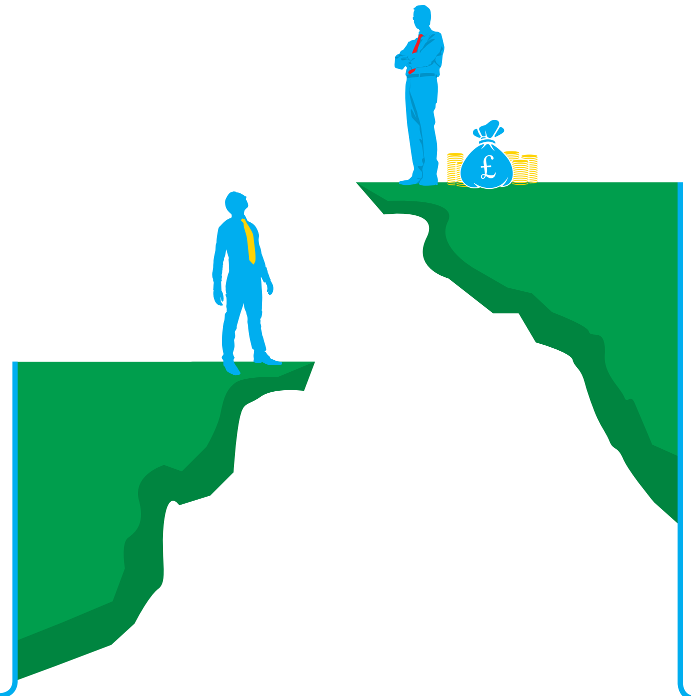
FUNDAMENTALS

Mind the gap!

High pay does not always guarantee performance. Total pay for executive directors, and particularly chief executives (CEOs), has increased sharply over the past decade. When compared to the performance of the market, the increasing level of executive pay is becoming difficult to justify.



In this edition of Fundamentals, Angeli Benham, Corporate Governance Manager at LGIM, discusses the implications of increased executive pay and what investors can do to help align it with the interests of all stakeholders.

The disparity between pay for chief executives and their employees has widened significantly in recent years. Research by the High Pay Centre shows that earnings for FTSE 100 CEOs increased by 146% from 2000 to 2013, compared with only 43% for all FTSE 100 full-time employees.

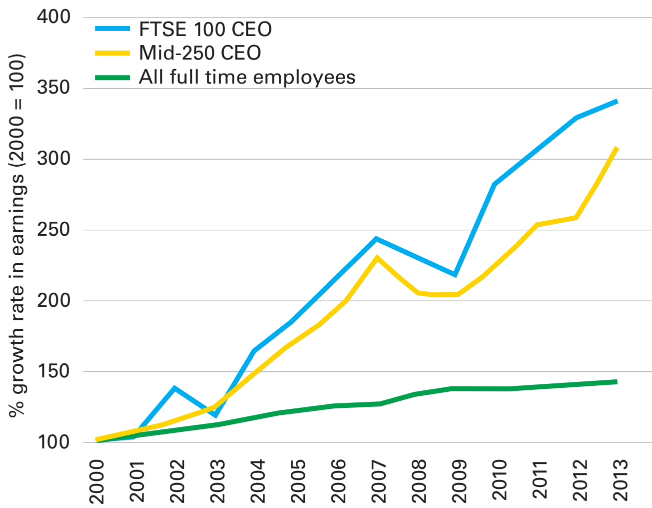
Evidence on whether increasing pay leads to improvements in performance is mixed. For example, research by Professor Dan Ariely of Duke University has shown that variable pay, such as bonuses, can substantially improve performance on routine tasks. However, for people working on innovation, creative and non-routine tasks, such as executive directors, variable pay can hurt performance.

We believe that the inequality faced by many employees has a material impact on society. This inequality, and the furore that surrounds executive pay, can no longer be ignored.

Legal & General Investment Management (LGIM) supports the idea that companies which demonstrate good long-term performance should be able to reward their executive management team. However, we believe that continuously increasing their pay is neither beneficial to shareholders nor to society at large.

Companies should not forget that workers are their most valuable asset and success would not be delivered without their effort. Companies that are exercising restraint, cutting costs and headcount should be sensitive if they are also increasing executive pay. All employees, regardless of the health of the company, should be recognised for their contribution to the success of the business.

Figure 1. Indexed FTSE 350 lead executive and full-time employee earnings growth 2000 to 2013



Source: High pay centre

Fair pay for employees is good for business and the economy. Employees on lower incomes spend a larger proportion of their pay than others. Data from the British Retail Consortium (BRC) shows that household consumption accounts for about 60% of GDP in the UK. Ensuring employees are adequately and fairly remunerated also promotes better worker productivity and retention.

Prime Minister Teresa May has committed to overhaul corporate governance, and MPs on the Business, Innovation and Skills Committee are now conducting an inquiry into issues such as executive pay. We welcome the review and will be making a written submission to the inquiry.

This article provides LGIM's view of what needs to be done by companies and investors to address the continual rise in executive pay.

> Unilever CEO Paul Polman thinks people at the top executive level should not just be motivated by salary. "If you would pay me double, I am not going to work twice as much, because I'm already probably maximizing my time available."
>
> Source NL Times Posted on May 26, 2015 by Demid Getik

WHAT STEPS DOES LGIM SUGGEST TO STOP THE INCREASING LEVEL OF TOTAL PAY?

While there is not one single solution, there are many changes companies and investors could implement today, to stop the pay gap widening.

The box below outlines our pay principles:

LGIM wants companies to:
Stop the annual use of benchmarks
Publish the pay ratio between the CEO (the 'single figure', see glossary below) and the median employee
Reduce their focus on the annual bonus
Reduce, over time, the disparity between executive and employee pension contributions
Identify employee representatives to meet with the remuneration committee annually
Apply a 50% discount if adopting restricted shares
LGIM believes investors should:
Vote against directors when concerns persist
Stop abstaining on pay resolutions

The High Pay Centre has said that the average ratio between FTSE 100 CEOs and the average total pay of their employees in 2015 was 129:1.

In 1998, the average FTSE 100 CEO was paid 47 times their average employee.

BENCHMARKING

Companies have access to peer group pay comparison tables for directors, known as benchmarks. These peer group pay benchmarking exercises are a crude assessment of the pay practices in comparable companies. In many cases, the companies are selected arbitrarily by size or hand-picked to produce a higher median.

Remuneration Committees should steer clear of annual benchmark data and instead give more time to considering the nature of the role, the time commitment, complexity and the pay and conditions being offered throughout the organisation. When companies are recruiting, or when their pay policy is being reviewed, the use of a benchmark may be helpful. However, they should not be the only sense check; companies should also consider what the role commanded ten years ago and why the same role commands so much more today.

PAY RATIOS

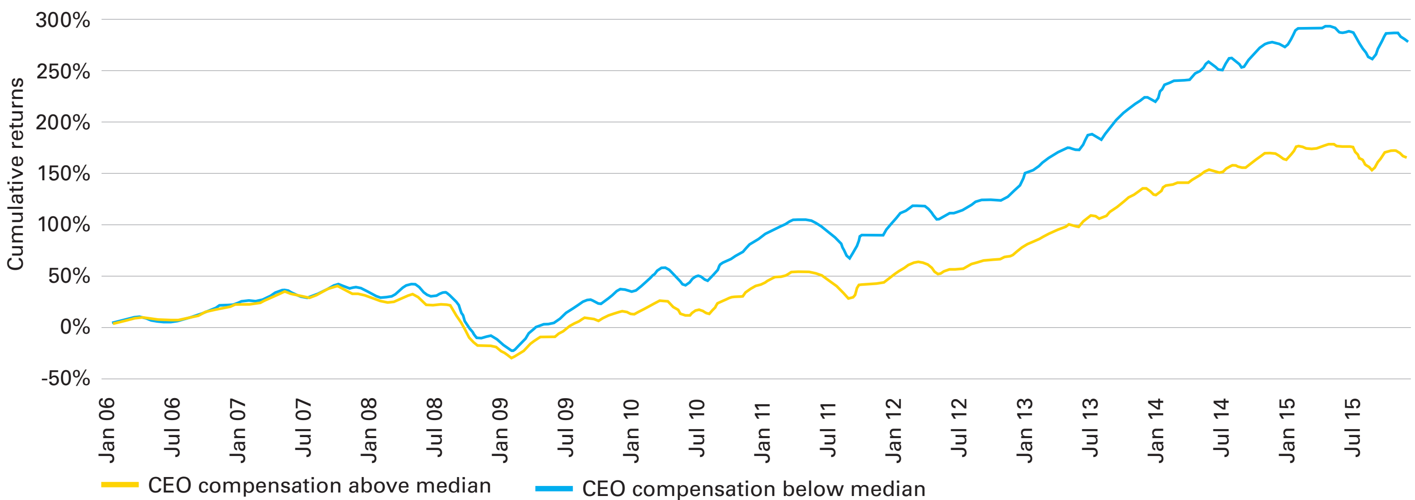
LGIM wants companies to publish the ratio between the CEO's total pay (the 'single figure') and that of the median employee. This will highlight how the pay gap compares with its peers. Gender pay ratios are now a legal requirement, but they address only one form of inequality.

The Board as a whole should be compelled to justify the pay ratio and why the take home pay for the executive for that year (single figure) is appropriate given the performance of the business and rewards for the general workforce.

This would help to address the issue that pay is not necessarily being linked to performance. A *recent study*[1] into US companies by MSCI found that companies that pay their boards above the median lead to underperform in terms of total shareholder returns, compared with those that pay below the median.

1. 'Research insight are CEOs paid for performance' by MSCI.

Figure 2. Companies with CEOs paid above median underperformed those paid below median



10-year Total Shareholder Return Time Series, based on above and below peer summary pay medians / returns shown are equal-weighted. Source: MSCI ESG research, July 2016

EMPLOYEE REPRESENTATION

We believe that the employee voice should be heard in this important debate. Regulation already requires the Remuneration Committee to take into account pay and performance across the business when setting pay for the executive directors. Explaining this to shareholders, without using boiler plate language, would evidence these considerations. Employee representatives should play a role by meeting with the Remuneration Committee annually to ask why the Committee considers the pay practices applied in the organisation to be fair.

STRUCTURAL CHANGES

To elements of pay

LGIM would like companies to reduce their focus on the annual bonus. Instead, more emphasis should be placed on long-term incentives. The annual bonus focuses management on short-term fixes to meet their targets. Our experience has shown that on average, 80–100% of the maximum bonus has been consistently paid out, which highlights that pay-outs have become a near certainty rather than an incentive tool.

Pay disparity not only relates to salary and bonuses, but all aspects of remuneration. Pension payments for executives are broadly around 25% of salary, while company contributions to employee pensions are significantly lower at around 5%–10%. This disparity should be reduced over time and instead companies should encourage long-term savings for all employees.

A *recent report*[2] published by the Executive Remuneration Working Group suggested the use of 'restricted' shares, which require a long holding period with no performance conditions. This would give directors more certainty over the value of awards. In return for this certainty, they should be willing to accept a reduction in the total value. LGIM agrees with the working group that a 50% reduction in the value of the long-term incentive scheme would be appropriate.

2. 'Final report' from Executive Remuneration Working Group.

Structural change, if needed, is not limited to the remuneration policy; it may also be necessary through the governance of the company.

Corporate culture

The board should set the tone for the organisation as a whole. They should demonstrate good corporate behaviour and ensure this message is filtered throughout the organisation. Employee satisfaction is an important indicator of a well-run company. Employees should be recognised for the value they bring to the organisation and this should be reflected in their remuneration.

Succession planning

Poor succession planning for key executive roles is another reason for increased executive remuneration. An executive director can claim they have received a better offer elsewhere, and boards might feel vulnerable when they know that several companies in their sector are looking for a finance director or a CEO. If companies had good succession plans in place to deal with the departure of an executive, the company would not feel as vulnerable if the best candidate is internal. This would also reduce the significant costs associated with recruiting externally.

The Nomination Committee should be held accountable for poor succession planning and liaise effectively with the Remuneration Committees to ensure they don't have to offer more pay than is necessary.

LGIM considers good succession planning as an indicator of a well-run board.

SHAREHOLDERS TO USE THEIR RIGHTS ON PAY

Regulation has provided shareholders with a triennial binding vote on the structure and maximum level of pay. In addition, there is an annual advisory vote on executive remuneration and votes on new share-based plans. Shareholders can also vote on director elections every year.

> '… the level of support for most resolutions was near unanimous with, for example, resolutions on director elections attracting 98% support across the FTSE 350.'
>
> Source NAPF 2015 AGM report

LGIM does not abstain on UK company general meetings and will vote against directors where we identify significant concerns over their pay schemes.

In 2015, LGIM engaged with 300 UK companies on a number of governance topics. We voted against 93 UK pay resolutions and 39 UK director elections.

IN CONCLUSION

LGIM is calling on companies and investors to act now. The pay gap should not widen, there is little justification for the current trend. The Nomination and Remuneration Committees need to work together and exercise restraint. Companies should recognise that fairly paid employees will be more productive and help the economy as a whole. Importantly, we need to speak together as investors to push for pay structures that are more aligned. LGIM is committed to exercising the rights of our clients.

GLOSSARY

Quantum: the level of total pay for executives

Single figure: Regulations require UK-listed companies to publish a 'single figure' detailing the total pay awarded for executive positions on the board

Total pay: salary plus other elements of pay such as bonuses

Variable pay: Elements of pay which are adjustable, such as bonuses

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