HEALTH WEALTH CAREER

THE PAY RATIO IS COMING

LET'S MAKE IT RATIONAL

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It is very likely that some form of CEO pay ratio disclosure will become a mandatory annual reporting requirement for UK PLCs within the next 12 months. This will be a new addition to the annual report in which CEO pay is expressed as a ratio of the pay of an average employee. On the surface this has the noble intention of creating both upward pressure on workforce pay and downward pressure on executive pay with a single measure. However, the current proposals[1] are fraught with difficulty and it may be impossible to avoid inappropriate comparisons and other unintended consequences without substantial changes.

Firstly (and as noted by the government in its Corporate Governance Review Green Paper), the ratio may be more a function of the type and demographics of a certain industry rather than a test of fairness. For example: a complex, international business which employs lots of part-time and temporary staff may have a very large ratio whilst a hedge fund would be likely to have a very high median pay level and so the ratio may be low. While this does draw attention to the fairness issue and calls for the duty of care to lower paid employees to be reinforced and communicated, it does not of itself suggest that pay is fairer in the latter organisation than the former and risks providing ammunition for inappropriate company comparisons.

Another difficulty is the employee sample itself. If the employee sample is taken globally, companies with larger operations in developing regions are likely to have a higher ratio. Conversely if only UK employees are used, companies might inadvertently be incentivised to move low paid jobs overseas. And how should employee pay be averaged? Median employee pay seems to be favoured currently, but this would represent a substantial administrative burden as current company processes and reporting requirements (for example in the Staffing Costs section of company accounts) tend to think in terms of mean pay – a number much easier to derive as it just requires knowing the FTE headcount and total pay cost of a particular segment, rather than ranking the annualised pay of every employee.

A third question is what kind of CEO pay will be measured? If we use the single figure in any one year, CEO changeovers and variability in LTI payouts will create huge volatility in the ratio and lend to misleading year over year comparisons, whereas smoothing this figure by averaging pay over a number of years could lead to claims that this is a ‘laggy’ measure and an inaccurate comparison.

We are raising these concerns in our response to the Government’s Green Paper, along with our recommendation on what the best approach might be. We have come to what we feel is a more effective and targeted approach to the two underlying problems – the concerns over excessively low employee pay and the perception of excessively high executive pay.

1. BEIS Corporate Governance Review Green Paper

NATIONAL LIVING WAGE (NLW) COMPARISON

A Credible Alternative to CEO : Employee pay ratio reporting

The National Living Wage is a level of income which aims to represent a baseline of welfare specific to UK society. It's a number that doesn't differ between companies and the act of publicising this relatively new measure alone exerts pressure on companies to adopt it and therefore pushes up pay at the bottom. Mercer recommends comparing both CEO pay and employee pay to the National Living Wage – *but not with one another* – is the best way to proceed for pay ratio disclosures.

A raft of measures aimed at increasing transparency and comparability of Executive Pay was implemented in 2012 under the direction of Vince Cable and the (then) Department for Business, Innovation and Skills (BIS). Mercer research[2] shows that the effects of these measures have been material and in our view we have not yet seen the full extent of these impacts as companies continue to adjust.

One of Cable's reforms required companies to disclose their 5 year Total Shareholder Return History versus the CEO's realised pay over the same period. The intention here was to highlight the level of alignment between gains made by the CEO, and gains made by the ultimate owners of capital. It is our opinion at Mercer that this is the correct place to add a reference to the other group of stakeholders of "UK PLC" – UK society.

While this disclosure is essentially the re-framing of information that is already available (the Single Figure of Total Remuneration) in the context of the NLW, Mercer also recommends that the government require companies to disclose the proportion of their employees that are paid under the NLW, and between NLW x 1 and NLW x2. The employee sample would need to be global so as not to encourage off-shoring labour, with relevant NLW values for non-UK employees. A measure such as this would shine the light on companies' junior employees pay policy and create an altogether more robust and targeted measure than a CEO : employee pay ratio.

Pay ratio reporting needs to be carefully thought out, and if the government is determined to implement a pay ratio directly between the CEO and an employee sample, we do not see a way to mitigate the many pitfalls effectively.

It is our opinion at Mercer that thinking has become so fixated on a CEO : employee ratio that we risk losing sight of the underlying intention of the proposals; to exert downward pressure on the pay of executives and upward pressure on the pay of employees. With this in mind, Mercer's recommendation to the government is to drop the CEO : employee comparison entirely and deal with these issues separately as we have outlined.

It's not too late!

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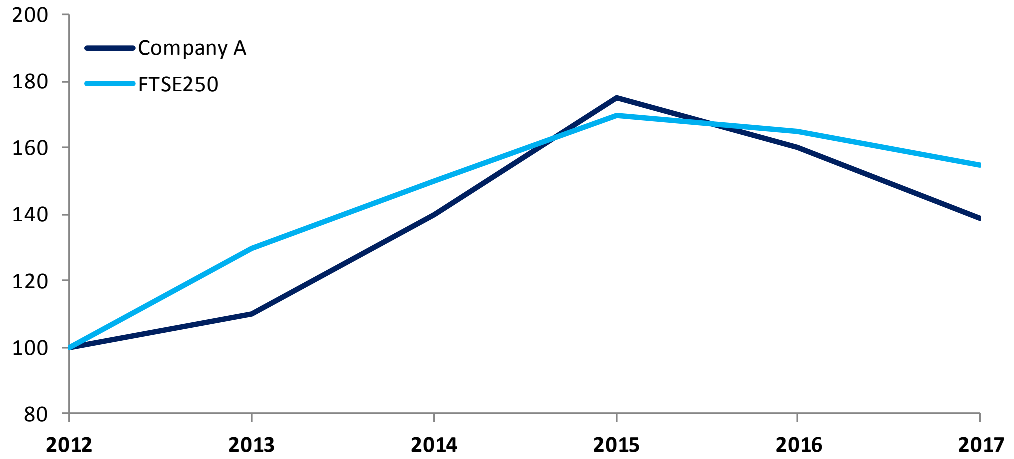
2. Mercer Response to BEIS Green Paper

MERCER'S RECOMMENDED NEW DISCLOSURES

Below is a hypothetical section from a Director's Remuneration Report in 2018. Existing sections such as the Performance Chart and CEO Single Figure are now combined with additional elements focused on expressing CEO pay as a ratio to the National Living Wage, and highlighting the proportion of the company's workforce that receives low levels of pay.

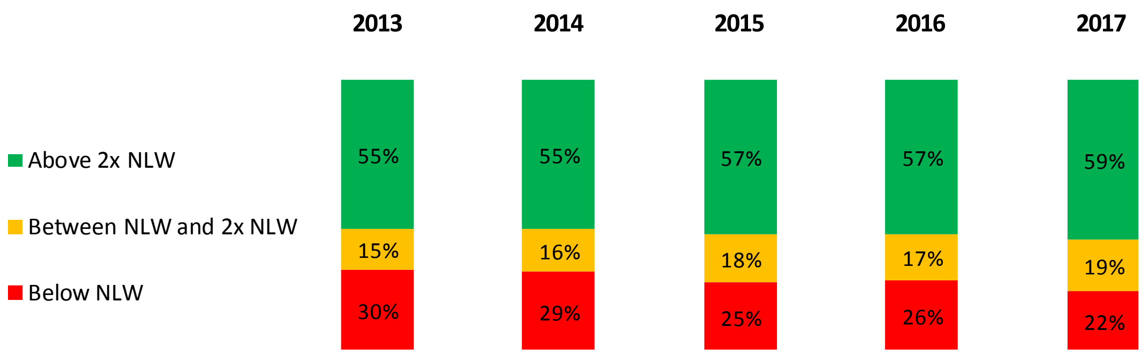
7.3 Performance Chart



7.4 Audited Information: CEO Pay versus National Living Wage (NLW)

CEO Single Figure (£'000)	1,400	2,167	1,934	2,228	1,600
CEO : National Living Wage	93.48	144.69	129.16	148.75	106.84

7.5 Proportion of Low Paid Employees



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