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# Mind the gap

## Investors' role in balancing fairness and competitiveness in executive pay

**Alexandre Prost**

Executive pay can frequently be a contentious issue and has attracted renewed attention, as remuneration committees have awarded inflation-busting pay package increases. These have often been justified as catch-up payments following the impact of the pandemic on company finances and in some cases due to 'one-off' windfall gains. There are situations where these increases are justified, but when most employees receive smaller, or even below-inflation increases, investors have a responsibility to engage with companies on this anomaly.

Responsible investors should consider the needs of all stakeholders in investment decisions, including employees, and engage with companies about executive pay and the widening gap with average employee pay. Investors can ask whether companies have taken steps to support their lowest-paid employees. Examples of this could be one-off payments, or prioritising the largest pay rises for the lowest-paid workers.

Meanwhile, some companies have blamed large investors for encouraging a 'skills drain' by exerting engagement and voting pressure on executive pay policies.[1] This has reportedly put UK companies at a competitive disadvantage relative to US competitors by creating a substantial gap between UK and US pay levels.[2]

We believe investors should advocate for fairer compensation structures, as inequalities can have unintended consequences for society, create instability and reduce economic growth. This is perhaps of even greater importance in times of economic hardship, when high inflation, especially in energy and food costs, has caused a cost-of-living crisis. This is all the more relevant in countries such as the UK, where some of the safeguards widely present in continental Europe are missing.

This paper explores different aspects of these issues, including:

- how widening the pay gap between employees and top executives is a risk for both investors and companies
- how investors and companies can work together to change remuneration structures for fairer pay packages.

### The pay gap as a reputational and financial risk

Pay is generally seen as a status symbol[3] and often a subject of controversy when there is a significant difference between the CEO and other employees' pay. It can have a positive or negative impact on public perception of a company—as a fair pay approach can garner social approval and positively influence public opinion about the organisation. However, high ratios of CEO pay to average employee salary can attract negative opinion, potentially causing a shift in consumer behaviour and damaging trust in the brand.

This is partly rooted in the belief that awarding high compensation to a CEO could possibly mean that resources are being misused—money which could have been used to benefit other employees, improve working conditions, invest in research and development or better customer service.

During the current period of high inflation [through 2023], companies have at times exercised their pricing power (or benefited from rising commodity prices) with the consequence of boosting their profits and stock prices. This has in some cases generated windfall payouts for CEOs, driven by so-called 'greedflation'. This appears to have been particularly prominent in the US than the UK and is more visible in some sectors such as retail, and oil and gas.[4]

From an investor and evaluator perspective, this trend may be associated with the idea that the creation of value has been shifted to self-serving efforts which could be detrimental to the long-term reputation and performance of the company.

Research has found that when there is a large pay gap between executives and employees, there is a limit to what is believed to be fair—sometimes referred to as an 'ethical ceiling'.[5] Today, it appears that public (and worker) opinion is leaning towards resentment over this pay gap as well as inequalities in general. This feeling can lower morale and productivity, having an impact on companies and in the end on their stakeholders.[6]

## Levelling the playing field

Some company bosses are calling for executive remuneration to be raised further. The CEO of the London Stock Exchange Julia Hoggett previously said she believed higher senior compensation in the UK is a way to counter the "lack of a level playing field for UK companies",[7] especially when compared to the US. This is perhaps a surprising comparison, given that US businesses are significantly larger than UK companies.[8]

Moreover, data from the American Federation of Labor and Congress of Industrial Organizations shows that chief executives of S&P 500 companies received $16.7 million on average in 2022, four times what UK CEOs received the same year.[9] We also note that the average CEO-to-worker pay ratio was 272:1 for S&P 500 companies in 2022, when overall, US workers' real hourly wages fell for the second year in a row by –1.6% after adjusting for inflation.

In the UK, the pay ratio of the median FTSE 100 CEO to the median UK full-time worker was 118:1 in 2022. Beyond numbers, the reality and specificities of each market must be taken into account, and matching UK executive pay with US standards increases the risks of widening inequalities in the former, with a negative impact on firms and the wider economy.

While the UK does lag the US, pay equality could still be seen as an issue. The High Pay Centre, a UK research institute, reported that the median FTSE 100 CEO took home £3.91 million in 2022, the highest level of median pay since 2017, and an above-inflation increase of 16% on the median FTSE 100 CEO pay in 2021. The highest paid FTSE 100 CEO received a total of £15.32 million, 464 times the pay of the median UK full-time worker.[10]

The report also highlighted that this marks the second consecutive year of CEO pay growth since the pandemic, which means that the idea of a one-time increase due to a post-lockdown surge can surely be refuted.

Further, this perceived lack of level playing field could be disputed when comparing the UK to other markets in Europe, as it faces similar challenges. In fact, retention of top executives is as much of an issue in Europe, though a slightly different approach to compensation can be noticed when compared to the UK.

For example, according to the High Pay Centre, median pay for CAC 40 CEOs—that is, those running France's largest blue-chip companies—was slightly lower than the median CEO pay for the top 40 UK FTSE 100 companies, while the median market capitalisation was actually higher than in the UK for those companies. Median pay for DAX 30 CEOs in Germany was also lower than the median for the top 30 FTSE 100 companies.[11] On this basis, UK blue-chip CEOs do not appear to be particularly low paid.

Whether Europe or the UK is fairer when it comes to the executive-to-employee pay gap could be seen as a subjective question that depends on various factors, such as the social and economic impact of the pay gap on the society.

However, even if there were to be a significant rise in average worker pay packages in the UK, there are still notable differences that could make European markets be perceived as a possibly fairer environment. Several countries in Europe include employee representatives on company boards of directors, injecting a workforce perspective into deliberations on executive pay levels and helping ensure that the distribution of pay is considered.

The Shareholder Rights Directive II also handed European investors greater say over executive compensation and includes important features—depending on local requirements—that have increased European companies' accountability over pay.

For example, a shareholder vote on the remuneration report is a binding rather than advisory one in France; in the Netherlands, at least 75% of support from shareholders for the remuneration policy is required.

While the gap is still relatively high in Europe between CEO pay and employee compensation, social protection for employees in Europe and the UK differs in several aspects, such as the coverage, contributions and benefits.

A direct consequence of the increase in CEO pay will probably be more challenging labour relations, as workers will almost inevitably raise questions and start demanding a bigger share.

The current real wage situation in the UK is particularly alarming. Regular pay grew 7.3% between March and May 2023 compared to the same period a year earlier, but taking inflation into account it actually fell 0.8%.[12] Average UK pay growth did then overtake inflation between June and August—for the first time in almost two years,[13] but the cost-of-living crisis is still affecting people's capacity to plan for their future.

**The quote**

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In the UK, more than one in five Britons have cut their pension contributions or stopped paying in altogether.[14] These struggles have potentially worsened the resentment over earnings inequality and highlighted questions around fairness.

## Changing remuneration structures for fairer pay packages

Not so long ago, some of the lowest-paid jobs came under the spotlight, as they were the ones society relied upon the most to keep us functioning through the pandemic. Today, as economic pressure bears down on the same group of people, vast CEO-to-worker pay differences may be strategically and morally harder to justify.

As investors turn up the pressure on companies for fairer executive compensation packages, remuneration committees increasingly justify their stance through peer benchmarking, sometimes using what can be viewed as questionable methodology and leading to ever higher packages. One study, for example, found evidence that "peer groups are constructed in a manner that biases compensation upward".[15]

This zero-sum game is likely to continue as long as investors and companies stay fixed to their views. The measures taken by investors during the last company annual general meeting (AGM) season [in 2023] showed growing discontent over remuneration packages, often manifesting in an increase of votes against remuneration reports.

Figures gathered by consultancy firm WTW (formerly Willis Towers Watson) highlight that for the UK's FTSE 250 companies, these reports received fewer votes in favour over the past two years.[16] Meanwhile in Europe, shareholders are increasingly voting against executive pay reports.[17]

## How investors can help move the dial

Investors are increasingly questioning whether companies are taking any steps to support their lowest-paid employees and are pushing for executive increases in base salary to be proportionally lower than the overall workforce. As such, it is expected that the issue of the pay gap will be even more prominent in the future.

As of today, there is uncertainty around how the current economic situation will evolve. Pressure on pay budgets could be severe, should inflation stay consistently high [as at November 2023] and exceed compensation increases. On the other hand, while a thoughtful and discounted approach for executive remuneration is likely to be welcomed, and expected, this could potentially backfire and weaken the competitiveness of pay packages on the market.

A practical response is needed, which may involve important changes at a company level. We would encourage remuneration committees to consider some of the following ideas and urge investors to engage on these topics:

- A greater variation in incentive structures, such as restricted shares or hybrid plan, tailored to the situation and the reality of the company.
- Enhanced transparency on how performance impacts teams and gathering wider employee perspective, with a consistent salary increase framework.
- Considering examples of peers based on good practice and approach, rather than using peer group benchmarking based on median pay, a major contributor to spiralling levels of remuneration.
- Measuring the impact of a low vote on remuneration—consulting top shareholders only reflects the opinion of an important minority but does not necessarily consider the position of the majority. Moreover, it often results in 'chasing votes' to improve the supporting rate and can negatively influence external perception that the company may have done something wrong.

In this way, we believe that investors have a significant role to play in helping to move the dial on executive remuneration, aiming to increase fairness and reduce inequality.

This in turn can help boost company morale and productivity, which stands to benefits both the corporate and its shareholders as well as the employees themselves. **FS**

**Notes**

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**The quote**

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