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Fair Pay for Fair Work: A Look at Executive Compensation

Companies form an organic part of society. The shared bargain between companies and society needs to be re-established so that the required basis for mutual trust can exist. The need to balance justice and self-interest in a way that society perceives as fair, as well as a desire to put the common good ahead of self-interest has guided St Paul's Institute through this work on executive compensation.

Friends Provident Foundation
Fair economy. Better world.

St PAUL'S INSTITUTE

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Foreword

St Paul's Institute is honoured to have been selected by Friends Provident Foundation for this project on *Fair Pay for Fair Work*. Executive compensation fits within the Institute's thematic work on inequality as well as within its recently launched programme *Democracy and the Common Good*. We believe that the current rifts within our society can best begin to be healed by simultaneous work on several fronts that: encourage people of different beliefs and different walks of life to speak constructively together; encourage communities to create structures for mutual help and support; ask each citizen to act, vote and spend in a way that prioritises mutual flourishing over individual self-interest in order to help create the society in which they wish to live.

Fair Pay for Fair Work fits within this framework to the extent that one of the key broken relationships is that between companies and individuals. The rebuilding of trust depends upon a clear sense of the long-term purpose for companies that re-establishes their license to operate. Remuneration policy is just one of the many aspects of corporate governance and behaviour that needs attention in order to rebuild a country in which all sectors of society make constructive contributions to the common good.

We are aware that there are myriad publications available on the subject of executive remuneration, from the scholarly to those overtly lobbying for a specific outcome and everything in between. The intention of this paper is to question why there has been so much talk, and so little real change on executive pay, and to try to use investors as the bridge between the interests of companies and their executives on one hand, and the wider societal interests on the other.

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Acknowledgements

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"Thirty years ago, when I worked in business, company chief executives were paid on average around 20 times the salary of the average worker – and people were worrying about the gap. CEO pay in the FTSE is now more than 150 times the average salary."[1] **Justin Welby,** Archbishop of Canterbury

Introduction: why does executive pay matter?

Debates on the appropriate pay ratios between senior executive pay and the shop floor worker are nothing new. J Pierpont Morgan, one of the wealthiest men in the world of the 1920s reportedly thought then that this ratio should never exceed 20:1. The most recent report on corporate governance reform by the Department for Business, Energy and Industrial Strategy puts the current ratio at 128:1.[2]

Why does this matter? It matters for several reasons, all of which are related to issues of how people live together and interact with each other in society. Since the financial crisis, living standards have declined for most of the population of the United Kingdom while a small group continues to garner an extravagant share of the earnings and to accumulate a disproportionate share of the wealth. At the same time, trust has diminished in financial services specifically, and in business and politics more generally.[3] A long-term deterioration in societal trust together with the sense that the system is not working for a large percentage of the population can lead to breakdowns in civil society, creation of identity politics and even a decline in faith in democratic institutions.

Moreover, perceived lack of fairness in the structures of society touches a very raw nerve in people. While there are a variety of theories on distributive justice, a perception of the lack of fairness in the distribution of the spoils of labour creates societal dissatisfactions. The text box which follows summarises some of the theories. It is important to recognise that in this context fair does not necessarily mean equal. It is also important to realise that people's views of what is fair can differ dramatically. How society determines a definition of fair that is acceptable to its members is beyond the scope of this paper, but perceived lack of fairness by any significant minority can have important repercussions for civil unrest and political outcomes.

Principles of distributive justice

To simplify complex political philosophy dramatically, theories of distributive justice can be distilled into the following six broad categories:

Entitlement: All voluntary transactions are just.

Efficiency: Income distribution should lead to an efficient allocation of labour.

Just desert: People who achieve more deserve more.

Equal opportunity: Outcomes will be fair provided the starting point is fair.

Sufficiency: Guarantee a minimum standard of living for all.

Maximin: Distribute income to make the worst off in society as well-off as possible.

Work by PwC used these six categories to survey people and built four philosophical 'tribes' from the results:

Idealist: Distribution of wealth should lead to moral outcomes.

Communitarian: All members of a community should have an income that is sufficient for them to lead a dignified life.

Free marketeer: Provided there are equal opportunities for all, talented people deserve to receive income in line with their contribution.

Meritocrat: Provided all members of a community have sufficient for a dignified life, individuals are entitled to receive economic benefits resulting from their contribution.

Source: PwC: *The ethics of pay in a fair society*
www.pwc.com/ethicsofpay

Private sector pay also matters because companies form an organic part of society. Society has given companies the privilege of limited liability for which they have reciprocal obligations in order to maintain their societal license to operate. The shared bargain between companies and society needs to be re-established so that the required basis for trust necessary for long-term flourishing can exist. This includes, among other issues: labour relations, environmental considerations, tax obligations and being a responsible member of the local community. Responsible businesses contribute to a good society and human flourishing.

In addition, there are theological reasons why business behaviour and issues of executive compensation matter to people of faith. Theological teachings suggest that in financial matters we should always take account of the community around us. Businesses can only thrive in the long-term if they have regard for the society in which they operate. Similarly, individuals in business need to have regard for those beyond themselves, be they co-workers, consumers or members of the community, in addition to shareholders.

Christian theology holds that all individuals are equal before God. When material rewards become vastly unequal, it becomes harder for people to perceive the truth of equality before God, since it is contradicted by their experience of the world.

Christian ethics looks at balancing justice and self-interest. The need to reward different contributions, incentivise staff and compensate for responsibility is justifiable within this thinking. However, such differentials must be linked to measurable differences in contribution, skills and responsibility. This includes fair rewards at all levels of the company, including the lowest.[4]

This work also matters in the broader context of efforts to heal societal rifts by shifting behaviours away from self-interest toward a concept of the common good. By 'common good', we mean an ordering of social relations in a way that holds in balance individual fulfillment with mutual flourishing, based on the dignity and equality of all people. To try and re-establish a common good framework implies building up those elements of society that contribute to the common good such as community organising or mutual societies, while working to iron out policy or behaviours that encourage individual prospering at the expense of others, or individual self-interest to the detriment of others.

The concept of the common good also contains an inter-generational element. We need to be concerned not only about the systems and communities in place now, but what we are leaving for those who come after us.

Can changes in pay move the dial of inequality?

Executive remuneration is only one subject among many which warrant attention as we strive to create a society where all can thrive. In and of itself it will not move the dial of inequality to the extent that changes in tax policy can, or the re-birth of radical ideas such as universal basic income.

There are, however, at least two reasons to look closely at renumeration. First, executive compensation has a disproportionate effect on perceived fairness as a result of both the publicity given to outliers in the media, and the residual resentment from the perception that the 'fat cats' got off cost-free from the financial crisis while most of the population continues to pay.

Second, there has been much debate on this subject since the upswing of the pay ratio beginning in the 1980s, with very little success to date on efforts to curb compensation extremes. In spite of moves on tax treatments, disclosure and shareholder votes in a variety of jurisdictions, salary multiples between the lowest and the highest paid remain stubbornly high. This paper will consider possible reasons for this and look at the levers of change, particularly investor action, that might be more effective.

Why so little change?

One reason that changing behaviour is difficult is that there is not a 'one size fits all' answer to an appropriate pay ratio across industries and national boundaries due to differences in tax policy, social safety nets, supply and demand for executives and the skill levels required between the top and bottom levels of a company in different sectors.

Second, the composition of executive compensation varies as a function of national tax policy, and has become increasingly complex over time. Until the 1990s, executive compensation in the United Kingdom was more or less split in thirds between salary, fixed salary pension contributions and incentive payments. Today salary may be as little as 20 per cent of total remuneration with 80 per cent in incentive compensation, and executives are increasingly responsible for their own pension provision.[5] The complexity of long-term incentive plans (LTIP) paid in equity or equity options over time makes it more difficult to compare executives with rank and file workers than it used to be, as well as more difficult for the uninitiated to understand.

Third, some argue that the vested interests around this subject prove an impediment to change. These interests include remuneration consultants, investment advisors, highly paid investment managers to whom executive pay does not look abnormal, LTIP experts within investment management whose careers require the continuing existence of equity incentives, and head-hunters whose fees are often based on the compensation of the executive they successfully recruit. While none of these participants can be held explicitly accountable, together they create a web which is difficult to untangle.

At the corporate level, directors, non-executive directors, remuneration committees and investors rely on and use the services of those mentioned previously. There are arguments that there exists an asymmetry of information between directors, non-executives and investors that gives directors an upper hand in compensation and bonus or long-term compensation setting and achievement. Directors have both levers over and information on short-term outcomes that can, in some cases, have a direct impact on financial results and their ultimate compensation. In addition, the argument that executive pay levels are based upon supply and demand for talent can be challenged, as there are many foreign chief executives (CEOs) at FTSE 100 companies but not many UK CEOs abroad, implying that the UK is not experiencing a particular brain drain based on pay, with the main salary pressure coming from the United States.

William Lazonick has claimed that harmful effects have resulted from having chief executives' pay so intrinsically linked to their employers' stock prices. Such linkages can lead to CEO salaries increasing during share price declines to retain talented directors. Combined with the ability of CEOs to retain the gains from immediately selling stock acquired from options, this has entrenched a system where those at the top of major companies may prioritise inflating share prices above other corporate objectives.[6] Rather, incentives should be based on behaviour and performance criteria that reflect the company's overall long-term priorities. Over-reliance on any one measure will distort behaviours.

Where are the levers for change in this system?

The most obvious point of leverage in this system is investors. Investors each hold an ownership interest in companies through the shares, or equity, of the company they hold. They are liable for the debts of the company only to the extent of the value of their shares, and share in any profits or increase in value of the company. This ownership interest gives shareholders the following rights: to vote their shares on company resolutions at annual and special shareholder meetings; to influence companies directly in discussions; and to influence firms' share price indirectly by buying and selling their shares in the market.

However, investors are not a homogenous group of actors. They can range from individuals in their Individual Savings Accounts (ISAs) or pensions, through to charities, foundations and institutional investors who manage money on behalf of others. Increasingly, shares are held through exchange-traded funds (ETFs), which give investors only indirect holdings. As a result, most shares are voted through brokers and fund managers, though individuals can request the right to vote their own shares if they own them outright.

Few investors hold sufficient shares of individual firms to permit them to exert direct influence through holding a board seat or having direct access to senior executives. However, investors will often work together where they have similar interests to make their voices heard to companies. Within the church community, two examples are the Ethical Investment Advisory Group and the Church Investors Group. Fund managers are also increasingly recognising that some investors want investment vehicles that reflect their personal values and objectives and are beginning to build investment vehicles, funds and ETFs around these, sometimes known as ethical funds.

In addition, popular initiatives can have a direct impact on investment managers' behaviour. Most recently this has been evident in thinking around how to react to public horror at the incidence of gun-related deaths in the United States. BlackRock, one of the world's largest investment managers has found itself in an awkward position. Chief executive Larry Fink recently wrote to corporate CEOs that their companies "must not only deliver financial performance, but also show how it makes a positive contribution to society." However, many of the funds managed by BlackRock are in index funds. Index funds hold all the shares contained in a given stock exchange index. As a result, these index funds make BlackRock the largest shareholder in many gun companies. So long as the positions are in index funds, it cannot divest. This gives BlackRock three choices: it can be an active manager, engaging with the companies in the index to change their business; it can create funds that explicitly exclude such companies, or it can ask something of companies it holds that it cannot do itself.[7]

Investment managers sell what they perceive their clients want. This has led to an increase in ethical funds and to BlackRock's initiative. To the extent that investment managers perceive an investor emphasis on quarterly returns, and are compared against each other based on short-term returns, they have little incentive to shift their behaviour. This implies that absent a concerted public effort on issues of executive remuneration, most investment managers will put their efforts and attention elsewhere.

> "...because of the passivity of many shareholders, a relatively small proportion of activists can have a disproportionate impact."

However, this outcome is not as bleak as it sounds. The nature of investor activism means that it does not take too much noise in this community to get attention. To the extent that public action and investor behaviour begins to affect share prices, board and executive minds will focus very quickly on a topic. In addition, because of the passivity of many shareholders, a relatively small proportion of activists can have a disproportionate impact. Many investment managers have traditionally avoided activism because of the 'free rider' principle where the costs of activism are borne by the activists whereas the benefits are attributable to all shareholders, putting the activists at a cost disadvantage. However, as markets move to ETFs and index funds, it is increasingly difficult for mainstream investment managers to differentiate themselves, encouraging the construction of investor-specific products and activism to distinguish themselves in a way that is increasingly difficult to do in cost structures and returns.

Another clear point of leverage should be the board of directors, particularly the non-executive directors and the remuneration committees. Over time, more power has been given to the investor in votes on pay and votes on remuneration committee membership. To date neither of these have had any significant impact on curbing any but the most egregious executive pay headlines in the UK. This underlines the board's role as an optimiser, trying to balance profitability, shareholder return, staff motivation, talent attraction and retention, corporate citizenship and the long-term sustainability of the business. It may also be evidence of the disinclination of many boards to do anything that will draw attention to significant behavioural differences with other firms, given the comfort of staying 'within the pack' of an industry or index on most measures.

The other clear point of leverage in the system is regulation. In the case of the United Kingdom, this takes the form of the Financial Reporting Council (FRC). In most cases regulators are more responsive than proactive, and work through consultations with the regulated and the public. The FRC launched a consultation in December 2017 entitled '*Proposed Revisions to the UK Corporate Governance Code*,' which included specific references to issues of pay and remuneration committees.

Conclusion

In the last 40 years, increasing globalisation of business together with jurisdiction shopping by corporations has made it difficult to arrive at a coordinated response to the issue of executive compensation. In addition, cultural differences on both the subject of wealth and income distribution and issues of privacy vs. transparency on compensation issues have impeded consistent efforts across countries.

In spite of efforts to curb executive pay, in the UK it remains both a stubbornly high multiple of median compensation and stubbornly opaque. The public tends to be occasionally outraged by specific outliers or by executives who leave a company personally wealthy while the companies they run become bankrupt or the workers' pensions underfunded. A web of interested parties who benefit from the system and have significant influence in outcomes deter systemic change.

And yet there is an increasing movement, and an important one, toward a system where companies privilege sustainable long-term returns and sustainability over the short-termism often favoured by shareholders and company executives alike. Short-termism can lead to artificially increasing share prices to benefit short-term shareholders and executives with significant vested share bonus plans, while discouraging long-term productive investments that have initially dilutive effects on share price.

Years of policy recommendations and changes in reporting and shareholder voting have not driven any substantive change in executive compensation, though it may be argued they have curbed further growth in the executive pay multiple. For this reason, we believe a more radical overhaul is necessary to arrive at a system that rewards contribution and attracts the necessary talent while still being perceived as fairly rewarding all employees. The first section contains the policy recommendations, and the second needed actions by investors to bring these changes to fruition.

> "Short-termism can lead to artificially increasing share prices to benefit short-term shareholders and executives with significant vested share bonus plans, while discouraging long-term productive investments that have initially dilutive effects on share price."

Policy recommendations

1. Implement the publication of a pay ratio between the executive and the median staff pay as proposed by the government.

This crude measure will always be flawed and can be extremely misleading. Nonetheless, as evidenced by the recent gender pay gap reporting requirement, simple reporting measures can be extremely effective. The ability to compare across companies and sectors within the United Kingdom immediately leads companies to detail the reasons for the outcome and any plans to act on it. For this reason, any publication of pay ratios should be accompanied by detailed information on how each ratio was reached, and how the extent of the variation between the highest and lowest-paid members of staff relates specifically to the context of each organisation, as well as how these relate to trends in their sector or industry. Most importantly it requires companies to articulate their philosophy on pay and either justify the figure or explain what they are going to do to bring about change. For this reason, companies should be encouraged to make statements on whether action will be taken as a result of the findings, and if not, why not.

As a vital corollary, annual pay increases at senior levels should be compared with pay increases for the rest of staff, with the track record of this reporting published over time. Efforts to obfuscate by changing definitions frequently should be challenged. Transparency on relative pay bands and multiples and the reasons for them will clearly focus the mind on where value is being added and how that added value is being shared.

2. Simplify pay packages, and rein in stock-based pay.

The complexities of pay packages make them very difficult to compare across companies and industries, and through time. Ideally packages would be simplified, but at a minimum the total package should be quantified, with a minimum, maximum and most likely outcome summarised. These are the figures that should be published and used for the government's proposed publication of pay ratios, currently limited to salary only, and thus hugely understating the reality of pay differentials.

The original intention of aligning executives' interests with those of shareholders, while worthy, can easily become distorted over time. This is particularly the case when incentives are based on equity options instead of outright equity grants. Options contain a significant element of leverage, by permitting executives to buy shares at a pre-set price which can net them sometimes extravagant gains on exercise.[8] Information asymmetry between executives and boards or remuneration committees as well as between executives and other shareholders can affect incentive and strategic target setting, particularly as options available for exercise accrue.

3. Increase the pay of those paid least.

It is far more effective to raise the denominator to change a ratio, than to reduce the numerator. Depending on the numbers of those paid least, the total bill might be higher, but the impact on staff motivation and productivity will certainly be greater than if the remuneration of the most highly paid is reduced.

Arguments abound about the importance of control of labour costs to prevent offshoring of work, and about the importance of flexible contracts to cope with variable demand. However, the shrinkage in median real income in the UK since the financial crisis has created a class of both the 'precariat' with unpredictable incomes and the working poor, reliant on food banks and credit to live, in spite of being in full time work. If there is to be a social contract between business and society in order for businesses to retain their license to operate, the very first stage is ensuring that companies pay a living wage. If companies do not change behaviour of their own accord, legislation should be considered. The decline in employee activism through unions needs to find a counterbalancing voice.

Perversely, executives are often rewarded financially for successfully restraining or reducing the wage bill of the company. This needs to be considered in an overall 'fair pay' strategy (see below).

4. Publish interior salary multiples, sometimes known as 'next layer multiples.'

Next layer multiples demonstrate how salary ratchets up by pay grade. Publishing the salary bands per pay grade and then the actual pay multiple between grades is a powerful way of demonstrating, and forcing a company to justify, where they see added value. As a policy, the compensation of the next layer up can actually be set as an upper limit of some multiple of the people the next layer below. Companies which have used this strategy have often found that whole layers of management and salary have been able to be much more efficiently redeployed with both the company and its staff benefitting.

5. Build and publish a fair compensation framework.

All of the recommendations above come together in the creation and ultimately publication of a fair compensation framework. This would cover issues such as: are we treating people decently and how do we know? Do we have a reward system that works and how do we know? The very creation of such a policy often identifies much needed simplifications in layers of staffing, and improves understanding of the culture.[9] To be effective, regular internal reporting and reporting to the board of directors' remuneration committee on how behaviour compares with the compensation framework is necessary.

How can investors support these actions?

As already stated, investors are not a homogenous group, but a relatively small minority of vocal shareholders can have significant impact. As hedge fund and vulture fund activity can change company behaviour, so too can concerted efforts by like-minded investors. To do this well requires consistent and collaborative efforts. Below are just a few ways investors can increase their impact both generally and around executive compensation issues specifically.

1. Create an investor group to influence executive compensation.

Investors can join groups that work together on issues that matter to them. These can be national or international, faith-based, charity-based, or simply about issues of governance. In the same vein, investor groups form and re-form around specific issues such as the environment and modern slavery. Creation of an investor group on executive compensation could be done within the aegis of an existing organisation or a single-issue investor group could be created.

2. Support the recommendations listed above.

In groups or individually, investors can encourage the companies in which they invest or the fund managers they use to support these initiatives actively.

3. Act on remuneration committees.

Investors should be looking at the composition and diversity of board remuneration committees, in income levels as well as backgrounds and experience. In addition, there is a growing movement to vote out individual remuneration committee members where votes on remuneration taken at Annual General Meetings are not taken into account over 2-3 years. Investors should also encourage remuneration committees to work toward a fair compensation framework, ensuring that ratios published are accompanied by clear policies on the target levels and the measures that the company will use to achieve them.

4. Tackle the web of vested interests.

As compensation policies become simpler, clearer and more transparent, some of the various advisory functions will fall away naturally. However, this will take a very long time. To expedite the process, asking companies to disclose their use of advisors would be one step. This is something most boards already regularly review, so disclosure would not increase reporting burden by very much. Another tactic would be for investors to ask and understand the use of internal and external compensation advisors and consultants and their pay levels among the investment managers they mandate. This could be done as part of any review of investment managers or whenever investment mandates are being reconsidered.

The intention of these proposals is to simplify the chains of intermediation that exist for shifting responsibility for compensation levels and complex packages. They should also diminish the excesses in the system. This report is not suggesting that such services should be done away with, as many, such as benchmarking and competitive analysis have value for boards, especially where remuneration is not transparent.

Dear CEO letter

A clear and simple way of getting one's message out lately is either the Dear Shareholder letter written by company chief executives to their shareholders and other stakeholders, or the Dear CEO letter written by major investors, or regulators to the companies they own or supervise. Here is our very own Dear CEO letter for investors to consider adapting to send to the companies in which they invest.

Dear CEO,

First of all, let me thank you for the work you do on behalf of the shareholders.

Talking about how we value and incentivise your skills and work is very difficult. The very private nature of personal income and finance make comparisons to your peers or to the people who work for you very difficult. Unfortunately this can lead to a culture of secrecy and a tendency toward complexity in pay packages that makes people wonder if there is something to hide.

Moreover, the focus on financial compensation and incentives risk crowding out other intrinsic motivations of executives just as relevant to the company's success: the satisfaction of doing a good job, the pride in leading and growing a great company, the respect of peers, and the legacy of a sustained and sustainable success.[10] You choose to do this work. You and all your peers are being paid dramatically more than the amount they need to live. As such, pay risks becoming a poor yardstick by which to gauge success against your peers, instead of a measure of compensation for work, skill and accomplishment.

This letter is intended to encourage you to build, publish and implement a fair compensation framework, where staff and all stakeholders can understand the basis of compensation for all staff within the corporation, their perceived value-added and the differentials in pay as staff move from level to level. We firmly believe that doing this will actually improve long-term performance and loyalty at the company, simplify structures, and reduce any gaming of results to meet incentive targets.

The actual fair compensation framework needs to be adapted to the nature of your business and structure. To the extent that results exceeding budget derive from group achievement, then some portion of the excess may be pooled for sharing among all staff, either as cash or shares. To the extent that individual performers have an outsize impact on results over expectations, then some differentiation in distribution of those excess profits may be warranted.

This is just a first step. Over time, we would also like you to consider the basis for share-based awards, particularly share option-based awards. While the original basis for such awards seemed to make sense, in many cases, they have driven such outsized awards and the accumulation of significant share positions that they may create conflicts, rather than congruity between shareholder interests and senior executive team interests. This is particularly the case in short-term vs long-term decision trade-offs, share buyback policy, investment decisions and mergers and acquisition activity. In the same vein, we would also like you to consider compensating some of your senior staff in debt of the company rather than shares, so that they have equal regard to the appropriate gearing of your company and your industry as well as to its profitability.

We very much look forward to a conversation with you on this topic, and watching how your compensation policy develops.

Yours sincerely,

Your shareholder

Follow-up steps

Progress on the issue of executive compensation will only occur with consistent and concerted effort by all interested stakeholders. Compensation reform sits naturally within efforts to re-focus companies on purpose and long-term sustainability. Below are four initiatives which warrant attention by those engaged in executive compensation reform.

1. UK Government Private Company governance review

- The intention of this review is to scrutinise non-quoted companies' remuneration levels
- Laws exist that compel UK listed companies to publish their pay ratios. However, those whose shares are not listed on the stock market have not been subject to the same level of scrutiny. An increasing number of companies are opting for the private route, often financed by private equity or venture capital. Talent moves between the listed and unlisted sectors such that looking at one sector without looking at the other can have unintended consequences, such as a shifting of talent toward a sector where pay rates are under less scrutiny.
- For large private companies, the government's plans, released in August 2017, only consist of encouraging them to sign up to a voluntary code regarding disclosure of pay ratios.[11] Yet this was combined with proposals, issued a month later, that involved compelling private companies to assess more stringently the activities of their directors, including promoting the voices of employees in the boardroom and submitting reports annually to Companies House on risks and non-financial data.[12]
- At the very least, non-quoted companies should be compelled to release data on pay ratios and remuneration packages to the extent they have disclosure requirements from Companies House.
- Although the government's comments on this matter are a good start, they could arguably go further. Guidelines on private companies need to be more rigorous and subject to greater scrutiny, particularly over pay ratios and remuneration packages for directors. This can ensure that at the very least, those working for such companies can push for better practices. Rhetoric around reforming 'the unacceptable face of capitalism' will continue to ring hollow if only publicly-listed companies are pressured into proving that their payment polices are fair, equitable and linked to good performance.

2. Outcome of the Financial Reporting Council's Consultation

- Watch for outcomes from the Financial Reporting Council's (FRC) consultation launched in December 2017, 'Proposed Revisions to the UK Corporate Governance Code.'

3. UK Government investigation on buybacks

- On 28 January 2018, the Government announced its plans to research whether companies buy back their own shares to inflate executive pay.
- A share buyback is where a company buys back its own shares from the market, often to reduce the number of available shares in order to increase their value.
- While there are a number of valid reasons why a company would use these schemes, there are concerns that a minority of companies are using them to inflate executive pay and that they can crowd out investment.
- The government has appointed consultants PwC to undertake the research into share buybacks and will be supported by Professor Alex Edmans, Professor of Finance at the London Business School. The findings will be published later this year.

For more information see: https://www.gov.uk/government/news/government-to-research-whether-companies-buy-back-their-own-shares-to-inflate-executive-pay [Last accessed 25 April 2018.]

4. UK Government proposals on executive pay ratios launched November 2017

- The proposal to legislate was announced in November 2017. In an article in the Financial Times dated 23 April, it was suggested that the law would be tabled in May 2018.[13]
- It will be important to scrutinize the content of the legislation and its progress through Parliament.

Other resources

Over the last several years, there has been much good work done on executive compensation, some specifically on this topic and some as part of wider mandates on corporate governance or the purpose of business. The sources below were useful in the preparation and understanding of this topic by St Paul's Institute. The reader who wishes more detail than provided in this paper may wish to refer to them for further reading.

Edmans, Alex. "**Why We Need to Stop Obsessing Over CEO Pay Ratios**." *Harvard Business Review.* February 23, 2017. https://hbr.org/2017/02/why-we-need-to-stop-obsessing-over-ceo-pay-ratios [Accessed September 04, 2017.]

Financial Reporting Council Consultation on Corporate Governance

https://www.frc.org.uk/getattachment/31897789-cef6-48bb-aea9-f46b8cf80d02/Proposed-Revisions-to-the-UK-Corporate-Governance-Code-Dec-2017-1.pdf [last accessed 25 April 2018.]

High Pay Centre

http://highpaycentre.org/

and in particular the recent report by Chuka Umunna MP on *Reciprocity at the top table: Progress on Boardroom Pay*

http://highpaycentre.org/files/Reciprocity_at_the_top_table_Progress_on_boardroom_pay.pdf [last accessed 25 April 2018.]

The Purposeful Company within The Innovation Centre

http://www.biginnovationcentre.com/purposeful-company

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Surowiecki, James. ***"Why Can't We Reform C.E.O. Pay?"*** *The New Yorker*, The New Yorker, 20 April 2015, www.newyorker.com/magazine/2015/04/20/why-c-e-o-pay-reform-failed [last accessed 18 May 2018.]

UK Government Consultation on Corporate Governance and Outcomes

"World-Leading package of corporate governance reforms announced to increase boardroom accountability and enhance trust in business." www.gov.uk, 29 Aug. 2017, www.gov.uk/government/news/world-leading-package-of-corporate-governance-reforms-announced-to-increase-boardroom-accountability-and-enhance-trust-in-business . [Last accessed 25 April 2018.]

Endnotes

1 'British society deserves an economy rooted in the common good', *Financial Times*, 6 September 2017. https://www.ft.com/content/64f88e80-918c-11e7-83ab-f4624cccbabe [Last accessed 23 April 2018.]

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3 Giles, Chris, 'Britain's social ills cannot be blamed on rising inequality.' *Financial Times,* 29 March 2018. https://www.ft.com/content/62c19998-3297-11e8-b5bf-23cb17fd1498 [Last accessed 23 April 2018.]

4 This section relies heavily on the Church of England Ethical Investment Advisory Group's 2013 paper *Executive Remuneration Policy*. https://www.churchofengland.org/sites/default/files/2017-11/Executive%20Remuneration%20Policy_0.pdf [Last accessed 23 April 2018.]

5 Estimation from a participant in St Paul's Institute February 2018 roundtable.

6 Lazonick, William, et al., 'Profits Without Prosperity', *Harvard Business Review*, September 2014. hbr.org/2014/09/profits-without-prosperity [Last accessed 23 April 2018.]

7 'BlackRock Ends Up in an Awkward Place on Guns,' *Bloomberg.com,* 8 April 2018.https://www.bloomberg.com/view/articles/2018-04-08/larry-fink-s-blackrock-ends-up-in-an-awkward-place-on-guns [Last accessed 23 April 2018.]

8 Should share options expire below the strike price, they become worthless, but the loss in their value is less than the loss incurred by a direct grant of the same number of shares.

9 As an example, see Unilever Framework for Fair Compensation at https://www.unilever.com/Images/unilever-framework-for-fair-compensation-2015-final_tcm244-502647_en.pdf [Last accessed 23 April 2018.]

10 I am grateful for this concept to Chuka Umunna's paper for the High Pay Centre 'Reciprocity at the top table: Progress on boardroom pay.' [Last accessed on 25 April 2018.]

11 Walker, Peter, 'Companies must reveal pay disparity between boss and workers', *The Guardian*, 28 August 2017. www.theguardian.com/business/2017/aug/29/companies-must-reveal-pay-disparity-between-boss-and-workers [Last accessed 23 April 2018.]

12 Burgess, Kate, 'Private businesses face new rules on corporate governance', *Financial Times*, 3 September 2017. www.ft.com/content/85eb2f3a-8e3a-11e7-9084-d0c17942ba93 [Last accessed 23 April 2018.

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Afterword

On 21 May, St Paul's Institute launched the findings of this report to a group of investors and other interested parties. The discussion was so fruitful that we have decided to add a few of the key points made in the discussion to the end of the report so that readers may also benefit from the wisdom in that room.

- Link pay to performance in both directions so there is accountability for those who have not performed.
- Link pay to the growth of the company, but not necessarily as measured by share price, possibly by return on capital employed.
- Give some portion of pay in restricted shares that can be redeemed only some time after the executive has left the company. Consider giving restricted shares to employees more widely.
- Consider a 'Dear CEO' letter that says simply 'Would your company adopt a fair pay framework? If not, why not?'
- It was argued that pay has ratcheted upward due to uncertainty of outcomes. Were there to be a larger, more stable pay component, it might not be necessary to make the variable component so large.
- The emphasis should be placed on 'solidarity' among all employees of a company, and within the larger society, rather than on fairness.

Fair economy. Better world.

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