

Life at the top

Is managing time the route to smarter working?

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the work foundation



Life at the top: The labour market for FTSE-250 chief executives

Greed is good¹

As Frank and Cook asked in their 1995 book *The Winner-take-all Society*², what happens at the top of certain labour markets when so many want to do so few jobs? Why do certain labour markets behave differently to others? After all, a plentiful supply of labour should drive down the price of that labour. Yet in many areas, finance, the legal profession, professional sport and for those running top companies, the opposite seems to happen.

In the case of senior executive remuneration, the recent DTI consultation '*Rewards for Failure' Directors' Remuneration – Contracts, Performance and Severance* has emphasised the considerable disquiet felt by many over the way in which chief executives, and to a certain extent other board-level directors, have continued to be well-remunerated even when by any objective measure they could have been deemed to have failed.

The contrast between those chief executives who have walked away from their companies with multimillion pound pay-offs, despite their perceived poor performance, and what happens to every other group of worker when they fail has struck many individuals and organisations, including both the Trades Union Congress (TUC) and the Confederation of British Industry (CBI), as a little odd.

As Patricia Hewitt, secretary of state for trade and industry, says in her introduction to the DTI consultation: 'Over the past months, we have seen a high level of public debate and concern over the granting of generous compensation packages to departing company directors, particularly in cases where the company has performed poorly.'³

According to the Pensions Investment Research Consultants (PIRC) the median salary for the highest paid directors among FTSE-100 companies has increased by 92 percentage points since 1993 from £301,000 to £579,000 in 2002. In the same period, inflation rose by 25 percentage points and average earnings by 44

¹ The character Gordon Gekko in *Wall Street*, 1987

² Robert H Frank, Philip J Cook, *The Winner-take-all Society*, Simon and Schuster, 1995

percentage points.⁴ And in 2001, UK top executives' pay rose by 12 percentage points while the value of the companies these executives ran fell by 16 percentage points. While profits were down by 5 percentage points, bonuses were up by 34 percentage points.⁵

How top directors and chief executives are being paid is also changing. More of the salary is being paid as bonuses. Five years ago the upper limit for annual bonuses was between 40% and 60% of base salary in most cases. By 2003, this had risen to 100% in a third of cases, and more in others. The same trend is evident in the granting of executive share options.⁶ However, there seems to be little indication that performance targets have been toughened to merit such increases in bonus pay according to some reliable sources.⁷

In short, people heading up the UK's top companies seem to be being paid more almost regardless of the performance of the companies they run or their own performance in the jobs they do. As the select committee report on trade and industry rather pithily puts it: 'It would appear that executives have been rewarded not only for success but for failure as well.'

Yet this is not a new debate. The levels of remuneration received by chief executives and top directors have been exercising us since the early 1990s. It was first triggered by the furore when Cedric Brown, the former chief executive of British Gas, became rich overnight when the company was privatised. Over the last ten years, a succession of high-level, business-led consultations and final reports examining corporate governance and executive remuneration has been published. Common to all has been a focus on reforming the management of pay and remuneration through improving governance structures and developing codes of behaviour and practice. For example, the Hampel report's combined code states:

'Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully, but companies should avoid paying more than is

³ DTI, *'Rewards for Failure' Directors' Remuneration – Contracts, Performance and Severance*, 2003

⁴ Evidence given by PIRC to the Select Committee on Trade and Industry 16th Report 2003

⁵ *Channel 4 News*, July 18 2002

⁶ Select Committee of Trade and Industry, *Sixteenth Report: Rewards for Failure*

⁷ See PIRC evidence to Committee of Trade and Industry, *Sixteenth Report: Rewards for Failure*

necessary for this purpose. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.⁸

Earlier, the Greenbury report asserted in 1995:

'The key to encouraging enhanced performance by Directors lies in remuneration packages which: link rewards to performance, by both company and individual; and align the interests of Directors and shareholders in promoting the company's progress.'⁹

And: 'Remuneration committees should be sensitive to the wider scene, including pay and employment conditions elsewhere in the company, especially when determining annual salary increases.'¹⁰

Yet only recently has a combination of a bear market, some muted shareholder activism, and negative media commentary difficult to dismiss as mere Schadenfreude, exerted enough pressure to effect change at the top. Up to this point, ten years of exhortation, improved governance structures and denigration of fat cats has achieved little.

Why I'm worth it

It may seem that when chief executives accept pay-offs that increase their personal wealth they are merely following the economist's maxim to be rational. But though this may or may not be rational for the individual, it can seem very unfair to everyone else. Economics may posit markets as being essentially amoral places, but in the real world morality infects most economic choices. Increasingly, consumers are being asked whether they can really live with themselves if they buy non-dolphin-friendly tuna, or unfairly traded coffee, or factory-reared chickens. So too is the investment community waking up to the fact that looking after their investors' interests means more than simply examining the last quarter's share price performance. As Einstein acknowledged, his achievements were based on the labours of many.¹¹

⁸ *Committee on Corporate Governance – The Combined Code*, derived from the Hampel Committee final report, and the Cadbury and Greenbury reports.

⁹ *Directors' Remuneration – Report of a Study Group chaired by Sir Richard Greenbury*, 1995

¹⁰ *Ibid*

¹¹ Quoted in Howard Schultz, *Pour Your Heart into It: How Starbucks Built a Company One Cup at a Time*, Hyperion, 1999

For people at the top of private companies there are three main reasons given for 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 short report will examine in more detail the third of those claims. The second claim listed above needs closer examination. People who run things, with one or two exceptions, will tend to be confident, intelligent, articulate people. However, they will almost certainly not be the only confident, intelligent or articulate people who could be doing the job. They also have an X factor. They are in the right place at the right time. They have built up the right networks. In short they have often been lucky. If it helps, think John Smith and Tony Blair.

Linked to the idea of exceptionalism is the idea of the leader as visionary. Visionary leaders are how CEOs would like to see themselves, and how most would like us to see them. But in reality, for every Branson there are 100 bureaucrats. Indeed, as Porras and Collins argue in *Built to Last*¹², visionary leaders can often be detrimental to a company's health – to quote them verbatim: 'Far better to be a clock maker than a time teller.'

We live in an age when the cult of the leader is ever-present. From sporting heroes to fictional leaders in blockbusting films to business chiefs, all such leaders have characteristics in common: they are risk takers; they create a vision that others want to follow; they keep going where others would stop; they are decisive. I could go on.

Yet as Dr Michael Hammer has argued at length, most corporate leaders are nothing like this.¹³ They are stewards not change agents, administrators not leaders. The culture of too many businesses is too often the opposite of that they portray. This

¹² James C Collins and Jerry I Porras, *Built to Last*, Random House, 1994

¹³ Dr Michael Hammer in The Work Foundation-hosted seminar *The Truth About Leadership*, November 2003

leads to prioritising finance above strategy, or marketing or operations. Deals are glamorous, whereas work is not. Deals help boost share prices in the short term whereas managing over time to grow the business rather than merely financially engineer it, is more time-consuming and riskier to the short-tenured Chief Executive. The short term is what counts and only the top of the company makes a difference. Every other group of worker is merely cannon fodder.¹⁴ In short, the behaviour exhibited by those leading many of our top companies is the diametric opposite to the rhetoric deployed in part as justification for the levels of remuneration they receive.

The Work Foundation's recent report into productivity, *The Missing Link – From Productivity to Performance*, argued that high-performance companies are those that manage well the strategies across five key areas:

1. Customers and markets
2. Shareholders and governance systems (including finance and investment)
3. Stakeholders (suppliers, customers and people but also community and CSR objectives)
4. Human resources practices
5. Creativity and innovation management.

Integral to such high performance is leadership and management that are in balance. This means having chief executives that understand when and where to take risks and innovate; that understand how to transform performance in a balanced way over time; that focus on the long term and all the areas listed above, and not just that quarter's share price.

On the question of risk in being a chief executive (the first of the three arguments for high pay listed above), many well-researched and compellingly-argued books have been written on the subject of risk and who is taking it in the new world of work.¹⁵ Suffice to say that it is not the CEOs of large companies who are seen as being particularly at risk (though the psychological harm that can be done through a damaged reputation should not be underestimated).

¹⁴ Ibid

¹⁵ See Ulrich Beck, *The Risk Society*, Sage Publications, 1992

Nor, arguably, as alluded to above, are most firm's business strategies risk-inclined. If the history of the labour market tells us anything it is that those most vulnerable to economic shocks are those furthest down the food chain of employability. It is the largely de-unionised, low skilled private sector workforce that has increasingly borne the brunt of the new flexible labour market since the end of the 1970s. Indeed, large swathes of the male labour market are now so economically inactive that without a plethora of supply-side interventions¹⁶ they have little hope, if any, of re-engaging with the labour market. And many of the nearly 3 million economically inactive people who, when asked, say they would like a job, are likely to need a lot more demand-side activity to have any hope of so re-engaging.¹⁷

Home-grown

'In seventeen hundred years of combined life spans across the visionary companies, we found only four individual incidents of going outside for a CEO – and those in only two companies.¹⁸ Are Porras and Collins right? Do the current CEOs of the UK's top 250 companies conform to this general model? Remember Porras and Collins were looking at a mere 18 visionary companies across 18 sectors.

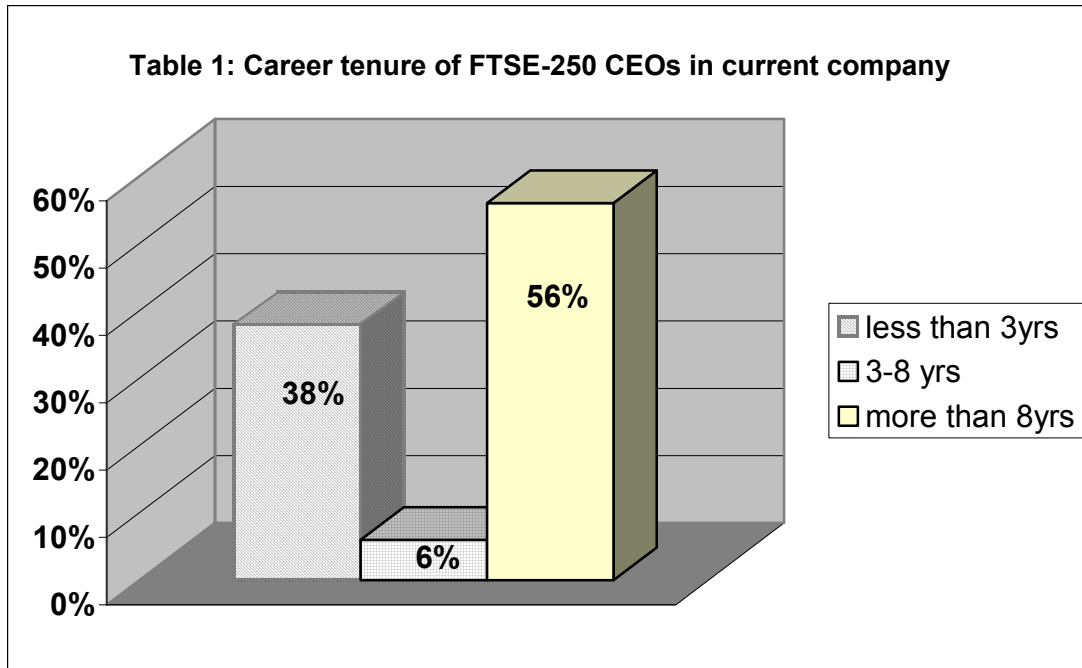
Table 1 shows the time CEOs of the FTSE-250¹⁹ have worked for their company (including any time as CEO). The majority – nearly 60% – have been with their company for eight years or more. The vast majority of these individuals have moved up the ranks, at least to some degree. A further 6% have been with their firm for between three and eight years, and the remaining 38% have been with their company for three years or fewer.

¹⁶ For example, the New Deals, Job Centre Plus, Intermediate Labour Markets, Working Family Tax Credits, etc. For a good recent discussion and set of policy recommendations on this aspect of the labour market see Andy Westwood and Max Nathan, *Broad Work*, The Work Foundation, 2001.

¹⁷ See ONS, *Labour Market Survey*

¹⁸ James C Collins and Jerry I Porras, *Built to Last*, Random House, 1994

¹⁹ As of August 2003



Average male job tenure is around five years and half years²⁰ so a significant proportion of the highest flyers seem to exceed the average male worker in the UK.²¹ Perhaps more significantly, it seems that many companies are behaving in the way Porras and Collins found in their high-performing group. Companies are nurturing and incubating talented people so that the internal labour market works well. This rational approach to managing human capital makes sense. After all, it is expensive to train and develop people who are of CEO calibre. In the UK, managers receive five times more training spend than any other group of worker.²²

Now we turn to nationality. It is a truism that the volume and dispersion of international trade has expanded rapidly over the last two decades, particularly since 1990. It is also true that many leading UK based companies trade in this international market. But that is all about products and services. If the labour market for chief executives is truly global, we might expect to find a similar pattern to that other truly global labour market in the UK, Premiership football.

²⁰ Labour Force Survey

²¹ Though it should be noted that the older the worker, the longer their tenure tends to be.

²² Andy Westwood, *Can the UK Learn to Manage?* The Work Foundation, 2001

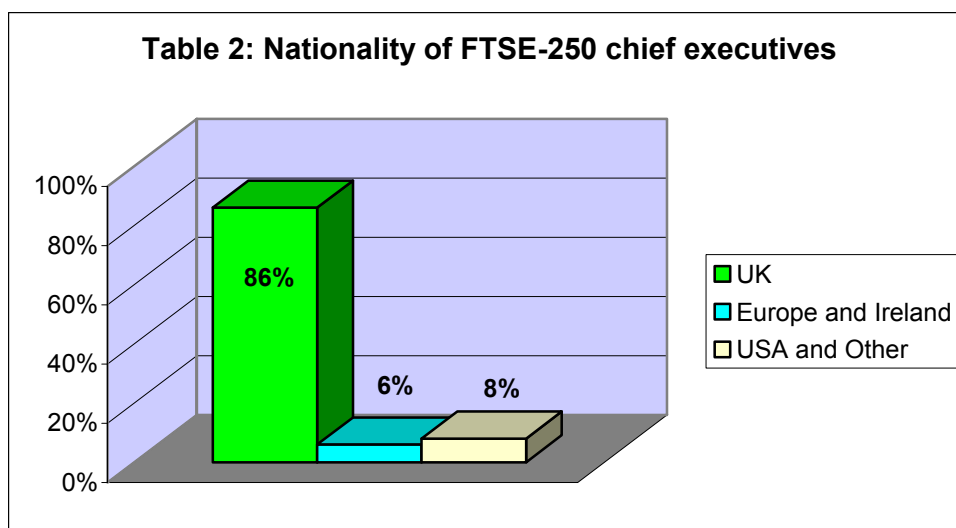


Table 2 shows the proportions of CEOs with UK, European or other nationalities. As can be seen, the vast majority – 86% – are UK citizens. And several of the 6% of other European Union CEOs were born in Ireland. On the face of it, there doesn't seem to be much mobility there. Perhaps we just don't pay enough? After all, US salary levels for CEOs can be up to ten times higher than in the UK. German and French CEOs are paid less than their UK counterparts, yet average French and German productivity performance is around 15–20% better than ours.²³ Given that the UK is second only to the US in terms of the global league for CEO pay, one might expect to see more entrants to that labour market from around the world, but we don't. Another survey of all directors in the top 150 UK companies found that nearly one in four directors of UK companies were from overseas, and nearly one in two companies had at least one overseas director.²⁴

In short, the labour market for CEOs in the FTSE-250 is very home-grown. Companies are behaving rationally by grooming talented members of staff to take over the top job when it becomes available. Top companies will have developed a pool of such talent and succession is planned and often seamless. This keeps knowledge in the firm, creates bonds of trust across the organisation and emphasises continuity. It is what great companies have been doing for the last 200 years, and 'greed' per se should have no place in such a world.

²³ Will Hutton, *A Declaration of Interdependence*, W.W. Norton & Company, 2003

Does what CEOs get paid really matter?

Yes. Leaders set examples. It matters what they do and how they do it. The relationship of the leader to his or her staff is an integral part of the psychological contract. Income inequality in society has damaging effects. It reduces overall levels of well-being, creates a wellspring of resentment and helps trigger antisocial behaviours and outcomes. Organisations are microcosms of wider society. In the world of the typical organisation, large pay differentials demotivate and demoralise. If the chief executive is being paid many times more than the average remuneration in an organisation, it sends out a powerful, and arguably negative, message.

A recent survey²⁵ 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 survey found that 96% of respondents²⁶ believed that overpaying top executives led to poor employee relations. When the differential between top and average wages in a firm exceeds 14, morale will begin to slide.²⁷ It is also the case that overpaying creates a 'top pay club', entry to which is very difficult for those not earning that level of income already. This perverse outcome results directly from market failure. Paying people too much is a form of market failure. And when the arguments for so doing are as flawed as I have maintained in this report, then that market failure becomes starker still.

What should be done?

First, The Work Foundation believes that successful chief executives should be well paid in an organisational context that rewards, retains and motivates everyone and not just the chief executives. There is scant evidence of a truly global labour market for CEOs and therefore that particular argument should be discounted in the debate about what constitutes fair remuneration for directors of our top companies.

Second, The Work Foundation in its formal submission to the DTI enquiry '*Rewards for Failure' Directors' Remuneration – Contracts, Performance and Severance* has argued that the common law of mitigation should be invoked to deal with the problem

²⁴ Spencer Stuart, *Top 150 UK Board Index 2002*

²⁵ Croner survey, August 2003

²⁶ The survey group was formed of HR professionals.

²⁷ Evidence quoted in the *Guardian* 23 August 2003

of rewarding for failure.²⁸ We believe that 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. Legislation is probably a step too far given that some flexibility is required for employers to make judgement calls based on individual cases, and where the employer balances the likely outcomes when dealing with 'successes' or 'failures'.

However, we do argue that the principle of mitigation should be reinforced by an express statement in the combined code that departing executives should be required to mitigate their loss, and should not normally be paid substantial, single lump sums unless there are sound commercial or legal reasons for doing so.

Finally, The Work Foundation would also recommend that it is in the interests of business that employees should, through their representatives, have an opportunity to express views on the employer's remuneration policy for senior executives. This is one of the matters on which the workforce should be informed and consulted through the machinery put in place under the Information and Consultation Regulations, which are currently in draft and subject to further consultation.

Last word

Who gets paid what is probably the most contentious issue that any organisation will face in managing its people. Most of us think we deserve more, but only a few of us will ever receive it. However, for a very small number large rewards are on offer. For those operating in winner-take-all situations, such as top sports stars or even national lottery winners, the sums can be astronomical. Fortune and obvious talent are understood as reasons for someone to be wealthy. So too is entrepreneurial verve and elan. People understand the rewards accruing to a Dyson or a Branson. What the government, the CBI, the TUC and everyone else do not understand is payment for failure. Companies need great people to run them. Great companies nurture, develop and reward those people well. Greed doesn't, and shouldn't, come into it.

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²⁸ *Rewards for Failure: Submission to DTI Consultation*, The Work Foundation, September 2003

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