

Complaint under the Competition Act 1998

Comparative Pay Positioning in the Determination of Executive Remuneration

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1. Summary of the Complaint

The use of comparative pay positioning in the determination of executive remuneration has a price fixing effect that restricts and distorts competition in the market for company executives and company executive directors in particular.

The practice of comparative pay positioning creates a cartel which is in breach of the Chapter 1 prohibition of the Competition Act 1998. The cartel involves, often unwittingly, almost all executive directors in listed companies in the UK today. The cartel is maintained by non-executive directors and a wide range of consultancies including remuneration consultancies, head-hunters, and many accountants and lawyers, all of whom have vested interests in increasing executive pay. Many of these participants are not conscious of their participation in a cartel, but participate simply by working for their apparent, own best interests.

Comparative pay positioning has come about through the supporting principle of clause B.1 of *The Combined Code on Corporate Governance* (Combined Code 2003). This supporting principle states that when determining the level of executive remuneration “The remuneration committee should judge where to position their company relative to other companies.” This has created an upward ratchet mechanism on the level of executive pay in the UK. Although listed companies are not strictly obliged to adopt this practice, almost all of them do.

Comparative pay positioning has an appreciable effect on competition. It is estimated that the cost of executive pay has risen on average by seven times the rate of inflation since the Greenbury Report endorsed comparative pay positioning in 1995.

The effects of ever increasing executive pay are extremely damaging. Companies pay more than they should for their executive directors, and consequently for most of their senior executives. Ever increasing executive pay has resulted in a breakdown of trust between shareholders and directors. This has caused increased regulation and bureaucracy which has a stifling effect on companies. Ever increasing executive pay has undermined the credibility of business leaders, damaging working relationships and business performance.

The UK's business performance is adversely affected by ever increasing executive pay. The people who lose out because of this reduced business performance are members of the public who have to pay more than they should for goods and services. Members of the public who invest in the stock market either directly, or through investment products or, as is most common, through pension schemes lose out even more. Disappointing or inconsistent stock market performance has been a major factor lying behind the UK's current pension crisis and various scandals involving the mis-selling of investment products. Directly, or indirectly every individual in the UK is adversely affected.

The complaint is described in more detail in the following sections.

2. Important Background Information about Executive pay in the UK

Remuneration committees

In the UK the remuneration packages of executive directors and other members of the senior management are determined by a subcommittee of the company board known as the remuneration committee. Remuneration committees became common after a recommendation in the *Cadbury Report* (Cadbury 1992: Code of Best Practice 3.3), and most listed companies now have a remuneration committee. Only independent non-executive directors are appointed to the remuneration committee. This is to ensure that the executive directors have no direct influence over the setting of their own pay.

Regulation and compliance

In recent years regulation and guidance in the field of executive pay has grown considerably. Before 1992 there was very little external guidance or information for a remuneration committee to take into account. Nowadays there is a great deal of information and guidance, much of which is frequently updated. Remuneration committees that are serious about implementing best practice have to work hard to keep up with the latest regulations and guidance.

First of all there is the *Combined Code on Corporate Governance* (Combined Code 2003) published by the Financial Reporting Council. This sets out best practice in the field of corporate governance and can be used by company chairmen as a handbook on how the company board should operate. The Combined Code is derived from two earlier codes of practice; the Cadbury code about the financial aspects of corporate governance (Cadbury 1992) and the Greenbury code (Greenbury 1995) about directors' remuneration. The two codes were merged into the combined code by the Hampel Committee (Hempel 1998). In 2003 the Combined Code was updated to take account of the Higgs recommendations on non-executive directors (Higgs 2003) and the Smith recommendations on audit committees.

Companies whose shares are traded on the London Stock Exchange must also abide by the Financial Services Authority's Listing Rules. The Listing Rules require companies to explain in their annual report how they have implemented the Combined

Code. Companies do not have to implement every provision of the code but where they have chosen not to implement the code, they must explain the reasons. This “Comply or Explain” principle is central to the implementation of the Combined Code.

The *Directors’ Remuneration Report Regulations 2002* (Regulations 2002) require company directors to prepare an annual Directors’ Remuneration Report setting out the company’s policy on directors’ remuneration and supplying details of all directors’ remuneration. The remuneration report is usually included within a company’s annual report and accounts documentation. It provides a good source of information on a company’s approach to executive pay. Shareholders must vote on whether or not to accept the report. There is no direct consequence if the company board loses this vote, although most boards would find this extremely embarrassing. These 2002 regulations have superseded disclosure requirements on directors’ pay in the Listing Rules.

Many shareholder organisations monitor executive pay and provide guidance to companies on what they consider to be acceptable and unacceptable. Perhaps the most important such guidance is provided by the Association of British Insurers (ABI), which publishes *Principles and Guidelines on Remuneration* (ABI 2004) and updates this document annually. This guidance is detailed and gives companies a good indication of what institutional shareholders are likely to support or object to. It is important to note that the interests of institutional investors are often not well aligned with the interests of the underlying owners of the shares they control (see Myners 2001: pages 89-93). For example, comparative pay positioning has a detrimental effect on the underlying owners of shares but is not usually considered unacceptable by institutional investors.

Difficulty of valuation of executive pay

Executive pay is usually made up of several different components. Some of these are predetermined (e.g. base salary and pension) and some vary with company or personal performance (e.g. bonus schemes, incentive schemes, share option schemes). The Combined Code requires that “a significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance” (Code 2003: main principal B1). There are usually several different components of variable pay. In practice it is usually extremely difficult to determine the

estimated annual average value of the different elements of variable pay. Even where all the details of the remuneration schemes are set out in the remuneration reports the valuation is difficult. One problem is that the expected value of a long term incentive scheme changes year by year, and it is not obvious how the total value should be attributed to the different years covered by the scheme. Another problem is that share options are intrinsically difficult to value. With all variable pay it is difficult to know how likely the performance criteria are to be met, or to what extent they will be met. Some companies set demanding performance criteria, others set targets which are easily achievable, but it is not easy to determine which is which. The difficulty of evaluating executive pay packages makes executive pay far less transparent than might be expected, given that complete disclosure is required by the Directors' Remuneration Report Regulations 2002.

3. **The Practice of Comparative Pay Positioning**

What is comparative pay positioning?

Comparative pay positioning is a practice operated by remuneration committees when setting the level of executive pay in their company. Typically, the remuneration committee will engage a firm of remuneration consultants to examine the levels of executive remuneration in the company compared to the levels in comparable companies.

The remuneration consultancy will first identify a group of companies that it considers comparable with the company in question. Definition of the comparator group is an important consideration. Sometimes it will be restricted to UK companies operating in the same sector. Sometimes companies from other sectors are included. Sometimes, especially for large companies, overseas companies are included.

Once the comparator group has been established the remuneration consultancy analyses the executive pay of each company in the comparator group. Sometimes this is done on a single component of pay such as basic salary or annual bonus. Sometimes the comparison is made over the total value of all elements of executive pay.

The remuneration committee will then determine where they want to position themselves with respect to these other companies. Typically the remuneration committee will seek a median position, but some seek a top quartile or “competitive” position. The remuneration committee will then set the levels of executive pay to ensure that they achieve the desired position in the comparator group.

It is very rare that remuneration committees want to set executive pay that appears to be below median position in the comparator group. As all companies seek to be median level or above, executive pay is forced upwards every time it is reviewed.

It is also very difficult to know whether the comparator group chosen is really an appropriate group to benchmark against. The remuneration consultancies may feel tempted to flatter their clients in their choice of comparable companies.

The origins of comparative pay positioning

Most shareholders invest across all UK equities, usually as part of a pension scheme or investment product. To such shareholders comparative pay positioning, as described

above, makes no sense at all. It forces executive pay relentlessly upwards irrespective of performance considerations. So why is comparative pay positioning considered a good thing? Why is it included in the Combined Code as good practice? It is very clear why executives like it but from a shareholder perspective the logic is far less clear.

The mainstream interest in comparative pay positioning arose with the widespread public outrage at substantial increases in pay awarded to the directors of newly privatised utilities in the late 1980's and early 1990's. The Greenbury committee was concerned that the companies in question were paying more than was required to recruit, retain and motivate quality managers. It affirmed that companies should "take a rounded view of the markets in which they operate and the marketability of their Directors" (Greenbury 1995: paragraph 8.6) when setting executive pay.

Shareholders were certainly prepared to support this comparative reasoning when it was very clear that certain directors were being paid too much. However this rather obvious "sense check" is very different from the approach to comparative pay positioning that we see today. Pay positioning today has become a science. The consultants produce very detailed reports that systematically consider each different element of the reward package and the total reward position. The result is a pool of data and information that is both extensive and deep. Depending on how the data is selected and presented, a wide range of possible conclusions on executive pay can be justified.

Introduction through Greenbury Code

The 1995 Greenbury code of best practise included recommendation C2. "Remuneration committees should judge where to position their company relative to other companies. They should be aware what other comparable companies are paying and should take account of relative performance" (Greenbury 1995: Code of Best Practice C2).

To comply with recommendation C2 a remuneration committee needed to compile a large amount of detailed information about the pay and performance of other comparable companies. The required data about what other companies were paying was just becoming available because Greenbury also recommended increased disclosure of executive pay. Remuneration committees therefore started to make much greater use of

remuneration consultancies which were well placed to gather all the necessary data and to advise remuneration committees on what could be deduced from it.

The effect of comparative positioning of pay levels

However, right from the beginning there were concerns about recommendation C2. The Greenbury report itself includes several cautions about the practice of positioning pay relative to other companies. It states, “Companies should not pay above average regardless of performance. They should also beware of basing remuneration levels on a skewed comparator group so as to justify higher remuneration levels. If companies generally pursue such policies, the effect will simply be to ratchet up the general level of executive remuneration. Remuneration committees’ annual reports to shareholders should disclose and justify any deliberate policy of paying above average.” (Greenbury 1995: paragraph 6.12.)

These warnings became self fulfilling prophecies. Companies paying below average found that they could move up to average levels very easily and quickly by paying more, whereas companies that were above average generally wanted to maintain that position so also paid more. Almost all companies aimed to pitch pay at average levels or above, ensuring that the average level moved upwards every time that pay was reviewed. Similarly the choice of comparator group, and the choice of which components of executive remuneration to include in the benchmark, gave companies plenty of scope to demonstrate that they needed to move pay upwards to achieve average position. The result was indeed a powerful upward ratchet on the general level of executive remuneration.

This quickly became a matter of concern. When the Hampel Committee produced its 1998 report it urged caution about the use of comparative pay surveys in setting executive pay because it recognised that few remuneration committees would want to recommend lower than average salaries (Hempel 1998: paragraph 4.4). When the first version of the Combined Code was finalised in June 1998, it included the original wording of recommendation C2 from Greenbury, but added to it, “But they [remuneration committees] should use such comparisons with caution, in view of the risk

that they can result in an upward ratchet in remuneration levels with no corresponding improvement in performance.” (Combined Code 1998: code provision B.1.2.)

Executive pay continued to ratchet upwards quite rapidly after 1998, and even continued to ratchet upwards though the bear stock market from January 2000 to March 2003. From the policies described in company remuneration reports it is clear that benchmarking performed for comparative pay positioning is usually the main reason why increases in executive remuneration are deemed necessary. Despite the endless upward ratchet the principle of comparative pay was included in the revised version of the Combined Code finalised in July 2003. This requires that, “The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.” (Combined Code 2003: supporting principle B.1.)

Advantages and disadvantages of comparative positioning on pay

The big argument used by remuneration committees to justify comparative pay positioning to shareholders is that if a company falls seriously out of line with industry practise then its reward package may fail to recruit, motivate and retain executives of the required calibre. This is a powerful argument that has been used very effectively, but on close examination the argument has many weaknesses from a shareholder perspective.

Firstly the argument does not work for investors who invest in a wide range of UK equities, as almost all investors do either directly or indirectly. Increasing executive pay to keep up with the market only forces the same problem onto other companies, who the investor also has shares in. If the other companies respond in the same way then executive pay ratchets upwards across the board without shareholders seeing any benefit at all.

Secondly the argument depends on a very competitive and liquid market in executive talent. It is doubtful whether the market really behaves in this way, and these market based considerations are discussed later in this document.

Thirdly the falling out of line has to become very significant before it becomes noticeable and starts to have an effect. The very detailed surveys produced by the

consultancies pick up discrepancies that are far more subtle than executives themselves could ever hope to notice, never mind act upon. The complexities of reward packages today mean that, without expert help, it is very difficult to compare overall levels of executive pay in different organisations.

Fourthly the argument assumes that pay is the all important factor in recruiting, motivating and retaining executives. In fact it is far from the most important factor. When Gerard Roche, the head hunter, was asked how he persuades the people he finds to change company he replied “Oddly enough, it’s not compensation. How much they earn is important, but it is not their main reason for moving. They can only eat two eggs a day, drive one car at a time. What they really want is, number one, to run their own show. After that they want to be sure that they will enjoy working with their new colleagues, that the job is in an industry that they like and in a part of the world they would be happy to live in. Compensation could not get Jim Kilts to go to Coke.” (Financial Times 29/07/04 page 10). These other factors beyond remuneration actually have far more impact on an executive’s quality of life than pay does, but they have become seriously overlooked because of excessive interest in pay.

Fifthly even if a company is demonstrably paying market rates, or even top quartile rates, this does not necessarily protect it from a competitor who wants to poach executive talent. For very senior executives the competitor can always offer more money, although in practice the quality of the role offered may well be a more decisive factor than the money.

In addition, from a shareholder perspective, there are serious disadvantages with using comparative pay positioning for senior executives.

Firstly there is the upward ratchet problem, caused by all companies seeking to remunerate their executives in an average or above average way. This ensures that average remuneration either steps or nudges upwards each year.

Secondly comparative pay positioning reflects what other companies are paying rather than the needs and aspirations of the company in question. Can the company afford it? Is it in the best interests of the company? If executive pay goes up, does pay increase for those people just below executive level? How far do the effects of executive pay cascade down the organisation? Is the company still competitive on this basis? Will

other people in the organisation resent the higher executive pay? How does the executive pay fit with the culture and values of the company? Does the level of executive pay make the leadership of the company more or less credible? Are executives reaping rewards for sacrifices made by others? What does the executive pay say about the company's commitment to shareholder value? These more internal company considerations are extremely important. They are part of what makes each company unique and ensures a healthy diversity in our economy. Unfortunately such internal considerations are seldom discussed in remuneration reports. It would appear that remuneration committees are usually more influenced by the perceived need to keep executive pay in line with the market.

Thirdly comparative pay positioning is concerned solely with relative considerations and has no points of reference in more absolute considerations. If the overall level of executive pay in industry and commerce rose to such a high level that companies could not flourish and the stock market could only stagnate, then this problem would never be identified by comparative pay positioning. Is it possible that we reached this point a few years ago and still have not realised it?

4. The Market for Executive Talent

Market in executive talent as a basis for company remuneration policy

Company remuneration reports set out policies on remuneration and these usually include reassuring statements about alignment of executives' incentives with shareholder interests and a high proportion of executive pay being linked to performance. On the specific issue of the overall level of remuneration for executives they usually say something like this:

“The Remuneration Committee aims to set executive pay at a level that allows the company to recruit, motivate and retain executives of the high calibre required to run the company and deliver good returns to shareholders. The Committee is mindful of the intensely competitive and increasingly international market from which executive directors are recruited. To ensure that our remuneration packages remain competitive the Committee benchmarks against a group of comparable companies. Executive benefits are adjusted to ensure that they remain at around median level in the comparison group.”

In many cases the report does not refer to median level, but instead says, “the company aims to provide remuneration packages that are highly competitive in the market,” or, “the level is set to retain a recruitment advantage.” There are some companies where the reports explicitly state that they use a higher than median level of remuneration and such companies usually give some justification for this.

It is clear from remuneration reports that the market comparison approach is the approach typically used to determine the level of executive pay. The central justification for the current level of executive pay is therefore the need to recruit and retain executives in a competitive market for executive talent.

Although almost universally assumed in remuneration reports, it is extremely questionable whether or not a competitive market in executive talent should exist at all. The process of a company board bidding for the services of its own executive directors in a competitive market sets up a fundamental conflict of interest that is incompatible with fiduciary duty. However this question is beyond the scope of the complaint and the complaint will take at face value the statements typically made in remuneration reports.

On this basis it should be assumed that a competitive market exists in the recruitment and retention of executive talent.

Supply and demand

The market for executive talent does not behave like a normal market in respect of supply and demand. In a normal market if the price of a commodity goes up then the economics of supply are improved and supply is increased. However the market for executive talent does not train up more potential chief executives because they are getting paid more. In fact the higher reward packages have the effect of reducing the number of potential candidates who could fill the post. The higher the reward package the more important it is that the person appointed is well known to the company board, the wider industry and the financial press. This restricts the pool of candidates. Also higher executive remuneration makes it far harder for executives to perform effectively in executive posts. Levels of trust are much lower, expectations of performance are much higher and more immediate, and there are more hounds baying for blood at the first hint of a slip.

The fact that high executive pay makes it harder rather than easier to recruit suitable executives is most clearly seen in the US, where executive pay is much higher than in the UK. Coke, Boeing, McDonalds and Delta all filled the CEO position with retired former executives during 2003 or 2004. The expectations on the CEO position have become so extreme and the conflicts of interest so delicate that it is increasingly impossible to find candidates with the required credibility. Lower executive pay would increase trust, help to build more realistic expectations, and make it much easier to find suitable candidates.

The argument that a company should pay more to recruit a better chief executive might appear reasonable to people who own shares in that one company alone. However most shareholders own shares in many different UK companies, typically through pension schemes or investment products. To these shareholders the argument clearly does not work. The higher pay simply causes a good chief executive to move from one company to another. The damage to the losing company, where the chief executive has a proven track record, is likely to be greater than the benefit to the recruiting company where the new appointment carries significant risk.

In real life the supply of new executive talent is the responsibility of executives who are currently in post and of chief executives in particular. Companies need to have good plans and procedures for developing future leaders and giving them the opportunities and exposure required to become great leaders of the future. This process requires high levels of trust because it is not comfortable for executives to have highly capable successors waiting in the wings. It is important to notice that it is not market forces that develop new executive talent; in fact market forces work against its development. Executives would clearly have greater market value if they had no obvious successors.

Healthy companies normally appoint new chief executives from within. About three quarters of the FTSE 100 chief executives were appointed from within. Healthy companies have a succession plan with two or three potential future chief executives always under development. Hopefully (although often this is not the case) the existing chief executive has some incentives to ensure the success of the company after his or her departure, and therefore some reason to care about succession.

A more real, tradable market in executive talent exists one or two levels below the executive director level. The risks involved in changing company at these levels are much lower, both for executives and companies. It is at these levels that reward packages can really make a big difference to the quality of candidates available. However, even at these levels, higher reward packages do not increase the overall supply of potential executive talent. Executive talent has to be specifically nurtured and developed by more senior managers.

There are very good reasons for believing that the supply side of the market in executive talent should have improved strongly over the last two decades. Globalisation has made available huge pools of talent, especially from third world companies. The increased global use of the English language should also have helped supply in a very significant way. MBA programmes have mushroomed and the output of business school graduates has grown exponentially over the last 20 years. The materials and courses produced by business schools and other agencies for training and developing company executives have developed in quite unparalleled ways. There is every reason to believe that the supply side of the market is extremely healthy. If this is not the case then the

most likely reason is the failure of existing executives to train up and nurture a new generation of executives and to provide them with opportunities and exposure.

The difficulty of determining market prices

Even if it was a good idea for shareholders to set executive salaries at competitive market levels then it is far from clear that this could actually be done. Certainly it could not possibly be achieved through the current benchmarking procedure. By definition, half of all reward packages would have to be set below median level!

Meaningful price discovery is almost impossible in a market for executive talent. The poaching of a senior executive by another company is a relatively rare event, and when it does occur the financial aspect is only one of a very large number of considerations. The quality of opportunity, timing, business relationships and personal considerations are all likely to be more important than the detail of the reward package. Headhunting organisations would be best placed to comment on price discovery, but their fees are defined as a proportion of the executive salary so they have very strong incentives to force salaries upwards.

The unexpected departure of a senior executive is a very significant event that can easily be very damaging to a company. It is therefore very understandable that remuneration committees want to pay enough to make sure that unexpected departures do not happen on account of pay. This pressure makes remuneration committees want instinctively to pay above average remuneration. The extra money paid appears unimportant to a remuneration committee when it considers how badly criticised it would be if an important executive was lost for want of pay. However it is also abundantly clear that not all remuneration committees can pay above average, much as they might all like to. This is one of the factors that are continually forcing executive remuneration upwards in an unsustainable way.

There is another important factor that prevents normal market levels of pay from becoming clear in the case of executive remuneration. Normally, when a senior manager is hired the remuneration package is determined as part of a negotiation. This negotiation will also cover many other topics such as responsibilities, reporting lines, travel arrangements and office locations. These factors are at least as important as pay in any

final deal. One outcome of the negotiation is a good understanding of what the important issues are in the recruitment, motivation and retention of that particular senior manager. In particular it will be known if the proposed level of remuneration is satisfactory, or whether it needs to be increased to secure the appointment. This information is obviously essential if a market driven salary is to be set.

However, in the case of executive directors, it is very unclear how this essential market information can properly be brought together. The Combined Code requires that, “No director should be involved in deciding his or her own remuneration.” (Combined Code 2003: main principle B.2.) Similarly it requires that, “Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to avoid conflicts of interest” (Combined Code 2003: supporting principle B.2). The Combined Code also envisages a separation of responsibilities between the Nomination Committee, who recommend board level appointments and the Remuneration Committee who set remuneration. All this separation is intended to avoid conflicts of interest, but it has the unintended consequence of preventing the information necessary for setting remuneration at an efficient market level from all coming together in one place at one time. In the absence of full information the remuneration committees have to pay more than would be required by the market, in order to be on the safe side. If all the necessary information does come together in one place then this is likely to be with an external head hunting agency and such agencies have incentives to inflate salaries, so are unlikely to recommend efficient market levels of remuneration.

5. The Cycle of Vested Interests Surrounding the Level of Executive Pay

Given that there is so much public and shareholder controversy about the levels of executive pay it might at first sight appear rather surprising that executive pay continues to rise. The most obvious conflicts of interest have been eliminated by the Combined Code which insists that no director should be involved in deciding his or her own remuneration (Code 2003: main principle B.2). The Combined Code has also substantially eliminated mutual back scratching arrangements such as the one that contributed to Richard Grasso's infamous \$187.5 million proposed remuneration at the New York Stock Exchange in 2003. Mr Grasso was on the board of Home Depot where the founder was Kenneth Langone, chairman of the NYSE compensation committee.

The most obvious conflicts of interest and mutual back scratching may have been removed, but they have been replaced by more sophisticated interrelationships with common, self-reinforcing vested interests. These can be examined by considering the incentives on the various parties involved in setting executive pay in the UK.

The incentives on executives

Executives themselves clearly have very strong incentives to see executive pay continue to spiral upwards. They are the most direct beneficiaries. Everyone likes to get a pay rise! Most executives are very happy to see executive pay moving upwards.

The incentives on company chairmen

There is some correlation between rises in executive pay and rises in the pay of company chairmen. Company chairmen therefore have a personal financial incentive to see executive pay move upwards. In fact they sometimes express the view that executive pay in public companies in the UK is inadequate (e.g. Allan Leighton FT 13/05/04 page 23). However, if institutional shareholders take exception to executive pay proposals then they can cause embarrassment and a great deal of hard work for company chairmen. Sir Christopher Hogg spent much of 2003 sorting out the problems arising from the shareholder vote against the GlaxoSmithKline plc remuneration report for 2002.

Chairmen may benefit from executive pay rising, but they are sensitive to the views of institutional investors.

The incentives on remuneration committees

Remuneration committees hold direct responsibility for executive pay. They are made up of independent non-executive directors who typically have substantive other jobs and so have very limited time to spend on their remuneration duties. The Higgs review identified lack of time as the biggest barrier to the effectiveness of non-executive directors. (Higgs 2003: paragraph 12.12.) This is particularly true for members of the remuneration committee because there is huge complexity and detail involved in executive pay. The committee has to consider the incentive regime, the performance conditions, the overall level of executive pay and considerations surrounding external presentation. Ideally they would also discuss proposals with shareholder representatives. All these issues require time for thought and dialogue between the committee members. It obviously cannot all happen in the day or two of time available each month. The committee is necessarily very dependent on the remuneration consultancy or management group that manages the detail and comes up with the proposals. This makes the remuneration committee far less independent than it appears to be at first sight.

It is also important to remember that most remuneration committee members have been executive directors of other companies in the past. Many still have executive style responsibilities, most commonly as company chairmen, but often as executive directors either in the UK or abroad. People with this background are almost certain to benefit if the general level of executive pay rises. They are naturally sympathetic to the message that executive talent is a scarce resource that needs to be better remunerated. The remuneration consultancies know this, and consequently make it a central component of their sales pitch.

As independent non-executive directors the remuneration committee members do not have executive responsibility for the company. They consequently have little responsibility for the company ethos, culture and values which are primarily set by the chairman and executive directors. This means that policy on executive pay, even though it makes statements that are central to the company's leadership, culture and values has

become separated from the actual leadership. The remuneration committee have some accountability to shareholders for problems caused by ever increasing executive pay, but most of the difficulties with relationships and trust that arise from ever increasing executive remuneration fall on the chairman and executives.

Even if a remuneration committee did feel the need to fight hard to exercise restraint on executive pay it is very difficult for it to do this. All the data and proposals that are prepared and presented for discussion come from the remuneration consultancy and the executives, all of whom have financial incentives to see executive pay move upwards. The company chairman also has incentives to see pay move upwards and the chairman is normally very influential on the question of the future reappointment of the non-executive directors. For the remuneration committee to take a strong stand it would need to devote both time and resources and neither of these two things are available to it.

The primary incentive on the remuneration committee is therefore to take the path of least resistance through the problem. The remuneration committee inevitably therefore focuses on “What will appear acceptable?” rather than “What is best for the company?” The only really compelling reason for a remuneration committee to oppose a remuneration proposal arises when failure to take on a fight now would result in even bigger problems later with external stakeholders.

The role of remuneration consultancies

Remuneration committees are made up of part time independent non-executive directors, who usually have very limited time available to devote to their duties. It is also difficult for them to use company employees to work on executive remuneration issues because of concerns about conflicts of interest. This means that it is very common for almost all ‘hands on’ work on the development, implementation and presentation of executive remuneration policies to be done by remuneration consultancies. This approach is strongly endorsed by the Combined Code which states, “The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.” (Combined Code 2003: supporting principle B.2.)

This role of remuneration consultancies really took off with the inclusion of recommendation C2 in the Greenbury code of best practise in 1995. Collecting the large amount of data needed for comparative pay positioning was a natural task to outsource to a consultancy, and certainly one that a remuneration committee would struggle to do itself. Recommendation C2 appears to have been a massive scoop on the part of Towers Perrin, the remuneration consultancy who acted as professional advisors to the Greenbury study group. It guaranteed them, and many consultancies like them, a huge new market with excellent possibilities for further expansion.

The large and important role of remuneration consultancies has made them extremely influential in executive pay matters ever since Greenbury. It has also ensured that a very large part of all expertise on executive remuneration resides inside the remuneration consultancies. A big proportion of all serious public comment on executive pay, be it in government consultations, books, newspaper articles or TV interviews, originates either directly or indirectly from remuneration consultancies.

Just like any other consultancy a remuneration consultancy's main business objective is to sell consultancy services. The consultancy measures its own success by the value of consultancy it sells.

The incentives on remuneration consultancies

Given that remuneration consultancies are so influential it is important to be aware of and to understand the incentives to which they themselves are operating. In doing this I do not wish to suggest that remuneration consultancies operate with anything other than the greatest professionalism and integrity. However the fact remains that the remuneration consultancies that grow and develop and become most influential are the ones that sell the most consultancy services. They are in the business of selling consultancy services.

Given this, remuneration consultancies tend to welcome any developments in executive pay that will help them to sell more services. In practice most developments in executive pay will help consultants to offer more services. New regulations, new guidance from shareholders, new definitions of best practise and new research all help to move industry practice forward and all create opportunities to sell services.

There are some potential developments in industry practice that would work against the interests of the consultants. For example a move away from comparative pay positioning would seriously undermine the remuneration consultancy business. Any such proposal can expect to meet fierce opposition from the consultancies.

Remuneration consultancies stand to benefit from the growing complexity of executive remuneration packages. Complexity increases the dependency of remuneration committees on consultancies. They need someone to keep track of what is happening and to advise them. This increases the influence of the consultancies and creates new opportunities for them to sell services. In itself higher complexity generates additional work that the consultancies can charge for, increasing the size of their market. Complexity also makes it more difficult for non-specialists to provide the services required, improving the consultancies competitive position.

Remuneration consultancies usually benefit from controversy and shareholder rows associated with executive pay. There is a good chance that a remuneration committee engaged in a row will hire a remuneration consultancy to develop its case and find a way forward. Perceptions about good practice are very likely to move on as a result of the controversy and it may lead to additional guidance or regulation in the longer term. All these things create opportunities for remuneration consultancies.

To keep executive remuneration practice moving along it is firmly in the interests of remuneration consultancies to recommend increases in executive pay. Justified proposals to increase executive pay are likely to lead to further work for consultancies. A new incentive scheme might be required to make the payments. Explanation and justification of the higher pay will be required, especially if shareholders are uncomfortable. The bigger executive remuneration becomes as a financial cost and as a business issue then the more work there is for remuneration consultancies.

At first sight the remuneration consultancies might be able to build their business just as effectively by recommending reductions in executive pay. However in practice this just does not work. It is far easier to sell the idea of higher executive pay to a remuneration committee than the idea of lower executive pay. Most remuneration committee members have been executive directors at other companies and they naturally identify with suggestions that good executives are a scarce commodity, under paid and

under appreciated who really deserve more. In contrast it is extremely difficult to attract attention with a message about reducing executive pay. It is difficult enough for a remuneration committee to make a reduced payment under an annual bonus scheme. To actually reduce the expected value of remuneration is extremely difficult and could easily cause serious rifts at board level.

Shareholders therefore need to take notice of the fact that most of the incentives that are faced by remuneration consultancies actually work against the shareholder interest. Shareholders want to see stable long term incentives in place whereas remuneration consultancies always want remuneration practice to move forward. Shareholders are suspicious of the upward ratchet arising from comparative pay positioning, but remuneration consultancies firmly support this practice. Shareholders want simple and transparent remuneration schemes. Remuneration consultancies benefit from complexity. Shareholders want remuneration committees who they can trust, but consultancies benefit from rows and controversy. Shareholders want to see the average level of executive pay constrained or reduced whereas remuneration consultancies have a strong interest in seeing it rise.

6. The Appreciable Effect of Comparative Pay Positioning on Competition

Comparative pay positioning has the effect of a continual upward pressure on executive salaries. This means that the current ‘price’ of an executive salary in the market place is significantly higher than it would be without this distorting pricing effect.

As discussed in the ‘supply and demand’ section there is every reason to believe that the potential supply of executive talent has increased dramatically since the inclusion of comparative pay positioning in the Greenbury code in 1995. Clearly there has been some increase on the demand side too but there is no reason to believe that prices in the market should have climbed any faster than inflation. In fact globalisation has reduced the price of many commodities in real terms and there is no reason why this should not be the case in the market for executive talent.

In contrast there is a widely held opinion among shareholders and the public at large that executive pay has risen in an unjustifiable way over the last decade. The complexity associated with executive pay, and the difficulty of valuing executive pay packages makes it very difficult to demonstrate this definitively but the evidence is overwhelming.

Consider as a benchmark, the famous 1994 salary of Cedric Brown, chief executive of British Gas plc. This salary was considered very controversially high at the time and was one of the factors that led to the establishment of the Greenbury Committee. [The British Gas report and accounts show that his basic salary increased from £270,000 in 1993 to £475,000 in 1994. It is explained that the pay rise was justified by comparative pay positioning with a comparator group focused on the top FTSE 50 companies and a target of median position.] A crude estimate of Cedric Brown’s 1994 remuneration (excluding pension) can be made from the report and accounts: (pto)

Basic salary	£ 475,000
Bonus	£ 0
Benefits	£ 17,602
Share options	£ 393,600 (estimate of value is very crude)
Long term incentive	£ 0

Total	£ 886,202

Now, for comparison, a crude estimate of the 2004 remuneration (excluding pension) of Sir Roy Gardner, who as chief executive of Centrica plc is arguably Cedric Brown's present day successor. This estimate is based on data provided in Centrica's remuneration report for 2004:

Basic salary	£ 846,000
Bonus	£ 701,000
Benefits	£ 76,000
Share options	£ 790,000 (estimate of value is very crude)
Long Term Incentive	£ 333,000 (estimate of value is very crude)

Total	£ 2,746,000

If we assume that the scope of Sir Roy Gardner's job in 2004 was comparable with the scope of Cedric Brown's job in 1994 we can see that pay has increased by a total of 210% over the ten year period. This can be compared to an overall increase in the RPI index of 29.56% over the same ten year period. This suggests that executive pay has increased seven times faster than inflation on a sustained basis for ten years!

Comparisons of this kind are extremely problematic and need to be treated with great caution. However the comparison above is made on a very cautious basis and is much more likely to understate the actual rise in executive pay than to overstate it. It is cautious for the following reasons.

Firstly a salary that was considered outrageously high at the time has been used as the starting point. If a more reasonable starting point had been chosen then the overall percentage rise would have been greater.

Secondly, the scope of Cedric Brown's job in 1994 probably exceeds the scope of Sir Roy Gardner's job in 2004. In 1994 British Gas plc had a market capitalisation of around £15 billion compared to around £9 billion for Centrica plc in 2004. Also in 1994 British Gas plc was passing through a period of change that is almost beyond comparison.

Thirdly the analysis above does not include pension entitlements earned during the year. The British Gas report and accounts for 1994 state that the cost of funding the pension entitlement increase associated with Cedric Brown's pay rise was £555,000. The Centrica plc remuneration report for 2004 tells us that the increase in transfer value of Sir Roy Gardner's pension during 2004 was £ 2,238,012 net of his personal contributions. A footnote suggests that this figure is misleading and a more meaningful figure would be £1,893,812.

The evidence of an appreciable distortion in the market is overwhelming.

7. The Adverse Consequences of Excessive Executive Pay

In respect of executive directors pay, the Greenbury report noted that “Paying over the odds ... is incompatible with the fiduciary duty of the Directors to act in the company’s best interests. It can spread through normal differentials to other levels in the company, thus increasing the cost base and impairing the company’s ability to compete. It can cause resentment among staff and damage a company’s reputation” (Greenbury 1995: paragraph 6.7)

All of these factors are likely to damage the long term prospects of the company. However every increasing executive pay has a much more damaging effect in the longer term because it makes leadership of the company much more difficult. Trust between executives and shareholders decreases. Expectations of performance become higher and more immediate, and can be less realistic. Good company leadership is often about communicating values. These values can appear compromised if the leaders are over paid. Highly paid individuals have a very high profile and are subjected to a great deal of scrutiny. Executives complain about operating in a goldfish bowl and being smothered by red tape, but many of these problems arise directly or indirectly from the very high levels of executive pay. Ironically the greater difficulties have caused some executives and company chairmen to argue that they now deserve to be paid more! In reality however higher pay would just make all the problems worse. The problems can only really be addressed by reducing executive pay.

When setting the levels of executive pay remuneration committees should take far less notice of what other companies are paying. They should focus much more on the needs of their own company and their shareholders. In particular they should focus on the messages received by shareholders, customers, employees and other stakeholders when they hear about executive pay. If the level of executive pay supports the overall leadership message of the company board then this is evidence to suggest that the level of executive pay is appropriate. If the level of executive pay is inconsistent with the leadership message and undermines the credibility of the leadership then this suggests that the level of pay is not right.

8. Important Reference Material

ABI 2004

Association of British Insurers – Principles and Guidelines on Remuneration – 7 December 2004 (available from: http://www.abi.org.uk/Display/File/38/ABI_-_Guidelines_Draft_-_Final_Doc_-12_Nov_2004.doc)

Cadbury 1992

The Report of the Committee on The Financial Aspects of Corporate Governance – 1st December 1992 (London: Gee and Co. Ltd)

Combined Code 2003

The Combined Code on Corporate Governance – July 2003 (London: Accounting Standards Board, Financial Reporting Council) Available from: <http://www.asb.org.uk/documents/pagemanager/frc/combinedcodefinal.pdf>

Combined Code 1998 (superseded in 2003)

The Combined Code: Principles of Good Governance and Code of Best Practice Derived by the Committee on Corporate Governance from the Committee's Final Report and from the Cadbury and Greenbury Reports. Available from: http://www.fsa.gov.uk/pubs/ukla/lr_comcode.pdf

Greenbury 1995

Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury – 17th July 1995 (London: Gee Publishing Ltd)

Hempel 1998

Committee on Corporate Governance: Final Report – January 1998 (London: Gee Publishing Ltd)

Higgs 2003

Review of the role and effectiveness of non-executive directors – January 2003 (London: DTI) Available from: http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf?pubpdfload=03%2F636

Myners 2001

Institutional Investment in the United Kingdom: A Review (London: HM Treasury) available from <http://www.hm-treasury.gov.uk./media/2F9/02/31.pdf>

Regulations 2002

Statutory Instrument 2002 No. 1986: *The Directors' Remuneration Report regulations 2002* (London: The Queen's printer of Acts of Parliament)