

What goes up must come down

An analysis of the forces driving executive pay over the next decade

March 2014



Introduction

For proof that the world can change in unexpected ways, those concerned about executive pay need to look no further than a 1976 Harvard Business Review article entitled *The 'devaluation' of the American executive.*

In this lament for the plight of the corporate CEO, David Kraus observes that 'the worth of the American executive, as measured by his pay, has declined in both relative and absolute terms over the past decade', with consequences for executive motivation and the ability to attract executives to take the top jobs in corporations. He goes on to assert that '...compensation compression and relative decline in executive pay are probably here to stay'.¹

These sentiments might seem bizarre today. Executive pay in the UK has doubled since the millennium in real terms, while average earnings have increased by only 10%. But equally in 1976, would anyone have thought that within a decade the great executive pay inflation would be underway?

Starting with the Greenbury report of 1995, the last two decades have seen a slew of governance reports, best practice guidance and regulations on executive pay for UK companies. Recent legislation builds on the advisory vote introduced in 2003: from 2014, UK listed companies will have to put their executive pay proposals to a binding shareholder vote and report on pay policy and outcomes in a much more transparent way. This will arguably give the UK the toughest and most transparent executive pay regime in the world.

With stock markets recovering strongly over the last couple of years, rising share prices will inevitably lead to increases in the 'single figure' of remuneration, which is favoured in the new disclosure rules. The single figure values share options and other long-term incentives when executives become entitled to the gains rather than when they are awarded. There will be plenty of opportunity, for those who wish to do so, to make the case that executive pay continues to be spiralling out of control and that more must be done. And with a General Election looming, there will be plenty for whom the temptation will be too great.

But is the tide actually turning, just as people are saying the problem can't be solved? Bonuses paid to FTSE 100 chief executives have fallen in each of the last two years and salary freezes have become commonplace. Many believe this is simply a blip and the relentless upwards trajectory of executive pay will resume once the economy recovers. But is this right? There's a credible argument that executive pay could stagnate in real terms. And there's even the possibility of a decline as the forces that drove executive pay up abate or go into reverse.

In this paper we explore these arguments and consider the implications for the future trajectory of executive pay.

¹ Kraus, D., 1976, *The 'devaluation' of the American executive*, Harvard Business Review, p. 88

Executive summary

Five major forces that drove the increase in executive pay in the UK over the last three decades are likely to abate or go into reverse. There's a strong chance that executive pay will stagnate or fall in real terms as a result.

Global competition is a reason often given for high executive salaries. Companies that don't match the pay offered by foreign rivals risk losing out in the war for talent. But there's reason to think the globalisation of pay levels has now run its course. Research shows that pay levels have largely converged, with pay declining in the US as it has risen in Europe and emerging markets. International benchmarks can no longer be used to make the case for ever higher pay.

Another factor driving executive pay was the increase in complexity. Following the Greenbury Report in 1995, companies introduced new long-term incentive plans alongside existing share options. By 2004, four out of five FTSE 100 companies used at least two long-term incentive plans, and one in five used three. But complexity has backfired. Our 2012 *Psychology of incentives* research with the London School of Economics and Political Science², shows that executives drastically discount complex pay packages and would be happier being paid less in a simpler more certain form. Investors have begun the revolt against complexity in the UK and we already see examples of pay coming down as it simplifies.

As the attraction of the 'star CEO' has waned, companies are investing more in succession planning. And over the last two years more than two-thirds of CEO appointments in the FTSE 100 have been internal promotes. These CEOs have been appointed on a salary 13% below their predecessor on average. This will have a sustained dampening influence on executive pay. Benchmarking has been blamed for ratcheting pay, but it simply accelerates trends. We could now see benchmarking acting as a brake on pay.

There's no doubt regulation has a role to play. Research shows pay in financial services tends to be inversely correlated with the intensity of regulatory intervention. As banking was deregulated, a pay bubble formed in the sector with spillover effects across the economy. The current regulatory focus will put this into reverse. Pay in investment banking has already fallen by nearly 40% relative to pay in the general economy and further falls are expected over the next decade.

Over the last 35 years the share of profits in GDP has grown relentlessly at the expense of wages paid to labour. And as the share of profits grows, so does executive pay. But what goes around comes around. Just as 1976 turned out to be a high-water mark for wages as a share of GDP, so 2013 could turn out to be a high point for profits, and hence executive pay. All of the post-war gains for labour have now been reversed. The profit share could well have reached its peak, or at least a plateau.

There's a lesson here for policy makers. It's easy to imagine that recent trends will carry on forever unless governments act to stop them. But the world is often a confounding place. Whether executive pay goes up or down will largely be determined by forces beyond the ability of governments to shape.

² PwC, 2012, *Making Executive Pay Work: The Psychology of Incentives*, Research Paper, p. 27

1 The great global convergence has run its course

A significant factor behind executive pay inflation in the UK from 2000 to 2010 was the increasing use of global (in other words US) comparators for benchmarking purposes. Companies who had claimed they were fighting a global war for talent established total compensation philosophies that were at least transatlantic and sometimes fully global in nature.

This led to increases in total compensation directly within the firms concerned. But there was also a flow through to UK-focused businesses that benchmarked themselves against UK FTSE 100 companies, many of whom, in turn, benchmarked themselves globally.

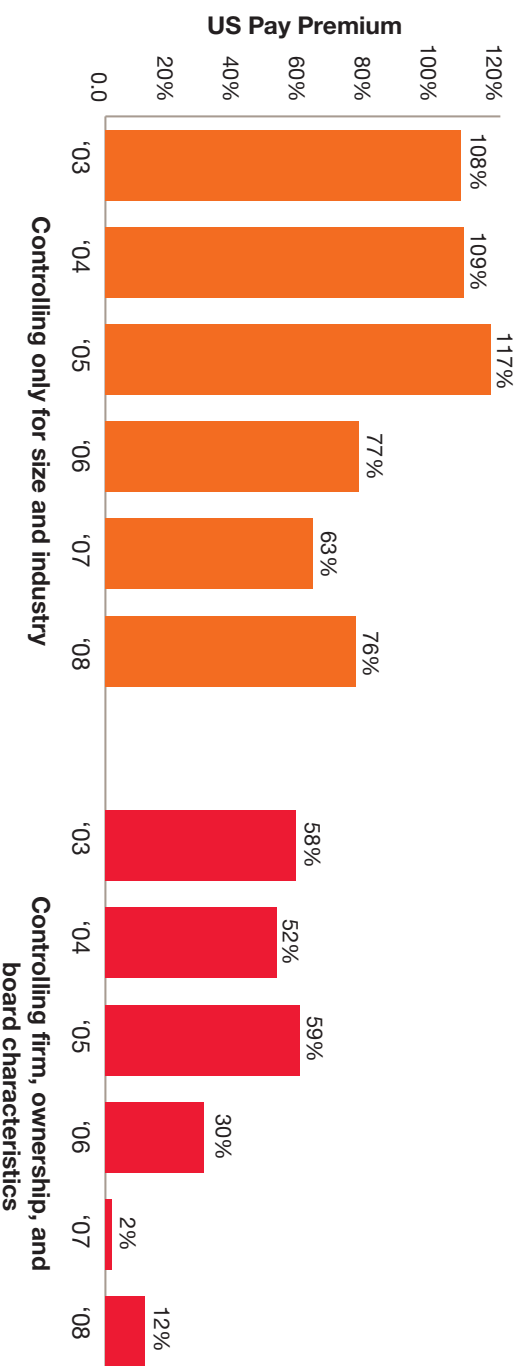
But, in a 2011 paper, Professor Martin Conyon and co-authors have demonstrated that, once adjusted for firm characteristics and board composition, UK and US executive pay levels have now largely converged. Whereas the premium of US CEO pay to the UK was in excess of 99% in 1997, it had fallen to 38% in 2003.³ Subsequent work shows that the pay premium for US versus European CEOs, after controlling for firm size, ownership, and board structure, had fallen to 12% by 2008.⁴

The authors note that "...there has been no [statistically] significant difference between US and European CEO pay since 2006 after controlling for firm, ownership, and board characteristics."⁴

This finding fits with our experience of undertaking global benchmarking exercises for clients. A decade ago rates of pay differed dramatically by country and region. While this is still the case for the majority of the workforce in most corporations, rates of total compensation across North America, Western Europe, and emerging markets for the internationally mobile elite are much more convergent now.

Of course there are still some individual pay awards to US CEOs that seem to defy norms elsewhere, but when you look at the overall picture, global pay levels for senior executives are now, to a large degree, normalised across territories. International benchmarks can no longer be used to make the case for ever-higher pay.

Figure 1: US CEO pay premium versus Europe



³ Professor Conyon, M. (Lancaster University and The Wharton School), Core, J. and Guay, W., 2010, *Are U.S. CEOs Paid More Than UK CEOs? Inferences From Risk-Adjusted Pay*, The Review of Financial Studies (2011) 24 (2), p. 412

⁴ Professor Conyon, M. (Lancaster University and The Wharton School), Fernandes, N., Ferreira, M., Matos, P. and Murphy, K., 2013, *The Executive Compensation Controversy: A Transatlantic Analysis*, in Boeri, T., Luchora, C. and Murphy, K., Productivity, Profits and Pay, Oxford University Press, p. 57

2

Executive pay will become less complex and will reduce as a result

Back in the early 1990s, UK executive pay was relatively simple, and comprised base salary, pension, a simple cash bonus and possibly some share options, but without performance conditions. But then, amid concerns about rising executive pay, the Greenbury report in 1995 made recommendations about how to link pay to performance. Following this many companies introduced long-term incentive plans alongside existing share options. By 2004 four out of five FTSE 100 companies operated at least two plans; one in five used three. But these plans are often fiendishly complicated, leaving executives unsure of how much they are likely to be paid.

Higher rewards have been used to compensate for the uncertainty. Over the same period the size of incentives multiplied. But our *Psychology of incentives* research⁵,

carried out in conjunction with Professor Alexander Pepper at the London School of Economics and Political Science, has demonstrated the extent to which these complex deferred incentive plans are discounted by senior executives. The evidence suggests that the typical executive incentive package is discounted by at least half relative to pay delivered in simpler forms (see Figure 2). In part the additional quantum of incentive pay has been to pay a premium to overcome the discount executives place on complex pay structures.

The revolt by shareholders against complexity has already begun in the UK. Investor bodies such as the Association of British Insurers and their members have argued for greater simplicity in incentive design. The National Association of Pension Funds has gone even further, suggesting radical

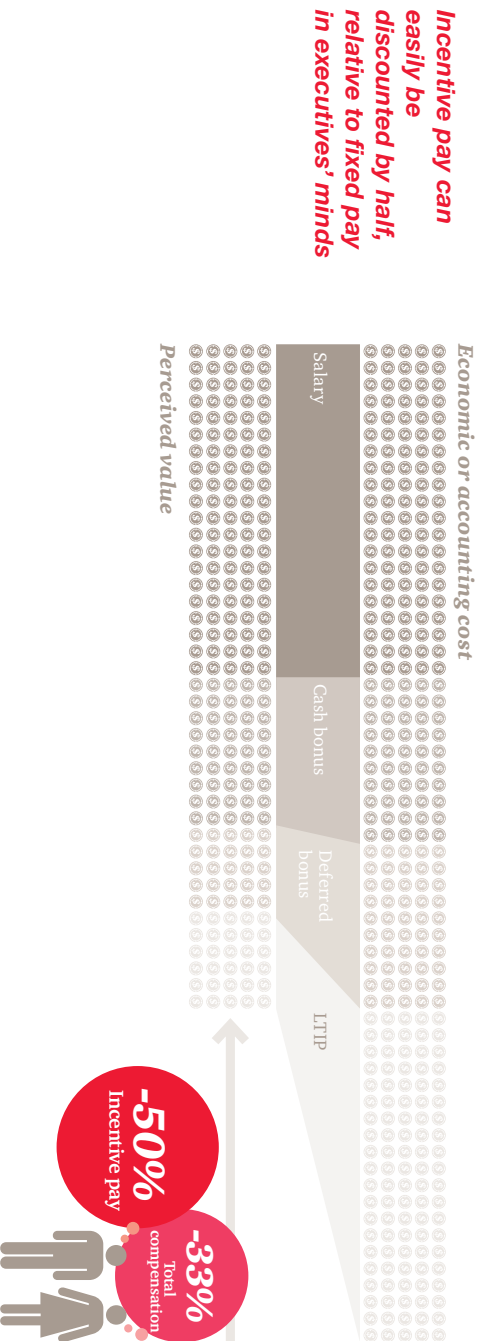
simplification as a possible way forward - abolishing long-term incentive plans and replacing them by very significant long-term stock ownership requirements.⁶

Within the UK we have seen some examples of such radical simplification, discussed in more detail in our report *Sense at last*.⁷ As predicted, these simplified models are associated with pay opportunity being reduced by 10%-20%. At a more conventional level, simplifying by removing deferred bonus matching plans to leave a single long-term incentive plan is also leading to lower pay opportunities.

The approach is being given greater impetus in the banking sector through the EU-imposed bonus cap. And, as a result, UK banks are replacing a portion of incentive pay with stock subject to long-term holding requirements. The exchange from incentive pay to stock is being undertaken at a significant discount, typically 50%, adding further impetus to the reduction in executive pay opportunity.

Executives are being paid less, but in a simpler, more highly valued, form.

Figure 2: Estimated typical perceived value discount on executive incentives



⁵ PwC, 2012, *Making Executive Pay Work: The Psychology of Incentives*, Research Paper, p. 27

⁶ National Association of Pension Funds (NAPF), *Hermes Equity Ownership Services*, BT Pension Scheme, RPMI Ralipen Investments and USS Investment Management, 2013, *Remuneration Principles For Building And Reinforcing Long-Term Business Success (February 2013)*, *Remuneration Principles For Building And Reinforcing Long-Term Business Success (November 2013)*, NAPF site

⁷ PwC, 2013, *Sense At Last*, Research Paper, p. 6

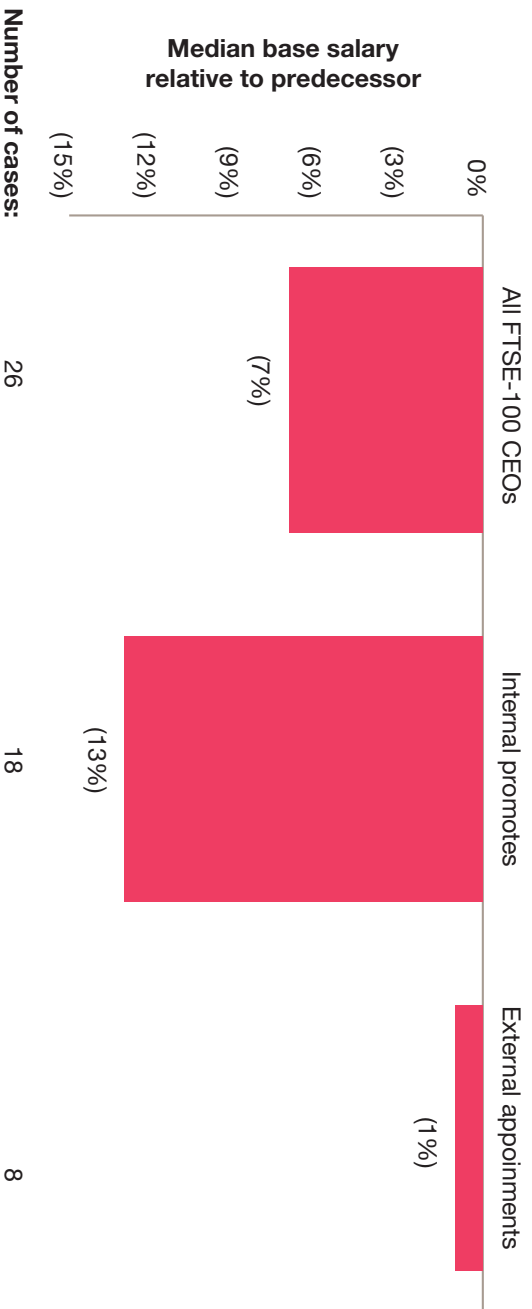
3 A focus on succession planning will result in pay benchmarks coming down

Advocates of the belief that benchmarking fuels pay inflation will be startled by the criticism from Kraus of benchmarking from 40 years ago: "...[a company's] tendency to wait and see what other companies are doing before raising its own managers' salaries is almost certainly one cause of the lag in executive pay levels".⁸

There's truth to both sides of the argument. Readily available benchmark information simply accelerates trends in whatever direction they are going. Across the FTSE 100 in 2012 and 2013, new CEOs were on average appointed on a salary 7% below their predecessor. So pay benchmarks are actually coming down in some cases.

A significant cause of these reductions is the fact that over this period 70% of CEO appointments have been internal promotes. And these CEOs are typically recruited on a salary 13% below their predecessor. As the attraction of the 'star CEO' has waned, companies have sought to invest more in succession planning. Internal candidates cost less, so this investment is likely to have a sustained downward effect on executive pay.

Figure 3: Base salary received by newly appointed FTSE 100 CEOs vs predecessor



Source: PwC analysis of annual reports and company announcements for new CEOs in 2012 and 2013



⁸ Kraus, D., 1976, *The 'devaluation' of the American executive*, Harvard Business Review, p. 90

4 Re-regulation of financial services will prick the banking pay bubble

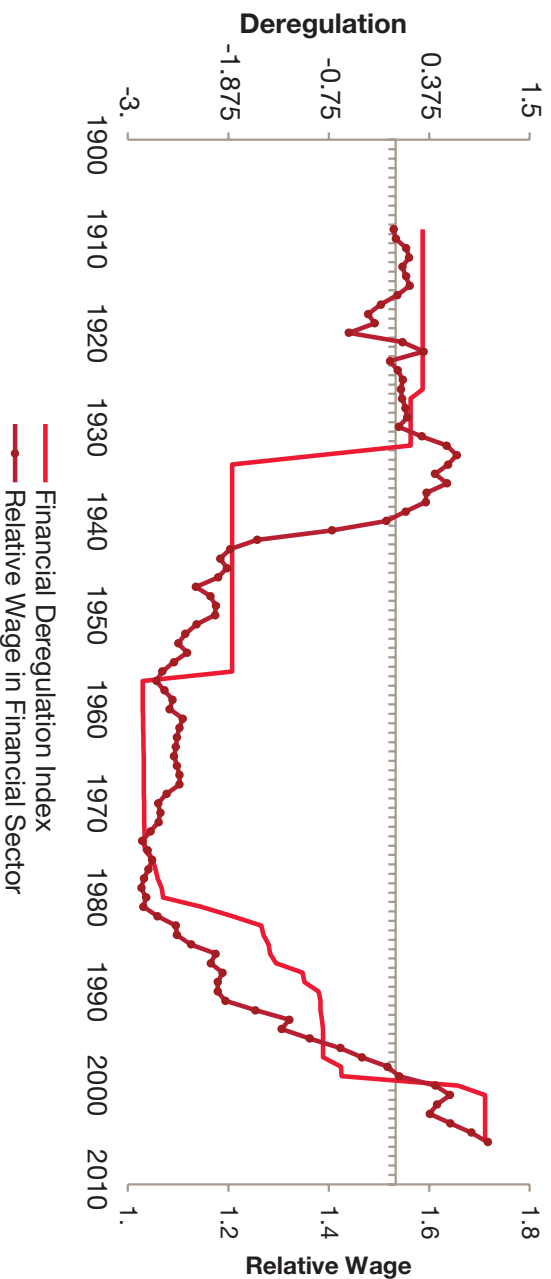
In a comprehensive analysis, Philippon and Reshef make a compelling case for the link between financial services regulation and levels of pay in the industry.⁹ The main conclusion is summarised by the comparison in Figure 4. Philippon and Reshef developed an index of regulatory intensity and compared this with the ratio of average wage in the financial services sector to average wage in the non-farm private sector. Although this analysis was undertaken in the US, we can reasonably assume the same trends apply here in the UK given the similarity in many of the financial services sector trends and influences.

There is a clear correlation between relative pay and the extent of deregulation. The contention of Philippon and Reshef is that regulation is a leading indicator of pay levels in financial services, with approximately a five-year time lag. Increasing regulation leads to lower pay and vice versa. In the run-up to the 1930s, deregulation had resulted in a wage premium of approximately 60% in financial services. Following the 1930s crash, heavy regulation such as separation of retail and investment banking under Glass-Steagall, was associated in a rapid reduction in this premium to around 10% by the 1970s. Deregulation took hold again

in the 1980s with the reversal of many of the prior regulatory reforms. The pay premium soared, returning to 1930s levels by the time of the financial crisis. If current proposed regulatory changes are enacted (capital, ring-fencing, Volker, bonus cap and so on) then according to their analysis a pay reduction of nearly 40% may be expected over the next decade or two in the financial services sector. Interestingly, Philippon and Reshef decompose the changes into two key components:

- regulation leads to reduced complexity of activities carried out in financial services and so the average level of educational achievement of employees in the sector declines - as a consequence sector wages also decline, and
- at the same time, regulation appears to lead to a reduction in excessive 'rent seeking' by financial services executives (i.e. pay above the levels justified by job complexity and education). These changes are most notable at the most senior executive levels.

Figure 4: Relative Financial Sector Wage versus Extent of Financial Deregulation in the US



⁹ Philippon, T. and Reshef, A., 2009, *Wages And Human Capital In The US Financial Industry: 1909-2006*, National Bureau of Economic Research Working Paper Series, p.55

The increased supply of skilled executive labour, combined with the reduction in rent seeking, should have a significant impact on pay levels both in banking and across other sectors of the economy, as supply of executive talent to other industries is increased.

Our 2013 analysis into pay in the banking sector¹⁰ shows that this readjustment is already underway: compensation in investment banking has already fallen 20% from its pre-crisis peak. Relative to the overall private sector average pay has fallen 40% since its peak in 2006. Within banking overall the reduction is 20% on a relative basis.

Philippon and Reshet identify a premium of around 50% over to the median of the non-farm, non-financial sector that emerges during periods of deregulation and then is eroded as regulation returns. The banking sector seems already to be on this path. While banking is just one sector, it's an important one in the UK and has a significant impact on market pay levels across industries. If the heat comes out of the banking market we'd expect it to have a dampening effect on the executive pay market more widely.

And even the much maligned EU bonus cap may even have a role to play. As bank pay comes down, the bonus cap, to some degree, locks in the reductions, by reducing the rate at which pay can increase again in hot areas – a significant source of bank pay inflation pre-crisis. And increasing fixed pay may enable banks to accelerate the trend of reduction, as many employees will place a value on the increased certainty.



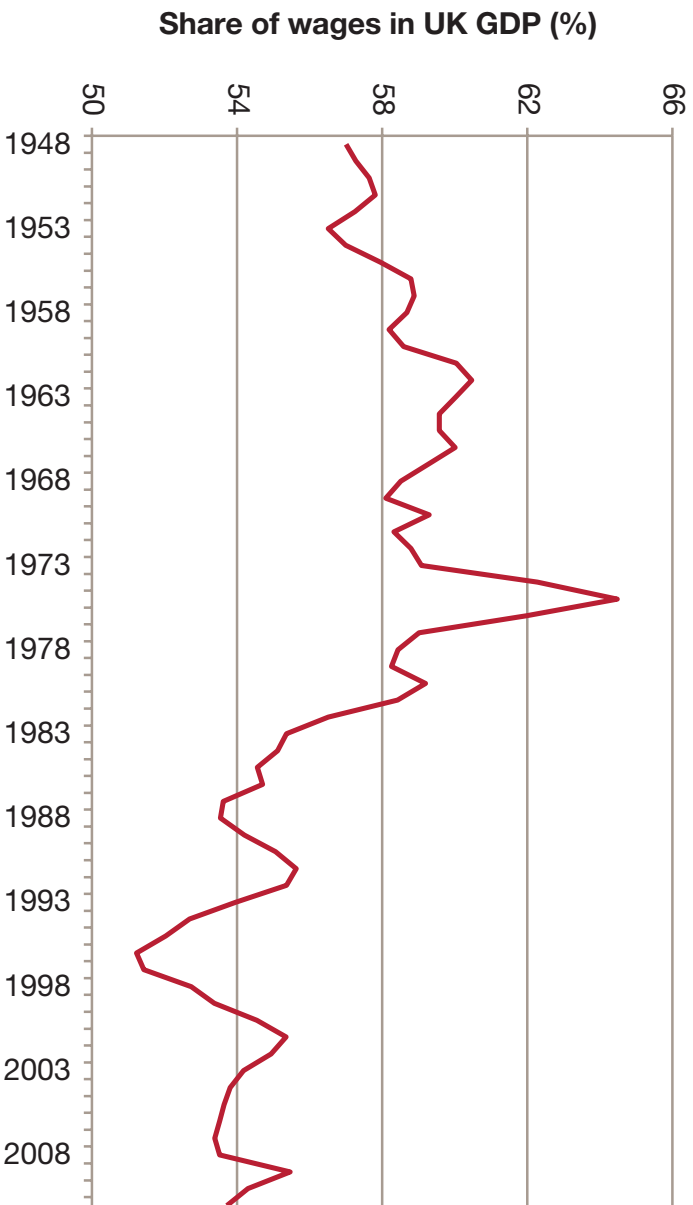
¹⁰ PwC, 2013, *Closing the gap: An analysis of pay in the banking sector*, Research Paper, p.2

5 *The wage share in GDP will increase again, causing executive pay to fall*

At the point Kraus was writing his article in the mid-1970s, the wage share in GDP was at a historic high in the US having risen consistently since the war, with strong economic growth combining with tightening labour markets. The same is true of the UK as shown in Figure 5. Analysis by Lansley and Reed in a report for the Trade Union Congress shows that since then the share of wages has fallen dramatically as profits have grown.¹¹

Executive pay tends to be inversely correlated with the general wage share in GDP. As profits rise, ever higher executive pay packages seem justified, even as employee wages stagnate. This is shown in Figure 6, which shows the income share of the top 1% of the income distribution in the UK. This had fallen over 60 years and two world wars until reaching its nadir in the mid-1970s.

Figure 5: Share of wages in UK GDP



Source: Lansley and Reed ¹¹

The UK trends in Figure 6 were mirrored in the US. So when Kraus was writing in 1976, it must have indeed appeared as if the compression of executive pay was remorseless. In fact he was writing exactly at the turning point. Over the next three decades, the income share of high earners returned to the levels of the 1930s as the share of wages in GDP fell.



¹¹ Lansley, S. and Reed, H., 2013, *How to Boost the Wage Share*, Trade Union Congress, p. 6

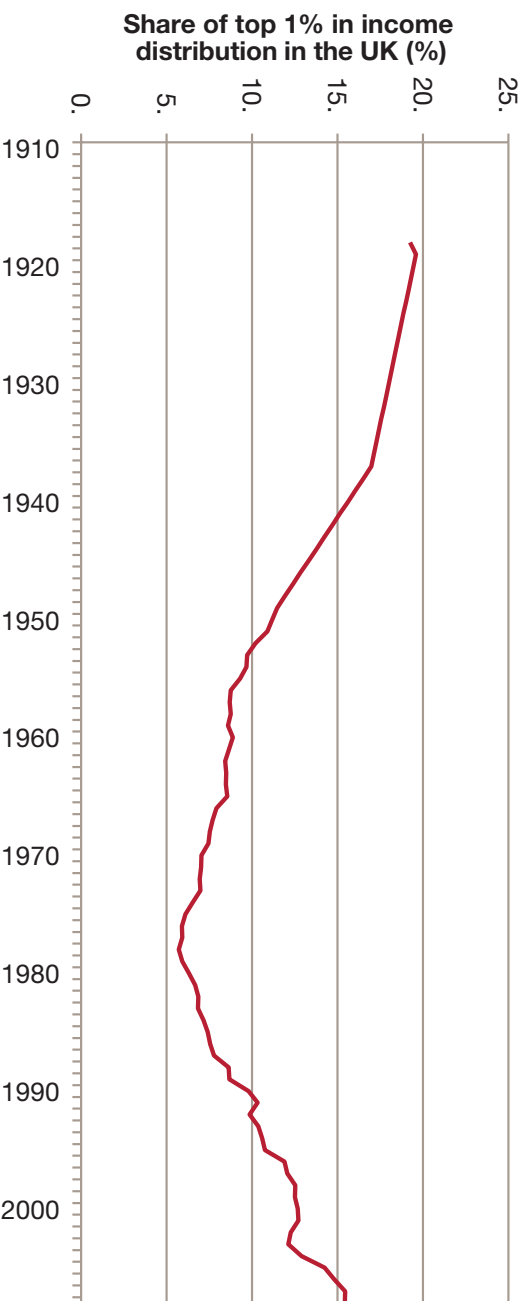
We can't say for sure that we're at a similar turning point to 1976, but with the wage share down to levels last seen before the war, it's hard to see it continuing to decline at the same rate. Writing in the Financial Times, Merryn Somerset Webb observed that much of the rise in corporate profits over recent decades has been due to a fortuitous combination of falling interest rates, falling corporate tax rates, and falling depreciation charges (arising from low investment in capital stock).¹² These can't go on forever. Of course it could be different this time as a result of globalisation, technology and consequently an increasing pay premium for those with high levels of skill and knowledge. These may permanently change the dynamics of the labour market. But this seems more likely to argue for a

reversal of the fall in wage share, rather than a continued decline, which must come up against political realities at some point. We have been through major economic transformations before, yet reversion to the mean remains a powerful force.

With the recession driving up youth unemployment it seems hard to envisage now, but a reducing labour force driven by an ageing population, combined with lack of political will to make the case for immigration, could cause labour market tightening once more.

If the wage share stabilises or goes into reverse, historical experience suggests that executive pay will plateau or decline.

Figure 6: Income share of top 1% of the income distribution in the UK



Source: The World Top Incomes Database, PwC analysis¹²



¹² Alvaredo, F., Atkinson, T., Piketty, T. and Saez, E., 2012, *The World Top Incomes Database*, Database

¹³ Somerset Webb, M., 7 February 2014, *Workers of The World Will Unite*, FT Money

Conclusion

Following a dramatic increase in UK executive pay over three decades, could the scene be set for a reversal? There's certainly a case to be made. The Government would welcome it if their reforms to the UK's executive pay regime coincided with such a trend. But will the current reforms be the key factor? It's unlikely. Perhaps they'll give change a nudge along the way, but when it comes to long-term trends in pay rates, macro forces trump the micro. The changes proposed are an incremental development of what went before rather than a revolution. The UK has fundamentally the same governance framework that has operated since 2003, with the advisory vote on remuneration reports already proving an effective sanction where necessary.

But there has certainly been a change in atmosphere in UK Board rooms. Before the financial crisis, there was a view that executive pay just kept going up, with base salary increases of 7% to 8% per annum being quite normal and increases to incentive opportunity being frequent. Little regard was had for comparability of executive and employee pay awards. The demands of the market ruled. This undoubtedly contributed to a certain mindset amongst remuneration committees, and even investors.

But if the trend is turning, what does this mean for the various actors on the executive pay stage?

Remuneration committees find themselves in the toughest spot. If executive pay is coming down, they have to deliver the medicine. Here regulatory intervention has helped. Three-year gaps between policy approvals, with little changing in-between, should help to take the heat out of the market. But without the balm of increasing quantum,

remuneration committees will need to ensure that pay is effective and valued. And Boards will need to reinforce other methods of affirmation beyond pay.

As for shareholders, they need to make it as easy as possible for remuneration committees to deliver on what will be a difficult remit. Firmness from investors can help remuneration committees. But equally attempts to reduce pay by increasing its perceived value should be welcomed. As discussed in our research report *Sense at Last*, we think there's significant merit in moving away from conventional long-term incentives and relying on long-term shareholding to create alignment.¹⁴ Not only does this create a better pay-for-performance relationship over the longer term, it also allows pay to be lower, through being simpler and more valued. We've been disappointed that shareholders have made this a rockier path than it should be.

Executives perhaps need a reality check. Most are not greedy, but pay has become a way of keeping the score. And executives have lived through two decades in which pay has only gone one way. But an endless upwards trajectory is not possible. Ultimately exponential growth will come up against a form of Malthusian economics. Leading firms are increasingly concerned about questions of fairness within the workforce, recognising that employee engagement and loyalty are undermined if different rules are seen to apply at the top and the bottom.

Governments need to be modest and not try to do too much. Good regulation can help. But it is easy to imagine that recent trends will carry on forever unless governments act to stop them. But the world is a confounding place. Whether executive pay goes up or down will largely be determined by forces beyond the ability of governments to shape.

And what about consultants? Although their influence is often overstated, they've been undoubted beneficiaries of rapid changes in executive pay practices and levels, rising complexity, and increasing pay regulation. They'll need to find different ways to make money. Figuring out how to make pay truly effective in support of organisational goals would be a start.

Who knows what the future holds. Bill Gates once said that we tend to overestimate the change that can happen in five years but underestimate what could happen in ten, at which point the world has often changed in profound ways that were not obvious as each year passed.

But if we do find ourselves in a situation of declining executive pay and poor executive motivation we'll have Kraus' analysis to guide us: "more companies probably ought to explore the greater use of special benefits and perquisites for executives".¹⁵ Two of his recommendations that are likely to find favour with beleaguered executives and underemployed remuneration consultants are generous non-qualified pension plans and liberal travel policies with first class travel, hotels and spousal travel allowances.

Now there's an idea.

Acknowledgement

We'd like to thank Dr. Ruth Bender of Cranfield School of Management for bringing David Kraus' article to our attention -the inspiration for this paper.

¹⁴ PwC, 2013, *Sense At Last*, Research Paper

¹⁵ Kraus, D., 1976, *The 'devaluation' of the American executive*, Harvard Business Review, p. 92

Further reading

Are U.S. CEOs Paid More Than U.K. CEOs? Inferences From Risk-Adjusted Pay

<http://rfs.oxfordjournals.org/content/24/2/402.full.pdf+html?sid=0c100df5-b1e4-4e1f-83be-8b51f1b2f870>

How to Boost the Wage Share, Trade Union Congress

<http://www.tuc.org.uk/sites/default/files/tucfiles/how%2520to%2520boost%2520the%2520wage%2520share.pdf>

Making Executive Pay Work: The Psychology of Incentives

<http://www.pwc.co.uk/human-resource-services/publications/making-executive-pay-work.jhtml>

Remuneration Principles For Building And Reinforcing Long-Term Business Success

http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/_media/Policy/Documents/0290-Hermes-EOS-NAPF-Pay-Principles.ashx,

http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/_media/Policy/Documents/0351_3_remuneration_principles_for_building_and_reinforcing%20longterm_business_success_nov2013.pdf

The Executive Compensation Controversy: A Transatlantic Analysis

<http://digitalcommons.ilr.cornell.edu/ics/5>

The World Top Incomes Database

<http://topincomes.g-mond.parisschoolofeconomics.eu/>

Wages And Human Capital In The US Financial Industry: 1909-2006

<http://www.nber.org/papers/w14644>

Workers of The World Will Unite

<http://www.ft.com/cms/s/0/79c26af6-8fde-11e3-ae9-00144feab7de.html#axzz2uiv6DhgCT>

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