HOW HIGH IS TOO HIGH?

If there's one thing that is sure to capture the public's imagination, it is how much people in positions of power get paid for doing their job, says Pádraig Floyd

£75m

The annual pay of Persimmon Homes CEO, Jeff Fairburn, before he was ousted

While sportsmen and celebrities are often admired for pulling down multi-million-pound deals, captains of industry are treated more severely. Often labelled as fat cats, their remuneration tends to attract more attention – and vitriol.

A number of recent cases have put chief executive pay back under the spotlight. Renault chairman Carlos Ghosn was sacked from his role as chair of Japanese car maker Nissan over alleged wrongdoing concerning his reward package. The internal inquiry turned into a criminal investigation and Ghosn remains in custody in Tokyo facing several charges relating to under-reporting his pay and financial misconduct.

Though Ghosn's situation is extreme, he is not the only boss under scrutiny. In 2018, the now ex-CEO of Persimmon Homes, Jeff Fairburn, was vague enough about his £75m pay – including a £47m bonus awarded in 2017 – to spark a media storm that made his position at the house builder untenable.

Last summer, John Ridding, chief executive of the *FT*, was censured by the FT Group's chapel of the National Union of Journalists over his £2.6m pay in 2017. The award was seen as excessive as the *FT*'s operating profit for that year was just £4m. Many staff had seen little or no increase in their pay over a number of years and the union was also seeking to address the gender pay gap. Despite Ridding returning £510,000, the chapel passed a vote of no confidence in the CEO in November 2018.

Who determines what excessive executive pay is? Regulatory limitations or even pay caps are not popular. They are likely to operate as a disincentive

WHAT'S GONE WRONG?

CEO reward has been going up ever since the mid 1970s, says Ruth Bender, reader in corporate financial strategy at Cranfield University. Academics at the time suggested CEOs were underpaid and that there needed to be greater alignment between shareholders and the directors running the organisation. "The argument said there is a need to encourage agents – the directors – to work on behalf of the shareholders and the way to do this is to incentivise them," says Bender.

In 1995, *The Greenbury Report* said that UK pay had to be justified in relation to performance, and introduced disclosure in order to discourage excessive pay levels.

Over time, this became a substantial link with performance, but was removed in the last iteration of the corporate governance code because it had "backfired horribly", Bender explains. "It was removed because they realised it didn't work. All it led to was more and more layers of complexity."

To attract and reward good candidates, the traditional salary became salary and bonus, and then salary, bonus and a long-term component. Within that structure there were all kinds of different conditions and targets.

WHERE ARE WE NOW?

By 2017 the average Standard & Poor 500 CEO was paid 361 times that of an average worker, according to pay ratios compiled by US trade union body AFL-CIO. Data from the Economic Policy Institute that targets the top 350 US companies shows the ratio as reaching 312.7 in 2017 (see box out).

But the ratios are not so everywhere. AFL-CIO data from 2011-2012 shows that while the US pay ratio was already at 350:1, Switzerland and Germany were around the 150:1 mark, with the UK at around 85:1 above Japan (60:1) and Denmark (50:1).

The reason that certain Western economies – predominantly the US, UK and Germany – have higher pay ratios is down to a difference in culture, says Umar Boodoo, an assistant professor at Warwick Business School.

"In Japan – and also to a degree in Scandinavia – there's a culture where senior executives are concerned how they will show their face if they are being paid too much," says Boodoo. "It runs against the co-operative ethos, but that is different here and the US. The culture encouraging higher pay has been ingrained for decades and so is very difficult to change."

THE HIGHEST PRICE

But just who determines what excessive executive pay is? Regulatory limitations or even pay caps are not popular. They are likely to operate as a disincentive and in reality would be difficult to enforce. Unlike Japan or Scandinavia, no company in the UK or US would apply a cap unless mandated by regulation, as it would leave them at a disadvantage against other companies competing for the best talent.

In the case of listed companies, it is the shareholders who are going to be the arbiters of value. However, despite a considerable amount of activism around levels of CEO pay, shareholders are only likely to be gunning for the CEO over pay when things are going badly.

"Shareholders are not one homogeneous group and are quite diverse in terms of their objectives," says head of corporate governance at the Institute of Directors, Roger Barker.

"Although this is gaining more prominence and a record number of activists' campaigns are under way in Europe, most are demanding actions to generate short-term shareholder value creation."

"I'm very much in favour of the long-term share value being an important ingredient of the makeup, as it is more difficult to manipulate"

Though CEO pay continues to increase faster than that of ordinary workers, there are signs that there is a growing awareness of the dangers of paying a CEO more than the shareholders consider appropriate.

In the US, 52 Russell 3000 companies failed to receive a majority support in say on pay votes in 2018, an increase of 53% on the previous year. In almost 70% of cases, this was the first time these companies had faced such disapproval.

The EU is considering extending say on pay. However, in the UK the reforms to extend the influence of stakeholders, including employees, on pay matters have been dropped, though pay ratios must be published and justified.

Boards in some sectors are also looking at placing caps on board directors' pay in the light of increased litigation from shareholders. And though say on pay votes are only advisory, boards are increasingly taking note of unrest over pay levels.

In 2018, the average say on pay vote in the US received 90% support. However, in recent years, some boards have agreed to review pay policies on the basis of a strong showing, even when they receive a healthy majority.

The most recent concession to shareholders was made by Royal Dutch Shell in November. The energy company, lobbied by a number of shareholder groups, led by environmental forum Follow This, agreed to tie future executive pay to carbon emission targets instead of pure financial metrics. It is the first climate-change-related say on pay vote, but is likely to be repeated at other general meetings in 2019.

CONNECT AND REFLECT

ICAEW published a paper outlining its approach to excessive pay, based on self-awareness and engagement, which sets out an action plan for boards (see boxout, right). It says: "Boards need to be stoical in their determination to follow and revisit this action plan, and they also need to be determined to adhere to their principles whatever internal or external pressures they face."

This may highlight a number of issues, indicating those companies paying their CEO less than others, companies and executives campaigning for pay restraint and even employees feeling informed and moved to stick up for how much their own CEO gets paid.

"Companies could move away from having a small number of highly empowered and highly paid executives and replace them with a flatter structure and more democratic decision-making; or, a company could pay its executives the same high pay that they pay today but without attracting outrage," the paper concludes.

FOCUS ON STANDARDS

Gerry Brown, an experienced board director and author of *The Independent Director: The Non-Executive Director's Guide to Effective Board Presence*, sees high levels of CEO pay as indicative of wider governance failings.

There is a fundamental issue, says Brown, that remuneration committees are often populated with independent directors. This may appear to be a good idea, but it only works if those directors are sufficiently experienced and confident to challenge the board or even oppose proposals.

However, boards generally lack diversity and fail to select directors on the basis of finding the best candidate via a nomination committee, Brown explains. He says a recent report by global recruitment firm Harvey Nash shows that, despite the combined code, 50% of director appointments are made on the basis of knowing the directors, or in effect, "jobs for the boys", as he puts it.

Brown believes these weaknesses have developed because the regulatory code is too weak, with the regulator rarely taking companies to task on financial matters, unlike in the US and – as in the case of Ghosn – Japan.

Brown argues that base pay should be a small part of a CEO's reward, with bonuses tied into longer term company performance. There are myriad ways of achieving this, but having in place a long-term incentive plan that awards equity in the company rather than large annual bonuses for short-term targets should be favoured.

"I'm very much in favour of the long-term share value being an important ingredient of the makeup, as it is more difficult to manipulate," says Brown. He warns that benchmarking has to be appropriate and realistic in order to avoid a never-ending upward spiral of CEO pay. But, ultimately, it must come down to strong governance and a willingness to say no.

"Every company should have clawback written into their executives' employment contracts by now," says Brown. "This is very important, because if performance is seen to have been in any way manipulated – or considered not to be appropriate – the board can claw back that portion of reward."

The ultimate decision has to be taken by the board – with shareholders' implicit or explicit consent. Ghosn has pleaded ignorance about the need to report and, while that investigation continues, CEOs' complex pay structures certainly lack transparency and are rarely understood by any but those who draw them up.

Boards may carry on regardless, but CEO pay is a perennial favourite of politicians, lobby groups and the press. Social media trends can effect lasting damage in seconds – the Persimmon case is an object lesson in how not to handle CEO pay.

Boards may consider making changes, because doing something unwillingly is always better than being compelled to do something. ●

ICAEW BOARD ACTION POINTS TO END EXCESSIVE PAY

1. Treat everything as though it is public.
2. Recognise all of the reasons why pay is important.
3. Look at the entire pay structure.
4. Talk about fairness.
5. Use simple language.
6. Lift the lid.
7. Have real conversations.
8. Admit mistakes.
9. Set out your pay principles.
10. Persist and be patient.

CEO-TO-WORKER COMPENSATION RATIO*

Year	Based on options realised
1965	20.0
1973	22.2
1978	29.7
1989	58.2
1995	112.3
2000	343.5
2007	327.4
2009	187.8
2013	278.6
2014	284.0
2015	271.6
2016	270.1
Projected 2017	312.7

* Based on averaging specific firm ratios and not the ratio of averages of CEO and worker compensation