Roundtable Summary: Executive Pay

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How can executive remuneration be reformed to restore trust in business and encourage long-term sustainable value creation?

This is the summary of a roundtable that Tomorrow's Company held on executive pay as part of the Futures Project. Tomorrow's Company is a non-profit think tank with the purpose of encouraging and enabling business to be a force for good, see more detail at the end. The Futures Project is a research program looking at progress over the last 20 years in order to identify the key obstacles and drivers for change; and in this context present a renewed vision for business. See here for more detail.

The issue of executive pay has been raised in a number of different contexts. It is often cited as a cause of short-termism. Public surveys show it as a key reason for low public trust in business. Non-executives say it is one of their key governance concerns. And heads of governance in investment funds say it is the issue they spend most of their time on.

We therefore sought to hold a discussion looking for pragmatic solutions that would be mutually acceptable to management, shareholders, employees and the public. In order to achieve this we held a roundtable with people from a variety of backgrounds, such as corporates, investment funds, remuneration consultants, board advisors, law firms and NGO campaign groups.

The next step will be to test the ideas developed at the round table with members of the Tomorrow's Company Good Governance Forum, with a view to developing further research looking at pragmatic solutions to the growing dilemma around executive pay.

Outline
1. Pre-reading context for discussion
2. What are the current problems with executive pay?
3. What are the possible solutions?

1. Context for discussion

The current structure and level of executive pay is increasingly acknowledged as a problem, since it is reducing the public's trust in business and evidence is suggesting it is not leading to improved company performance. This discussion event will bring together senior business figures to discuss practical changes to executive pay that would help restore public trust and support long-term business success.

Given the increasing acknowledgement amongst senior business leaders that further action needs to be taken with respect to executive pay, this discussion event will bring together such figures to discuss practical steps and resolutions. This discussion forms part of the Tomorrow's Company Futures Project, a business-led programme of inquiry, debate and dialogue that will produce a positive and practical vision for companies to be a force for good.

Executive pay has increased significantly and become more variable

- In the UK, executive pay to average worker pay has increased from 45 to 120 times from 1998 to 2010[i].
- Research by the High Pay Centre found that management bonus payments increased at double the rate of EPS (earnings per share) between 2000 and 2013[ii].
- Increasing executive pay has been driven by an increase in variable pay, due to a desire to solve the agency problem by aligning management incentives with shareholders. For FTSE 100 executives, the annual bonus as a percent of salary has risen from an average of 36% in 1996-99 to 131% in 2011-13. For the LTIP (long-term incentive plan) this has risen from 40% in 1996-99 to 206% in 2011-13[iii].

However higher variable pay is not linked to higher performance

Despite the increase in variable pay linked to performance metrics, there is increasing evidence that this does not lead to higher performance. Furthermore, high levels of variable pay may be creating short-term incentives, leading to the destruction of the long-term value that it was created to avoid.

- One study of UK companies from 1998 to 2010 found that “CEO incentive pay is negatively associated with both short-term and medium-term subsequent returns”[iv].
- Andrew Smithers, amongst others, argues that we have seen a reduction in business investment since the 1990s as a result of the increase in variable pay[v].

This is leading to a loss of trust

The tripartite issues of inequality, the disconnect between pay and performance, and indeed the high absolute levels of executive pay, are leading to a loss of trust in business, which we see regularly in the press and on social media. In an Ipsos MORI poll of the general public, executive remuneration was the second most widely cited issue that needed addressing, with the first being corporate tax avoidance[vi].

There has been some progress, but not enough

There has been some progress, with the main change being in 2013 when the UK government introduced legislation requiring all companies to put their pay policy to a shareholder vote at least every 3 years. This has led to shareholders contesting a number of pay deals, although success has been limited and the trend of rising executive pay has shown little sign of reversing. The controversial EU Shareholder Rights Directive has proposed divisive, yet in some ways innovative, legislation in relation to listed company executive pay that deserves to be debated[vii].

How Tomorrow’s Company can help tackle this issue

The debate around executive pay is either dominated by groups striking an anti-business tone - portraying business leaders as greedy individuals who are paid too much - or it becomes stuck in the technical details of remuneration. Instead, we need to acknowledge that a significant part of the problem is due to a broken system where executive pay is ratcheted up by a pressure to pay based on performance. We believe that any solution must take a more holistic approach, and look at the problems from the perspective of companies, investors and society; this is the core of Tomorrow’s Company’s approach.

We know from our members and discussion event participants that many senior business figures recognise this is a problem and want to take action. For example, a survey by the Institute of Directors found that 52% of its members saw anger over executive pay as the biggest threat to public trust in business[viii]. In addition business leaders are not purely motivated by remuneration, they want to build a successful business and gain the respect of society for doing so. The problem is that people also desire status and an executive’s pay package is too often seen as the determinant of status.

Discussion Summary:

2. What are the current problems with executive pay?

We initially discussed what the current problems are with executive pay. The following is a broad reflection of the consensus of the discussion rather than an agreed list by all participants.

1. **Ratcheting of pay** – Many boards target paying above the median, or there is a strong desire to pay a competitive wage. There is sometimes a perception that total remuneration is a reflection of talent, therefore boards want to be seen to be paying above average. Combined with increased transparency on pay this naturally leads to an increase in pay as companies compete with each other to remain above the average.

2. **Short-term incentives** – Many pay schemes contribute to short-term incentives either through the annual bonus or LTIP (long-term incentive plans). It was acknowledged this was part of a much broader problem involving short-term focused shareholders, and therefore blame could not be solely directed to executive pay structures.

3. **Gender pay gap remains** – Despite progress over the last few decades there remains a gender pay gap especially at senior levels.

4. **Disconnect between executive team and employee's wages** – A greater problem than the absolute level of pay is the disparity between executive pay and ordinary employee wages. Employees will feel disgruntled if they have flat pay while the CEO receives a pay rise each year, irrespective of the total amounts. If this gap between executive and ordinary worker is too large it can have a negative impact on employee motivation and hence productivity.

5. **Disconnect between pay and social impact** – The aim with most executive pay schemes is to align management interests with financial return and hence the shareholders. This leaves no automatic connection between executive pay and positive social impact. For example, the public will show more outrage against a CEO who is being paid well while firing thousands of workers.

6. **Too little link between performance and pay** – There is too little connection between pay and the specific strategy and purpose of a company. Too often LTIP schemes are solely based on TSR (total shareholder return) and EPS (earnings per share).

7. **Executives are not incentivised to plan succession** – Too often pay structures are designed only to incentivise an individual while they hold a job, rather than incentivising them to plan for succession and the long-term success of the company. CEOs should be incentivised to develop the next generation of leaders in the company, who can take over when they leave. CEOs should also be incentivised to pass the company on in a condition ready for long-term success.

8. **Lack of transparency** – There is too little transparency around executive pay, especially on the rationale for why an individual is paid a certain amount. This creates the public perception that executives are setting their own pay. It was remarked that executive pay disclosure, while improving in recent years, still had a long way to go. For example disclosure generally explains the 'how' and ignores the 'why'.

9. **Motivation is not all about financial incentives** – It was raised that recent psychology studies show that financial incentives are not always a good motivator of people especially for creative tasks. Pay structures are yet to factor this thinking into how they motivate executives.

3. What are the possible solutions?

The following is a list of the possible solutions discussed at the roundtable. The key theme was a greater link between pay structures and the company's strategy. This connection should then be communicated clearly, with disclosure focusing on both the why and the how executive are paid. In addition remuneration committees should have a wider remit to set the pay and incentives across all employees including executives. These points are again drawn from broad consensus rather than a list agreed by all participants.

1. **Increased appointment of internal candidates** – One reason for escalating pay is a bias towards appointing external candidates. Hiring external candidates typically involves a pay benchmarking exercise and having to create a package attractive enough to entice an individual away from their existing company. It was felt that there is often a sufficient pool of talented internal individuals, who are too often overlooked. If boards were more open to the potential of internal candidates there would be less pressure to offer extremely high packages.

2. **More variation in LTIP schemes** – Longer LTIP schemes is a possible way to create long-term incentives. However, each company is different and therefore there is no 'one-size fits all' LTIP structure. The problem is that currently the vast majority of companies have a 3 year LTIP scheme despite the many differences between company's investment cycles and growth ambitions. The current homogeneity of pay structures highlights the lack of connection to company strategy.

3. **Greater connection between pay and strategy** – While there has been progress in this area more could be done to make a clear link between a company's strategic priorities and how it is paying its executive team. One idea was that the remuneration committee might be required or at least challenged to set out the definition of performance against which the person concerned was being judged, stating the balance between results and other impacts such as culture, succession and even impact on society.

4. **Greater employee wide profit sharing** – A possible solution to the disparity between executive and employee pay is greater profit sharing schemes. This could be achieved through legislation as is the case in France. Another option is greater tax incentives, though it was pointed out that these tax incentive schemes are often abused. Either way the introduction of employee wide profit sharing schemes helps prevent an 'us and them' culture developing between employees and executives.

5. **Composition of remuneration committee** – It is often difficult for remuneration committee members to challenge a CEO over pay one minute and then provide a supportive role the next during normal board room activity. Further work on remuneration committee composition and who chairs it may lead to some answers.

6. **Remuneration committees should consider all employee pay** – In order to solve the disparity between executive and ordinary employee pay remuneration committees (remcos) should have a remit for pay and incentives for all employees and executives and explain their rationale in this regard. While remcos are already meant to consider relative pay gaps, the extent to which this happens is limited. Having a broader remit would enable remcos to balance the need to hire talented executives against the potentially damaging impact this may have on employee motivation.

7. **Greater communication and transparency from remuneration committee** – Remcos should provide clear communication for why management have been paid a certain amount and with a certain structure. This should be accessible, rather than the overly technical current disclosure. This disclosure should also clearly explain the connection between pay decisions and the company's strategy and culture. This transparency is important for gaining public trust as well as the support of employees. It can help employees buy into the long-term targets for the business, seeing how management targets align with their own targets and with the long-term success of the company.

8. **Voluntary CEO commitments and non-monetary status** – CEOs are often motivated by the desire for status rather than purely for financial reward. The problem is that status and financial reward are often conflated. In addition many CEOs would like to tackle the issue but are holding back from acting first. One solution could be a joint initiative by several CEOs to collectively commit to reducing their pay, or to donating a proportion of their pay to charity, or to sharing with colleagues pay received over a certain level. Such a commitment when taken with other CEOs could help provide the status without high pay. It may even provide higher status doe to the moral leadership it would provide.

9. **Clarity on tax** – One cause of public outrage around executive pay is when individuals pay very little tax. Greater clarity on tax laws could help remove this source of public distrust.

10. **External assessment of social impact** – There could be a simple assessment of the social impact of a CEO and company. This would help the public gauge where there is a disconnect between pay and social benefit. This could be a simple score or kitemark so that the public can get an easy assessment of the social impact a CEO has.

About Tomorrow's Company

Tomorrow's Company is an independent, agenda setting think-tank that exists to inspire and enable companies to be a force for good. We believe that adopting an inclusive approach – which focuses on relationships, purpose and values is the key to enduring success for business. We succeed in our goal by convening business leaders, investors, policymakers and NGOs to participate in a uniquely thoughtful process and set new agendas. Our impact has included changes to company practice, policy and regulation. Tomorrow's Company was founded in 1995 following the RSA inquiry into the role of business in a changing world.
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[i] Steven Bloomfield, "Theory and Practice of Corporate Governance and Integrated Approach", 2013.
[ii] High Pay Centre, "No Routine Riches: Reforms to Performance-Related Pay", 13 May 2015.
[iii] High Pay Centre, "No Routine Riches: Reforms to Performance-Related Pay", 13 May 2015.
[iv] Nick Balafas and Chris Florackis, "CEO Compensation and Future Shareholder Returns: Evidence from London Stock Exchange", June 2014.
[v] Andrew Smithers, "Road to Recovery", Sept 2013.
[vi] Ipsos MORI, "Consumers vote with their feet on corporate tax avoidance", 18 Feb 2015.
[vii] http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1398680488759&uri=COM:2014:213:FIN
[viii] Guardian, "Public anger over pay is serious threat to UK business, IoD survey finds", 2 March 2015.