

The Risk Myth CEOs and Labour Market Risk

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1. Introduction

'The world has never been more full of risk'. So wrote Thomas Aquinas in 1345. Then the Black Death was ravaging Europe. Now it is the threat of terrorism, global warming, health scares, and even the rise of global capitalism that make people fearful. We may have near full employment in the UK but there are no more jobs for life. And many people still work in insecure, low paid, poor quality jobs that offer not good work but day after day of unremitting drudgery. In short many people at work feel at risk of losing their jobs.

In our developed knowledge economies things were not supposed to be like this. As recently as 1995 Charles Handy wrote in *Beyond Certainty*, "The fact remains that for good and ill the portfolio life is for most of us the life of the future. Organisations are never again going to stockpile people. The employee society is on the wane."

Others have argued that the emergence of a service sector-driven knowledge-based economy is creating an hour-glass labour market that has hollowed out jobs in intermediate skills leaving winners at the top and a bank of losers at the bottom. The losers have been propped up by Minimum Wage regimes and active labour market policies. Handy's mis-read the runes and the purveyors of the 'hour-glass' labour market theory are having to re-visit their earlier analyses in the face of new evidence.

Whatever the facts, this short paper attempts to look more broadly at who bears risk in today's labour market, and in particular, it examines the risks and rewards of CEOs of our top companies and compares them with the risks borne by average workers.

For, arguably, risk taking is synonymous with capitalism. Risk is the oil that helps makes the parts of an economy work more smoothly. Without risk, some would argue that there cannot be any fairness to the considerable returns one receives from being a successful entrepreneur. Risk is the ingredient that stirs the blood, that requires brilliance to mitigate and that increases for the individual as they climb the pole of corporate success.

Markets are inherently 'risky'. Businessmen (and it is still the case that they are usually men) are 'risk-takers'. Those who back businesses are described as 'venturers' as in venture capitalists. Risk is integral to how business has to be done and perhaps more critically how business people see themselves – as risk-takers.

But is this world view correct? Are we in fact remunerating and rewarding the right people on the right basis? Is our assessment of risk accurate or convincing? Is the CEO more at

risk than his or her workers? And how should assessments of 'risk' play a part in how we assess CEO performance? For as I argued in my previous provocation 'Life at the Top' (2004) 'For people at the top of private companies there are three main reasons offered as explanation of why they deserve to be so well rewarded:

1. The risks they bear in taking the position of CEO.
2. The fact that they are more talented and have more responsibility than anyone else.
3. The fact that they are working in a global labour market where Adam Smith's invisible hand of market forces is at work setting pay levels and contract terms on an ever upward spiral.'

This provocation will examine the first of the propositions listed above - whether CEO's do indeed bear more risks than other groups of workers in the UK economy in terms of labour market outcomes.

2. What is 'risk'

Before moving on to the detail we must first examine what we mean by 'risk.'. The Oxford English Dictionary defines risk as follows: 'a situation involving exposure to danger'.

Being able to understand and judge risk is hard-wired into our DNA as the prompt for flight or fight behaviours. In 1944 Beveridge saw risk in the five great social evils, want, squalor, ignorance, disease and idleness.¹ Since then, while those risks have not disappeared entirely, in our more affluent societies we have different risks, such as a seeming increase in mental ill-health.²

Risk is also subjective. For some, risk is thrilling, exhilarating and life would be unimaginable without it. Rock climbers, base jumpers, deep sea divers and astronauts might fall into this category. For these individuals not taking such risks would itself be a risk. But for most, an inability to cope with risk leads to higher levels of misery and unhappiness, for unpleasant outcomes too often result.

There is good evidence that those with lower status, low control over their jobs and low levels of autonomy suffer more ill-health and die earlier than those who don't. Put simply risk to well-being is reduced by higher status. As Michael Marmott has highlighted Oscar winners have a life expectancy on average four years longer than other actors even those who have been nominated for an oscar.³ There is also strong evidence that risk of unemployment and unemployment itself is very bad for people. It damages their health and lowers life expectancy.

So in very broad terms we can define risk in three ways. All are inter-linked:

- Risk to health including mental health
- Risk to income and future employment
- Risk of personal harm

This short paper focuses on the economic aspects of risk – risks to income and future employment. In particular who is really bearing the risk in today's labour market - the CEO at the top or the average worker with average pay and skills?

1 Beveridge, William, Social Insurance and Allied Services (1942) HMG

2 See Layard, R Happiness 2005; Marmot, M Status Syndrome 2005 for detailed argument and evidence; also Beck, U, The Risk Society, Giddens A. Modernity and Self Identity

3 Status Syndrome, Marmott, M 2004

3. Risky business?

If Chief Executive Officer jobs are inherently more risky than the jobs of normal workers, arguably we would expect to see higher rates of turnover and in particular higher rates of involuntary turnover among FTSE 100 CEOs when compared with the average employee.

UK CEO's have seen their pay increase to 76 times that of the average worker compared to a ratio of 10-1 in 1980⁴. Admittedly compared to the pay of US CEOs (which is more than 300 times that of the average worker) this differential is modest.

For the year to summer 2006 average CEO remuneration packages had increased by 28% against inflation of 2.8% and average wage increases across the whole economy of 4%⁵. Average FTSE CEO remuneration topped £2.4 million up from £2.1 million the year before. Performance related pay made up 55% of the total, up from 46% in 2003.⁶ And this was a year of one of the lower rates of salary increases for CEOs in recent times.

Now let us look at turnover figures. Between 31 July 2005 and 31 July 2006 FTSE 100 CEO turnover stood at 14%. The national average was 18.3%⁷ and in the private sector 22.9%.⁸ The public sector by contrast stood at 13.3%.⁹

Of the 14 FTSE 100 CEO's who left their posts during the measurement period (see Annex 1 for details) only one was made redundant. He left with a pay off of £5million

'to compensate him for missed bonuses and pension contributions plus a year's salary'¹⁰.

In contrast over the course of the same time period national redundancy rates for all groups of workers averaged out at around 0.58%. So arguably the CEO rate is twice that of the national average. However there is considerable variation by sector and gender as Graph 1 and 2 illustrate. As all the CEO's in the measurement period are male their redundancy rate should be compared more closely with that of the male whole economy average

4 Guardian survey, 2 October 2006

5 Guardian Survey reported 2 October 2006

6 New Bridge Street Consultants as reported in IR magazine

7 CIPD Recruitment, retention and turnover survey July 2006

8 Ibid

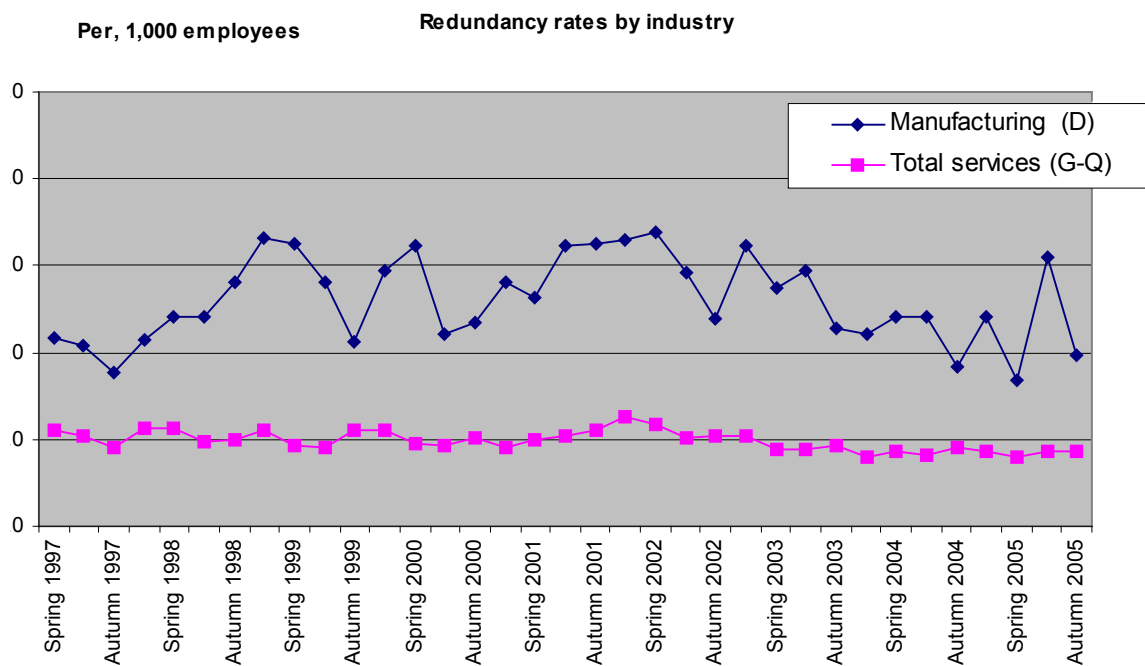
9 Ibid

10 Reported in The Scotsman 13 January 2006

Table 1: Redundancy Level and Rates by Gender over time¹¹

Month	Level (,000s)	Rate per 000 (All)	Men	Women
August 2005	157	6.3	7.9	4.6
September	142	5.7	7.0	4.4
October	140	5.6	7.0	4.1
November	143	5.7	7.5	3.8
December	142	5.7	7.7	3.6
January 2006	141	5.7	7.5	3.8
February	144	5.8	7.7	3.8
March	149	6.0	8.2	3.7
April	147	5.9	7.9	3.8
May	139	5.6	7.5	3.5
June	142	5.7	7.3	4.0

Graph 1: Redundancy rates by Industry¹²



11 Labour Force Survey

12 Labour Force Survey

Arguably FTSE 100 CEO's higher redundancy rate (1%) compared with average labour market redundancy rates (0.58% or 0.75% for men) show they endure slightly more risk than the average worker. Admittedly the FTSE 100 is a small sample size but the disparity in risk between ordinary workers and FTSE 100 CEO's on these comparative figures is 1.3 not 79.

Moreover when we look at labour market outcomes for all groups of workers after redundancy we find the following picture emerges. Around one third of those made redundant are likely to still remain jobless 15 weeks after becoming unemployed. Six months after being made redundant around 18% of people are still jobless.¹³ This is not the case for the FTSE 100 CEOs in our sample.

It should be noted that though many organisations offer more generous redundancy payment schemes the minimum statutory redundancy pay is between half a week and one and a half week's for every year of service for employees with two calendar years of continuous employment with the same employer depending on age¹⁴. For employees aged between 22 and 40 it is a week for every year. A man on average male earnings of £25,800 per annum with average tenure of 7.5 years would receive around £3,700. The FTSE 100 CEO who was made redundant received a pay off more than 1,350 times that.

So when employed, FTSE 100 CEOs earn around 76 times average earnings but when sacked the differentials go from the 10s into the thousands. Certainly, like any redundant worker, CEOs who involuntarily lose their jobs will suffer damage to their self-esteem. Nor should we lightly under-estimate the stress and responsibility that comes with running such a large and complex institution as a FTSE 100 company.

These are undoubtedly among the toughest jobs around and the 'stewardship' risk is considerable. But this is not the same as labour market risk and it is labour market risk on which claims for high remuneration are partly based.

But does this matter? Do large income differentials such as this affect the performance of the organisations that such well-paid CEOs lead? In effect does inequality matter to the performance of capitalist organisations? There is evidence that¹⁵ has shown that overpaying people at the top of the organisation damages, rather than enhances, the performance of organisations through lowering morale and reducing commitment. The

13 British Household Panel Survey

14 DTI

15 Croner survey, August 2003

survey found that 96% of respondents¹⁶ believed that overpaying top executives led to poor employee relations. Differentials seem to matter. Exceed around 14 – 1 between top and bottom and people feel that pay and reward is fundamentally 'unfair'.

And 'felt fairness' matters to employee engagement. As The Work Foundation's research and other studies have shown employee engagement leads to customer engagement.¹⁷ The rather obvious conclusion is that people are citizens as well as employees with a well defined sense of what is fair and what is not. Rewarding people regardless of how profitable the organisation may be is simply rewarding greed. A winner-take-all market has developed among top CEOs and other Directors and nothing seems able to stop it. People instinctively understand the difference between risk-taking entrepreneurialism as evidenced by many of the entrants to Evan Davies' Dragons Den series on BBC television and very able stewardship. If we pay our top public servant – The Prime Minister – £186,000¹⁸ a year why do FTSE 100 CEOs deserve 13 times that for stewarding their companies?

Winner-take-all effects are in effect a form of market failure. We need vibrant capitalist organisations. We need to encourage investment in the people who run and work in them. And these leaders deserve high levels of remuneration suitable for exceptional people doing great jobs running great companies. But this should not be at the cost of ultimately perversely damaging the prospects of long-term success for those companies.

Moreover a raft of enquiries and committees have failed to tackle the issue. From Greenbury to Hampel¹⁹ codes of conduct are offered up as the solution and yet pay continues to soar. More needs to be done. Inequality matters. High levels of inequality in wider society act as a brake on social mobility and high levels of inequality within organisations act as a brake on performance. As Richard Wilkinson has irrefutably demonstrated in his book *The Impact of Inequality: How to make sick societies healthier*, in wider society there is a strong correlation between high inequality and low levels of trust, low social capital, higher murder rates, and higher levels of hostility.

16 The survey group was formed of HR professionals.

17 See *Cracking the Performance Code*, The Work Foundation 2005 and Rucci A.J, Kirn S, and Quinn R.T. (1998). The employee-customer-profit chain at Sears. *Harvard Business Review*, Jan-Feb, 83-97

18 UK Parliament www.parliament.uk/faq/pay_faq_page.cfm

19 *Committee on Corporate Governance – The Combined Code*, derived from the Hampel Committee final report, and the Cadbury and Greenbury reports.

I would argue that over-paying people at the top in relation to others has the same effect on the firm. The winner-take-all effect needs better institutional responses to curb the enthusiasm of Boards to pay more-and-more.

4. Just Desserts?

So what can be done? There are four things that I propose to rebalance risk and reward in CEO pay.

1. Boards of governance need broadening. All boards should be able to draw on a wider pool of non-executive directors including workplace and Trades Union representatives. These new Boards need better information on the human capital and environmental dimensions of organisations. CEO reward should be linked much more routinely with these dimensions, in addition to share performance and deal-making.

Institutions that enable worker voice help curb pay excesses. As Dew Becker and Gordon have argued in a recent paper²⁰ the graph of income inequality over the last century looks U-shaped. From 1929 to the mid-1970s income inequality declined but has risen thereafter. They put this down to the decline and subsequent recovery of immigration and, most significantly, to the rise and recent fall of unionization. Some economists²¹ believe that the decline in unions can explain up to 40 percent of the rise in inequality. And it is a fact that the top 5 percent of income earners have seen most of the gains. CEOs are at the top of this pile.

As Frank and Cook identified a decade ago²² this winner-take-all-effect is a perverse by-product of competitive markets. Talent is narrowly defined and then sought in a form of arms race where compensation rises regardless of the normal economic rules governing efficiency and effectiveness. So, for example, in the 1989-97 period total real compensation of CEOs in the US increased by 100 percent.

20 Dew-Becker & Gordon, "Where did the Productivity Go?", *Brookings paper*, 2005

21 see Gosling and Lemieux

22 Frank and Cook, *Winner Take All Society*, 1995

2. Employment law needs tightening to make contracts of employment mean what they say. It is iniquitous that people can receive all their benefits and emoluments despite poor performance.
3. A top pay review body – a High Pay Commission - should be established similar to the ones that operate in parts of the public sector. Boards could then have an independent source of objective guidance and advice on what to pay to whom. Such a body could also provide objective evidence for what that pay should be based on in terms of performance dynamics. Membership of the body could be tri-partite like that of the Low Pay Commission.
4. Mitigation should be enforced. In 2003 The Work Foundation, in its formal submission to the DTI enquiry 'Rewards for Failure' Directors' Remuneration – Contracts, Performance and Severance, argued that the common law of mitigation should be invoked to deal with the problem of rewarding for failure.²³ Remuneration committees should demand substantial discounts on lump sum payments or provide for all or part of any agreed compensation to be phased over a future period on terms that all or part of it shall not be payable if the employee finds alternative sources of remuneration in that period. The combined code should reinforce the principle of mitigation and this could well be further reinforced through legislative fiat (see point 2 above)

²³ *Rewards for Failure: Submission to DTI Consultation*, The Work Foundation, September 2003

5. Conclusion

Life at the top of any organisation is certainly tough. Ask any CEO and they will talk of the loneliness of their position, the feeling of isolation they have from others as all bucks stop with them. And certainly they are exposed and are at risk of failure. Their decisions are more momentous and affect more people. All this is true. But is the labour market risk they bear really any greater than the labour market risk to the shop floor worker, or the retail assistant, or the engineer or the designer when one of their decisions goes awry?

For the personal consequences of failure for the ordinary worker²⁴ are usually greater than they are for the person who is often most responsible for that failure. Reward should follow for the talented, the able, the entrepreneurial and the wise but let us not base arguments about reward on myths about risk.

24 See Armstrong K, *Life after Rover* The Work Foundation 2006

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Annex 1: FTSE 100 CEO turnover and labour market outcomes 31 July 2005 to 31 July 2006

1. Merger of Alliance Unichem and Boots led to Stefano Pessina stepping down as CEO of Alliance Unichem and the merged company was taken over by Richard Baker CEO of Boots. Pessina was then appointed Executive Deputy Chairman of the merged group.
2. Charles Brady, Executive Chairman of AMVESCAP, retired on 27 April 2006. He was paid \$9 million and remained an employee of the company for an indefinite period , ' to ensure the continued and effective transition to a non-executive chairman'. The share price fell after the news was made public.
3. David Brennan took over Astra Zeneca from Sir Tom McKillop who left to be Chairman of RBS
4. Stephen Nelson took over from Mike Clapper at BAA after the Ferrovial buy out. Clapper stayed on as an 'adviser'. He is also a Director of ITV.
5. Rod Aldridge resigned from Capita in the wake of the Labour loans for peerages scandal.
6. Sir Rod Eddington retired from BA in October 2005 to return to Australia and has gone on to be non-Executive Director of Allco an Australian finance company.
7. Sir Roy Gardner left Centrica in July 2006 being succeeded by Sam Laidlaw. Sir Roy went on to become Chair of Compass.
8. Michael Bailey resigned as CEO of Compass and Richard Cousins took over on 1 June 2006.
9. Andy Hornby took over on 31 July 2006 as CEO of HBOS. Crosby the previous incumbent is now chairing Gordon Brown's Public Private Forum on Identity Management.
10. Sir David Prosser retired on 31 December 2005 from CEO role with Legal and General. He was succeeded by Tim Breedon. Sir David holds non executive Directorships with, among others, Investec, Epsom Downs Racecourse, RAC Ltd, Intercontinental Hotels.
11. Richard Segal resigned as CEO of Party Gaming in April 2006 after having decided he couldn't move to Gibraltar, where the other directors were based, for family reasons. According to a report in the Daily Telegraph of 20 April 2006, by Business Editor Alistair Osborne, he made £30 million in the two years since the company

had been set up. He has since been linked with other internet based gaming organisations seeking to launch on the stock market.

12. Persimmon's previous CEO, John White became Chairman on 20 April 2006.
13. Ian Russell was the only FTSE CEO in this period to actually be sacked. He was CEO of Scottish Power and had turned down a 'buy' offer from a German power company that valued the company at £5.60 a share. His pay-off was £2 million plus £3 million in share options to compensate him for missed bonuses and pension contributions plus a year's salary. (source Scotsman 13 Jan 2006).
14. Philip Green took over from John Roberts as CEO of United Utilities on 31 March 2006. John Roberts went on, among other things, to advise private equity firm Terra Firma on a planned bid for Thames Water.

