companies whose CEOs were the top ten highest paid in the UK in 2011. This is the first class lounge of executive rewards, marking the growth of the new £10 million club.

It is interesting to note that four of these top paid executives – Marjorie Scardino, Terry Leahy, David Brennan and Bob Diamond – left their respective companies since receiving these bumper rewards.

table 2 Top ten highest paid FTSE 100 CEOs (total remuneration realisable), 2011¹³

Company	Name	Total fixed remuneration (£000)	Total realisable variable remuneration (£000)	Total realisable remuneration (£000)
Barclays	Diamond	8,370	12,601	20,971
WPP	Sorrell	2,350	9,272	11,622
AstraZeneca	Brennan	2,216	9,102	11,318
BHP Billiton	Kloppers	1,896	7,922	9,818
Royal Dutch Shell	Voser	2,260	7,484	9,744
BG Group	Chapman	4,029	5,613	9,642
ICAP	Spencer	382	8,971	9,353
AMEC	Brikho	1,067	7,930	8,997
Pearson	Scardino	1,756	7,223	8,979
Tesco	Leahy	3,952	3,967	7,919

How we're paying it

Apart from the dramatic growth of executive pay, particularly unrelated to the company performance it is intended to encourage, we should also be concerned that the current trend in pay for executives is not efficient. Shareholders are paying more and getting less.

Most people receive a basic salary and little else, and there is a reason why this makes sense. According to the most up-to-date psychological research, how we pay people is as

important as what we pay them – and more is not always better.

Future discounting

Most people place more value on money they can have now, rather than on what they might get in the future. Individuals discount the value of future rewards by at least 20% every year they have to wait for them. Many executive packages rely on pay-outs several years ahead.¹⁴ Consequently, it is not surprising that in order to incentivise executives with rewards that pay

¹³ Source: Manifest – The Proxy Voting Agency (2012) Executive Pay Survey

¹⁴ PwC (2012) Making Executive Pay Work: The psychology of incentives

out a number of years in the future, remuneration committees find they need to be paid more.

Complex – good or bad?

Academic research demonstrates that most people would prefer a simple straightforward reward to a more complex one, even if the complex one would ultimately pay out more. Indeed, PricewaterhouseCoopers (PwC), the accountancy firm and remuneration consultants, recently looked at attitudes to complexity in rewards and found that most executives would choose a lower, simpler pay structure over a more complex one with higher potential pay-outs. People dislike rewards that seem unfair or arbitrary:

*Complex formulaic incentive plans can generate outcomes that participants think are arbitrary and unfair. This is bound to cause trouble because people are far more likely to remember bad news over good. One year when they believe the outcome is unfair can outweigh several years of undeserved windfall.*¹⁵

Risk aversion

Individuals' aversion to risk varies. The average entrepreneur is normally a risk-embracing go-getter, and modern executive pay schemes encourage this risk-taking attitude. However, executives in general are naturally more cautious individuals and, unsurprisingly, risk aversion increases with the sum at stake.

The ideal job factor

Research by PwC shows that executives would be prepared to sacrifice 28% of their pay if they could achieve their ideal job.¹⁶

If executives are risk averse, dislike complexity and discount deferred pay, we should ask why they are not being paid in a straightforward way. Is the way we are paying them also driving up the amount they are paid in total? Indeed the evidence suggests that a dramatically simplified pay structure would make executives happier and result in us paying them less.

David Pitt-Watson, chair of Hermes Focus asset management at the Treasury Select Committee, said in June 2012:

*Is it sensible to think about [CEOs] as people to whom you are giving some specific prize, some specific incentive, or do we need to go back and think about how we treat them the way that we would treat most employees—pay them well to do the job if we can afford so to do?*¹⁷

He suggested that executives should do the best for their shareholders “rather than something where they are chasing a prize through these complex alignment systems that we are setting up”.

Pay in the City

The public anger over top pay and bonuses has focused on the banks every January, with the onset of

¹⁵ Ibid

¹⁶ Ibid

¹⁷ D. P. Watson (2012) Evidence to Treasury Select Committee, <http://www.parliament.uk/treascom/>

bank bonus season. There is no sign that this anger will decline and although there have been some changes in bankers' pay, they are unlikely to abate public anger and indeed according to some academics, may increase instability in the banking sector.

¹⁸ T. Philippon and A. Reshef (2008) *Wages and Human Capital in the US Financial Industry: 1909–2006*
¹⁹ Ibid.

What happened to the Walker review?

The Walker review was commissioned by the last Labour government. It was carried out by the City grandee Sir David Walker (now chairman of Barclays), who set out to explore what should (and could) be done to increase transparency over bankers' bonuses. The report advocated wide-ranging reforms, not least the disclosure of pay bands.

Sadly, although the report was widely welcomed, these policy recommendations have not been implemented.

What happened to Project Merlin

While it may sound like something out of *The Thick of It*, project Merlin was a collaborative project between the banks and the government to encourage greater transparency. The government was reluctant to increase regulation to force greater disclosure, but recognised the growing public demand for greater transparency. The promise of Project Merlin was the disclosure of the top five executives' (as opposed to traders') pay packets outside the boardroom. Indeed this happened at Barclays in 2011, where we found out the top earners took home a combined package of £43m, the biggest winner being the aptly named Rich Ricci.

What has happened to pay in the City?

In the lead up to the great depression in the 1930s jobs in the financial sector were relatively skill intensive, complex and very highly paid.¹⁸ From the 1930s a dramatic shift occurred and the financial sector lost much of its wage premium relative to the rest of the economy. The change in the pay differential between the financial sector and the rest of the economy continued at a slower rate from the 1950s to the 1980s. By the beginning of the 1980s pay in the financial sector was similar on average to that in the rest of the economy.

After the 'big bang' in the 1980s the financial sector once again became a high skill, high wage industry. It is notable that relative wages in finance had returned to the levels of the 1930s by 2006.¹⁹

Studying what has happened to pay in the financial sector is challenging. Despite government attempts to increase transparency following the Walker Review and Project Merlin, which attempted to encourage voluntary disclosure of salary bands, banks continue to be opaque and generally very secretive about pay. It is argued that there is good reason for this secrecy: the banks fear competitive advantage being given to their rivals, and they worry about losing talent to them.

Since the financial crisis there have been some changes to pay in the banking sector, the most notable being a decline in bank bonuses. In 2011 the bonuses of financial workers fell to £12,000, – a drop of 9%.²⁰ However, this figure should not be taken at face value as it covers many more workers than just traders and investment bank employees, and includes financial intermediation workers.

A survey of average pay for chief executives at 15 leading banks in the US and Europe reported in the *Financial Times* in June 2012 showed that pay in 2011 had increased for the second year in a row. In 2010 there was a leap of 36%, which was followed by a rise of almost 11.9% in 2011.²¹

This pay rise occurred despite there being a 25% fall of the FTSE World Banks Index in 2011.²² The World Banks Index has been underperforming the overall World Index, which experienced a drop of 9% in 2011.²³ Indeed over the same period no banks beat the overall market and on average revenues in banks fell by 5.8% in 2011.

Lower bonus... more salary

While banks have been trimming bonuses and paying more out in shares rather than cash, this has not come at the expense of total packages. Globally, investment banks have been increasing salaries by an average of 37% over four years.²⁴

The sharp increase in fixed remuneration, which includes salaries, pensions and benefits in kind, has driven up the non-variable proportion of overall pay from 30% in 2007 to 55% in 2011, according to a study by the Association for Financial Markets in Europe, a lobby organisation.²⁵

Pan-European rules, which came into force at the beginning of 2011, require that the top executives and traders at a bank receive only about 20–30% of their bonuses in upfront cash. The European Parliament has also called for bonuses to be capped at 100% of basic pay. However, the European Banking Authority (EBA) has said that new rules that stipulate that half of a banker's bonus should be paid in shares, and about 40–60% of their total bonus should be staggered over three to five years, are not being implemented consistently by different EU countries.

Indeed, Europe's Internal Markets Commissioner Michel Barnier said he was "seriously worried" by the proportion of pay awarded as bonuses in some countries, suggesting that it encouraged excessive risk-taking.

According to the EBA report, the average bonuses paid to bank executives across the EU as a whole was 122% of basic pay, and for other staff it was 139% in 2011.

²⁰ Office for National Statistics (2012)

²¹ Compiled by Equilar, the pay research firm for the *Financial Times*. See 'No stop to banker pay rises' (2012) *Financial Times*, <http://www.ft.com/cms/s/0/abde55a4-bbeb-11e1-9aff-00144feabdc0.html#ixzz26LUOUe5G>

²² Ibid

²³ Ibid

²⁴ Ibid

²⁵ <http://www.ft.com/cms/s/0/8add88ba-a698-11e1-968b-00144feabdc0.html>

Government reforms on executive pay

²⁶ The High Pay Centre was established in January 2012 to continue the work of the High Pay Commission and conduct research into pay levels. The High Pay Centre is an independent organisation and is not affiliated to any political party.

²⁷ The exact nature of the policy is still under consultation but it is understood that it will show how executive pay promotes the strategic objectives of the company. It may also include key elements of pay, the performance measures that will be used and the principles on which exit payments will be made. However, it is now unlikely that this will include the publication of a pay ratio.

The thing I can confirm today does need to happen – and will happen is clear transparency in terms of the publication of proper pay numbers, so you can really see what people are being paid, and then binding shareholder votes so the owners of the company are being asked to vote on the pay levels; and, absolutely key, vote on any parts about dismissal packages and payments for failure.

David Cameron, Prime Minister

In response to the new public mood, and in light of the new damning evidence showing the dramatic growth in pay at the top of our companies, Business Secretary Vince Cable promised reforms in parliament in January 2012 along with the formation of the High Pay Centre.²⁶

After significant periods of consultation, the shape of these reforms is becoming clear, although there continues to be the opportunity for further amendments and changes. They include legislative reform, included in the Enterprise and Regulatory Reform Bill, and changes to the UK Corporate Governance Code.

The case for employee representation on remuneration committees

- Employee representation on remuneration committees would:
- encourage a greater link between executive pay and the pay for the rest of the work force
- force remuneration committees to consider pay across the company when setting executive pay, as they are required to do under the UK corporate governance code
- introduce a degree of common sense.

The case for dramatic simplification of executive pay

- Dramatic simplification of executive pay would:
- align the pay for the executive with the pay for the workforce
 - decrease obfuscation and increase transparency
 - increase long-term thinking in company bosses.

In parliament Vince Cable claimed to adopt ten of the twelve policies put forward by the High Pay Commission, which reported in autumn 2011, but:

- failed to adopt the recommendation that an employee representative should sit on remuneration committees
- did not introduce a dramatic simplification of executive pay, which the High Pay Commission had called for in order to ensure executive rewards aligned with the rewards enjoyed by their workforce.

If they had been implemented, these policies would have had a significant impact on executive pay.

Government reforms on executive pay

There will be a binding vote on pay policy for shareholders:

➤ This amounts to a **new binding shareholder vote on remuneration policy**, requiring the support of a simple majority of shareholders voting, rather than the 75% as had previously been suggested.²⁷

➤ It will be **compulsory for the company to hold the vote at least every three years**, but if the policy changes the vote can be held annually. Once the remuneration policy has been approved, the company will not be able to make payments outside the scope of that policy without further shareholder approval.

➤ **If the vote is not passed by a simple majority, the company will be required to continue to use its existing remuneration policy** until shareholders agree a revised policy. If a company then decides to alter the remuneration policy, a shareholder vote is required. This policy is designed to encourage companies to devise long-term pay policies and avoid increasing executive pay incrementally.

➤ Under the new reforms **companies will be required to explain their approach to exit payments**. Further, when a director leaves, the company will have to disclose any payments being made to that person in a timely way and demonstrate that it conforms with the pre-approved shareholder policy. This is different from the original proposal by the government, which required shareholder approval for exit payments of more than one year's base salary.

➤ The **annual advisory shareholder vote will be kept**. If the advisory vote is not passed on a simple majority, the company will be required to put its remuneration policy to shareholders for approval again in a binding vote the following year.

Reforms bringing in greater transparency:

➤ There will also be **simplified regulations setting out how companies must report directors' pay**. These are being introduced to ensure greater clarity and transparency in remuneration reports.

The government is continuing to consult on the proposal for a single figure to be published for each director's pay package. This figure will cover all rewards received by directors, including bonuses and long-term incentives. Companies will also be required to demonstrate in their reporting that they have met performance measures.

The original policy announcements stated an intention to have these corporate governance and legislative changes in place by October 2013. Amendments have been tabled to the Enterprise and Regulatory Reform Bill before parliament in autumn 2012 to introduce new regulations setting out what companies must report on directors' pay.

The Financial Reporting Council has announced that it will consult on whether to amend the UK Corporate Governance Code in relation to executive remuneration.

The shareholder spring

What was the rhetoric?

The “shareholder spring” was dubbed a “very capitalist revolution”,²⁸ but how revolutionary was this AGM season? During the AGM season in 2012 there were major votes by shareholders against remuneration reports and media coverage of the shareholder rebellions against executive pay. Significant votes against the remuneration report at Aviva, Barclays and William Hill culminated in the vote against the package for Martin Sorrell, CEO at WPP.

Shareholders have voted against pay packages considered too complex and out of step with the economic times or just excessive. Colin Melvin, CEO at Hermes EOS commented:

*There has been an increase in both dialogue and publicity around remuneration votes, and the instances of votes against, which reflects the public and political mood, particularly with regard to financial sector companies such as banks and fund managers.*²⁹

While some are claiming that shareholders are finally finding their voices to criticise corporate behaviour, the reality behind this is less clear.

What was the reality?

In 2011 just two FTSE 100 companies lost the vote on their remuneration report:

- The remuneration report of WPP proposed a 30% increase in Sir Martin Sorrell’s salary to £1.3m and total remuneration potential of £13m, but 60% of investors voted against the report. Sir Martin was defiant about the investor vote.
- Although Andrew Moss, CEO of Aviva, had waived a 4.8% pay rise to his basic salary, 54% of investors voted against his remuneration report. Mr Moss later resigned.

Seven remuneration votes were lost among FTSE 350 companies. The Pensions Investment Research Consultants (PIRC) carried out of a sample of just over 300 annual general meetings and found that the average vote against remuneration reports was 7.64% in the first six months of 2012, compared with 6.1% in the same period in 2011.³⁰ Table 3 lists the proportion of shareholders who opposed or abstained against the remuneration reports of FTSE companies between 2006 and the first half of 2012, and table 4 lists the names of the companies whose remuneration reports were defeated between 2003 and 2011.

²⁸ Alistair Heath (2012) City AM

²⁹ http://www.ipe.com/magazine/pay-propos-als-in-the-shareholder-spring_45802.php#.UFC0_FT6Qy4

³⁰ <http://www.ft.com/cms/s/0/0a1e41c4-ed42-11e1-95ba-00144feab49a.html#ixzz26Gzq9g00>

There have been shareholder rebellions at Aviva, Cairn Energy, Centamin, Central Rand Gold, Pendragon Darty and WPP in 2012.

The tipping point?

While an increase of just 1.5% from last year on shareholder votes against remuneration reports may seem insignificant, many are claiming this as a tipping point. Indeed, we should remember that most company votes go through with almost no rebellion. For example, very few shareholders opposed the appointment of directors in the first half of the year, with the average vote against at 1.88 per cent, marginally higher than the 1.7 per cent recorded for the same period last year.³¹

It is important also to recognise that the majority of executive pay packages continued to rise last year and that most of these were waved through with little dissent from shareholders. Only the most egregious pay packages were voted down.

The changing nature of shareholders

One explanation for this low level of shareholder activism is the changing nature of shareholders. Over the last 20 years there have been three parallel trends:

- > an increasingly heterogeneous shareholder base of UK listed companies
- > a growth in foreign ownership of UK shares, most notably the US
- > the increasingly short time horizon of a shareholding.

table 3 Average shareholder vote against the remuneration reports of FTSE companies, 2006–2012

	Opposed (%)	Abstained (%)
2006	3.28	2.24
2007	3.98	2.63
2008	3.30	2.22
2009	5.20	2.86
2010	5.63	2.82
2011	5.95	3.04
H1 2012	7.66	2.76

table 4 FTSE companies whose remuneration reports were defeated, 2003–2011

Year	Defeats	Companies
2003	1	GlaxoSmithKline
2004	1	Maiden Group
2005	4	United Business Media, MFI Furniture, Goshawk Insurance, Lonmin
2006	1	Croda International
2007	0	None
2008	0	None
2009	5	Bellway, RBS, Shell, Provident Financial, Punch Taverns
2010	3	SIG, Grainger, 21st Century Technology (AIM company)
2011	3	EasyJet, Robert Walters, Afren

³¹ PIRC (2012) Survey on Shareholder Voting 2012

Heterogeneous shareholders and foreign ownership

The decline of block shareholding and increasingly diversified owners has resulted in less opportunity for collective action by shareholders.

The Kay review argued that increased foreign ownership of UK equities has impacted on the form and possibility of collective action by shareholders,³² as shareholders are less likely to know each other well and as a result are less likely to collaborate. Further, foreign firms – notably American firms – were more likely to act aggressively and competitively rather than collaboratively with other shareholders.

Indeed, traditionally the National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI) had co-ordinated significant amounts of shareholder activism in part because they had influence over those investors who held a large proportion of the FTSE 100. Figure 3 shows the percentage of shareholdings of UK shares held outside the UK for selected years between 1963 and 2010; table 5 shows the total market value of UK quoted shares by sector of beneficial owner for selected years between 1963 and 2010.

³² J. Kay (2012) The Kay Review of UK Equity Markets and Long-Term Decision Making

figure 4 Rest of the world shareholdings of UK shares (end year position), selected years 1963–2010

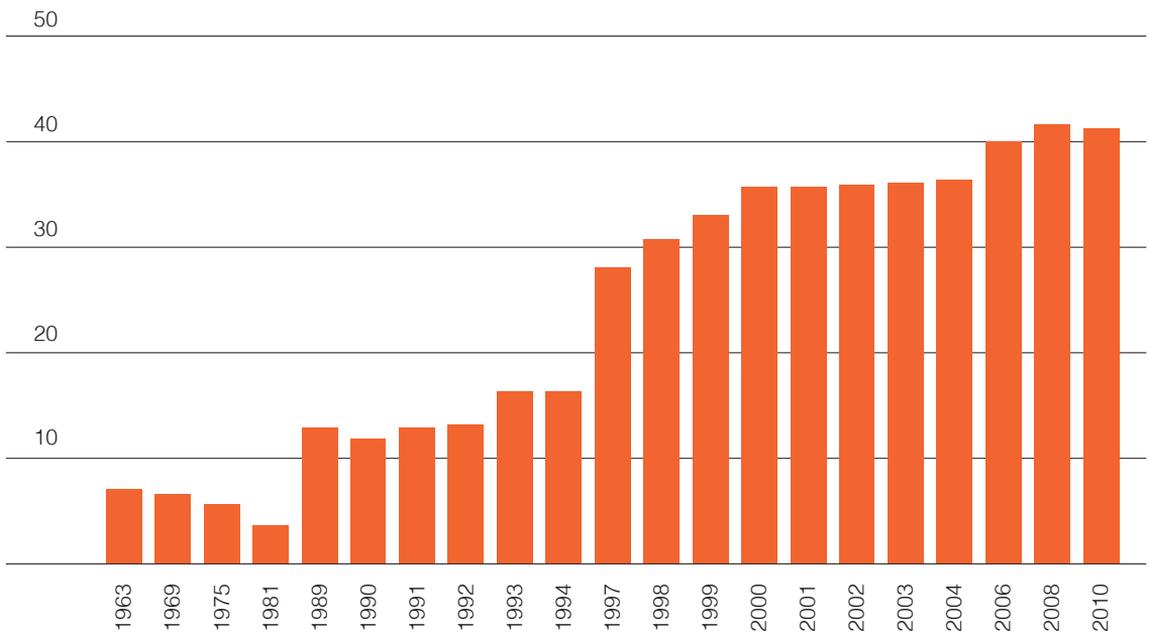


table 4 A Percentage of total market value of UK quoted shares by sector of beneficial owner 1963 to 2010³³

Sector	1981 (%)	1990 (%)	1994 (%)	2000 (%)	2004 (%)	2010 (%)
Rest of the world	3.6	11.8	16.3	35.7	36.3	41.2
Insurance companies	20.5	20.4	21.9	21.0	17.2	8.6
Pension funds	26.7	31.7	27.8	17.7	15.7	5.1
Individuals	28.2	20.3	20.3	16.0	14.1	11.5
Unit trusts	3.6	6.1	6.8	1.1	1.4	6.7
Investment trusts	–	1.6	2.0	1.3	2.5	2.1
Other financial institutions	6.8	0.7	1.3	2.8	8.2	16.0
Charities	2.2	1.9	1.3	1.4	1.1	0.9
Private non-financial companies	5.1	2.8	1.1	1.5	0.6	2.3
Public sector	3.0	2.0	0.8	-	0.1	3.1
Banks	0.3	0.7	0.4	1.4	2.7	2.5
Total	100	100	100	100	100	100

Shareholding time horizon

Over the last 50 years the length of time shareholders hold shares has gradually reduced, reflecting a dramatic growth in trading, where shares are held for a very short period of time, and a shrinking of the average long-term holding (see figure 4). There are fewer long-term shareholders; shareholders hold fewer shares for a shorter period of time.

Andrew Haldane of the Bank of England noted in 2011:

There is evidence of the balance of shareholding having become increasingly short term over recent years. Average holding periods for [shares in] US and UK banks fell from around three years in 1998 to around three months by 2008. Banking became, quite literally, quarterly capitalism. Today, the average bank is owned by an investor with a time horizon of considerably less than a year.³⁴

³³ Source: Office for National Statistics. Investment trusts not available separately for early years; 1 Not available for all years; 2 Includes Investment trusts for 1963, 1969, 1975 and 1981; 3 Public sector comprises local government, central government and public corporations; 4 Components may not sum to the total due to rounding

³⁴ <http://www.bankofengland.co.uk/publications/speeches/2011/speech525.pdf>

As a result of this changing nature and attitude, shareholders are less able and less likely to exert the influence over companies necessary to rein in executive pay or indeed ensure companies are run in their own long-term interest. Too few shareholders are committed to the long-term interests of the companies they own.

The board of directors

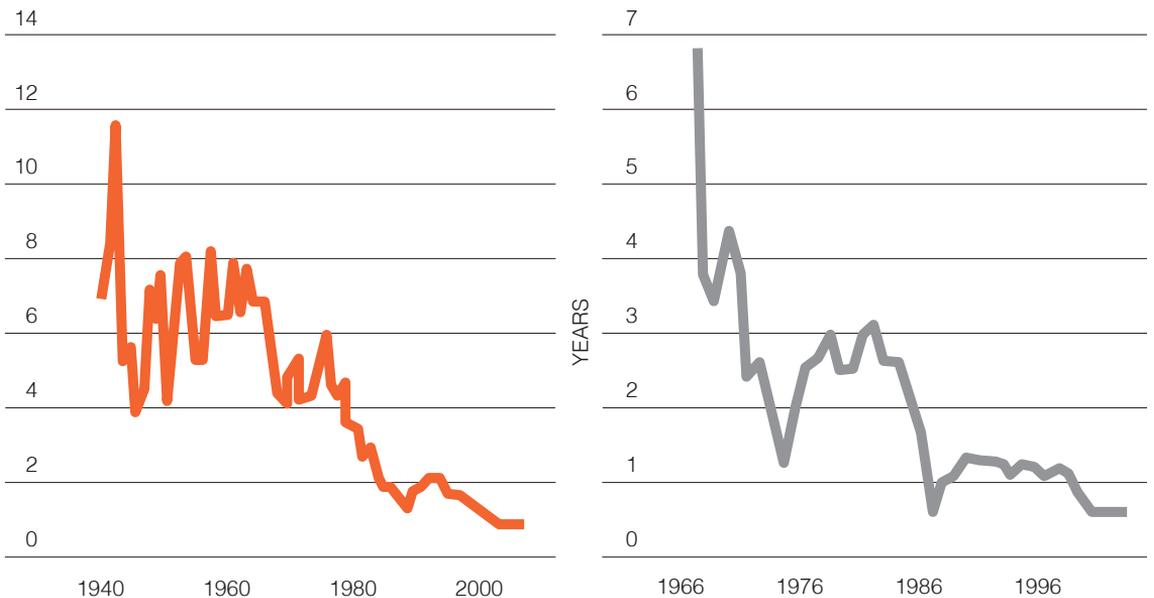
Despite the long-awaited Davies review and increasing focus on board diversity the biggest companies continue to have boards which are, to coin an old saying, “male, pale and stale”. However, it is not just the gender

and ethnic diversity that should be of concern: a potentially bigger issue is the fact that the majority of board members come from remarkably similar backgrounds. Most boards are made up predominantly of men from a managerial or financial background.

Looking specifically at remuneration committees, which determine executive pay levels, a study by the High Pay Centre called The New Closed Shop found that of 366 people who sit on remuneration committees in the FTSE 100 just 10% – 37 members – were not from business or financial intermediation. It also found that only 59, or 16% of the total, are women.

³⁵ <https://www.fidelity.co.uk/investor/news-insights/expert-opinions/details>.

figure 4 Average shareholding period in the New York Stock Exchange and London Stock Exchange³⁵



Individuals from the same background are more prone to “group think” and indeed more likely to reach a more extreme decision than groups made up of a more diverse selection of individuals. Indeed the Kay review reported that respondents expressed concern about the selection of non-executives. Its authors feared that the method of appointment, normally by a committee, made up of board members, resulted in a board composition that was insufficiently prepared to challenge the executive in the long-term interest of the company.

It remains the case that fear of poaching is encouraging generous rewards. While stock prices can be highly sensitive to movement of CEOs and chief financial officers there is no evidence that such moves are more or less likely to affect firm performance over time.

Why it matters

There is a growing public consensus that the current state of pay is unacceptable. This public consensus is reflected in the political mood and increasingly recognised in the business community.

The case for a revaluation of the state of pay and a debate about what to do is now compelling. The current and growing level of pay inequality has an effect on business on the economy and on social cohesion.

When it comes to pay at the top we are simply paying too much and paying in the wrong way.

The economic case

When the distribution of wealth changes it has an effect on our economy. It alters patterns of spending and saving. It changes where money is spent and therefore affects the price of goods and services.

Over the last 30 years wealth has accrued at the top of the income distribution. Simultaneously there has been a dramatic growth in the value of the housing market, particularly in London and the South East, as those with money look for somewhere safe to put it. There has been greater speculation on commodities and gold, and a drop in spending as a percentage of national income on the productive economy.

While those in the middle and bottom of the income distribution often spend any uplift in salary on goods and services, those at the top save and invest, but this saving and investing is not without

consequences: it drives up the housing market and food prices.

The business case

Businesses operate within a society, within a country; they cannot float free from this. Indeed companies depend on an implicit licence to trade. When they lose public trust, it is hard to regain it. Simon Walker, managing director of the Institute of Directors, said, "The very concept of business has been hit by lack of public trust. I am worried about how concern about business has spread outside of the Occupy tents."

Within companies pay inequality matters too. It has an impact on employee engagement. When employees feel they aren't getting their fair share or see unjust rewards for those at the top they are less likely to feel engaged with the company, and businesses are increasingly recognising this. Tom Gosling, a partner at PwC, said:

There is much that is wrong with executive pay in the UK. The flaws in the current model are recognised by remuneration committees and shareholders but there is genuine willingness on all sides to move towards a better future.

Where next?

We have seen that high levels of executive pay can be counter-productive, and potentially damaging to employee engagement and business productivity. We know that the current trend of growing pay at the top and stagnating pay across the rest of the economy is unsustainable, and corrosive to our economy.

It is right that in most cases the market can set a fair level of pay based on supply and demand. Although these levels may not always be perfect they are generally about right, but in recent years there has been a fundamental market failure. This failure is most apparent at the top of the income spectrum, where under the guise of pay for performance there has been excessive pay for mediocrity.

There is now an apparent and growing need for public debate on pay. It is no longer enough simply to hope that the issue resolves itself. It is in the interest of business and wider society to settle this issue. For this reason the High Pay Centre is calling for a public debate on pay and business governance. This debate must bring together businesses, shareholders, trade unions, employees and civil society to debate what is fair pay in the 21st century.

