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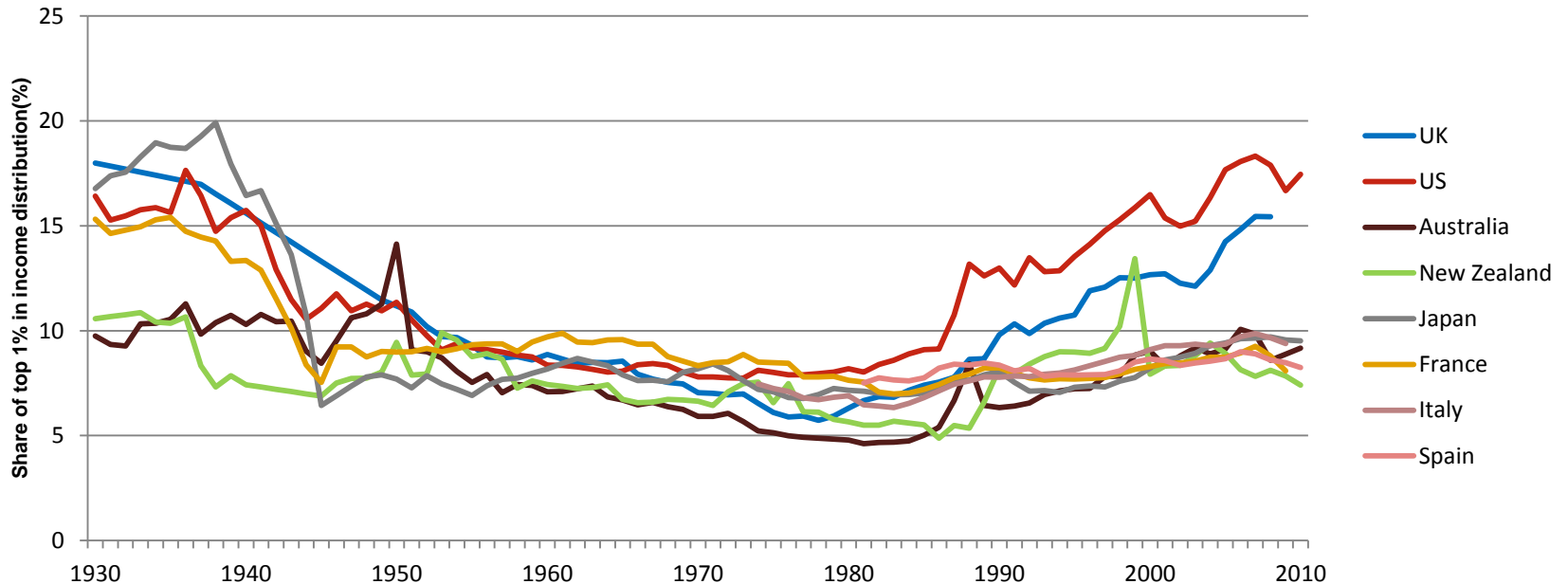
# *The Economics and Ethics of Pay*

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SARA Conference 2014



# The global fairness debate

## Global Income disparities are rising to early-century levels



- In 2008 the **US had the largest disparity** with the top 1% of individuals earning 18% of the country's total income, followed by the UK's 15%. In the same year **New Zealand had the lowest** rate at 8%.
- **Japan is the country with the greatest decrease**, moving from 20% in 1938 to 10% in 2010.

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## *On the horizon... matters of interest*

### **California seeks to increase corporate tax rate for companies with large wage gaps**

In May 2014 the California Senate voted 19-17 against a bill that would have imposed a higher tax rate for companies conducting business in California which had CEO pay ratios above specified levels.

The bill would have imposed a sliding scale for the corporate income tax rate (currently 8.84%) that would vary between:

- 7% (for companies with a CEO pay ratio of 25:1 or less)
- up to
- 13% (for a CEO pay ratio of 400:1 or above).

### **Shareholder engagement efforts continue to rise**

Increasing awareness of the need to engage shareholders surrounding the advisory remuneration policy vote.

However, international say-on-pay trends reveal a need to ensure that beyond engaging shareholders, subsequent efforts are undertaken to ensure that shareholder concerns are fully addressed, to ensure that a negative vote is not repeated.

This also translates to a need for disclosure of any changes to policy made by companies in response to shareholder feedback.

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## ***On the horizon... matters of interest***

### **Shareholders in developed and developing countries continue to focus on “pay for performance”**

Remuneration policies and variable pay structures should support the creation of sustainable long-term value for shareholders.

New study<sup>1</sup> of 1,500 US companies with the biggest market caps reveals that the more CEOs got paid, the worse their companies performed. It is suggested that these results indicate CEO overconfidence induced by high-pay, leading to shareholder wealth losses from value-destroying activities.

Performance metrics need to be revisited to ensure that they do not ‘oversimplify success’. There is an increased need for analysis to determine which measures of performance have the most influence on their shareholder value.

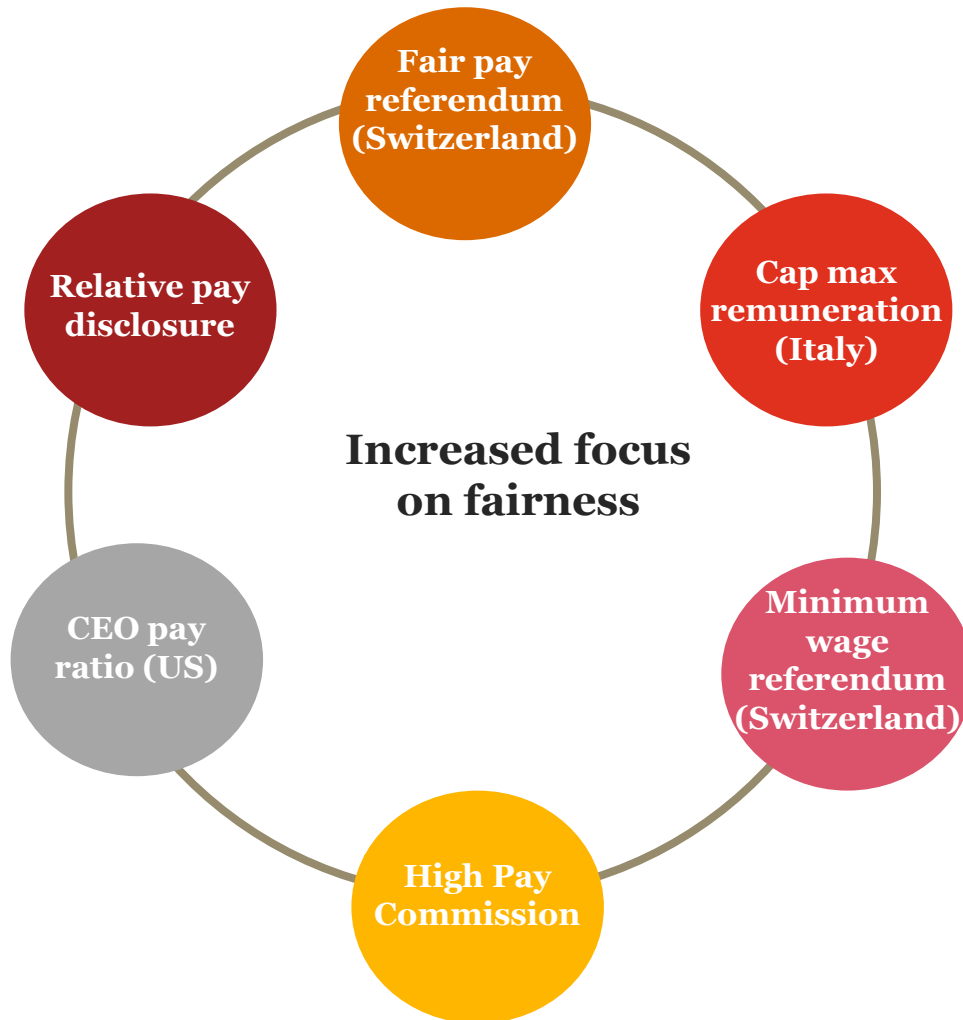
<sup>1</sup>*Performance for Pay? The Relation Between CEO Incentive Compensation and Future Stock Price Performance*; Cooper M, Gulen H, Raghavendra P; January 30, 2013

### **Evolution of performance metrics in line with the increasing importance of “sustainability”**

Sustainability is becoming an increasingly important focal point for companies

This is leading to a re-evaluation of the value that companies create not only for shareholders, but for all stakeholders. In light of this, we may see the development of a trend towards the inclusion of sustainability performance into employee remuneration, especially for executives.

# Fairness and executive pay



**“Fairness is what justice really is”**

*Potter Stewart (former Associate Justice of the US Supreme Court)*

**“Fairness is not about what works. It is about what’s right”**

*Cynthia.V. Ward (Professor of Law, William and Mary College (US))*

**“Fairness can be interpreted as being equal in provision, in opportunity or in result”**

*Dr.Orville Boyd Jenkins (American minister)*

# The fairness debate

## Enlightened self-interest

## Moral

Society

### *IMF: Redistribution, inequality and growth*

Inequality undermines progress and causes political and economic instability

Lower net inequality drives sustainable growth

### *Piketty: Capital in the Twenty-First century*

$r > g$  = wealth grows faster than economic output

Inequality is not accidental, it is a feature of capitalism with dangerous consequences

Importance of wealth is approaching pre WWI levels

Only rapid growth or government intervention to prevent "patrimonial capitalism"

Corporate

### *Firms of endearment (FOE)*

Seek to maximise the wealth to society

Higher shareholder returns

Honest, transparent and fair

Modest exec pay, generous employee pay & benefits

Loyal employees and customers

### *'Licence to operate'*

Pressure from 'millennials', calling for increased transparency, equity and fairness

Social media and societal perceptions

Companies' duty to consider public opinion

# *Might the issue solve itself?*

**The great global convergence has run its course**

*What goes up...*

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

**Wage share in GDP unlikely to fall further**

*...must come down*

**A focus on succession planning will result in pay benchmarks falling**

**Re-regulation of financial services will prick the banking bubble**

- 2014 - more restraint for FTSE100 CEOs;
- Third year of consecutive bonus reductions;
- One quarter had their salaries frozen.

- Pay rises, where given, have generally been in line with the wider workforce at less than 3%.

- Bonuses have been largely flat in £-terms but falling relative to salary;
- Total pay has been flat year on year, despite market recovery.

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# ***South Africa – The wage gap in context***

## ***Trends***

Increasing worldwide attention surrounding the wage gap continues, with strong movements towards the mandatory disclosure of the wage gap overseas. Meanwhile, in South Africa, there is ever increasing attention due to socio-political circumstances.

Shareholders and the public are particularly concerned about **unsustainably high executive pay where company results are poor.**

The ratio of total CEO pay to average company pay in South Africa is around 73 times, with a range of 30 (in Norway) up to 164 in the US, with India at 32, Australia at 55 and the UK at 93.

South African CEO pay is thus not extreme compared to some countries with successful economies but is higher than other developing countries such as India.

The two highest wage gaps in the USA:

- JC Penney 1,795
- Abercrombie and Fitch 1,640<sup>1</sup>

1) Stats from Mergence Investment Managers report on the wage gap



## The Gini Co-efficient of the Employed

- Most articles on the “Pay Gap” in South Africa begin with the statement that ... South Africa is the most unequal society in the world **with the highest Gini co-efficient** of any nation ... Calculations of South Africa’s actual Gini co-efficient vary from 0.63 (World Bank) to 0.72 (Statistics SA). Other nations’ Gini co-efficients:

USA	0.49	UK	0.48
Italy	0.54	Germany	0.50
South Korea	0.34	Brazil	0.55

- We calculated the Gini co-efficient using data on salary income from the PwC REMChannel® remuneration survey. The results of this calculation are:

Gini co-efficient of the Employed (Salary only)	0.40
Gini co-efficient of the Employed (Salary and Incentives)	0.44

- Whilst South Africa still needs to exercise restraint with respect to executive pay, and offer fair pay for junior workers ... this analysis indicates that South Africa’s **high level of unemployment** has a profound effect on inequality and the Gini co-efficient, ... and that all stakeholders should focus on **Education, Capacity Building and Job Creation** to address unemployment.

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# *The Market for CEO Pay*

- The ratio of total CEO Pay to average pay is **73** times, and to entry level worker pay, it is **150** times.
- For large companies this ratio increases to up to **300** times.
- This statistic is quoted by unions and the press to evoke strong emotions around the subject of executive pay.
- Institutional investors appear to be more concerned with aligning pay with performance, than the absolute quantum.
- The total remuneration for executives of most South African industries is fairly well aligned, based on size, although the pay mix differs.
- CEO pay in developed countries (for example US, UK and Australia) ranges from **2-3** times more than their SA counterparts based on a size basis, without adjusting for cost of living.
- SA large companies pay their CEOs **USD 2-3 million** per annum in total remuneration, and US Fortune 500 CEO's receive **USD 10 million** per annum.
- It is thus difficult to systemically reduce CEO pay in any one company in the SA market, or across the entire market without compromising the company or country competitiveness for executive and leadership talent.

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# *Squeezing the wage gap from both sides*

## **Top down – appropriate level of executive pay**

- Making sense of the number: representing CEO and executive pay as a % of the total salary bill
- Making a meaningful comparison: CEO vs lowest paid worker, CEO vs average worker
- **Design** - designing adequately robust STI and LTI structures which prohibit pay-out where there is poor performance
- **Adherence** - honest adherence to these structures
- Less **volatile** and **leveraged** structures
- **Communication** - transparent communication of methodologies used within the structures to shareholders and the public, through the annual report and shareholder roadshows

## **Bottom up – a living wage**

- Understanding and exploring a “living wage”
- Direct communication with workers to understand their needs
- Innovative new ideas to address the disparity in ways which make a practical difference
- Communicating the wage gap in a way that makes sense to the workers
- Communicating the concept of a productive workforce: the more revenue and profit the workers generate, the more available to pay individuals.



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## ***The wage gap: a solution for all***

**Shift the focus to a “win – win” situation:**

- **Boost the productivity and profits of the business**
  - **Share the benefits fairly**
- **More effective spend on employee benefits**

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# *What can companies do about junior employee financial wellness?*

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## ***Brainstorming of ideas...***

- Can companies use their buying power, procurement and logistics skills to provide more cost-effective access to essential goods and services?
  - Food
  - Housing
  - Transport
  - Education
  - Connectivity, phones and tablets
- Focus on garnishee orders and financial wellness.
  - Review and interrogate all existing orders for legality, balances, statements etc.
  - Financial education campaign to create awareness of the process, deemed penalty fees, high interest rates and obligation of the company to recover debt + additional fees + interest.
  - Partner with the State to set up a judgement process early warning system
  - Arrange employee loans with approved financial services partners to avoid default judgement, additional fees and high interest rates on garnishee orders – R 2000 original debt -> R 12 000 garnishee orders.

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## ***Brainstorming of ideas...***

- Understand the level of a living wage ...
- Expenditure surveys.
- Aim to pay entry level workers sufficient pay to afford a frugal but dignified lifestyle.
- More ideas from the floor ...

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# Questions?

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