high pay centre

THE NEW CLOSED SHOP: WHO'S DECIDING ON PAY?

THE MAKE UP OF REMUNERATION COMMITTEES

About the High Pay Centre

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

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

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

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Executive Summary

This report looks at the make up of remuneration committees in FTSE 100 Companies. Three key trends are apparent.

Indirect Interest. Through the common process of benchmarking current executives may have an indirect financial interest in increasing pay in other companies.
> 9% of FTSE 100 companies have a current FTSE 100 lead executive on their remuneration committee.
> 33% of FTSE 100 companies have a current lead executive on the remuneration committee.

Similar Professional Backgrounds. The majority of non-executive directors who sit on remuneration committees come from business or financial intermediation, a significant minority are current or former lead executives.
> 46% of people sitting on remuneration committees are current or former lead executives.
> Of the 366 non-executive directors who sit on remuneration committees 37 are not from business or financial intermediation; that is just 10%.

Gender Makeup. The majority of people sitting on remuneration committees are male and a significant minority of companies have all male remuneration committees.
> 45% of the companies in our survey in the FTSE 100 have all male remuneration committees.
> There are 59 women sitting on the remuneration committees of the FTSE 100 companies. This is 16% of the total.

[1] IDS (2011) Directors Pay Report
[2] ICM polling conducted January 2012 for the High Pay Centre

Introduction

Over the last 30 years there has been a dramatic escalation in executive pay awards, putting average pay for a lead executive in a FTSE 100 Company at £4.2m in 2010.[1]

In a survey conducted by the High Pay Centre only 7% of people thought that the CEO of a large FTSE 100 company should be receive more than a million pounds including salary and all bonuses and other benefits. Only 1% thought they should be paid over the £4m that is now average.[2] This begs the question, why is executive pay so out of line with public opinion? There are a number of factors which are often pointed to when discussing this, such as the role of the global market place, the power of the executive, and threat of flight. While it is right to recognise that these each play a part, this report looks specifically at the body that decides executive pay in a publicly listed company: the remuneration committee.

The Conservative and Liberal Democrat coalition government has promised to open up the membership of remuneration committees. David Cameron has suggested they represent a form of "crony capitalism" that exacerbates the pay awards seen by companies and encourages the ratchet we have seen in the last 30 years. This report explores the make up of the remuneration committees in the current FTSE 100 and asks is it really a closed shop?

This paper is part of a series which will explore issues relating to top pay including: remuneration consultants, shareholder engagement, the complex nature of executive pay, and the role of other stakeholders in decision making.

Fact File: the remuneration committee

What is the remuneration committee?
The remuneration committee is a sub-committee of the main board of a publicly listed company. It is made up of non-executive directors. There are typically three to five members but some companies have more, for example Centrica has seven members. Remuneration committees are required by corporate governance guidelines, rather than legislation and were initially advocated in the Cadbury Report 1992 which stated "Boards should appoint remuneration committees, consisting wholly or mainly of non-executive directors, to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary"

What does the remuneration committee do?
The committee determines the pay of the lead executive, or CEO of the company. However, it also will normally have a remit to determine pay policy across the company and normally determines the pay of the Chairman and also the Company Secretary, and potentially executive directors of the company who sit on the board: this may include but is not limited to, the Chief Financial Officer and the Chief Operations Officer.

How do they make decisions?
Decisions are made at meetings of the remuneration committee. These decisions should be made in line with the FRC (Financial Reporting Council) guidelines and conform to a series of best practice documents issued by industry association groups such as the Association of British Insurers (ABI) and National Association of Pension Funds (NAPF). As the decision of the remuneration committee is currently subject to an advisory shareholder vote, good practice in companies normally means larger shareholders are also engaged. Remuneration committees also purchase advice from remuneration consultants to inform their decisions.

What do the remuneration consultants do?
They are normally hired by the remuneration committee. The voluntary guidelines for remuneration consultants state that if they are engaged by the remuneration committee they cannot also work for the executive, whose pay they are determining. The advice they provide varies, but typically includes designing new remuneration plans, and drawing up a comparator group against which the executive pay can be benchmarked.

How does benchmarking work?
First a group of comparable companies is drawn up. 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 relative performance for the company concerned. The practice of benchmarking has been extensively criticised as a reason for ratcheting pay as a result of both poorly-designed comparator groups and the prevalent practice by remuneration committees of seeking to pay above median or upper quartile rates. This effect is described in the 2010 UK Corporate Governance Code.

Are Remuneration committees a closed shop?

Remuneration Committees have been accused of "cronyism" but to what extent is this the case?

To explore this issue the High Pay Centre conducted a survey of FTSE 100 companies' remuneration committees.[3]

Professional background

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[4]

There is a growing concern over remuneration committees made up largely or in some cases such as Reckitt Benckiser, wholly, of current or former-lead executives.

When non-executives largely come from a very specific employment background this will affect their decisions about remuneration, or indeed takeovers, strategic direction or board appraisals, their decisions will be coloured by their experience.

While current chief executives have no direct financial interest in the pay of the chief executive of the company on whose remuneration committee they sit, they may have an indirect financial interest in the level of remuneration as a result of the benchmarking practice that is common place among companies. The vast majority have a background in business or financial intermediation: 90%.

- 9% of FTSE 100 Companies have a current FTSE 100 lead executive on the remuneration committee (see table 1).
- 46% of people sitting on remuneration committees are current or former lead executives
- 41 out of 366 remuneration committee members are current lead executives
- 33% of FTSE 100 companies have a current lead executive on the remuneration committee.
- 23 members of remuneration committees serve on more than one remuneration committee in the FTSE 100.

[3] This survey was conducted by the High Pay Centre between 15th December 2011 and 31st January 2012. It included 96 companies as listed in the FTSE 100 on the 15th December. International Consolidated Airlines was not included in the survey as it was in the process of a merger. For more information see Appendix 1

[4] CBI, Room at the Top: improving gender diversity on UK corporate boards, p. 4, www.cbi.org.uk/pdf/room-at-the-top.pdf

figure 1 **Professional background of FTSE 100 remuneration committees Committees**

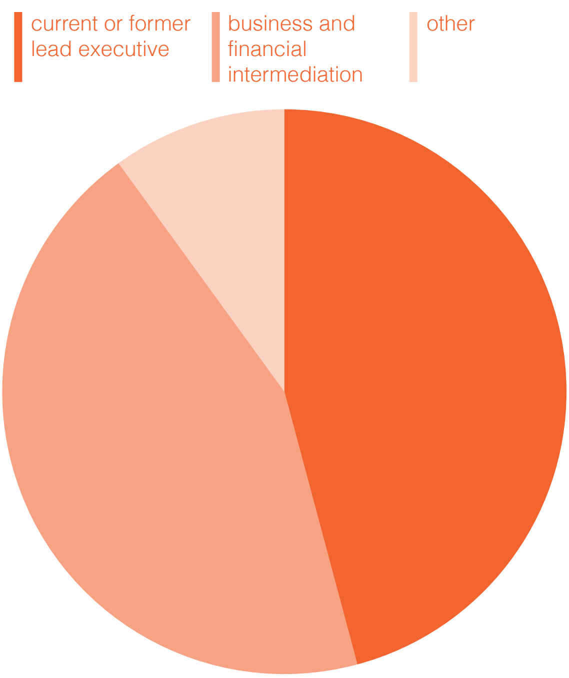

table 1 **Lead Executive of a FTSE 100 Company sitting on other FTSE 100 Remuneration Committees**

	Sits on the remuneration committee of:	Is the lead executive of:
Philip Bowman	Burberry Group	Smiths Group
Ian Meakins	Centrica	Wolseley Group
Sam Laidlaw	HSBC Holdings	Centrica
Michael Roney	Johnson Matthey	Bunzl
Phillip Cox	Morrisons	International Power
Francis Salway*	Next	Land Securities Group
Martin Lamb	Severn Trent	IMI plc
Paul Walsh	Unilever	Diageo
Ian Cheshire	Whitbread	Kingfisher

*Francis Salway has announced his resignation and is to hand over the Chief Executive role to Robert Noel at the end of the financial year.

Of the 366 non-executive directors who sit on remuneration committees 37 (see table 2) are not from business or financial intermediation that is just 10%. It is clear that there continues to be a prevalence of those from a managerial or financial background.

Women at the top

Since the Davies Review there has been a renewed attention on the role of women on boards.[5] Indeed David Cameron suggested that more women on boards would result in better decision making and better decisions on pay.[6]

Sitting on the remuneration committees of the FTSE 100 companies are 59 women. This is 16% of the total. This is equivalent to the number of women sitting on FTSE 100 boards – which currently stands at 15.6%.[7] However, it disguises the fact that 45% of companies in the FTSE 100 have all male remuneration committees.

table 2 **Professional background of the 37 members who do not come from a largely business or financial intermediation background**

Professional Background
2 worked for the BBC
20 are civil servants or from politics
3 lawyers
1 film producer
4 academics
7 accountants

[5] Davies, Women on Boards (2011)
[6] BBC (2012) David Cameron won't rule out women in boardroom quotas
[7] Davies, M (2012) Women on Boards: one year on

Does the make up of remuneration committees matter?

'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.'

Manifest[8]

Companies need high calibre individuals to sit on the remuneration committees of companies, as a subcommittee of the board they are also responsible for decision making outside of executive pay.

However, when the majority of individuals on remuneration committees come from similar backgrounds it is not surprising that critics of remuneration committees have suggested that they fall victim to "group-think" where individuals are reluctant to challenge the consensus view. It has been demonstrated by Cass Sunstein that group polarisation can occur, and more extreme decisions are reached, when groups are made up of like minded individuals.[9] This may in part explain why we have seen such a gap between public perception of what is an acceptable level of pay and the current norm in executive pay awards.

Indeed increasingly even insiders are questioning whether the system works. In a survey conducted by DirectorBank, just over 50% of chairmen and non-executive directors thought the existing remuneration model was broken, 30% disagree and believe the current model is effective with the remaining 20% neutral.

Role of the remuneration committee

The remuneration committee is a subcommittee of the board and is responsible not only for representing the shareholders' interests, but also supporting the executive. This dual role can cause difficulties for boards, particularly when it comes to decisions on remuneration.

If non-executives are doing their job properly they should believe that they have the best executive team in place and understandably wish to reward them appropriately. Additionally fears over the executive leaving or being poached by a rival, can drive the remuneration committee of one company to increase pay awards, rather than risk losing their lead executive. While this may seem logical for one company, it results in a ratcheting effect as each company benchmarks against its competitors.

Even without the threat of flight from the executive, most boards seek to pay above the median for salary and increasingly make awards in the upper quartile of the pay scale for performance-related rewards. This results in a spiraling upwards of pay packages. It takes a very brave remuneration committee to seek to pay its executives below the median. It is seen as the equivalent of admitting they are mediocre or not up to the job.

[8] Manifest (2011) How best to rein in executive pay?, http://blog.manifest.co.uk/2011/01/4603.html.

[9] Cass R. Sunstein: Worst-Case Scenarios (2001), and Nudge: Improving Decisions about Health, Wealth, and Happiness (with Richard H. Thaler, 2008).

Added to this there are the social or cultural factors which come into play. Pay is a very sensitive subject, which is freighted with notions of worth, and personal value. Non-executive directors are often peers of the executives involved and it is hard to argue that rewards should be lower.

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.

Conclusion

This survey has shown that remuneration committees are made up of individuals from largely similar backgrounds.

This lack of diversity may be impacting on their decision making. This in turn raises questions on how effectively the board is able to monitor the company's management in the interests of shareholders and other stakeholders.

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.[10] 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.[11]

The fact that remuneration committees comprise individuals from similar backgrounds appears to lead to a lack of challenge over decision-making around pay. This evidence contributes to the debate on the make up of remuneration committees and the potential for other stakeholder involvement.

[10] M. Bhogaita, 'Companies with a better track record of promoting women deliver superior investment performance', New Model Advisor, 2011.
[11] 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.

Appendix 1

Methodology

This survey was conducted by the High Pay Centre between 15th December 2011 and 31st January 2012. It included 96 companies as listed in the FTSE 100 on the 15th December. International Consolidated Airlines was not included in the survey as it was in the process of a merger.

The survey was based on the most up to date public information on the make up of the remuneration committee. This was predominantly found on the company websites. Where there was no information on the company website the previous years remuneration report was used as an alternative source to provide the most up to date public information.

Professional background was normally provided by the company both on the company website and in the annual report, this was cross-referenced with Forbes, and Reuters biographies.