THE HIGH PAY COMMISSION

More for Less: what has happened to pay at the top and does it matter?

Interim report of the High Pay Commission May 2011

About The High Pay Commission

The High Pay Commission is an independent inquiry into high pay and boardroom pay across the public and private sectors in the UK. The Commission was established by Compass with the support of the Joseph Rowntree Charitable Trust.

The Commission is independent from any political party or organisation. It is non-partisan in its approach and will draw conclusions based solely on the findings of the Commission.

Over the last 30 years pay at the top has increased, and pay differentials have grown. The Commission provides an opportunity to explore and understand the drivers behind this trend and to look at its effects. It will also seek to look at reforms that could to mitigate or reduce this trend.

The Commission will run for one year from November 2010.

For more information visit:
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Commissioners

The Commissioners are business, trade union, and civil society representatives. They are drawn from a range of backgrounds and represent a cross section of political interests. All of the commissioners serve in an individual capacity and not as representatives of the organisations for which they work.

Deborah Hargreaves (Chair) is the former business editor of the Guardian, a post she held from 2006 to 2010. She previously worked at the Financial Times where she was news editor and before that, financial editor. She held a variety of posts over 19 years at the FT including personal finance editor and as a foreign correspondent in Brussels and Chicago.

Brian Bailey is the director of pensions for the £8.0 billion West Midlands Metropolitan Authorities Pension Fund. Brian has also held a number of company non-executive directorships and was for many years an audit committee member of two US private equity funds. He currently holds a non-executive directorship of PIRC Limited together with the honorary treasurer role for LAPFF (Local Authorities Pension fund Forum).

Lord Richard Newby is Co-chair of the Liberal Democrat Parliamentary Treasury Committee, having been the Party's Treasury spokesman in the Lords since 1999. He worked as Director of Corporate Affairs of Rosehaugh plc. He now advises companies and other organisations on corporate responsibility issues.

Frances O'Grady is the Deputy General Secretary of the TUC. Frances has lead responsibility for a wide range of key areas of policy development across the TUC's work including trade union recruitment and organisation, inter-union relations and TUC services to members.

Robert Talbut is the Chief Investment Officer, for Royal London Asset Management. His career in asset management has seen him take on a wide variety of portfolio management roles of both a retail and institutional nature. Prior to RLAM Robert was the Chief Investment Officer of the ISIS Group retaining direct responsibility for a number of retail and institutional funds while helping to create a new investment team.

Professor Michael Taylor was Director of Christian Aid for twelve years from 1985–97. He was closely involved in the creation of the Centre for the Study of Global Ethics and was President of the Jubilee 2000 Debt Campaign and chairs several NGOs. He is Emeritus Professor in Social Theology at University of Birmingham.

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Foreword

DEBORAH HARGREAVES,
CHAIR OF THE HIGH PAY COMMISSION

‘If leaders of big companies seem to occupy a different galaxy from the rest of the community, they risk being treated as aliens,’ said Richard Lambert, at the time director-general of the CBI employers’ lobby, in a speech a year ago.

He was referring to the vast wealth now available to the heads of companies, making them ‘seriously rich’. When even insiders start questioning established business trends, time is ripe for reform.

Since Mr Lambert gave his speech, the coalition government has embarked on the toughest round of spending cuts since the Second World War. Over the next year, these austerity measures are likely to widen the gap between the general public and the corporate elite even further.

Recent figures show that take-home pay fell for the first time in 30 years in 2010 as prices rose faster than incomes, and this trend is expected to accelerate this year. By contrast, boardroom remuneration appears immune from financial constraints and some estimates suggest it rose by 55% last year, continuing a so-called ‘arms’ race’ in pay as companies rush to reward their executives with ever greater packages.[1]

Given this background, the work of the High Pay Commission could not be more timely. The Commission was set up in November 2010 to investigate the causes of the exponential increase in high pay in the private sector and the social and economic effects of this. We are now summarising the current debate about pay before going on to conduct our own research and explore some solutions.

Discussions about earnings are extremely sensitive and any inquiry into pay at the top inevitably lays itself open to the claim that it is all about envy at the large sums involved. While there may be some prurient fascination with wealth in all its guises, as a society, we are right to be concerned if our leaders and those with a powerful influence over our daily lives have little connection with the way ordinary people live.

An international labour market has benefited those at the top by pushing up their overall remuneration while keeping down the earnings of those lower down the income scale who are competing with workers in low-wage economies. Furthermore, attempts to link top pay with company performance only seem to have resulted in pushing up remuneration, with little corresponding step up in business success.

It is important for our economy that we understand these trends and their effect on society before we seek to influence them. Existing attempts to rein in top pay have not worked; we need to explore alternatives such as improving disclosure, reforming remuneration committees and simplifying pay structures.

We need to ask whether the dramatic growth in pay at the top of our companies means we are paying more and getting less.

[1] Income Data Services (2010) Director’s Pay Report.

Executive summary

The UK's top earners are taking a bigger slice than ever of the national income.

Between 1949 and 1979 the share of income going to the top 0.1% earners dropped from 3.5% to 1.3%. Today the top 0.1% of earners take home as big a percentage of the national income as they did in the 1940s.

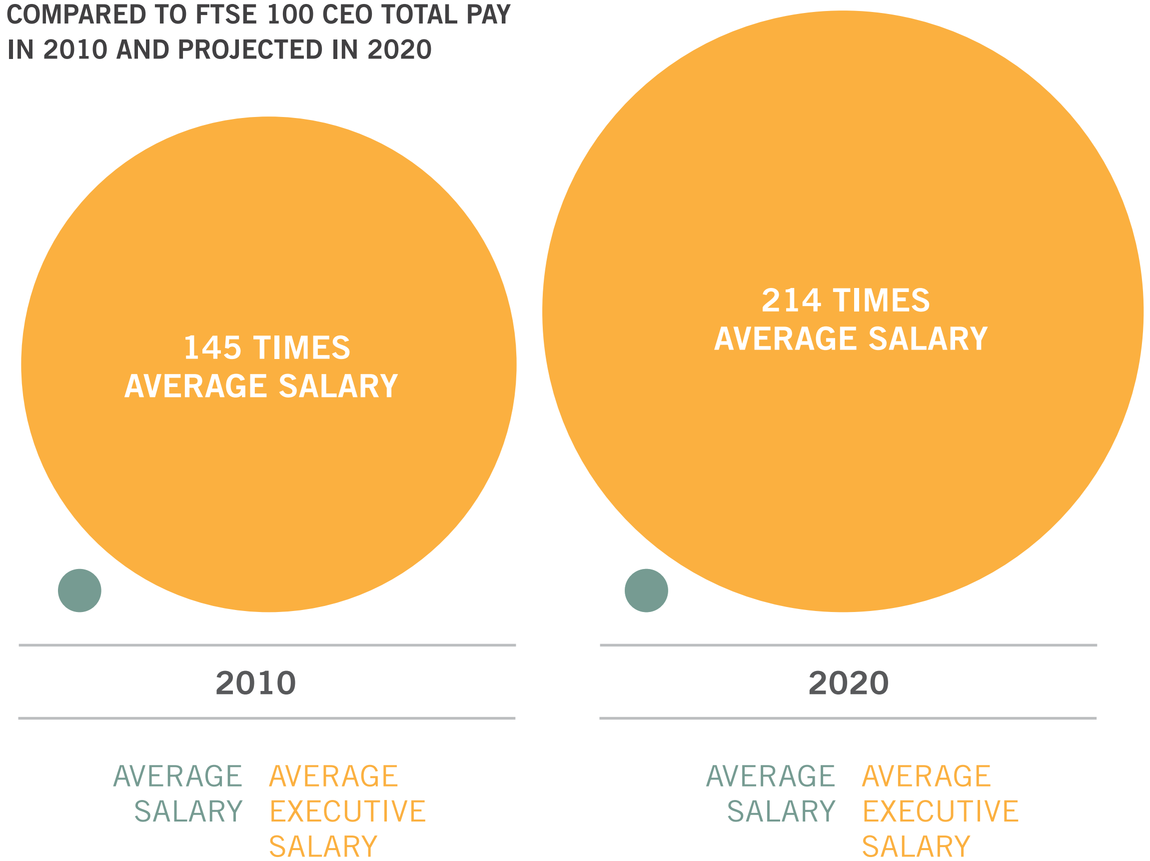
If current trends continue, by 2025 the top 0.1% of earners will take home 10% of the national income and by 2030 we will have gone back to levels of inequality not seen since Victorian England.

The winners – those who make up the lion's share of the top 0.1% earners – are finance workers (30%), those working in business (38%) and company directors (34%), with **FTSE 100 chief executives also topping the scale with average total remuneration of over £4.2 million in 2009/10.**

During the financial crisis executive pay dipped but has since begun to rise again. Last year executives in the FTSE 100 saw a 3% increase in their basic salary, compared with an increase of just 0.1% in the average wage.

If we return to trends seen before the crisis, which looks likely, by 2020 the average FTSE 100 CEO will see their pay nearly double to £8 million, while the average wage continues to stagnate. **A top executive is currently paid 145 times the average wage. By 2020 the differential will be 214 times.**

AVERAGE SALARY FOR WORKERS COMPARED TO FTSE 100 CEO TOTAL PAY IN 2010 AND PROJECTED IN 2020



High pay as a problem

60% of the public agrees, or strongly agrees, that ordinary people do not get their share of the UK's wealth.

Fairness clearly matters to people and there is consensus among the public about who deserves what in a world where pay at the top has grown rapidly while the average wage has stagnated.

Excessive rewards are undermining relationships with employees and shareholders; they are encouraging harmful risk taking and creating an economic elite which wields enormous power but appears to have lost touch with how the rest of us live.

Pay is about just rewards, social cohesion and a functioning labour market, and it is the view of the High Pay Commission that the exponential pay increases at the top of the labour market are ultimately a form of market failure.

Failure to tackle the pay issue

Businesses and Government has failed to tackle the dramatic growth in pay at the top of the income distribution amid growing public disillusionment and a hardening in attitudes towards business.

High pay in the financial sector naturally generates the strongest feelings among the British public and trust in the banking sector has plummeted. **In 1983, 90% of us thought banks were well run – better run even than the BBC or police. Now just 19% think this is true.**

But public anger over bank bonuses has not stopped **staff in 11 European banks increasing their pay by 7% in the year from 2009.**

Nor has it stopped Barclays giving bankers three times as much in bonuses as it paid investors in dividends, HSBC revealing that its highest paid banker got £8.4 million and the financial regulator, the Financial Services Authority (FSA), showing that **2,800 staff in 27 banks received more than £1 million in 2009.**

Banks are very reluctant to disclose these pay awards and this lack of transparency is an area of significant concern.

The causes

There are four causes of this dramatic growth in top pay:

ATTEMPTS TO LINK PAY TO PERFORMANCE

Performance-related pay has grown significantly and pay packages have become so complex that shareholders struggle to understand them or evaluate their true cost. The average top award that could be achieved under all share-based incentive schemes in the FTSE 100 was 328% of salary in 2010. This compares with 174% as a maximum award in 2006.

What's more, there is much scepticism about whether performance-related pay actually works – research shows high levels of scepticism, with one expert in executive remuneration arguing that **performance-related pay only works 50% of the time.**

Over the past ten years CEO remuneration has quadrupled while share prices have fallen.

Attempts to link pay to performance are a primary cause for the dramatic growth in top pay particularly for executives.

COMPANY STRUCTURES FAIL TO EXERT PROPER CONTROL OVER TOP EARNINGS

The fact that boards, remuneration committees and shareholders have failed to tackle the huge growth in pay packages shows the weakness of one of the most significant relationships in the corporate world.

Remuneration committees determine executive pay levels but many of the people on these committees have an indirect financial interest in the level of remuneration, through the process of benchmarking, and have been accused of 'cronyism'.

Committee members have been shown to be afraid of rocking the boat with shareholders and executives, and often rely on unaccountable remuneration consultants to 'cover their backs'.

The current regulation will not be effective in restraining top pay and has even been shown to be a contributory factor pushing it up.

THE LABOUR MARKET CONTRIBUTES TO INCREASING PAY AT THE TOP

Defenders of high pay talk about executives being poached by international competitors if they don't pay well enough but **only one FTSE 100 company has had its CEO poached by a rival in the last five years** – and it was by a rival British firm.

There has been a growth in the number of external appointments for CEOs but internal candidates are still most likely to be selected for top positions **(59% of CEOs in the current FTSE 100 had been part of the company for five or more years before appointment)**. The point is reinforced by executive search companies who report no growth in client demand for global searches. In the end, global mobility is limited by human habit and behaviour.

Risk is also often cited as a reason for high executive pay but the rationale must be challenged. Our survey of CEOs in the current FTSE 100 shows only six left during 2009 – **a turnover rate of 6%, which is less than half the national average.**

While jobs at the top may be very challenging they are not as high risk as many suggest – certainly not when compared with innovative entrepreneurs.

Poor succession planning within firms and the current fashion for external hiring has contributed to increasing pay packages at the top without resulting in improved individual or company performance.

THE RISE IN INDIVIDUALISM

Performance, business structures and labour markets are the main influencers of high pay but social and political trends impact on pay levels too. The British Social Attitudes Survey shows there has been a rise in individualism.

Value is measured by what you earn and own, and your quality of life is equally determined by these personal factors. This is a broad social change and the rise in pay at the top is part of the trend.

Social and cultural changes, the rise of individualism and the decline in trade union influence has also contributed to the escalation in top pay.

A fair framework for fair pay

Businesses struggle to act alone against the status quo but action on top pay is now necessary. **It is essential that business and government recognise the need to tackle the issue of rapidly increasing pay at the top.**

The High Pay Commission will continue to gather evidence and look to develop policy recommendations that can grapple appropriately with this issue.

The High Pay Commission will report finally in the autumn with detailed policy proposals. Our preliminary research has identified three key areas for policy development:

- **Transparency:** a lack of publicly available information and the general level of misinformation on the issue of pay limits the current debate. Reforms that would increase transparency and allow for more meaningful disclosure, will be considered by the High Pay Commission.
- **Accountability:** the current structures restraining pay at the top, namely the board and shareholders, have proved ineffective. It is therefore right for the High Pay Commission to consider how pay at the top can be made more accountable, potentially through reforms of the Remuneration Committees and the inclusion of other stakeholders.
- **Fairness:** The British public have a deep and ingrained sense of what is fair. When it comes to pay at the top, this is fundamentally about playing by the rules. The High Pay Commission will seek to understand further what is fair pay in a modern corporate environment and consider what reforms could engage greater fairness in relation to pay.

1 | Introduction

The absolute and relative levels of top pay in the private sector remains controversial. Uncertain economic times and the likelihood of what Mervyn King, Governor of the Bank of England, describes as a 'sober decade' mean that ever greater attention is being paid to pay. As the cuts in the public sector bite and living standards fall for the majority, this focus will only become more intense. A debate that was restricted to academia and the backrooms of companies has hit the mainstream. When times are tight, who gets what simply matters more.

Public outrage and vitriol directed at the bankers who 'got us into this mess' is overflowing and the spotlight is on the behaviour of businesses.

Pay is just one element of this – but it's an important one. Pay structures send signals about the company and its values; they affect hardening social attitudes towards big business and have an impact on public trust.

The debate around pay is also bigger than simply who gets what. It reveals wider areas of concern about our corporate governance structures, the growth of short-termism in the City and the opaque nature of some of our biggest companies and banks.

The Conservative and Liberal Democrat coalition government has called on the public to judge its time in government based on how it has dealt with the issue of 'fairness'. Fairness remains an elusive concept, particularly when it comes to pay, but it is essential to debate the issue of what is a fair reward in a modern corporate environment.

The High Pay Commission has been charged to look at what has happened to top pay and, more importantly, whether it matters and what should be done about it. This interim report acts as an audit of the current debate. It draws together key areas of discussion, which create a vivid picture of what has happened to top pay and how this influences our understanding of what is fair pay.

The High Pay Commission is looking at top pay across the private sector with a focus on executives and the financial sector.[2] Finance accounts for 30% of the top 0.1% of the income distribution scale but just 4% of the rest of the population. Company directors in turn make up a significant minority of those in the top echelons of the national pay scale – they represent 34% of the top 0.1% of highly paid individuals – those earning over (circa) £350,000 (see Table 3). With the average total remuneration of FTSE 100 chief executives including base salary, bonuses and equity awards at over £4.2 million, some of these executives earn enough to put them in the top 0.01% of the population.

Our interest in public companies is not only because many of us are owners of them through our pensions and savings but also because of their distinctly public nature. The modern corporation was born in the late 16th and early 17th centuries to explore and plunder international resources. To do this they required significant amounts of capital, which was raised collectively. Defined sections of the public – the shareholders – were the beneficial owners. Those doing the hard work – the captain and his crew – were the servants of the shareholders. The risks were high but the returns could be enormous. Critically, these companies or ventures were public rather than private affairs. They were explicitly licensed by the state.

The limited liability corporation was thus created and would prove to be an engine for discovery and enrichment. It allowed many parties to buy a 'share' in the venture. Ownership of corporations

[2] Public sector employees account for less than 1% of the top 1% of the income distribution scale. This was acknowledged in the government inquiry headed by Will Hutton, which looked at the issue of high pay in the public sector. This investigation issued its final report in March 2011 and presented 12 pay policies for fairness. The High Pay Commission will explore the applicability of these policies to pay in the private sector.

became a more collective enterprise. Sharing ownership shared the fruits of success among many and not just a few. We should recognise the significance of this history when we seek to understand pay in publicly listed companies. It is wrong to see private enterprise as distinctly separate from the public it exists in. This has never been more evident than in the banks, where private excesses led to a financial crisis that required public support in order to prevent complete collapse.

The pay of the directors of these companies is the issue the public are most concerned about. Further, executive pay and increasingly pay in the financial sector often acts as a benchmark against which the pay in other sectors is determined. It is not surprising that the senior partners in the big four accountancy firms are paid on a par with the CEOs of the companies they work for.

There has been a faster rate of growth in pay among executives than others in the top 0.1% of the earnings scale. This is partly due to the growth in performance-related pay, which has resulted in increasing complexity in top earners pay. Further, the growing use of comparator groups has contributed to an 'arms race' in pay. There are also many unanswered questions about whether attempts to link pay to company or personal performance have been successful. This is a key area of concern for the High Pay Commission and one which we will continue to explore.

Pay inflation at the top of companies creates a long tail within organisations, affecting the pay levels of those directly below the board, but having a limited impact on low or average wages. Indeed, it seems that

> *pay at the top of companies has become dislocated from the rest of the business.*

Discussions on high pay are shrouded in popular myths and a generally high level of misinformation across the population. It is very clear that the highly paid have very little idea where they sit in the income distribution scale and the 'man in the street' has limited understanding of what amounts to high pay.

We are all inclined to estimate we are nearer the middle than we actually are. In polling conducted by the High Pay Commission, only 9% of people correctly estimated that the average CEO of a FTSE 100 company was paid a total of more than £4 million. The polling also demonstrated that most people think executives are paid significantly less than they are, 4% of people thought an executive of a FTSE 100 company was paid £50,000.[3]

This makes it hard to conduct an informed debate about top pay. The general level of secrecy and the opaque nature of pay in general are of concern. However, one thing is clear; the public are not satisfied with the current situation: 62% agree or strongly agree that differences in income in Britain are too large while only 12% disagree or strongly disagree.

Any discussion on pay revolves around the three-point mantra of attracting, retaining and motivating staff. While pay decisions for those at the top still involve this, it fails to explain the dramatic increase in recent years. Experts have identified no fewer than 16 theories explaining executive pay rises including everything from CEO entrenchment to a global market for talent.[4] In this report, the High Pay Commission looks at these explanations and draws attention to four distinctive issues:

- pay and performance: how attempts to link pay to performance have led to a sharp growth in executive remuneration with little corresponding corporate success
- pay and business structures: the role played by the board, shareholders and company size in determining top pay
- labour markets at the top: how does the competitive labour market function at the top and the effect of this on pay
- social and political factors: how the social and political environment has affected pay.

It is often suggested that pay at the top is the result of a functioning labour market, suggesting particularly in relation to pay and performance that high levels of remuneration should be accepted if they are linked to performance. However, our research has shown that at the top of the income scale the labour market is not working effectively. Pay it seems is not being effectively linked to performance and the business structures that form the basis of our economy are unable to exert effective influence. This not only raises concerns over pay, but also runs to the heart of our economy.

When it comes to pay there is no golden bullet, easy solution or even easy explanation. What has driven top pay varies across sectors, industries and individual companies. However,

> *this growth in top pay is unsustainable: if it continues at the current rate, executive pay will have doubled in ten years while median and bottom wages will continue to stagnate and the gap will grow.*

At the moment, executives are paid on average 145 times the median wage; if this trend continues in ten years they will be paid 214 times the median wage.

[3] Polling conducted by Ipsos Mori in November 2010 for the High Pay Commission.

[4] J. Otten, 'Origins of Executive Pay and Corporate Governance Reform Codes: essays on an institutional approach to corporate governance', 2007, Utrecht University, http://igiturarchive.library.uu.nl/dissertations/2007-0515-200203/index.htm.

2 | Why pay matters

Fairness is important to people. It is part of our DNA. That is why what people are paid matters. Pay reflects the outcome of both a written and unwritten contract between payer and payee. But it is not a neutral or value free transaction. It is loaded with perceptions about fairness, value, worth, status and much more. Research indicates that in general there is a consensus among people about who deserves what. The entrepreneur is deemed worthier than the bank trader. Earning is seen as more deserving than gambling. Stewardship of large bureaucracies is less valued than the genius of an actor, painter or Formula 1 racing driver. And today in 2011 it is clear that people are concerned about what has been happening to the pay of those people, the stewards, at the top of our largest private sector organisations. For it is clear that pay at the top has escalated dramatically since the 1980s and despite the crash seems to demonstrate no signs of stopping.

Understanding why this has happened is only one element of the debate; another is why it matters. There is a clear public interest in the issue – but is that enough to justify action?

Top pay is about more than the standard mantra of attracting, retaining and motivating. Pay is about just rewards, social cohesion and a functioning labour market.

It is the contention of this report that rather than perfect examples of fine working machines markets tend to fail. Monopolies can accrue. This is why intervention and regulation are so important in order to help markets work more effectively. This is never more true than over the labour market where a host of regulations on working time, minimum wages, equal treatment of women and men, and the resolution of conflict are in operation.

The exponential increase in pay at the top of the labour market is a form of market failure – where normal rules of competition have been suspended and where the elongation of differentials actively hinders rather than helps firms perform optimally. When pay stops being perceived as fair, where the majority of citizens and stakeholders do not consider those at the top to play by the rules, intervention is required. Fair pay matters to companies, the economy and society.

To companies

Fair pay within companies can have a positive effect on public attitudes, employee engagement and relationships with shareholders and stakeholders.

The 18% bonus awarded to the CEO of John Lewis in 2011 was welcomed universally, because it was accompanied by an 18% bonus for the rest of the staff. While 18% of the CEO's wage may be a significantly larger amount in real terms than 18% of the cashier's wage, it is clear, transparent and linked to the success of the business.

Pay at the top as well as pay at the bottom sends out messages about the company's values.

Successful companies depend on the support of their workers and the general public. Increasing criticism of the pay practices in companies has a detrimental effect on trust among both employees and the public.

[5] L Elliott, 'CBI's John Cridland: "There is a sense of urgency about making Plan A work"', Guardian, 15 April 2011, http://www.guardian.co.uk/business/2011/apr/15/john-cridland-sense-of-urgency-plan-a-work.

Unfair rewards can damage corporate and personal reputations, undermine relationships with employees and shareholders, and contribute to a cynical attitude towards business;

a feeling that business leaders are 'in it for themselves' pervades all discussions on the behaviour of businesses. Indeed the current Director General of the CBI, John Cridland, pointed out in an interview that 'businesspeople are about as popular as estate agents. That's not a good space to be in.'[5]

According to the British Social Attitudes (BSA) Survey, trust in business has declined; the number of people with very little or no confidence in business at all has risen from 19% in 1998 to 26% in 2008, and the number of people with 'some confidence' in business has fallen from 62% to 55%.[6] According to Richard Lambert, former Director-General of the CBI, the depletion of trust is not recent, but part of a reaction to the 'unsettling' developments in capitalism over the last 20 years.[7]

Employee engagement is one of the most important factors of a successful business. However, our initial research has suggested that large pay disparities within a company have an impact on employee engagement.[8] Those who head our biggest companies have a responsibility to their workers and to the society they sit within. We should be demanding ethical leadership from our captains of industry regarding pay at the top.

This decline in trust and support for businesses is accompanied by views that businesses serve the interests of managers rather than workers. Andrew Witty, the CEO of GSK, in an interview for the Guardian argues that one of the reasons for the increasingly cynical attitude towards business is that companies have 'allowed themselves to be seen as being detached from society'. The public reaction to this is most evident in the popular protests of campaign groups such as UK Uncut.

Executive remuneration further raises questions about the relationship between directors, their shareholders and other stakeholders.

Perhaps most importantly it forces us to ask what we expect from businesses, and the people who lead them.

[6] British Social Attitudes Survey (2010)
[7] Richard Lambert, former Director-General of the CBI, RSA/Sky Sustainable Business Lecture Series, 30 March 2011.
[8] The High Pay Commission is conducting a series of focus groups with employees. The full results of these focus groups will be published at a later date.

To the economy

'In judging whether corporate America is serious about reforming itself, CEO pay remains the acid test. To date the results aren't encouraging,' said Warren Buffett in his letter to shareholders of Berkshire Hathaway in February 2004.

The impact of pay practices on our economy is most clearly exemplified in the financial sector. The link between risk and reward led the September 2009 meeting of the G20 leaders to conclude they were 'committed to act together… to implement strong international compensation standards aimed at ending practices that lead to excessive risk taking'.[9] Indeed it is argued that soaring pay in the banking sector encouraged traders to discount risk and that stock-option bonuses goaded financial services companies to use leverage to boost returns, and traders were given "aggressive incentives" to discourage them from defecting.[10]

Successful banks and companies are vital to the health of the UK economy. Companies should attract, retain and motivate their staff and pay is an essential element in doing this. But how we pay individuals affects the way they behave. Paying bonuses to bankers for taking big risks in the financial sector can have devastating consequences, just as tying pay to quarterly financial performance targets can encourage a short term attitude among executives.

Pay policies also drive labour market trends. The huge pay packages on offer in the City have resulted in the 'best and brightest' being attracted to the financial sector.[11] This means they are not working in other sectors such as engineering, or indeed regulatory bodies and the public services.

The growth in pay in one specific sector namely finance in the City in turn helps to create a London-centrism and could be impacting on regional economic disparity. Pay does not occur in isolation; it is a result of wider economic and social trends and in turn creates its own trends, asset bubbles and sectoral imbalances.

For executives, there remain significant questions about how pay has been linked to corporate performance. The initial findings of the commission suggest that attempting to link pay to performance has not resulted in the creation of long-term shareholder value or the economic stability that many desire.

[9] Basel Commission on Banking Supervision, Enhancements to the Basel Framework 25–27, 2009; Leaders' Statement.
[10] Financial Crisis Inquiry Commission (2011) Financial Crisis Inquiry Commission Final Report.
[11] R.H. Frank and P.J. Cook, The Winner-Take-All Society: why the few at the top get so much more than the rest of us, Penguin, 1998.

To society

Income distribution matters; it has social as well as economic effects and the growing disparity between the top and the middle, let alone the top and the bottom, has an impact on social cohesion. While discussion of pay at the top is often dismissed as the politics of envy, the issues go deeper than this.

There is an underlying public unease about the level (absolute and relative) and structure of pay. The dramatic growth of pay at the top has created an economic elite, which appears to 'float free' from the rest of society; its members are more likely to have private health care, send their children to private schools or live in a private gated community separate from the rest of society. As the heads of companies, these people have enormous influence and power over our lives, and yet they seem to have lost touch with how the rest of us live.

Will Hutton in his Fair Pay Review, commissioned by the coalition government, called for pay as 'due desert' for discretionary effort, rather than luck. Individuals should face the consequences of their choices and effort, but not be rewarded or punished for brute luck or circumstances beyond their control. He argued that pay must reflect the importance of the job and the performance of the post holder.

The question that remains unanswered is what is fair pay in our modern corporate environment? According to the 2008 BSA Survey, 60% agree or strongly agree that ordinary people do not get their fair share of the nation's wealth while only 12% disagree or strongly disagree (see figure 2).

As a result of dramatic shifts in income distribution, median wages have remained relatively static, despite 15 years of sustained economic growth, while top incomes race away. Despite economic growth standards of living have not improved for the vast majority. It appears not just that the rich are getting richer but they are doing so at a cost to the rest of society. The distribution of the rewards of economic growth has focused at the top. As we enter a period of lower economic growth and austerity, it is not clear whether we will also all share the pain; indeed last year we saw a growth in executive pay that well outstripped average earning increases.

The effect of this growing gap on social well being, cohesion and happiness is well charted and indeed many people believe that there is one rule for the rich and another for the poor: 58% of people either agree or strongly agree that there is one rule for the rich and another for the poor, while only 18% disagree or strongly disagree (see figure 1).

There is more than ever a clear public interest not in quick fixes, but in a permanent reform of our pay structures.

FIGURE 1 **BSA SURVEY 2004-2008 RESPONSE TO STATEMENT: 'THERE IS ONE LAW FOR THE RICH AND ONE FOR THE POOR'**

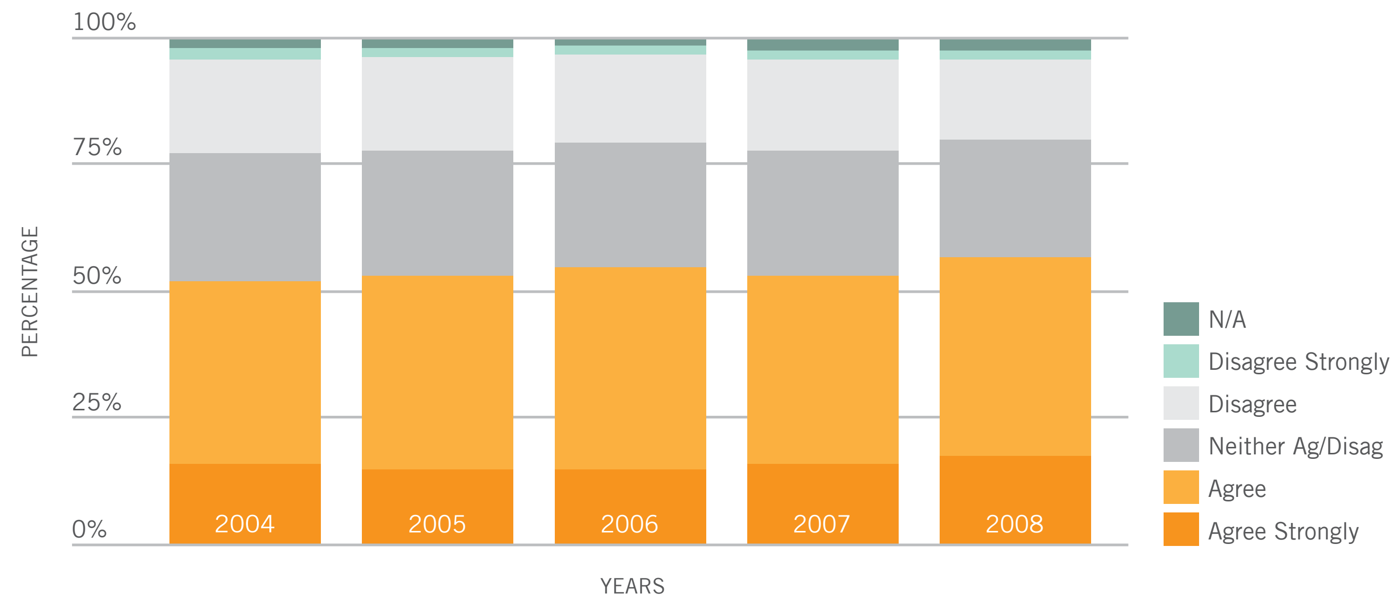
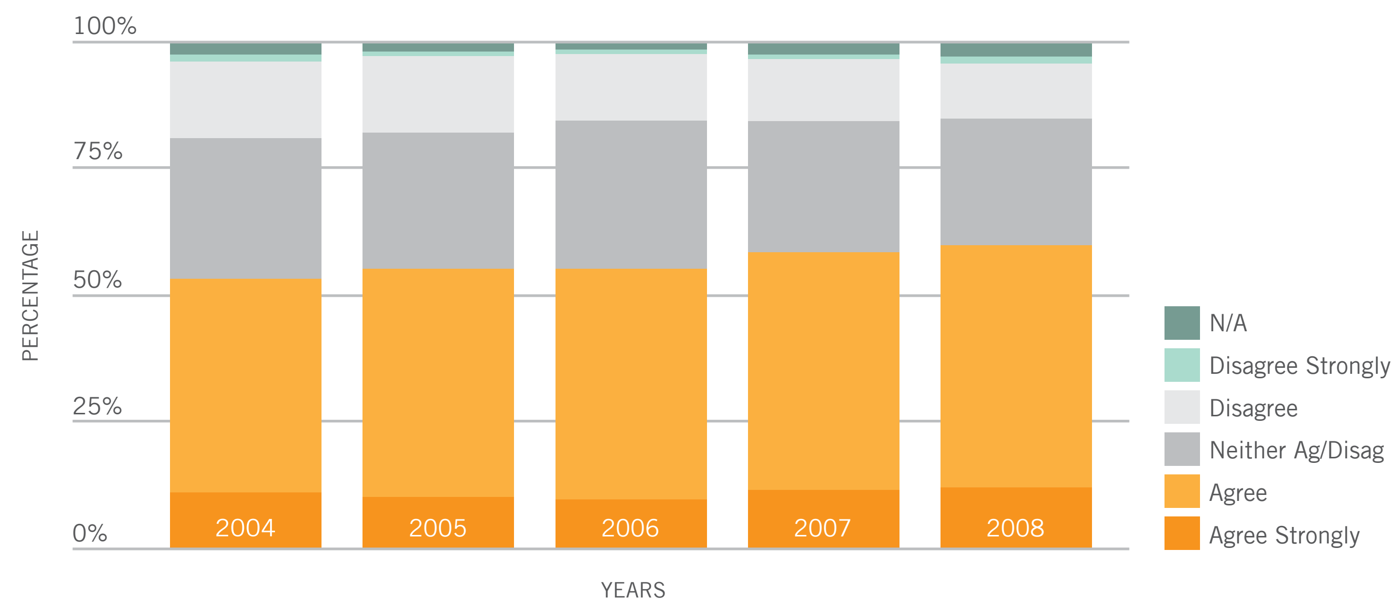


FIGURE 2 **BSA SURVEY 2004-2008 RESPONSE TO STATEMENT: 'ORDINARY WORKING PEOPLE DO NOT GET THEIR FAIR SHARE OF THE NATION'S WEALTH'**



3| The state of pay

What has happened to top pay?

In recent years there have been significant changes in pay as wages at the top of the income distributions have increased rapidly in relation to the rest of the population.

During the post-war period from 1949 to 1979 the share of personal income going to those in the top 10% decreased. The share of Britain's personal income going to the top 0.1% declined from 3.5% in 1949 to 1.3% in 1979. In the following 30 years, however, this process has been thrown into reverse to such an extent that now personal income shares are comparable to those in the late 1940s. By 2000 the total share of the top 0.1% was 4.6%.[12]

In the UK the 1980s were a period of rising income inequality. The incomes of those in the top percentiles grew at a faster rate than percentiles in the middle, and those in the middle percentiles experienced faster growth than those in the bottom percentiles. This trend continued into the early and mid-1990s.[13]

Under the Labour government from 1997 to 2010, inequality continued to grow as measured by the Gini co-efficient; however, there was a slightly faster relative growth in income for those in the bottom of the income distribution than under the previous Conservative government. At the same time, the incomes of those in the top 10% of the income distribution increased rapidly, while the pay of those in the middle of the income distribution remained relatively static in real terms.[15] In this period the income of those in the bottom quartile started to catch up with that of those in the middle, but the income of those at the top continued to race away.

Analysis by the High Pay Commission shows that between 1997 and 2007/8 income for the top 0.1% of the population grew by 64.2% while the income of a person in the 50th percentile only grew by 7.2% over the same period (see table 1). The income of those at the top has increased dramatically in relation to the rest of the income distribution.

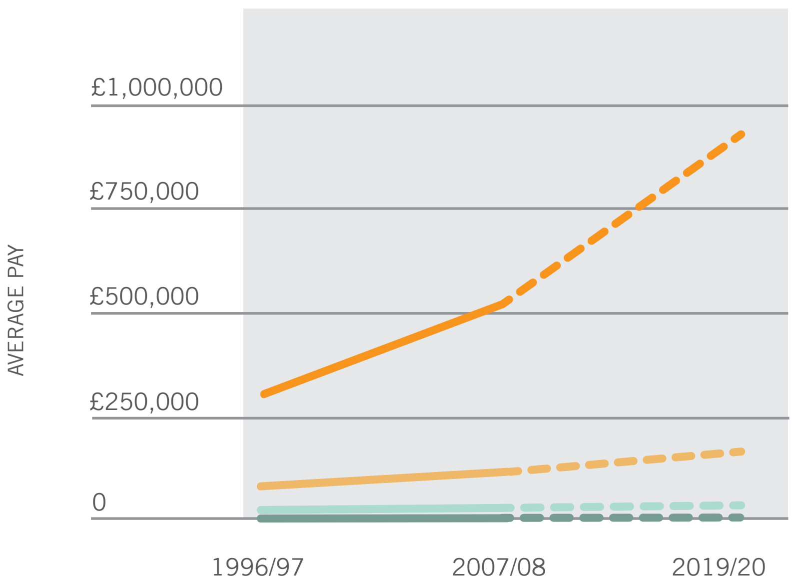
TABLE 1 **GROWTH IN REAL INCOMES AT DIFFERENT POINTS IN THE INCOME DISTRIBUTION, 1996/7 TO 2007/8**[14]

Percentile	Overall growth	Per year growth
10.0	3.7%	0.3%
25.0	5.2%	0.5%
50.0	7.2%	0.6%
75.0	9.3%	0.8%
90.0	13.1%	1.1%
95.0	16.1%	1.4%
96.0	18.2%	1.5%
97.0	20.9%	1.7%
98.0	26.6%	2.2%
99.0	34.3%	2.7%
99.1	34.5%	2.7%
99.2	35.8%	2.8%
99.3	36.7%	2.9%
99.4	38.5%	3.0%
99.5	40.4%	3.1%
99.6	41.9%	3.2%
99.7	46.1%	3.5%
99.8	53.5%	4.0%
99.9	64.2%	4.6%

If these trends continue, wages for those in the top 0.1% will almost double to nearly £1 million by 2020 (see figure 3), while wages of a person in the 50th percentile will increase from £17,100 to just £18,700.

[12] A.B. Atkinson and T. Piketty, Top Incomes over the Twentieth Century, Oxford University Press, 2007.
[13] IFS, Racing Away, Institute for Fiscal Studies, 2009.
[14] High Pay Commission Calculation using SPI HMRC data. Note: the RPI index has been used to translate figures in to real terms.
[15] IFS, Racing Away.

FIGURE 3 PROJECTED GROWTH IN INCOME GAP BETWEEN TOP PERCENTILE EARNERS AND EARNERS IN THE 50TH PERCENTILE[16]



	1996/97	2007/08	2019/20
99.9th percentile	328000	538600	901600
99th percentile	95700	128500	178400
90th percentile	36700	41500	47600
50th percentile	16000	17100	18700

[16] Based on High Pay Commission calculations using SPI HMRC data.
[17] High Pay Commission analysis of SPI HMRC data. Figures in 2007/8 prices. All figures based on SPI data relate to "earned income" which includes: income from employment, profits from self-employment and income from pensions (including state retirement pension). Note on SPI data: As part of the anonymisation process for the SPI, composite records have been created on the Public Use Tape dataset. For example, in 2007-08 104 such records were created from 3,130 sample cases and accounted for 32k individuals in the population. These composite records have been created by combining sample cases toward the top end of the income distribution. This results in a slight loss of precision for estimates above percentile 99.3.

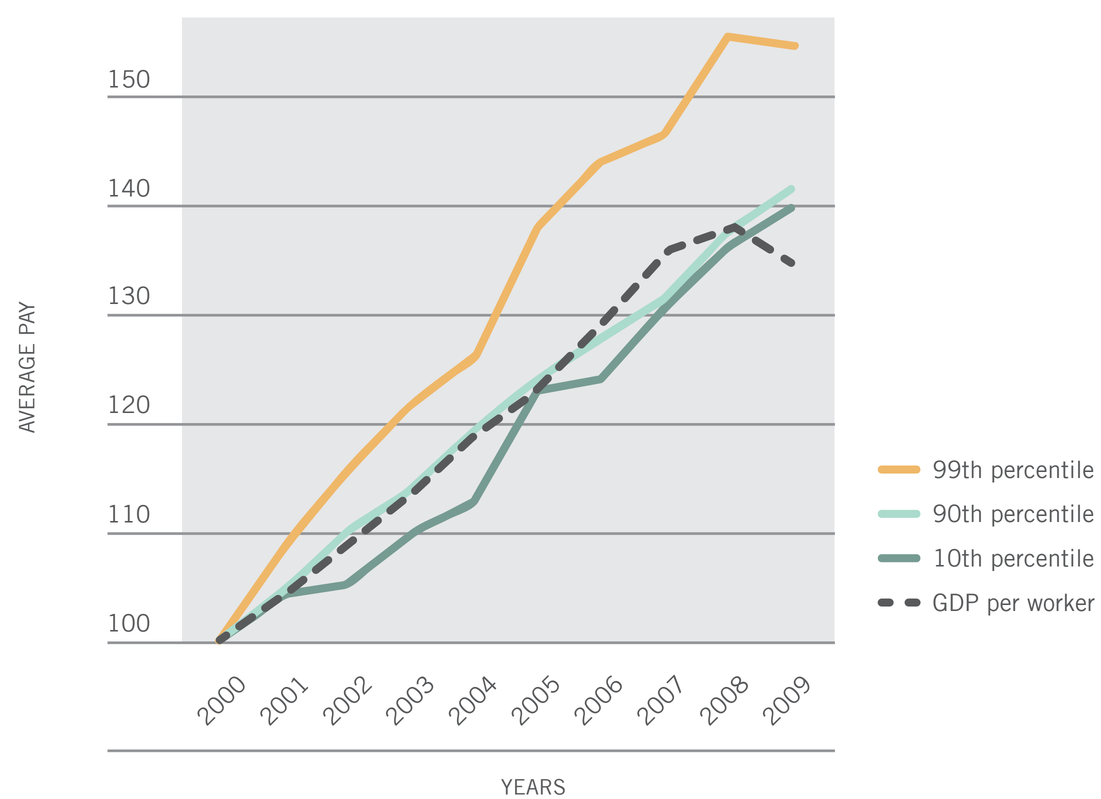
TABLE 2 INCOME TAX PAYERS INCOME BY PERCENTILE[17]

Percentile	1996/7	2007/8
10.0	£6900	£7200
25.0	£10000	£10600
50.0	£16000	£17100
75.0	£25100	£27500
90.0	£36700	£41500
95.0	£47900	£55600
96.0	£52200	£61700
97.0	£58800	£71100
98.0	£69700	£88300
99.0	£95700	£128500
99.1	£101100	£136000
99.2	£107000	£145200
99.3	£114200	£156100
99.4	£122700	£170000
99.5	£134600	£189000
99.6	£152300	£216200
99.7	£178000	£260100
99.8	£223400	£343000
99.9	£328000	£538600

TABLE 3 WHERE 'HIGH-INCOME' INDIVIDUALS WORKED 2004/5[18]

	All taxpayers	Top 10–1%	Top 1–0.1%	Top 0.1%
Company directors	3.40%	9.70%	24.20%	34.60%
Proportion working in the following industries				
Financial intermediation	4.30%	7.20%	16%	30.20%
Real estate, renting and other business activity	15.60%	21.50%	30.50%	38.50%
Public administration and defence	5.50%	7.20%	1%	0.30%
Education	10.70%	11.10%	1.80%	0.30%
Health and social work	10.20%	6.80%	15.50%	3.60%

FIGURE 4 GROSS ANNUAL EARNINGS OF 99TH, 90TH AND 10TH PERCENTILES AGAINST GDP (INDEXED, 2000=100)[19]



[18] Based on IFS Report Racing Away Rich: All data are presented at the adult level and for Great Britain only. IFS calculations based on SPI 2004/5.
[19] Fair Pay Review analysis of Annual Survey of Hours and Earnings (ASHE). GDP figures from HM Treasury. Note that the relationship between earnings and GDP can change over the course of an economic cycle, which can make inference difficult through time. This chart makes no attempt to adjust for these changes.

Executive pay

Executive pay in the UK has rapidly increased in the past 30 years, after remaining relatively flat in the preceding 30 years.

During the 1980s and 1990s executive pay increased swiftly, leading to significant further growth in the 2000s. Between 1983 and 1986 the average pay for an executive of a large public company was £77,000; by 1998 pay for an executive in the FTSE 100 was over £1 million. Since then pay has increased by 67% to reach £3.7 million (see figure 5) in 2009 or £4.2 million, depending on the method of analysis used.[20]

Accurate data on executive pay is limited before the late 1990s but the evidence suggests this trend emerged at the beginning of the 1980s. Between 1949 and 1979 executive pay grew by 0.8% per year on average. Over the last ten years annual growth has been closer to 7%.[21]

High pay in the private sector and executive pay are not synonymous. However, 34% of the top 47,000 adults who make up the top 0.1% of the income distribution are company directors (see table 3). Executive pay often acts as a benchmark for those within companies and the accountancy firms or law partnerships that provide services for them. It is not surprising that the heads of PWC, Ernst & Young Deloitte and KPMG earn the equivalent of the executives of the companies for which they provide services.[22]

Many top executives sit at the upper end of the income distribution chart; they are highly paid even within the top 0.1% of earners. On average FTSE 100 CEOs received a total reward of £4,248,657 in 2009/10, according to Incomes Data Services, which puts them at the very top end of the pay distribution scale.[23] Indeed this would be enough to put any CEO into the richest 0.01% of adults (about 5,000 adults).

Who is an executive?

Executives are the highest-ranking corporate officers running the company.

What is executive pay?

Executive pay is made up of a base salary, on top of which a bonus is awarded. This is joined in most cases by a long-term incentive plan (LTIP), which is usually an award of shares, as well as other perks such as payment into a pension plan. There is some difference between analysts over how to calculate the value of share awards, for example, which is why there are often different figures for the total.

Even the average base salary of executives in the FTSE 100, which in 2009/10 stood at £824,046, would put them well above the average of those 0.1% of earners. Move outside the FTSE 100, and while rewards for executive are lower, the average CEO of a mid cap company still took home £734,624 in cash in 2010, which would have been supplemented by share schemes and long-term incentive plans.[25]

The upward trend in executive pay is clearly defined – despite the differences in measuring the data. The largest increases appear to have occurred in 1999/2000 and 2000/1, with real rises in excess of 10% per annum. These are even larger than the annual real-terms increases of around 6.8% for the richest 0.1% of the population.[26] It has been suggested that the cause of this increase could be accounted for by the rise in the economic value of companies and the inflating of the 'dot-com' bubble.

Even within the FTSE 100 there has been a much faster rate of increase at the top than across the whole of the FTSE 100. The top 10% of pay packages has increased by 214% between 2002 and 2009 (see table 6).

During the financial crisis there was an initial dip in executive pay, as demonstrated in figure 5. However, since the crisis pay has begun to rise again; between 2009 and 2010 the salaries of CEOs in the FTSE 100 increased by 3.1% and their cash bonus increased by 4.4%.[27]

TABLE 4 **PERCENTAGE INCREASE IN CEO AND AVERAGE WORKER REMUNERATION, 1999–2009[24]**

Year	Increase in earnings for CEOs (%)	Increase in average earnings for other workers (%)
2000	37	6
2001	7	5
2002	44	3
2003	7	4
2004	11	4
2005	7	4
2006	0	3
2007	17	3
2008	2	5
2009	-5	3
Total	203	45

[20] Data on executive pay before 1998 is difficult to obtain as companies only started to publish this information then. Estimates on total executive pay vary significantly because of the difficulties in accurately estimating the true value of the equity based aspects.
[21] C. Frydman and R. Saks, Executive Compensation: a new view from a long-term perspective 1936-2005, 2007.
[22] A PWC senior partner took home £3.3m plus bonus in 2009; see http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6823182.ece. A Deloite senior partner took home an estimated £5.2m in 2009; see www.dailymail.co.uk/money/article-1204279/Deloitte-boss-rakes-5-2m-bailout-RBS.html. John Griffith-Jones, the UK chairman of KPMG, received £2.3m for 2009; see www.dailymail.co.uk/money/article-1339281/KPMG-partners-counting-good-fortunes-pay.html#ixzz1la7jDJjA.
[23] Based on Income Data Services calculation on average total income of the FTSE 100.
[24] High Pay Commission calculation based on ASHE data for average pay and Manifest data on executive pay.
[25] Calculations provided by PIRC.
[26] P. Gregg, S. Jewell and I. Tonks, 'Executive pay and performance in the UK 1994–2002', CMPO Working Paper 05/122, 2005, www.bristol.ac.uk/cmpo/workingpapers/wp122.pdf.
[27] High Pay Commission calculations based on average salary increases in the FTSE 100.

TABLE 5 **REMUNERATION OF CEO COMPARED WITH AVERAGE YEARLY EMPLOYEE PAY 1998-2009**[28]

Year	Average CEO remuneration per year	ASHE data (average pay) per year	Multiple
1998	£1002441		
1999	£1234983	£17803	x69
2000	£1686973	£18848	x90
2001	£1805717	£19722	x92
2002	£2599143	£20376	x128
2003	£2786143	£21124	x132
2004	£3087023	£22011	x140
2005	£3304533	£22888	x144
2006	£3308814	£23554	x140
2007	£3876921	£24043	x161
2008	£3958000	£25165	x157
2009	£3747000	£25816	x145

[28] MM&K and Manifest Data on executive pay compared to Annual Survey of Hours and Earnings data on average employee pay.
[29] MM&K and Manifest Data on executive pay. Data taken from Manifest, The Executive Director Total Remuneration Survey 2010, September 2010. Note that data from 1998 to 2001 may not be directly comparable with data from 2002 to 2009. 1998–2001 data include new recruits and internal promotions.

FIGURE 5 **TOTAL EXECUTIVE REMUNERATION**[29]

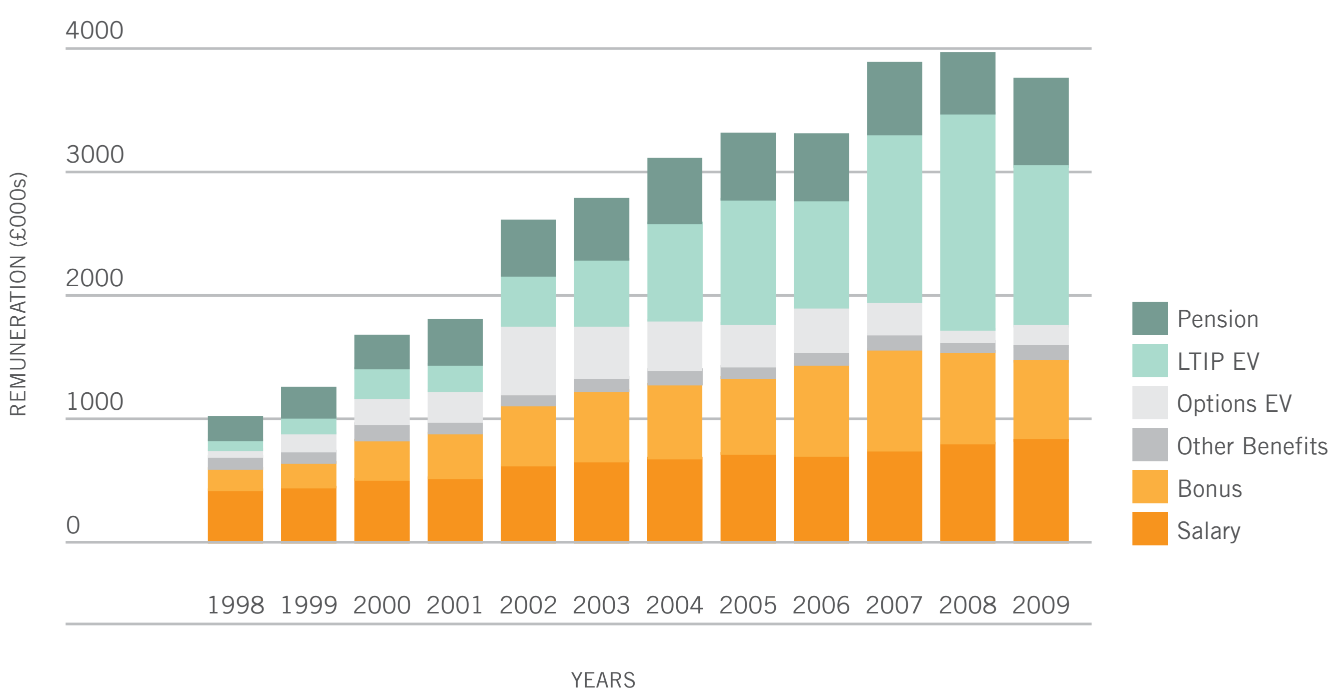
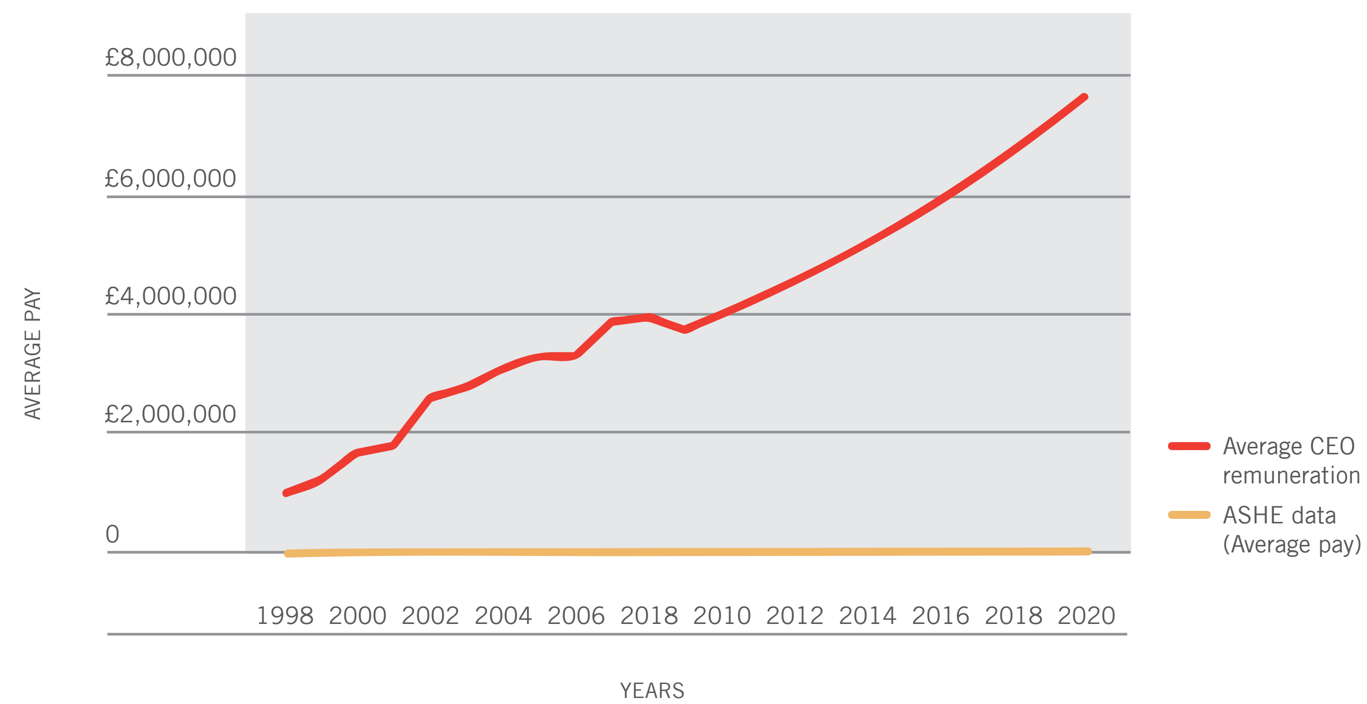


FIGURE 6 **PROJECTED GROWTH OF AVERAGE CEO PAY IN THE FTSE 100 COMPARED TO AVERAGE EARNINGS**[32]



There has been a slightly slower bounce back to growth for mid cap firms, with total cash rewards growing by 1.9%. Over the same period, average annual earnings for full-time employees increased by just 0.3%.[30] If we return to previous rates of increase, next year the gap between top executives and workers will have returned to the rate that existed before the crisis. If this continues trend continues by 2020 executives will be paid 214 times the average wage receiving nearly £8million (see figure 6)

The interim report of Will Hutton's Fair Pay Review highlights that top executive pay in the UK rose by eight times between 1986 and 2010 – an even faster rate than in the US.[31]

TABLE 6 **AVERAGE EARNINGS THE TOP 10% OF EARNERS IN THE FTSE 100, 2002/3–2008/9**[33]

Year	
2002/3	£5236000
2003/4	£5140000
2004/5	£6368000
2005/6	£10349000
2006/7	£11418000
2007/8	£12621000
2008/9	£16427000
Total percentage increase	214%

[30] ASHE, Statistical Bulletin: 2010 Annual Survey of Hours and Earnings.
[31] W. Hutton, Hutton Review of Fair Pay in the Public Sector, 2010.
[32] High Pay Commission calculation of projected growth based on assumption of equivalent growth over the past ten years. Based on figures from the Annual Survey of Hours and Earnings (ASHE).
[33] High Pay Commission calculation based on Income Data Services data on top ten executive pay packets.

International comparisons

Comparing data across countries is notoriously difficult, but there are a few things we do know:

- Executive pay in the UK is significantly higher than that in the rest of Europe and is lower than the levels in the US, even when company size is taken into account. US CEOs have higher compensation and much higher incentives.[34]
- The gap between executive pay in the UK and the US has decreased. In 1997, US CEO pay was 2.2 times that of the UK; by 2003 about it stood at about 1.6 times. In 1997, US CEO incentives were about 8.4 times those of the UK, but this had narrowed to 5.2 times in 2003. This shrinking of the gap in basic salary and incentives represents an increase in UK CEO pay.[35]
- In 2006, US CEOs received total compensation that was on average 170% higher than the compensation received in 26 other countries.[36]
- In 2007, in the US, the salaries of S&P 500 CEOs averaged $10.5 million or 344 times the pay of the average US worker.[37]
- From 1992 to 2002, the average CEO pay in US S&P 500 firms rose by a factor of 3.5.[38]
- From 1995 to 2007, the average executive pay in German DAX30 firms stepped up by a factor of 4.6.[39]
- From 2002 to 2006, the average executive pay in Swiss firms increased by a factor of 2.1.[40]

[34] Conyon, Core and Guay, How High is US CEO Pay?
35 Conyon, Core and Guay, How High is US CEO Pay?
[36] N. Feanandes et al, The Pay Divide: (why) are US top executives paid more?, European Corporate Governance Institute, 2009.
[37] According to the 2008 CEO compensation report from United for a Fair Economy, www.entrepreneur.com/magazine/entrepreneur/2009/february/199680.html.
[38] M.C. Jensen, K.J. Murphy and E.G. Wruck, 'Remuneration: where we've been, how we got to here, what are the problems, and how to fix them', Negotiation, Organizations and Markets Research Paper Series, Harvard Business School NOM Research Paper 04-28, 2004.
[39] J. Schwalbach, Vergütungsstudie 2008: Vorstandsvergütung und Personalkosten der DAX30 – Unternehmen, 1987-2007, Institut für Management, Humboldt-Universität zu Berlin, 2008, www2.wiwi.huberlin.de/institute/im/_html/verguetungsstudie_2008_140408.pdf.
[40] K. Rost and M. Osterloh, 'Management fashion pay-for-performance for CEOs', Schmalenbachs Business Review, 61 (4), 2009, 119–49.

Pay in the financial sector

Doesn't it make you angry that the banks have been allowed to ride roughshod over our economy, and are still handing out bonuses by the bucket-load?

Nick Clegg, Deputy Prime Minister, preface to the Liberal Democrat Manifesto 2010

Top pay in the financial sector alone accounts for 30% of the top 0.1% of the income distribution scale and this pay has attracted the most public attention. This is partly because of the absolute amounts in question, which at a time of austerity jar with public opinion.

Some of the awards are undoubtedly large. It would take the average person 11 lifetimes to earn the £14 million believed to have been paid to Rich Ricci at Barclays in just one year.[41] But on top of this fascination with the aggregate amounts, the number of millionaires created, and the obsessive accounting of who got what, a deep sense of injustice pervades. Indeed, as Mervyn King, Governor of the Bank of England, stated, 'The price of this financial crisis is being borne by people who absolutely did not cause it.'

It seems that in many ways the public has lost patience. In 1983, 90% believed banks were well run, and their reputation for being well managed was higher than in many other institutions, including the police and the BBC. Now just 19% think banks are well run.[42]

The links between the financial crisis and pay in the financial sector have been presented in many reports of the crisis. The Financial Crisis Inquiry Commission (FCIC) conducted in the US reported that one of the causes of the crisis was 'dramatic breakdowns in corporate governance, with too many firms acting recklessly and taking on too much risk', combined with lax regulation and compensation that 'too often rewarded the quick deal, the short-term gain' and 'encouraged the big bet'.[43]

While in most businesses top pay refers to that awarded to boardroom executives, in banks it is very often the case that the highest earners are below board level, although the executives themselves are also well rewarded.

Recent board changes have exacerbated this: Stuart Gullivar replaced Mike Geoghegan as chief executive at HSBC and his pay increased to an estimated £9.8 million; estimates of the pay for Bob Diamond, boss of Barclays, put him on £8 million, over double the amount taken home the previous year by his predecessor and well above that of the average chief executive. The new CEO of Lloyds will be awarded £8.3 million

[41] Calculation by the High Pay Commission based on average wage according to ASHE and an average working life of 40 years.
[42] British Social Attitudes Survey, 2010.
[43] Financial Crisis Inquiry Commission (2011) Financial Crisis Inquiry Commission Final Report

[44] S. Bowers, 'Lloyds' new chief in line for 'golden hello' package worth millions', Guardian, 17 January 2011, www.guardian.co.uk/business/2011/jan/17/lloyds-banking-group-bonuses.
[45] J Treanor, Lloyds Banking Group forced to admit scale of millionaire staff', Guardian, 31 January 2011, www.guardian.co.uk/business/2011/jan/31/lloyds-bank-bonuses-pay-fsa-code.
[46] J Treanor, 'HSBC sets pace on pay disclosure as it reports profits doubled in 2010', Guardian, 28 February 2011, www.guardian.co.uk/business/2011/feb/28/hsbc-profits-double-almost-twelve-billion-pounds.
[47] J Treanor, 'Almost 3,000 City staff took home more than £1m last year, says FSA', Guardian, 29 July 2010, www.guardian.co.uk/business/2010/jul/29/fsa-toughen-city-pay-code-bonuses.
[48] B. Bell and J. Van Reenen, Bankers' Pay and Extreme Wage Inequality in the UK, 2010.
[49] D. Thomas, R. Armstrong and D. Clarke, 'Bank pay creeps over uneven regulation', Reuters, 2010, http://us.mobile.reuters.com/article/businessNews/idUSTRE7211X520110302.
[50] Thomas, Armstrong and Clarke, 'Bank pay creeps over uneven regulation'
[51] T Bawden and J Treanor, 'HSBC doubles salaries to beat clampdown on big bonuses', Guardian, 16 November 2010, www.guardian.co.uk/business/2010/nov/16/hsbc-bank-bonuses-goldman-sachs.

in annual pay, bonuses and pension contributions, which will come on top of a 'golden hello', which some estimates put at £5 million.[44]

However, this compensation pales in comparison with the amounts awarded to those high up in the bank who are not members of the board. In Barclays, the top five non-board executives have been awarded a combined total of £49 million in salary, bonuses and long-term incentive plans in 2010. **The top-paid banker will receive £14 million, nearly four times the amount awarded to the then CEO John Varley, and 1,128 times the amount taken home by the lowest-paid member of staff.**

Lloyds revealed that up to nine of its employees earned more than the £3.4 million paid to CEO Eric Daniels.[45] And HSBC revealed that its highest-paid banker was paid more than £8.4 million.[46] The financial regulator, the FSA, says that more than 2,800 bank staff received more than £1 million in 2009 across 27 banks.[47]

It is argued by academics that over the last ten years pay in the financial sector is accounting for a larger proportion of the pay increase at the top than in previous years.[48]

The public anger over bank bonuses has not significantly affected total pay in the sector as in 11 European banks staff costs last year totalled $164.5 billion, up 7% from 2009, according to an analysis by Reuters, with staff costs rising at all but two firms.[49] Anger about bonuses seems to have had the effect that a greater amount of pay is now awarded in fixed salary as opposed to discretionary bonus, while more bonuses are being paid in shares rather than cash. Investment bankers across the globe are now getting a higher level of fixed pay:[50] HSBC doubled basic banker pay and reduced levels of bonuses.[51]

These pay awards are high and banks have reluctantly disclosed them, but the most significant issue is just how little we know about the pay practices in these banks. It is this lack of transparency that is of concern in relation to pay in the financial sector. Greater disclosure would allow more scrutiny by shareholders, government and other stakeholders. Most importantly, it could allow a greater understanding of where the risks lie within the business.

The interviews conducted by the High Pay Commission have also raised the question of the inflationary effect that pay in the City may be having on executive pay and the impact on labour market trends. This requires further investigation and discussion but remains relevant to the issue of high pay.

The government has also put pressure on the banks to reduce the cash element of bonus awards and to disclose more information about pay through its Project Merlin initiative, but with limited apparent success.

WHY ARE BONUSES SO HIGH?

Pay in the financial sector even shocks CEOs from other businesses with many suggesting it is a much bigger problem than executive pay in general. Indeed, there are relevant questions as to why a trader in a bank is earning more than the CEO of Sainsbury's or Rolls-Royce. Top investment bank employees uniquely demand a portion of the bank's revenues on deals and trading as part of their bonus. These bonuses are paid before shareholders get their cut and even before costs and tax – they are paid based on revenue and not profit.

Many argue that the banking model is at fault, creating a small number of hugely profitable investment banks with a lot of information on the world's trading patterns. This level of profitability demands closer examination, which goes beyond the remit of this project, but it is clear that this level of profitability is allowing the large bonus payments.

According to KPMG, the big five banks – Barclays, HSBC, Lloyds Banking Group, Royal Bank of Scotland and Standard Chartered – made combined pre-tax statutory profits of £22.2 billion in 2010, up from £11.3 billion in 2009.[52]

There is a legitimate debate to be had about how an investment bank's revenue should be allocated: between reinvestment (increasing lending), building capital reserves, payouts to shareholders, tax revenue and spending on staff. In banking, staff pay continues to take the lion's share. Indeed, since the drop after the financial crisis, the share of banks' revenue devoted to pay has increased.[53] Barclays awarded bankers three times as much in bonuses last year as it paid investors in dividends.[54]

There are further fundamental questions on the pay in banks which led a Times editorial to ask: 'Banks were mispricing their assets for years. Could they now be mispricing labour?'[55]

GOVERNMENT ACTION

The government response to pay in the banking sector has been mixed. Vince Cable recognised the significance of greater disclosure on pay in the banking sector, stating: 'We've got to have disclosure rules. If you keep people in the dark, you grow poisonous fungus.'[56] Government pressure has resulted in some limited additional disclosure, but not much.

Fears over the international disparity in regulation has stymied action: while the Basel committee calls for more transparency over bankers' pay and bonuses, the success at a national level has varied globally.[57]

[52] 'Major banks' profits double', Independent, 14 March 2011, www.independent.co.uk/news/business/news/major-banks-profits-double-2241339.html.
[53] R. Peston, 'Diamond: "I am compelled to pay big bonuses"' BBC News, 2011, www.bbc.co.uk/blogs/thereporters/robertpeston/2011/01/diamond_i_am_compelled_to_pay.html.
[54] P. Aldrick, 'Barclays facing investor backlash over bonuses', Telegraph, 15 February 2011,www.telegraph.co.uk/finance/newsbysector/banksandfinance/8324166/Barclays-facing-investor-backlash-over-bonuses.html.
[55] Times editorial, 11 January 2011
[56] J. Treanor, 'RBS seeks to pay cash bonuses as bankers prepare to meet Vince Cable', Guardian, 19 December 2010, www.guardian.co.uk/business/2010/dec/19/executive-pay-bonuses-banking
[57] P. Inman, 'Basel committee calls for transparency over bankers' pay and bonuses', Guardian, 27 December 2010, www.guardian.co.uk/business/2010/dec/27/basel-committee-targets-bankers-pay

4 | What has driven this rise in pay at the top?

Pay in the public and the private sector is negotiated within complex and generally opaque environments. Companies often include non-disclosure clauses in contracts and while the Equality Act 2010 went some way to mitigating their effect it did not eliminate them entirely. Executive pay in publicly listed companies has been subject to an increasing number of disclosure requirements, but they often act to disguise as much as they disclose. There remains a lack of transparency when it comes to pay across the income spectrum.

The functioning of the labour market generally and in relation to pay is widely recognised as imperfect. Legislation such as the Equal Pay Act 1970, the Minimum Wage and the Equality Act 2010, and guidance on executive pay contained in the UK Corporate Governance Code – previously the Combined Code – and recent FSA guidance on pay in the financial sector have all been brought in to correct or manage the market. The central tenet of governance or regulation is that market pressure is not enough and that government must step in to manage market failures, monopoly powers, externalities and information asymmetries; the same is true when it comes to the labour market.[58]

Equal pay legislation has blown away some of the cobwebs surrounding pay and the Low Pay Commission has enabled a greater understanding of pay at the bottom of the income spectrum. However, no such scrutiny has been given to remuneration at the top, which remains opaque at best.[59]

There have been many attempts to understand the forces behind the dramatic growth in pay at the top of companies and the current framework for determining pay.

There are four key areas of discussion:

- pay and performance: how attempts to link pay to performance have led to a sharp growth in executive remuneration
- pay and business structures: the role played by the board, shareholders and company size in determining top pay
- labour markets at the top: how does the competitive labour market function at the top and the effect of this on pay
- social and political factors: how the social and political environment has affected pay.

Looking at these in detail provides an essential insight into the growth in high pay, which will allow the High Pay Commission to develop policy that can address the issue.

It is clear that a primary driver for the growth in pay at the top is the attempt to link pay to performance, but this alone cannot account for the full growth we have witnessed; other factors such as a failing labour market at the top and social change also contribute to the growth in pay at the top.

Further, the discussions on pay raise fundamental questions about corporate governance and regulation and the relationship between executives, the board, shareholders and other stakeholders.

[58] M. Blair, Ownership and Control, 1995.
[59] Corporate governance reforms have introduced tighter disclosure requirements for executive pay, but information is still limited. While the government has recently forced banks to reveal more data about top earners and the financial regulator has issued guidance on bonuses, bankers' remuneration is still shrouded in secrecy See annex 1 for a discussion on current regulation.

Pay and performance

I was praised for things I didn't do, and now I'm being blamed for things I didn't do.

Alam Greenspan 2008

Pay at the top, no matter how high, is often justified with arguments about how it has been linked to company performance. Performance is used in general terms, referring to three distinct elements – personal goals, company profits or more specifically long-term corporate performance. Attempts to link pay to performance are considered a key force driving up pay, particularly for executives.

However, the High Pay Commission's early interviews revealed a high level of scepticism about the efficacy of attempts to link pay to performance. One expert in executive remuneration argued that while these measures can work, they were effective perhaps less that 50% of the time. As attempts to link pay to performance have proliferated, pay packages have become increasingly complex. It has reached a point where shareholders and other stakeholders often struggle to understand or assess them.

[60] M.C. Jensen and K.J. Murphy, 'Performance pay and top-management incentives', Journal of Political Economy, 98 (2), 1990.
[61] Mehran, Hamid, 'Executive compensation structure, ownership, and firm performance,' Journal of Financial Economics, Elsevier, 1995.
[62] D. Bergstresser and T. Philpon, 'CEO incentives and earning management', Journal of Financial Economics, 2003.

GROWTH OF PERFORMANCE-RELATED PAY

In the early 1990s, a series of articles appeared in academic journals calling for a greater link between executives' personal and company performance and rewards to align managers and shareholders' interests. In the 1990s, academics Jensen and Murphy urged shareholders to be more accepting of large pay packets that tied executive pay to share price performance.[60]

This was an attempt to manage the classic principal/agent problem experienced since the beginning of the 20th century. Proponents of the link between pay and performance argued that a firm's performance was positively related to the share of equity held by managers and the proportion of managers' compensation that was equity based.[61] As a result, the exposure of CEO wealth to company stock prices has increased dramatically in recent years.[62] Yet questions remain over whether this exposure has resulted in improved company performance.

In an effort to link pay to performance, ever-more complicated schemes have been designed. An executive pay package now starts with a basic salary, and on top of this there are cash bonuses, share schemes, long-term incentive plans (LTIPs), favourable loans, pensions, golden hellos, severance parachutes, merger bonuses, contractual notice periods and various other perks.

The performance-related element of pay has rapidly increased and become more complex for executives across the board, but at the same time, there has also been a growth in salary for those at the top. The introduction of equity pay and incentive schemes has not substituted base salary.

In fact base salary has also increased over the same period. Increasing performance sensitivity, it seems, requires a rise in value of total remuneration – the performance element of a pay packet – and an increase in the basic salary, to maintain risk-averse CEO participation.[63]

Performance-based remuneration commonly takes the form of equity as well as cash bonuses. The equity element can be through share option grants, share appreciation rights and other stock-based compensation. Many people consider this form of pay to be costless, but academics have questioned the veracity of this claim.[64] What is apparent is that this form of compensation makes evaluating the true costs of remuneration extremely difficult for the board or shareholders.

While performance-based pay has added to the complexity of executive pay, it has also boosted the amount that can be received. In 2010 the average top award that could be achieved under all share-based incentive schemes in the FTSE 100 was 328% of salary, according to PIRC in 2010. The median award was 200% of salary. This compares with 174% as a maximum award in 2006 and 150% as a median, indicating a rapid rise in the past five years.

EFFICACY OF LINKING PAY TO PERFORMANCE

Most incentive plans are based on total shareholder return as a measure of performance or earnings per share, or a combination of both. According to PIRC, 33.5% of schemes use total shareholder return as a performance measure, 27.6% use earnings per share and a further 15.7% use a combination of both. However, it is extremely difficult to demonstrate an individual's contribution to either of these measures.

While businesses have embraced the link between pay and performance, there is limited academic agreement on the success or otherwise of these attempts:[65]

- In 1990, Murphy and Jenson first identified the lack of a link between pay and performance between 1930 and 1990, and called for a closer link through greater use of equity incentives.[66]
- In 1998, Hall and Liebman argued that pay for performance sensitivity has more than doubled between 1981 and 1998.[67]

[63] X. Gabaix and A. Landier, 'Why has CEO pay increased so much?', Quarterly Journal of Economics, 123 (1), 2008.
[64] B. Hall and K. Murphy, The Trouble with Stock Options (May 2003). Harvard NOM Working Paper No. 03-33.
[65] P. Gregg et al, Executive Pay and Performance in the UK, 2005.
[66] Jensen and Murphy, 'Performance pay and top-management incentives'.
[67] B. Hall and J. Liebman, 'Are CEO's really paid like bureaucrats?', Quarterly Journal of Economics, 113 (30), 1998.

- In 1993, Gregg et al demonstrated that pay to performance relationships had weakened between 1983 and 1991.[68]
- In 1999, Benito and Conyon argued alternatively that pay to performance had strengthened between 1985 and 1995.[69]
- In 1998, Conyon and Nicolias argued that smaller firms had a weaker pay to performance relationship than in larger firms.[70]
- In 2005, Daines, Nair and Kornhauser demonstrated that the pay to performance sensitivity was stronger in smaller firms.[71]

Indeed Cliff Weight, a director at MM&K, argued: 'Many performance-related pay schemes appear designed to satisfy the chief executive and, in fact, offer little incentive for anything above just adequate performance.'[72]

There are important unanswered question about pay and performance: can companies really design targets that accurately capture executive input? The executive at the top of the company is important – providing leadership and strategic direction – but measuring their value and input is an almost impossible task. Finally, is performance-related pay actually effective in motivating executives?

EXECUTIVE PAY AND COMPANY PERFORMANCE

Over the past ten years, chief executive remuneration has quadrupled while share prices have declined. Between 1998 and 2009 the remuneration of chief executives of FTSE 100 companies rose by 6.7% a year to an average of £3–4 million, while earnings per share fell by 1% per year over the same period, according to the Total Remuneration Survey 2010 by pay consultants MM&K and corporate governance group Manifest.[73]

There is evidence that excess compensation of directors and CEOs is associated with firm underperformance. In a study in the US, Brick, Palmon and Wald (2005) demonstrated that high director and CEO pay is positively correlated with poor governance, which is in turn related to poorer company performance.[74]

Furthermore, academics are increasingly contesting the added value of share-based compensation as a whole.[75] It is argued that increasingly complex pay arrangements are not an efficient method of incentivising executives to behave in the interests of shareholders.

Methods to link pay to performance

1. Share option grants

What: Stock options, which give the executive a right to purchase a certain number of shares at a predetermined exercise price for a specified period of time (option period). Often, the exercise price is set at the level of the market price at the date the stock options are granted. The vesting period (the period before the options may be exercised) amounts to several years.

Problems: Share price is a poor proxy for executive performance as falling interest rates can cause share price increases without CEO input; furthermore, markets rise over time.

2. Stock appreciation rights

What: A right to receive a bonus equal to the appreciation in the company's stock over a specified period. Like employee stock options, stock appreciation rights (SARs) benefit the holder with an increase in share price. The difference is that the employee is not required to pay the exercise price; instead they just receive the amount of the increase.

Problems: Similar problems exist as with share option grants.

3. Comparator groups

What: A group of selected companies chosen as a representative sample of peers for the industry or sector. This comparator group is then used as a benchmark against which to measure executive pay levels and performance targets.

Problems: Benchmarking with comparators results in a ratcheting up in pay and has been linked to rewards for poor performance, as the reward is linked to median performance.

4. Long-term incentive plans

What: Individuals are provided with free shares after a set period of time (usually three years), which are awarded subject to certain performance criteria. The shares are held on trust and if the conditions attached to the awards are met, the trustees release or transfer the shares to the participants.

Problems: The obvious problems are that often long-term incentive plans (LTIPs) are not very long term and the difficulty of setting adequate performance criteria.

[68] Gregg et al, Executive Pay and Performance in the UK.
[69] A. Benito and M. Conyon, 'The governance of directors' pay from UK companies', Journal of Management and Governance, 3, 1999.
[70] M. Conyon and D. Nicolitsas, 'Does the market for top executives work? CEO pay and turnover in small UK companies', Small Business Economics, 11, 1998.
[71] R. Daines, V.B. Nair and L.A. Kornhauser, The Good, the Bad and the Lucky: CEO pay and Skill, 2005.
[72] N. Fletcher, 'Executive pay rises while shareholder earnings fall, says MM&K survey', Guardian, 5 July 2010, www.guardian.co.uk/business/2010/jul/05/executive-pay-rises-shares-fall.
[73] The survey by the pay consultancy MM&K and the proxy voting agency Manifest looked at the latest annual reports of 657 companies. See www.guardian.co.uk/business/2010/jul/05/executive-pay-rises-shares-fall.
[74] I.E. Brick, O. Palmon and J.K. Wald, 'CEO compensation, director compensation, and firm performance: evidence of cronyism?', Journal of Corporate Finance, 2006.
[75] B.S. Frey and M. Osterloh, Yes, Managers Should be Paid Like Bureaucrats, CESifo, Working Paper 1379, IEW Working Paper 187, 2005, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=555697.

It is also demonstrated that highly paid CEOs are more skilled than their industry counterparts when they are in a small firm, especially where there is a large shareholder. In contrast, a study in the US showed that highly paid CEOs who operate in large firms perform worse than their more poorly paid peers – they are more likely to continue poor company performance and even to reverse good performance.[76]

UNFORESEEN SIDE EFFECTS OF PERFORMANCE-RELATED PAY

The rise in equity-based performance-related compensation has also been accompanied by unforeseen side effects. It has recently been suggested in the US that manipulation of reported earnings is more pronounced at firms where CEO remuneration is more closely linked to the value of stock option holdings.

In the years of high accruals, CEOs exercise unusually large numbers of options and CEOs and other insiders sell large quantities of shares.[77] Periods of high accruals are associated with sales of shares by insiders.[78] A study in the US demonstrates that earnings restatements are more common in firms where CEOs have a larger option portfolio.[79] Further questions are being raised about whether proliferation of share option schemes has contributed to aggressive accounting practices within firms.[80]

The growth in performance-related pay as a percentage of income raises the specific issue of 'gaming' the system. In the case of executives it may be that in the interests of maximising their personal rewards they encourage the board and the shareholders, who suffer from an information asymmetry, to set and accept less demanding performance targets in order to increase their pay. It is argued that it is for this reason that individual performance-related pay on the whole rarely delivers the performance boost it is designed to.[81]

UNDERSTANDING PERFORMANCE-RELATED PAY

What is apparent is that the increases in pay appear to have little connection to the added value of an executive's performance. The High Pay Commission believes this is a key area for debate and that significant further investigation is required. Over the coming six months, the Commission will seek to explore and understand this issue in greater depth.

[76] Daines, Nair and Kornhauser, The Good, the Bad and the Lucky.
[77] D. Bergstresser and T. Philippon, 'CEO incentives and earnings management', 2003, http://pages.stern.nyu.edu/~tphilipp/papers/dbtp.pdf.
[78] Bergstresser and Philippon, 'CEO incentives and earnings management'.
[79] Bergstresser and Philippon, 'CEO incentives and earnings management'.
[80] S. Bell, 'Directors remuneration' in V. Younghusband (ed) Corporate Governance: the practical guide for directors, 2003.
[81] W. Hutton and P. Schneider, The Failure of Market Failure: towards a 21st century Keynesianism, NESTA, 2008.

SHORT-TERMISM VS LONG-TERMISM

Poorly-designed compensation policies can create perverse incentives... Management compensation policies should be aligned to the long-term prudential interests of the institution.

Ben Bernanke, speech to the Independent Community Bankers of America, 2009

Since the financial crisis, there has been significant debate about the issue of 'short-termism' in the corporate sector. Companies, regulators and investors are looking to ensure that pay is focused around long-term objectives and does not encourage short-term risk taking.

It is argued that there has been a shift in executive pay towards increasingly expensive, short-term reward strategies:

'This mirrors the approach that caused so many problems in the banking sector... Furthermore, as most remuneration strategies now involve the use of long term incentive plans, reward horizons have shortened to only three years. A decade ago, when share options were the favoured incentive, the horizon average was seven to ten years.'[82]

GROWTH OF SHORT-TERMISM

The reasons for this growth in short-term incentive plans are not clear – it is likely that it is a combination of the executive influence over boards and the growth in short-term share holding periods. Like many things, there may also be an element of fad or trend in this – one company brings in a new incentive scheme and others follow suit.

It has been suggested that as a result of the rise in short-term shareholding it is optimal for shareholders to offer remuneration contracts under which CEOs can make early gains from a speculative stock price rise, even though at a later date the value may collapse.[83] Thus failure to maximise long-run firm value is not necessarily a symptom of weak corporate governance, but may be a reflection of a more short-term speculative interest among shareholders.[84]

[82] S. O'Grady, 'FTSE chiefs earn £3.1m a year despite recession, Independent, 5 July 2010, www.independent.co.uk/news/business/news/ftse-chiefs-earn-16331m--a-year-despite-recession-2018512.html.
[83] P. Bolton, J. Scheinkman and W. Xiong, 'Executive compensation and short-termist behaviour in speculative markets', Review of Economic Studies, 73 (3), 2006.
[84] Bolton, Scheinkman and Xiong, 'Executive compensation and short-termist behaviour in speculative markets'.

Pay and business structures

Share price volatility is undoubtedly exacerbated by the short-term investment horizon of many institutional investors. The investment strategy of a significant proportion of fund managers is oriented towards share trading rather than long-term company ownership.[85] Exacerbating this trend is the increasing focus of financial markets on the next quarter's earnings at the expense of the longer-term perspective.[86]

A recent survey of financial executives also revealed that the majority of managers would avoid initiating a positive net present value (NPV) project – one that offers long-term value for money – if it meant falling short of the current quarter's consensus earnings – three-quarters (78%) of executives would give up long-term economic value for smooth earnings numbers.[87]

This certainly raises concerns over the creation of value-destroying perverse incentives.

Interviews conducted by the High Pay Commission have revealed a decline in long-term outlook even for institutional shareholders from 25 years to 10 years. This is linked to the change in share ownership and the lack of incentives to invest in the long-term future of a company, rather than shorter-term share trading or investment in other products such as government bonds.

The emergence of complex organisations at the beginning of the 20th Century when family-owned firms transformed into publicly-listed companies, saw the creation of a conflict of interests between firms' now dispersed owner-investors and the managers and directors hired to lead them. This is famously captured in the now seminal 1932 text by Berle and Mears, 'Separation of Ownership and Control'.[88]

Attempts at reform to resolve that conflict of interest have generally been aimed at making managers more responsive to shareholders. This, as discussed above, has been done partly through a growth in performance-related pay, but also through wider corporate governance reforms. It may, however, be impossible to align managers' interests fully with companies' owner-investors, and corporate governance guidelines can, at best, manage the issue.

When it comes to pay at the top there are three key elements of the business structure that determine remuneration:

- the board of directors
- shareholders
- company size.

[85] CBI Evidence to BIS.
[86] Blair, Ownership and Control.
[87] J.R. Graham, R.H. Campbell and S. Rajgopal, 'The economic implications of corporate financial reporting', Journal of Accounting and Economics, 40 (1–3), 2005.
[88] A.A. Berle and G. Mears, Separation of Ownership and Control, 1932.

PAY AND THE BOARD

Debates on corporate governance and the current guidance on executive pay are based on an assumption of an arm's length bargaining or optimal contracting model.

Non-executive directors, acting in the interests of the shareholders, bargain with the executive, who is acting in his own personal interest, to reach a decision on a fair level of pay.[89] This model is based on a primary assumption that the executive will seek the highest level of pay possible, and that the board will seek the best deal for the shareholders. In a publicly listed company this will be carried out by a dedicated remuneration committee, which sits as part of the board of directors.

The relationship between the board of directors and top management is fundamental to the functioning of a business. However, there are questions about how effectively the board is able to monitor the company's management in the interests of shareholders. The High Pay Commission's preliminary research and interviews have raised some significant concerns about this relationship.

Board diversity

Most boards are made up predominantly of men from a managerial or financial background.[90] While the vast majority of companies now have a remuneration committee to determine pay levels of the executive made up wholly or mainly of non-executive directors, many of these non-executives are either current executive directors at other companies or recently retired executives. While they have no direct financial interest in the company, they may have an indirect financial interest in the level of remuneration as a result of the benchmarking practices that are common among companies.

Benchmarking: How executive pay is determined

To determine executive pay, remuneration committees design a comparator group, normally based on the advice of remuneration consultants. These comparator groups are normally based on a mix of market capitalisation and industry type. Once designed, the comparator group is used as a benchmark against which to measure reward and performance. The use of these comparator groups has been extensively criticised as a cause for ratcheting up pay as a result of both poorly designed groups and the prevalent practice of seeking to pay above median or upper quartile rates.

[89] This is the leading view among financial economists. See, for example, F.H. Easterbrook, 'Managers' discretion and investors' welfare: theories and evidence', Delaware Journal of Corporate Law, 9, 1984; D.R. Fischel, 'The corporate governance movement', Vanderbilt Law Review, 35, 1982; N. Wolfson, 'A critique of corporate law', University of Miami Law Review, 34, 1980; R. Thomas, 'Is corporate executive compensation excessive?', in M.B. Johnson (ed) The Attack on Corporate America, McGraw Hill, 1978.
[90] Lord E.M. Davies, Women on Boards, 2011, www.ukcae.co.uk/pdfs/LordAbersoch-February2011-Womenonboards.pdf.

Some academics describe the way boards function as 'cronyism'. Indeed Manifest, experts in executive remuneration, argues, 'Many of the worst-performing remuneration committees seem to be entirely comprised of CEO's [sic] or recent CEO's [sic] of other companies – which may prevent a sufficiently balanced view from being formed on remuneration issues.'[91]

Boards usually comprise of comparatively few women and a limited number of members from non-managerial backgrounds.[92] Non-executives generally come from a very specific employment background and when making decisions about remuneration, or indeed takeovers, strategic direction or board appraisals, their decisions will be coloured by that experience:

An organisation that recruits from the widest pool of talent ensures a diversity of experience and perspective in the board room that broadens discussion. Diverse views promote debate and challenge group mentality… Diversity of thinking is an essential driver for innovation.

Confederation of British Industry[93]

Diversity is a winning strategy. We get more talent, better ideas and we get closer to customers.

Peter Voser, CEO Shell

Academic studies suggest that greater diversity of ethnicity, gender and social background can improve board and company performance. A number of studies show a correlation between the financial performance of a company and greater diversity in representation.[94] It is possible that this can be accounted for by the fact that successful companies have the economic resources to encourage diversity.[95] However, the growing evidence charting a positive relationship between the two using a wide variety of indicators, coupled with the fact that no investigation has found a negative relationship between them, suggests there is a clear business case for greater board diversity.[96]

A recent study demonstrated that the groups that are highly under-represented on most boards and management teams are generally significantly more capable of giving correct forecasts than those best represented on boards and management teams.[97]

[91] Manifest (2011) How best to rein in executive pay?, http://blog.manifest.co.uk/2011/01/4603.html.
[92] Davies, Women on Boards (2011)
[93] CBI, Room at the Top: improving gender diversity on UK corporate boards, p. 4, www.cbi.org.uk/pdf/room-at-the-top.pdf
[94] M. Bhogaita, 'Companies with a better track record of promoting women deliver superior investment performance', New Model Advisor, 2011.
[95] R. Adams & D. Ferreira, 'Diversity and Incentives in Teams: Evidence from Corporate Boards.' Working Paper. Federal Reserve Bank of New York, New York 2002 (found no relationship between the percentage of female directors and ROA).

Board culture

In many ways board culture and board diversity are synonymous; greater diversity can change board culture, which inhibits constructive criticism or, as Jensen describes it, 'the great emphasis on politeness and courtesy at the expense of truth and frankness'.[98]

It is the role of the board not only to monitor the executive in the interests of shareholders, but also to support the executive in its decision-making. This dual role can cause difficulties for boards, particularly when it comes to decisions on remuneration.

The remuneration committee is made up of members of the board, and while they sit separately to make decisions on pay, this does not alter the existing board dynamic. The fact that non-executives, if they are doing their job well, should be convinced they have the best team in place and wish to reward them appropriately must also play a significant role.

The consequence is that most boards will seek to pay above the median, whether of salary or performance-related rewards, resulting in a ratcheting up of pay awards. It takes a very brave remuneration committee indeed to seek to pay its executives below the median. It is seen as tantamount to admitting they are not up to the job.

On top of this there are obvious social factors for not challenging executives over pay. Pay is a uniquely sensitive issue, and while we hope that the non-executive directors will put the interests of the shareholders over social awkwardness, we recognise that that may not always be the case.

This, in turn, leads to a further issue as shareholder or public anger over levels of executive pay can be costly to directors and managers, often causing embarrassment or reputational harm. Fear of a shareholder revolt can lead to camouflaging of pay within complex schemes, which in turn is inefficient and could reduce shareholder value.[99]

The Hampel Report in 1998 stated:

4.16: Remuneration disclosures are often excessively detailed, to the point where the essential features of remuneration packages have been rendered obscure to all but the expert reader… We hope that it will be possible for the authorities concerned to explore the scope for further simplification and for listed companies themselves to present the required information in a form more accessible to the lay reader.

[96] D.A. Carter, B.J. Simkins and W.G. Simpson, 'Corporate governance, board diversity, and firm performance', Oklahoma State University Working Paper, 2002, http://ssrn.com/abstract=304499 or doi:10.2139/ssrn.304499; D.A. Carter, F.P. D'Souza, B.J. Simkins and W.G. Simpson, 'The diversity of corporate board committees and financial performance', 2008, http://ssrn.com/abstract=1106698.
[97] K. Rost and M. Osterloh, 'You pay a fee for strong beliefs: homogeneity as a driver of corporate governance failure', 2008, http://ssrn.com/abstract=1304719.
[98] Jensen, Michael C., 'The modern industrial revolution, exit, and the failure of internal control systems', Journal of Finance 48, 831-880. (1993, p. 863)
[99] L. Bebchuk, J. Fried and D. Walker, 'Managerial power and rent extraction in the design of executive compensation', University of Chicago Law Review, 69, 2002; L. Bebchuk and O. Bar-Gill, 'Executive compensation with short-term incentives', working paper, Harvard Law School, 2002.

The transparency of remuneration reports has not improved. Many companies produce reams of data on remuneration – indeed it takes up an increasingly large section of most companies' annual reports – but present it in such an obscure way that it is impenetrable to the lay, or indeed often experienced, reader. Many remuneration reports would benefit from greater transparency and clarity.

Powerful CEOs and entrenchment

The third factor affecting the optimal contracting model is the CEO himself (and it is usually still a he). Academics argue that top executive pay is a symptom of excessive executive influence or managerial power and an example of rent extraction.

In most companies CEOs have some degree of influence over their board – the extent of this depends on the make-up of the board. Evidence from the US suggests that the more power or influence an executive has, the higher the pay awards.[100]

The managerial power approach suggests that boards do not operate at 'arm's length' in devising executive compensation arrangements; rather, executives have power to influence their own pay, and they use that power to increase it.

[100] Bebchuk, Fried and Walker, 'Managerial power and rent extraction in the design of executive compensation'

Indeed in interviews conducted by the High Pay Commission with remuneration consultants, it is suggested that the ability of executives to influence pay decisions should not be understated. If this is a contributing factor to rising pay levels, it obviously raises questions about the board's ability to scrutinise the executive on other issues, which may also affect shareholder value, such as empire building or mergers and acquisitions.

Information asymmetrics

The final reason for the breakdown of the optimal contracting model is the informational asymmetry, which is regularly discussed in relation to the board's ability to scrutinise the executive. The executives will always be at an informational advantage, as they are involved in the day-to-day running of the business. Indeed, when it comes to the remuneration committee, even well-informed and well-intentioned executives are limited by time and resource constraints. Most remuneration committees will not have an allocated budget so will have to seek sign off for spending from the executive team.

The role of the board

It is clear that the board has an important role in determining executive pay.

It would be wrong to say that corporate governance reforms had failed to have a positive impact. In recent years there have been major improvements in executive pay practices, particularly in contract length and disclosure.

However, the board and remuneration committees in particular have failed to tackle the huge growth in pay packages, which raises concerns over the fundamental weakness of what is one of the most significant relationships in the corporate world.

The board of directors should act as the 'middle-man' between the managers and the absolute owners (shareholders), but when it comes to executive pay it is not clear if it is effectively negotiating this relationship.

Greater board diversity, greater transparency and greater accountability could all help towards resolving this issue. The High Pay Commission will examine reforms, which could play a part in this.

Remuneration consultants

Remuneration consultants are brought in by the remuneration committee to advise on executive pay structures. There is some concern over the behaviour and use of remuneration consultants and they have been blamed for the dramatic rise in executive pay.

Remuneration consultants emerged as a distinctive entity in the 1980s and advised on profit share schemes, which were becoming prevalent in executive pay packets. During this time the only guidance on executive pay was that share schemes should not be more than four times earnings in a ten-year period. By the 1990s, new pay structures like the long-term incentive plan (LTIP) and share option grants emerged in an attempt to link pay to company performance.

This was largely driven by a series of corporate governance reports, which argued for greater alignment of pay and performance.[101]

Remuneration consultants earn between £450 and £800 per hour, and it is estimated that fees can add up to as much as £400,000 a year. Our interviews with remuneration consultants suggest that the average FTSE 100 company spends at least £50,000 per year on this advice and that designing a new incentive scheme, conducted once every three years, costs upwards of £200,000.[102]

[101] Cadbury Report (1992), Greenbury Report (1995)
[102] Based on interviews conducted by the High Pay Commission and other estimates such as those provided in the Times; see J. Davey, 'Now consultants come under fire over fat-cat pay', Times, 8 March 2009, http://business.timesonline.co.uk/tol/business/industry_sectors/support_services/article5864154.ece.

The activities of remuneration consultants continue to be unregulated and companies are not obliged to publish the reports they receive from them, nor to disclose how much they have spent on these consultants.

Directors who sit on company remuneration committees admit they use consultants to cover their backs. In an interview for the Times one said: 'It is often a butt-covering exercise for the non-executives. There can be quite a lot of kick-back from executives regarding their pay, so if the remuneration committee can say it took advice from external consultants it helps to absolve them of blame.'[103]

Conflicts of interests and remuneration consultants

While the UK guidelines for remuneration consultants prohibit cross selling services, and the remuneration consultants we have spoken to are adamant they do not offer other services to companies where they are providing executive compensation advice, there is no evidence available to demonstrate whether this is the case. Further, within larger management consultancy or accountancy firms individuals' status within the organisation depends on how well they bring in their colleagues, which at the very least creates a pressure to offer advice that meets the expectations of the executive. Marc Jobling, the ABI's assistant director of investment affairs, agreed: 'Pay consultants are a big contributor to the problems around executive pay. We have heard of some who admit they work for both management and independent directors — which is a clear conflict of interest and not acceptable.'[104]

There are concerns over conflicts of interest within the larger consultancy companies. A survey in the US showed that 113 of the Fortune 250 in the US received compensation advice from consultants who were providing other services to the company. While the other services were billed at $2.3 million, these companies only took $220,000 on average for executive compensation advice.[105] This study also revealed evidence of a correlation between the extent of the conflict of interest and the level of pay.

Executive pay consultants face potential conflicts of interest that can lead to higher recommended levels of CEO pay, including the desire to 'cross sell' services and to secure 'repeat business'.

For the larger accountancy firms the average audit of a FTSE 100 company costs on average £5.74 million, with about half as much again (54%) in the FTSE 100 spent on non-audit services.[106] One large accountancy firm, the High Pay Commission met with, described executive compensation as a 'tinsy winsey' element of their business. Where this is the case, we should ask what incentives there are on these remuneration consultants to put forward a proposal that will at least meet executive expectations of increasing pay to cross sell services or secure repeat business.

The additional disclosure brought about by the Directors' Remuneration Report Regulations, introduced in 2002, and the increasing use of remuneration consultancies combined with a desire to pay for top quartile, or at least above median, performance may have been factors ratcheting up executive pay in recent years.[107]

Pay consultants are often blamed for forcing up executives' rewards by providing benchmarks against which rivals' pay can be measured. Peter Montagnon, former head of investments at the Association of British Insurers, said: 'There is a lot of frustration with the role of remuneration consultants. They have made a very important contribution to the upward ratchet in executive remuneration.'[108]

However, remuneration consultants equally argue that they are not the cause of ever increasing executive remuneration; instead they emphasise the influence the executive has over the board in pushing up pay. One remuneration consultant we spoke to stated that while they 'always aimed to act with integrity' they knew that this 'would get them fired'.

While there may be issues in relation to conflicts of interest within these companies, they are not the primary cause of escalating pay, and the answers they give on executive pay will only ever be as good as the questions they are asked. Greater transparency and accountability in this area, however, may help us understand what has happened in relation to executive pay.

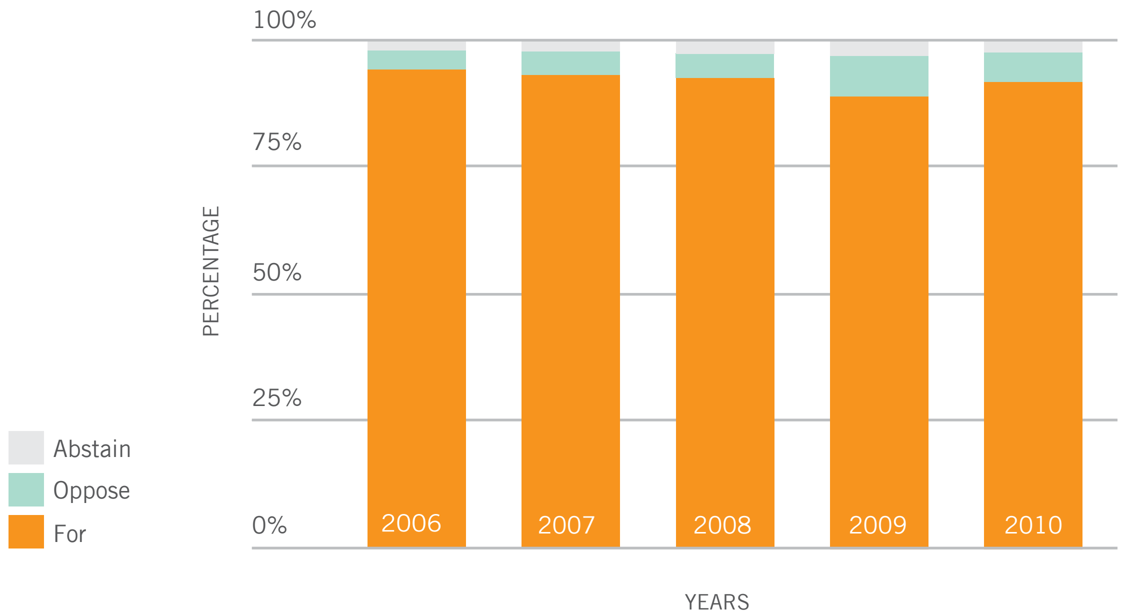
SHAREHOLDERS AND EXECUTIVE PAY

Shareholders as the owners of the business and ultimate beneficiaries are considered the best way of holding the executive and board to account through voting rights at the annual general meeting. Most recent reforms on managing executive pay have focused on strengthening shareholders' hands.

The Directors Remuneration Report Regulation, which came in to force on 1 August 2002, and the series of corporate

[103] Davey, 'Now consultants come under fire over fat-cat pay'.
[104] J. Treanor, 'Investors seeks [sic] curbs on executive pay advisers', Guardian, 15 September 2009, www.guardian.co.uk/business/2009/sep/15/guardian-executive-pay-survey-2009.
[105] H. Waxman, Executive Pay: conflicts of interest among compensation consultants, US House of Representatives, 2007, www.erieri.com/PDF/Executive-Consultant-Conflicts.pdf.
[106] PIRC, Annual Stewardship Review, 2010.
[107] CBI, Evidence to BIS review, 2011.
[108] Lord Matthew Oakeshott, the Liberal Democrat Treasury spokesman, was scathing: 'Top pay consultants get top pay to say 'pay top-paid directors even more. The corporate-governance boxes get ticked and shareholders get stuffed.' Treanor, 'Investors seeks [sic] curbs on executive pay advisers'.

FIGURE 7 **PROPORTION OF VOTES FOR REMUNERATION REPORTS FOR FTSE 100 COMPANIES**[111]



governance reforms following the Cadbury report in 1992 have focused on strengthening shareholders' influence.

Shareholders now have an advisory vote on the total remuneration report for the executives in a company. This has led to a greater involvement of the larger investors in remuneration decisions and has resulted in a number of embarrassing votes for companies.

The introduction of the shareholder vote in 2002 had an immediate effect: two companies were forced to withdraw their proposed share options schemes as a result of the level of opposition. The first of these was Prudential, which would have paid the CEO between £3 million and £6 million depending on estimates and about 90% of his salary for median performance. Given its position as an institutional investor, this was believed to set a benchmark for acceptable pay levels. The following week, Selfridges amended its share scheme proposals in response to a local authority pension fund forum campaign against its weak performance targets.[109]

In 2003, GlaxoSmithKline was the first major British blue chip firm to suffer a defeat, when 50.72% of shareholders' votes were cast against approving the group's remuneration report. Other major votes on BP, Barclays and Schroeders followed.

However, it is important to note that defeat over remuneration is rare – even at the height of the financial crisis only five companies lost the vote on their remuneration report. On average the vote against the remuneration report in companies was only 5.6% in the All Share index in 2010.[110] This was significantly higher in the FTSE 100 with remuneration reports receiving on average 8%, up from 3.3% in 2006.

[109] PIRC, Say on Pay, 2010.
[110] PIRC, Annual Stewardship Review, 2010.
[111] Pirc Annual Stewardship Review, 2010.

However, there are two significant problems with this model, which again go some way to explaining the rise in executive pay.

Information asymmetry

First, the information asymmetry between the board and the executive is exacerbated in the relationship between the board and the shareholders. Shareholders are limited by the amount of information available to them and often depend on being guided by the board.

While greater disclosure and shareholder votes have encouraged engagement between shareholders and boards, it is often not feasible because of the diversified portfolios and lack of time and resources of many institutional investors and fund managers devote to corporate

[112] CBI, Evidence to BIS review.
[113] Source: The Share Ownership Survey. 1 Includes investment trusts; 2 Public sector comprises local government, central government and public corporations; 3 The end-2008 survey did not identify any significant shareholdings of quoted shares owned by building societies; 4 The Share Ownership Survey has been conducted at irregular intervals since 1963, which leads to gaps in the time series shown here in tables and figures; 5 Components may not sum to the total due to rounding.

TABLE 7 **SHARE OWNERSHIP TRENDS IN UK LISTED COMPANIES AS A PERCENTAGE OF TOTAL OWNERSHIP, 1981–2008**[113]

	1981	1989	1994	2000	2004	2008
Rest of the World	3.6	12.8	16.3	35.7	36.3	41.5
Insurance companies	20.5	18.6	21.9	21	17.2	13.4
Pension funds	26.7	30.6	27.8	17.7	15.7	12.8
Individuals	28.2	20.6	20.3	16	14.1	10.2
Unit trust	3.6	5.9	6.8	1.1	1.4	1.8
Investment trusts		1.6	2	1.3	2.5	1.9
Other financial institutions	6.8	1.1	1.3	2.8	8.2	10
Charities etc	2.2	2.3	1.3	1.4	1.1	0.8
Private non-financial corporations	5.1	3.8	1.1	1.5	0.6	3
Public sector	3	2	0.8		0.1	1.1
Banks	0.3	0.7	0.4	1.4	2.7	3.5
Total	100	100	100	100	100	100

governance issues. As a result, they often fail to engage meaningfully with any individual company over a sustained period of time.[112]

The changing nature of shareholders

Second, the changing nature of shareholders is a contributing factor. At the beginning of the 1980s only 3.6% of shares in publicly listed companies were held outside the UK. By 1990 this figure had increased to 11.8%, and by 2008 41.5% of UK listed shares were held by overseas investors. Simultaneously, there has been a decline in the percentage of shares held by long-term UK investors such as pension funds and insurance companies from over 50% in 1990 to 25% in 2008 (see table 7).

Pension funds remain the largest group of institutional investors. In many cases the trustees of these funds delegate investment management to a fund management group.

When investment is delegated there are important issues around the effectiveness of fund management groups' to exert influence over companies. It has been suggested that trustees put fund managers under undue pressure to maximise short-term investment returns, or to maximise dividend income at the expense of retained earnings, and that the fund manager will, in turn, be reluctant to support board proposals that do not immediately enhance the share price or the dividend pay-out.[114] However, we should recognise the complexity in this relationship, which requires further investigation, as there are also concerns over the extent to which agents of shareholder (investment fund) managers act on their clients' views.

Many large investors also have a large portfolio, and while they may hold a significant share in one company, they may not invest the necessary resources needed to scrutinise corporate governance issues adequately. There is little publicly available information on the extent to which investment funds scrutinise corporate governance issues, including those of remuneration, and no information, for example on how much as a percentage of fees is spent on governance.

Many large institutional investors have relatively small teams focused on corporate governance issues relying instead on the advice of outside organisations such as the Association of British Insurers, Manifest and PIRC.

The effective time horizon of shareholders as measured by the frequency of turnover has also declined. Shares are now commonly held for a much shorter period than the time required to exert long-term discipline on company managers. Also our interviews suggest that larger institutional investors are decreasing their holding of shares and instead holding more bonds.

[114] J. Solomon, Corporate Governance and Accountability, 2004.
[115] Daines, Nair and Kornhauser, The Good, the Bad and the Lucky.
[116] M. Bertrand and A. Schoar, 'Managing with style: the effect of managers on firm policies', Quarterly Journal of Economics, 118, 2003.

Evidence suggests that the presence of an external monitoring shareholder strengthens the link between pay levels and skill,[115] and excessive CEO pay is more likely in the absence of monitoring block shareholders.[116]

It is not clear to what extent the larger shareholders are engaging generally and specifically over issues of remuneration. Shareholder rebellions remain unusual occurrences, which may be because of a greater degree of consultation between shareholders and managers, or may be because these shareholders lack the time and will to intervene effectively.

It is clear that this relationship between managers and owners is challenging. The ability of owners – shareholders – to exert influence over the company given their increasingly short-term time horizons raises questions about not only the issue of executive pay, but also fundamentally about in whose interests these companies serve.

PAY AND COMPANY SIZE

The link between executive pay and company size is the final issue in relation to business structures that is considered to influence pay. There is a long-standing academic view that managers have excessive incentive to expand the size of their firm.

There is a well-documented recent correlation between firm size and executive pay.[117] Furthermore, research by academics Bebchuk and Grinstein (2007) shows a significant economically meaningful correlation between firm expansion under a CEO and the growth of that CEO's pay.[118]

This could make economic sense, as when companies expand, the economic impact of the person at the top is greater so as to justify large pay disparities for a small dispersion of talent.[119] As firms get bigger the CEO has a greater marginal impact. While this is persuasive to an extent, it raises important questions about whether a CEO has a greater or lesser influence within a larger or smaller company. In a larger company, a bigger executive team and often greater external restraints would suggest that the CEO should have a lower marginal impact than a CEO in a smaller company.

This issue raises important questions about what we are paying executives for, and whether with increased company size the role becomes more demanding.

In the UK, the average firm size has grown over the last 20 years. However, academics argue that executive remuneration has increased at a far greater rate than can be attributed to changes in size and performance. A study by Bebchuk and Grinstein in 2005 into the impact of firm size on executive pay looked at firms in the US between 1993–1995 and 2001–2003

[117] Gabaix and Landier, 'Why has CEO pay increased so much?'.
[118] L. Bebchuk and Y. Grinstein, 'The growth of executive pay', Oxford Review of Economic Policy, 21 (2), 2005.
[119] Gabaix and A. Landier, 'Why has CEO pay increased so much?'

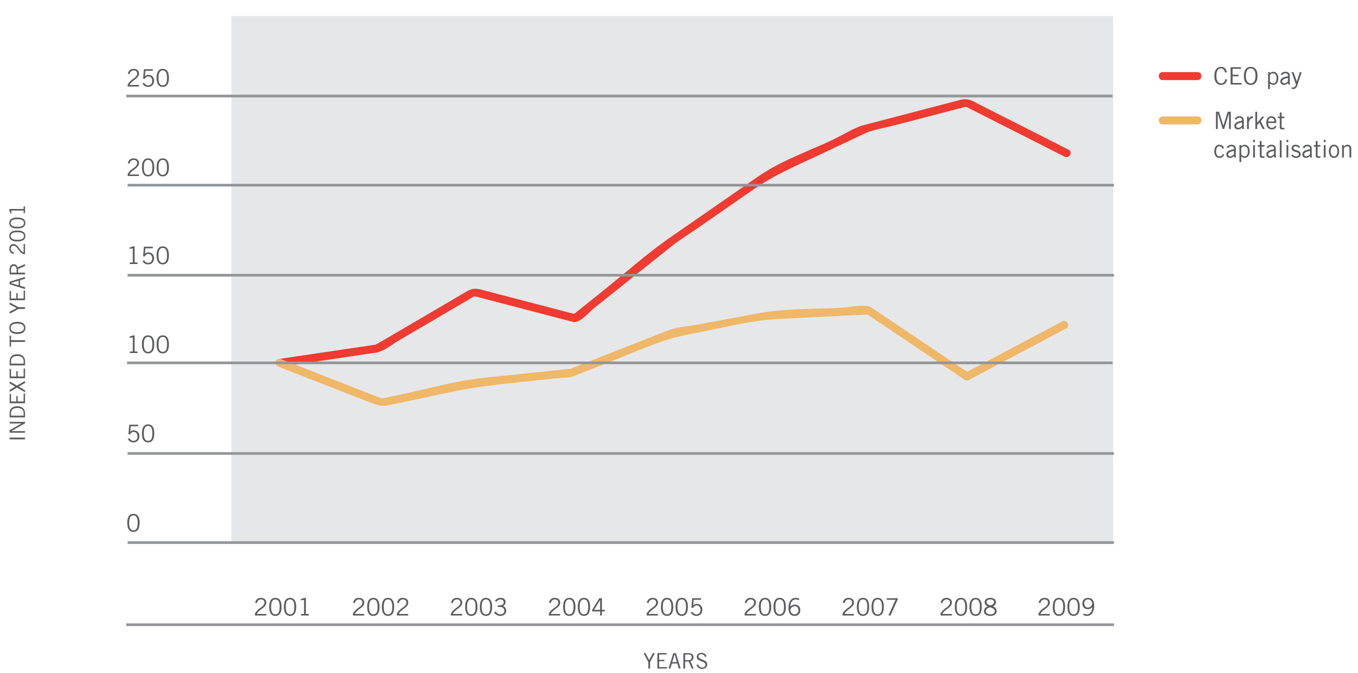
that increased in size, as measured by sales, by 40% (inflation-adjusted). Average CEO pay increased by 166% over the same period.[120]

In the past, increasing company size has not been accompanied by rising executive pay. The relationship between compensation and aggregate firm size was very weak between 1940 and 1970, according to Frydman and Saks. There was no essential change in CEO pay between 1936 and 1970 despite a massive growth in firm size.[121]

In addition, the high correlation between executive remuneration and firm size can be explained not only by the attraction of highly talented managers to large firms,[122] but also by management entrenchment in large firms,[123] which in turn enables them to extract greater rents from the board.[124]

While there may be a correlation between pay and company size, it is not clear whether this correlation is in shareholders' interests or whether the corporate expansion justifies the rise in the CEO's pay package.

FIGURE 8 **REMUNERATION OF CHIEF EXECUTIVES AT FTSE 100 FIRMS COMPARED TO FIRMS' MARKET CAPITALISATION (INDEXED, 2001=100)[125]**



[120] Bebchuk and Grinstein, 'The growth of executive pay'.
[121] C. Frydman and R. Saks, 'Executive compensation: a new view from a long-term perspective 1936-2005', 2007, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=972399.
[122] P. Kostiuk, 'Firm size and executive compensation', Journal of Human Resources, 25 (1), 1980.
[123] H.L. Tosi, S. Werner, J.P. Katz and L.R. Gomez-Mejia, 'How much does performance matter? A meta-analysis of CEO pay studies', Journal of Management, 26 (2) 2000.
[124] L. Bebchuk and J. Fried, Pay without Performance: the unfulfilled promise of executive compensation, Harvard University Press, 2004.

A competitive market at the top

The growth in pay at the top has been associated with four distinct trends in the competitive labour market:

- more options at the top
- poor succession planning
- global labour market
- risk and reward.

A non-competitive labour market at the top could be one reason for the dramatic increase in top pay.

MORE OPTIONS AT THE TOP

Increased options for executives are seen as one driver for the rise in executive pay. Many remuneration committees cite the lure of private equity or finance as an attractive option if they do not pay their CEO enough.

It has been suggested that changes in the skills required for executives have resulted in providing them with more options:

- Rather than internal communication skills, CEOs are now required to possess more effective external communication abilities. These are required to inform and persuade newly empowered shareholders and to communicate to capital markets, stock analysts and other external constituencies that affect their share price as a result of the growth in dependence on equity markets. These 'external relations' skills are largely general and not specific to a given organisation, and boards demanding them can look outside to fill CEO openings.[126]
- Changes in information technology and increased access to wide ranging company-specific data mean it is less important that a present-day CEO candidate spends an extended period of time in the company acquiring firm-specific knowledge.

This shift in the relative importance of general vs specific managerial skills leads to increased outside hiring and could result in increased wages in the managerial labour market.[127] Certainly our evidence suggests that there has been a growth in outside hiring.

However, there are problems with this argument, as if more general skills are in higher demand, this would suggest there is a larger pool of potential candidates rather than a restricted one. A larger pool should, in turn, reduce wages as supply outstrips demand.[128]

Even if it is assumed that transferable skills across firms are becoming more important, it is still questionable how many skills can in fact be transferred between different industries.[129] Academics have also demonstrated that this shift towards transferable managerial skills in large firms and increased outside hiring does not improve firm performance.[130]

[125] Fair Pay Review analysis of data from Incomes Data Services and Bloomberg.
[126] K.J. Murphy and J. Zabojnik, Managerial Capital and the Market for CEOs, 2007, http://ssrn.com/abstract=984376
[127] Murphy and Zabojnik, Managerial Capital and the Market for CEOs.
[128] There are further problems with this analysis of the global war for talent as most samples comprise firms from different industries, lumping the demanded talent in different managerial labour markets together.
[129] M. Cremers and Y. Grinstein, 'The market for CEO talent: implications for CEO compensation', Yale ICF Working Paper 09-11, 2009.
[130] K. Rost, The Rise in Executive Compensation: consequence of a 'war for talents', 2010, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1634799.

Part of the discussion of a 'talent war' is the idea that if executives are not paid well enough there is a danger of them being poached by an international competitor. However, this is not necessarily happening.

Between December 2005 and December 2010, 54 CEOs left their position in the FTSE 100. Of these, the majority have gone into retirement, taking up non-executive positions, chairman roles and charitable activities. Of the ten who have gone on to lead other companies, three left as a result of poor company performance; one set up his own company; two left and were later appointed CEOs of foreign companies; one went on to head a larger company in the same family; and one left and went on later to lead a British company. In fact, in the last five years only one FTSE 100 company has had its CEO poached by a rival, and that rival was also British – Morrisons' CEO Marc Bolland, who was poached by Marks & Spencer. The chance of having your CEO poached by a competitor in any one year would be 0.2%.

A number of people we have interviewed have drawn attention to the role of the City in providing executives with additional outside options, which improves their bargaining position and creates a benchmark against which to measure their pay. This requires further investigation, as while it may provide a significant benchmark, the transferability of skills from one industry to another is not necessarily a proven success.

SUCCESSION PLANNING

In recent years there has been a growth in external appointments for CEOs, this was a relatively slow trend. In the 1930s, the average CEO would have worked in 1.16 sectors; by 2000 the average CEO had worked in 1.92 sectors.[131] While internal candidates are still the most likely to be selected for succession to top positions outside hiring has increased.

A survey conducted by the High Pay Commission found that 59% of CEOs in the current FTSE 100 had been part of the company for five or more years before appointment and 33% had been with the company for more than ten years before appointment. A large minority, however, were external appointments: 41% of those surveyed. This figure has increased in recent years: in 2002 only 35% of appointments were external.[132]

There appear to be wide disparities in hiring policies across industries, with some sectors having almost no outsider CEOs and others appointing a majority of outsider CEOs.[133] Academics suggest that 'pay for luck' rather than for skill is less prevalent when the industry has a low percentage of outsider CEOs.[134]

[131] W. Hutton, Fair Pay Review Interim Report, 2010.
[132] Manchester Square Partners, FTSE 100 Index CEOs: where do they come from and what do they do next?, 2006.
[133] M. Cremers and Y. Grinstein, Yaniv, The Market for CEO Talent: Implications for CEO Compensation, 3rd Annual Conference on Empirical Legal Studies Papers; Yale ICF Working Paper 09-11.
[134] Rost, The Rise in Executive Compensation.

Succession at the top needs to be managed; traditionally, large companies ran highly structured schemes, designed to identify internal successors. However, this sort of succession planning declined in the 1990s. This raises important questions about the talent pipeline at the top and the effect it could be having on company performance and the increase in boardroom wages.

A study by Collins and Porras into 'visionary companies' – companies that were leaders in their fields – found, 'In seventeen hundred years of combined life spans across the visionary companies … [there were] only four individual incidents of [the companies] going outside for a CEO – and those in only two companies.'[135]

It is clear that most companies are nurturing talented people so their internal labour markets are working well. This approach to managing human capital makes sense. Training and development is costly, particularly when developing people who are of CEO calibre. In the UK, managers receive five times more expenditure on training than any other group of worker.[136]

Failing to plan a smooth succession is costly to a company; often when an external CEO is brought in, an internal candidate such as the finance director will depart, since they were turned down for the top job. Such disruption is costly and represents a wasted investment in training and labour.

Poor succession planning could also be having an inflationary effect on wages at the top as companies seek to harvest external talent, with golden handshakes and guaranteed bonuses. In Japan, for example, there has been much lower growth in executive pay and this is often attributed to the practice of almost exclusive internal hiring.[137]

The best companies will have developed a pool of executive talent, and succession is planned and often seamless. This keeps knowledge in the firm, creates bonds of trust across the organisation and emphasises continuity. It is what great companies have been doing for the last 200 years, and it makes sense. It should therefore be of concern if the practice is in decline.

GLOBAL MOBILITY AND EXECUTIVE PAY

The highly skilled labour market is in many ways international as private industries and academia often seek foreign staff for their specific knowledge or abilities. It is not unusual for those employed in the City of London or in large corporations to spend spells of time abroad. However, move further up the food chain and it is clear that this mobility has a shelf life, with many executives returning to the UK rather than continuing to live and work abroad.

[135] J.C. and J.I. Porras, Built to Last, Random House, 1994.
[136] A. Westwood, Can the UK Learn to Manage?, The Work Foundation, 2001.
[137] H. Kenji, No Outcry About CEO Pay in Japan, Bloomberg, 2009

TABLE 8 **COUNTRY OF ORIGIN OF CEOS OF THE FTSE 100 INDEX 2005–2010**

Country of origin	CEOs
Australia	3
Canada	2
Chile	1
France	5
Germany	2
India	2
Ireland	4
Israel	1
Italy	1
Mexico	1
Netherlands	5
South Africa	8
South Korea	1
Sweden	3
Switzerland	1
UK	**85**
Ukraine	1
US	19
Total	145

Indeed, Odgers Berndtson, a leading UK firm specialising in executive searches, reported in 2010 that there has been no obvious shift in client demand for individuals to be based overseas and no increase in client demand for global searches, because of a lack of appropriately talented individuals in the local area.[138] Indeed, there is also a correlating pattern, which shows that increasingly companies are seeking to invest locally in order to build winning teams rather than export or import foreign nationals.[139]

Our survey of FTSE 100 CEOs showed that even in this seemingly international setting the majority of top UK-listed companies are led by UK nationals: 59% of CEOs surveyed. In an additional survey of current FTSE 250 companies, 77% of CEOs were UK nationals.[140]

Global mobility is limited by human habit and behaviour. Although in theory you can live and work anywhere – and those at the top have used this as a bargaining chip – most people are grounded geographically. The UK and London are desirable places to live; as they have good schools, universities and cultural entertainment they are the location of choice for many individuals. Furthermore, most people who are born in the UK have family ties here, so uprooting and moving abroad is not always a popular option.

[138] S. Hill, 'Able to access the global talent pool..?', Odgers Berndtson blog, 16 July 2010, www.odgersberndtson.co.uk/gb/blogs/cfo-blog/post/able-to-access-the-global-talent-pool-2659/.
[139] CIPD, 'Implementing a global HRD strategy at local level: Ciba Specialty Chemicals', 2010, www.cipd.co.uk/helpingpeoplelearn/_casestudies/_ltcbspltchm.htm.
[140] Survey conducted by the High Pay Commission into the nationality of FTSE 250 CEOs. Finding based on a sample of 128 of the FTSE 250 companies; 98 were UK nationals according to company websites, official press interviews or press releases.

As the UK is second only to the US in the global league for CEO pay, one might expect to see fewer entrants from the US than from other countries and more entrants from around the world. However, after UK nationals, the second largest group of FTSE 100 CEOs are US citizens, who make up 13% of CEOs over the past five years. This can be partly accounted for by shared business practices, legal structures and language, which make moving across the Atlantic easier than hopping across the channel.

If pay was the primary motivating factor, we would expect to see a high number of foreign executives leading American companies, but a study in 2008 by Standard & Poor's showed that only 14 of the top 100 US companies was led by a non US citizen – up from 9 in 1998.[141] There seems to be limited support for the idea that we will lose executives to higher-paying companies outside the UK if limits are introduced on pay.

REWARDS FOR RISK

It is commonly argued that executives receive high levels of remuneration to compensate them for the high-risk nature of the job. Risk in this situation can cover a number of issues such as financial or labour market risk. Certainly the average CEO will not be in position for long, with the average tenure now 5.9 years.

However, most executives go on to take up non-executive roles or consultancy work, and accrue generous pensions while in post.

In a survey conducted by the High Pay Commission of CEOs in the current FTSE 100 between 1 January 2009 and 31 December 2009, only six CEOs left the company, giving a turnover rate of 6%, compared with the national average employee turnover rate of 13.5%. Thus it appears that CEOs experience significantly lower rates of labour market risk than other employees.

Of the CEOs that left, two went into retirement. A further three resigned voluntarily and received severance packages. In the sample only one CEO experienced involuntary redundancy in the period: Ian Smith of Reed Eleviser, who left after just eight months in position with a severance package of at least £1.1 million.[142] This is equivalent to a rate of involuntary turnover of 1%; the national average for the same period was 0.9%.[143]

While jobs at the top may be very challenging, they are not as high-risk as many suggest. Indeed it is important to separate the highly paid at the top of a large company from the innovative entrepreneur. Both may be highly remunerated, but only one has taken significant risks to get there.

[141] A. Zwaniecki, 'More U.S. companies led by foreign-born executives', America.gov, 28 February 2008, www.america.gov/st/businessenglish/2008/February/20080228113733saikceinawz0.2002985.html.
[142] R. Wray, 'Reed Elsevier axes chief executive eight months into job', Guardian, 11 November 2009, www.guardian.co.uk/business/2009/nov/11/reed-elsevier-chief-executive-axed.
[143] CIPD, Resourcing and Talent Planning, 2010.

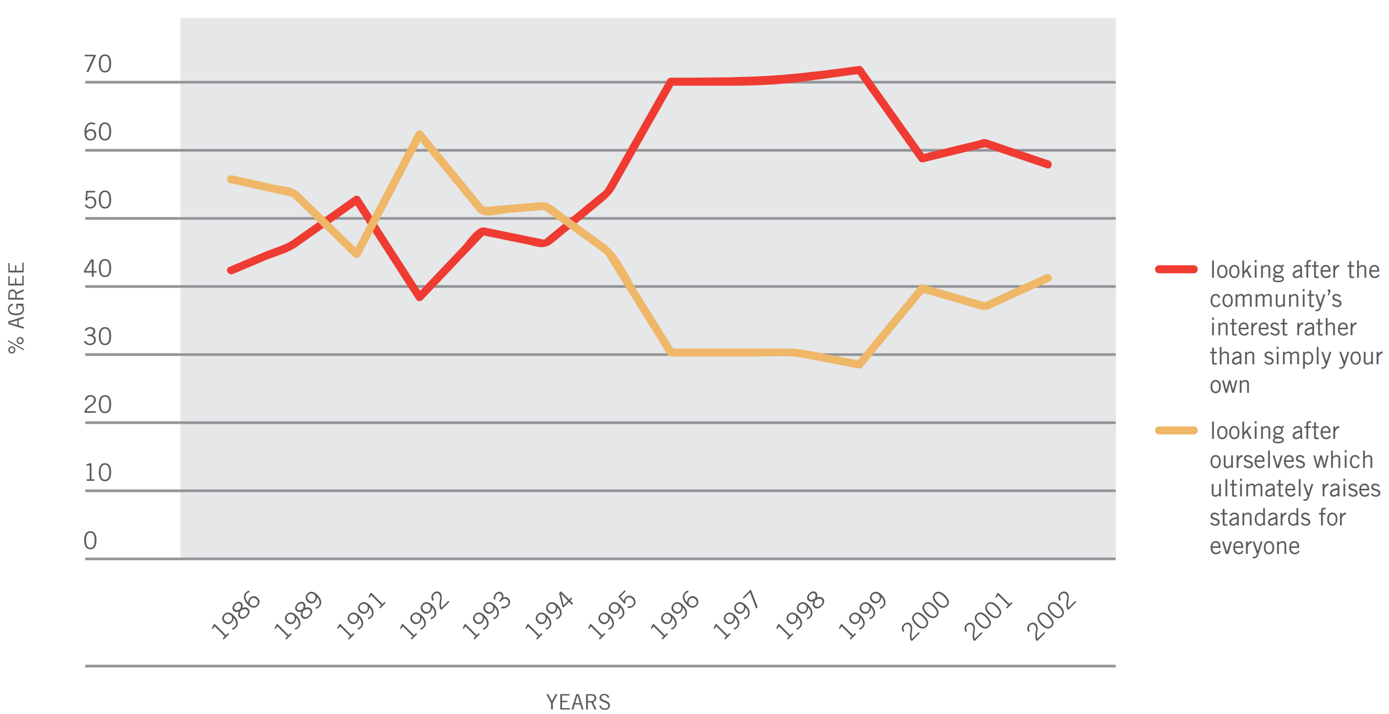
Social and political factors

Structural and institutional factors account for a large proportion of the change in patterns of pay at the top, but it is important to recognise that they do not account for all of it. We should also recognise that these changes have not taken place in a vacuum. Many of the changes in labour market and boardroom behaviour are also interlinked with social and political trends witnessed since the 1980s.

It should not surprise us that the same politics that gave birth to the phrase 'greed is good' also led to an explosion of pay at the top. Loosening social attitudes toward the very rich, and a shift in attitudes to view conspicuous consumption as a positive attribute, have characterised the last 30 years.

These changing attitudes are clearly exemplified in the 2010 British Social Attitudes Survey, which demonstrates a rise in individualism. This can be seen in an increase in the willingness of the public to attribute blame on the individual as opposed to the unfortunate circumstances – a growing number of people blame poverty on laziness rather than social factors or bad luck – and a hardening attitude towards the poor. In 1991, 58% thought the government should spend more on benefits; by 2009 that figure had more than halved to 27%.

FIGURE 9 BSA SURVEY 1986-2002 RESPONSE TO STATEMENT ON HOW THE QUALITY OF LIFE CAN BEST BE IMPROVED



This change in attitude is accompanied by an increase in the number of people who believe that quality of life can be improved by looking after your own interests, and a subsequent decline in the number of people who believe that looking after the community's interest is more important; this also points to a rise in individualism (see figure 9).

Value, it seems, is measured by what you earn and own, and your quality of life is equally determined by these personal factors. This is a broad social and cultural change and the rise in pay at the top is part of this trend.

We should also recognise that the decline in the influence of trade unions – whose membership fell from 50% of the population in 1980 to just 27% in 2008 (see table 9), a trend much more pronounced in the private sector – has undoubtedly had an effect on pay at the top. A study of executive pay in the US found that on average CEOs in unionised firms are paid 19% less than those in non-unionised firms, after controlling for several determinants of CEO pay.[144]

TABLE 9 TRADE UNION MEMBERSHIP 1980–2008[45]

Year	Percentage of the working population
1980	50.7
1985	45.5
1988	41.5
1989	39.0
1995	32.4
1996	31.4
1997	30.7
1998	29.9
1999	29.7
2000	29.8
2001	29.3
2002	28.8
2003	29.3
2004	28.8
2005	28.6
2006	28.3
2007	28.0
2008	27.4

It is beyond the remit of this project to explore or offer any remedy for the decline in trade unionism or the rise in individualism, but it is right to recognise that these social and political changes have had an impact on pay at the top.

[144] K. Banning and T. Chiles 'Trade-offs in the Labor Union–CEO compensation relationship', Journal of Labor Research, 28 (2), 2007.
[145] The figures for union membership among all of the employed UK population (including the self-employed) are incomplete, but in general are a few points below these figures and are also facing a decline.

5| Fair framework for fair pay

What constitutes fair pay for those at the top is now a pressing issue for our modern corporate world. Yet it is a question that businesses and governments have failed to grapple with effectively.

Pay at the top matters. Good pay structures within companies are essential to the functioning of a business. For companies they are primarily about retaining and motivating the best staff for the position. Yet the increasingly unbalanced nature of pay in our economy often doesn't even allow for this. The pay at the top of companies and within some sectors of the economy has become dislocated from the economic and social environment it sits within, and this in turn has damaging economic and social consequences.

The increase in pay cannot be isolated from the business milieu, nor can its increase be explained in simple terms. This report has looked at the four key strands of the debate in relation to top pay: business structures, pay and performance, the labour market at the top, and the social and political background. It is clear that the forces behind the growth in top pay are multi-faceted. There is no simple explanation. Combined social, political and economic forces have contributed to the dramatic growth in pay at the top and the regulation currently in place has failed to hold these pay packages to account.

However, there are key drivers, which the High Pay Commission has identified as including:

- An increased focus on pay for performance has resulted in a growth of pay at the top, although it is not clear what impact this has had on actual individual or company performance.
- The use of comparator groups and the pernicious and overwhelming desire to pay in the top quartile, or at least above the median, have had a significant effect on pay.
- A growth in external hiring and the costs this represents, resulting from poor succession planning, has had an upward pressure on pay, again without necessarily resulting in improved performance.

At the same time corporate governance has failed to rein it in:

- The inability of boards to exert influence and the concerning trend of having current executives on remuneration committees has meant that a key mechanism for controlling pay has failed and may even have contributed to its growth.
- The alternative mechanism, namely shareholders, has also proved ineffective in reining in executive pay.

There is significant evidence that the current corporate governance guidelines and regulations are not and will not be effective in restraining pay at the top. Bargaining with the board is, in fact, far from arm's length. Market forces are not sufficiently strong and fine-tuned to eliminate substantial deviations from optimal contracting and shareholders have little practical ability to prevent such deviations.

The failure of our corporate governance system means that we are now paying more and getting less. As workers, shareholders and members of society we are getting a poor deal.

This raises questions about not only executive pay, but also the fundamental workings of the key relationships in the business world and whether they are effective at managing companies in the long term.

While executives often feel singled out, it is important to recognise that their pay often acts as a benchmark for others and that the behaviour of publicly listed companies is of particular public interest.

This report has highlighted the key areas of discussion in relation to top pay. Each has relevance to the current debate, but further investigation is required to garner a fuller understanding of pay in the private sector.

Over the coming six months, the High Pay Commission will explore further issues of pay and performance, shareholder value and the role of competitive markets at the top.

This preliminary investigation has highlighted key areas for policy development. Based on our initial findings, the High Pay Commission will further explore the role of greater transparency, accountability, stakeholder involvement and corporate governance reforms, and also look at the wider regulatory and taxation framework for pay at the top.

Annex 1 Regulation

International

There is no international guidance on high pay generally, but there are a variety of non-binding guidelines on executive compensation. The most significant is the OECD 'Principles on Corporate Governance' (2004). This argues for shareholders to have an opportunity to express their opinions on remuneration for the board.

The European Commission also has recommendations dealing with compensation of executives and directors. These provide for information to be made available on directors' fixed and variable remuneration and for the provision of information on the performance criteria on which the variable part of the package is based. They further recommend that investors should have either a binding or advisory vote on directors' compensation and that share-based awards should be conditional on a prior vote at the annual shareholder meeting.[146]

The European Union (EU) recommendation leaves the implementation to the member states by either legislation or best practice rules. However, in a follow-up report on its recommendation, the European Commission comes to the conclusion that while a large majority of member states either recommend or require comprehensive disclosure of directors' remuneration, 'only a disappointingly low number of Member States considered it necessary to recommend that shareholders vote on the remuneration criteria of the board/management board'.[147] Even across Europe, disclosure and accountability to shareholders varies significantly.

[146] European Commission, Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC).

National regulation

Regulation of top pay in publicly listed companies in the UK is based on the 'comply or explain' corporate governance model and has three key elements: the establishment of a remuneration committee on every board, disclosure and a shareholder vote on pay. However, the shareholder vote is purely advisory.

The UK Corporate Governance Code (formerly the Combined Code) sets out standards of good practice. All companies with a premium listing of shares in the UK are required under the Listing Rules to report on how they have applied the UK Corporate Governance Code in their annual report and accounts.[148]

Remuneration committees

Remuneration committees emerged in the 1990s to resolve the issue of a potential conflict of interests of directors being involved in setting their own pay. The Greenbury report on corporate governance called explicitly for them to be fully independent and comprise wholly non-executive directors, who would not stand to gain financially from their decisions. The remuneration committee agrees the pay package for top executives and produces a report setting out its rationale.

Disclosure

Quoted companies must publish a director's remuneration report, approved by the board and signed by the director or company secretary. This remuneration report is then published in the annual report and put to the shareholders in a vote. Many remuneration committees consult the larger shareholders before the publication of their report to ensure the vote is passed.

[147] See European Commission, Staff Working Document of 13 July 2007, Report on the Application by Member States of the EU of the Commission Recommendation on Directors' Remuneration, SEC (2007) 1022, p. 3.

[148] The relevant section of the Listing Rules can be found at http://fsahandbook.info/FSA/html/handbook/LR/9/8. The new Code applies to accounting periods beginning on or after 29 June 2010 and, as a result of the new Listing Regime introduced in April 2010, applies to all companies with a Premium Listing of equity shares regardless of whether they are incorporated in the UK or elsewhere FRC (2010). The UK Corporate Governance Code.

Shareholder vote

The remuneration report is required to be put to a company's annual general meeting as an ordinary resolution for approval. The vote is advisory, and failure to pass the vote does not invalidate the payments made, but a vote against a remuneration report suggests shareholders have strong misgivings. It is embarrassing for the company and most boards do not ignore it.

Reforms in the financial sector

The FSA has introduced reforms on remuneration in the banking sector and in line with EU principles and the Basel Committee of Banking Supervisors. In 2009, the Financial Stability Board issued high-level principles and standards on remuneration, including a principle on disclosure. The EU meanwhile included specific rules on remuneration and disclosure.

New regulations require firms to disclose information on their remuneration policies and pay-outs annually for staff whose professional activities have a material impact on their risk profile. They are also required to bear in mind risks and publish those that the board has considered when making decisions on remuneration. This includes information on the link between pay and performance; aggregate quantitative information on remuneration broken down by business area; and aggregate quantitative information on remuneration broken down by senior management, which includes:

- the amounts of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries
- the amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types
- the amounts of outstanding deferred remuneration, split into vested and unvested portions
- the amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments
- new sign-on and severance payments made during the financial year, and the number of beneficiaries of those payments
- the amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person.

This is to be included in their disclosures under Basel Pillar 3. The global reforms have contributed to improved financial stability but done almost nothing to constrain the profitability that produces the bonuses.[149]

[149] P. Augar, 'Only global action can curb bonuses', Financial Times, 11 January 2011, http://cachef.ft.com/cms/s/0/29c6d950-1d96-11e0-a163-00144feab49a.html#ixzz1HKdkBDEh.

The UK Corporate Governance Code
Section D of the code sets out guidance on remuneration:

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration

The performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company.

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.

They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

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