



THE
HIGH PAY
COMMISSION

Directors' Pensions: in it for themselves?

About The High Pay Commission

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The High Pay Commission is an independent inquiry into high pay and boardroom pay across the public and private sectors in the UK. The Commission was established by Compass with the support of the Joseph Rowntree Charitable Trust.

The Commission is independent from any political party or organisation. It is non-partisan in its approach and will draw conclusions based solely on the findings of the Commission.

Over the last 30 years pay at the top has increased, and pay differentials have grown. The Commission provides an opportunity to explore and understand the drivers behind this trend and to look at its effects. It will also seek to look at reforms that could to mitigate or reduce this trend.

The Commission will run for one year from November 2010.

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Foreword

Companies have been busy cutting costs in recent years by slashing the pension provision for employees across the board. This has seen much of the private sector workforce shut out from the best final-salary related schemes, but the boardroom has shown no such restraint.

As directors' pay has risen exponentially, packages have become ever more complex and a part of these pay awards is an extremely generous pension allowance. The average FTSE 100 director has accumulated a pension worth £3.6m - a sum that can only be dreamt of by an ordinary worker.

Many directors have now filled up their pension pots so that they are not eligible for further tax relief on contributions. Instead, they are increasingly being awarded cash payments in lieu of pensions at an average £160, 817 a year in the FTSE 100.

These startling new statistics are revealed in this report on executive pensions for the High Pay Commission, compiled by Incomes Data Services using latest available data from company annual reports and accounts and drawing on data from the ONS and NAPF. The report shows that only a third of private sector employees are enrolled in a pension scheme but almost all FTSE 350 companies provide a retirement scheme for their directors.

As ever with pay at the top, it is one rule for the workforce as it is exhorted to put up with a poorer retirement so that companies can stay competitive, and another one for the boardroom where generosity remains unchecked.

Deborah Hargreaves, Chair of the Commission

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Executive summary

Pay at the top of the income distribution is increasingly complex. Nowhere is this more apparent than for executives of top companies.

Within this complexity there is an aspect of executive pay packets that is often ignored because of the difficulty of making accurate calculations. This report changes that with an in-depth analysis of the current state of executive pensions.

In recent years we have seen a rapid decline in pension coverage for private sector employees. This has formed part of the current rhetoric around the proposed reduction to public sector workers' pensions.

However there is a key element missing from this debate; what has happened to the bosses' pensions?

There is a growing gap between the retirement benefits of a top director and the rest of the workforce.

Key facts:

- A FTSE 100 director with a defined benefit pension could be expected to receive a median annual pension worth £174,963 on retirement.
- The annual median pension paid from a private sector defined benefit pension scheme was £5,860 for the rest of the work force.
- The average FTSE 100 director has accumulated a pension worth £3.6m.
- The ONS survey found that only one-third of UK private sector employees receive a company-sponsored pension.
- This report reveals only 2.7 per cent of FTSE 100 companies and 2.3 per cent of mid-250 companies reported they had no formal arrangements in place for their executive directors.

There have been significant changes in executive pension provisions in recent years, much of it in response to changing tax provisions. In particular the changes in the tax provisions on yearly contributions and total pot which if exceeded would result in tax penalties. This has triggered a growing trend towards paying cash in-lieu of pension.

- The latest annual reports reveal that almost one quarter of mid-250 directors and a third of FTSE 100 directors received a cash pension supplement, either as a standalone provision or in conjunction with other arrangements.
- FTSE 100 lead executives received pension supplements worth £160,817 at the median, while the corresponding figure for their mid-250 counterparts was £121,500. Proportionally, the respective values were 24.5 per cent and 21.2 per cent of salary.

This area of top pay is often ignored – but it is clear that while the bosses of some of the UK's biggest companies have been very good at reducing their costs by cutting the pensions of their workforce they have also been very good at protecting their own.

Introduction

How much is your pension worth? In the past such a question would not have interested the majority of employees, but over the last decade concern about the value of pensions has climbed up the public agenda. As the recent debate about public versus private pensions has highlighted, how much an employee can expect to receive on retirement has become toxic. But while the recent focus has been on public sector pensions, less discussion has taken place about the growing gap in the private sector between the retirement benefits that top directors can expect compared to the rest of the workforce.

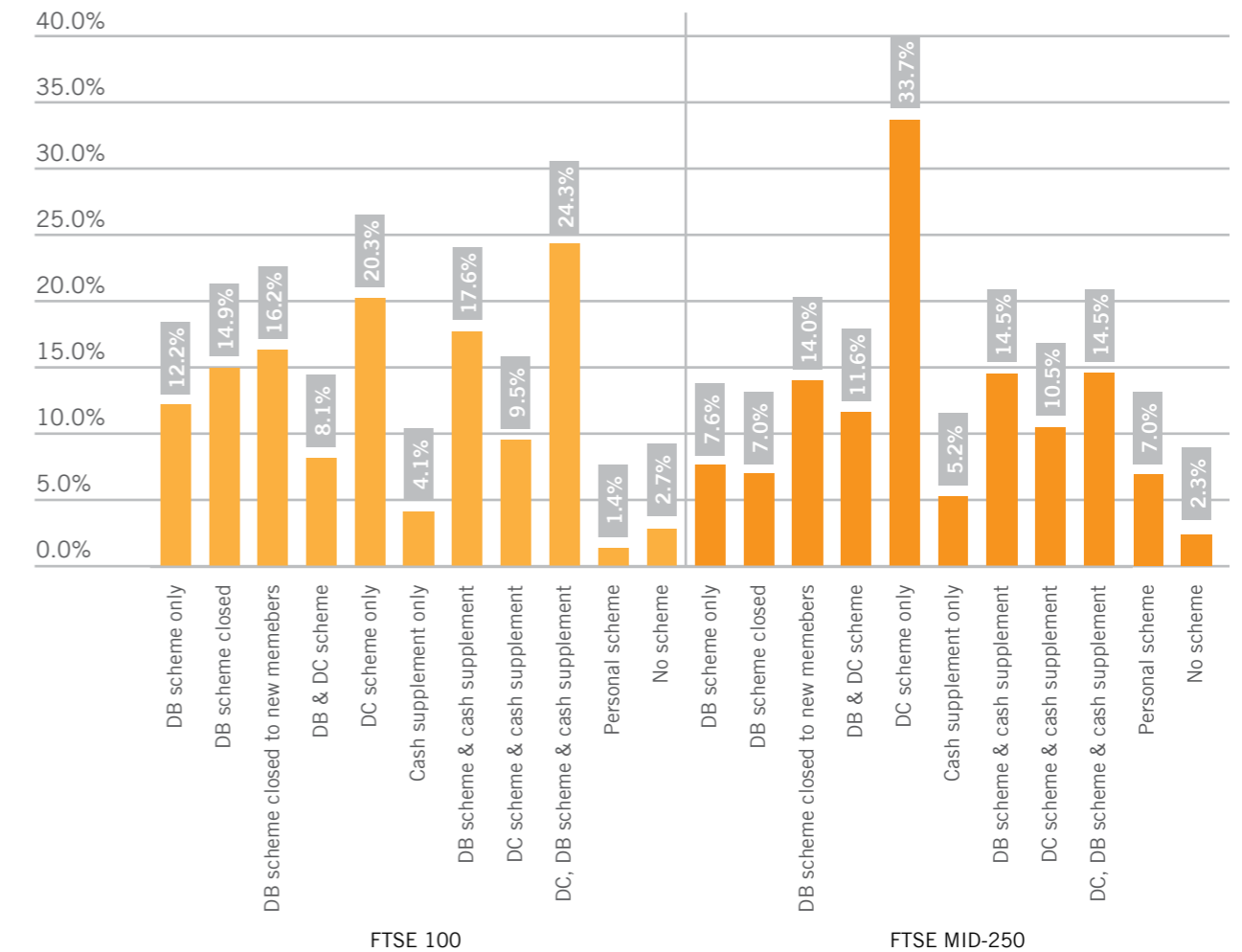
Using data from collected during our regular monitoring of boardroom pay, Incomes Data Services (IDS) has been asked by the High Pay Commission (HPC) to report on the pension provision for FTSE 350 directors. All data for our review of pensions is taken from annual report and accounts and, due to disclosure inconsistencies, some of the data may be limited. The year-end dates of the accounts used in our boardroom pension analysis stretch from December 2009 to January 2011.

Current boardroom pension arrangements

Like the rest of the workforce, pension provision for directors has undergone major changes over the last decade and what has emerged is a patchwork of arrangements, varying by company type, size and market listing and the length of service of the board member.

Most of the changes have been driven by simplification of the taxation of pensions in 2006. This introduced two key limits – an annual allowance specifying how much can be paid into a pension each year and a lifetime allowance stipulating the total pot from which a pension can be drawn.

GRAPH 1 FTSE 350 DIRECTORS' PENSION ARRANGEMENTS BY TYPE OF SCHEME AND MARKET LISTING 2010 (SOURCE: IDS/HPC)



Overstepping these limits could attract high tax penalties. In the last year, however, the Coalition Government has imposed restrictions on these ceilings. This year, the annual allowance for tax relief on pension contributions was reduced from £255,000 to £50,000, while next year the lifetime allowance will be cut from £1.8 million to £1.5 million. For reference, the typical annual retirement income for a director whose pension pot totalled £1.5 million would be £72,500.¹

Charting the range of schemes covering FTSE 100 and mid-250 directors illustrates the wide diversity in existing pension practice. As can be seen from **graph 1**, boardroom pensions range from the most generous standard final salary or DB schemes to the least beneficial arrangement of having no provision at all. In between these extremes are group money purchase or direct contribution (DC) schemes, personal pensions and even stakeholder pensions. But perhaps the most notable trend in recent years has been the growth of the payment of cash supplements in lieu of contributions by the employer to a formal scheme. The latest annual reports reveal that almost one quarter of mid-250 directors and a third of FTSE 100 directors received a cash pension supplement, either as a standalone provision or in conjunction with other arrangements.

In the FTSE 100, directors are most likely to be covered by a mixture of

arrangements, with around a quarter in a DB and DC scheme which is then supplemented by a cash sum paid in lieu of a contribution. Around a fifth are in a DC scheme only, while 12.2 per cent are in DB schemes only. But as the graph also shows, while the proportion of DB schemes only is just over a tenth, this does not mean that a far larger number of FTSE 100 directors do not benefit from final salary scheme pensions. Others have accrued benefits in a closed DB scheme or schemes closed to new members. An indication of how this may compare to the pension provision covering the rest of the UK private workforce can be seen in Box 1 taken from the latest available Office for National Statistics (ONS).

Comparisons between directors' pensions and pension provision in the wider workforce are complicated by the inherent complexity in directors' arrangements. Companies typically negotiate executive pension arrangements with each director individually and must take into consideration variables such as tax efficiency, age of the director and length of service. The pension arrangements that result from these negotiations can vary dramatically. Furthermore, disclosure of pension benefits can be as complex and as varied as the pension arrangements themselves. Companies only disclose their own pension arrangements – regardless of any arrangements directors may have with their previous employers.

Box 1: UK pension scheme membership – the official picture

- In the private sector, 39 per cent of male employees and 28 per cent of female employees belonged to an employer-sponsored (workplace) pension scheme in 2010, according to the Annual Survey of Hours and Earnings (ASHE). This compared with 52 per cent and 37 per cent respectively in 1997.
- Overall, employee membership of private sector workplace pension schemes fell from 46 per cent in 1997 to 34 per cent in 2010.
- The fall in employee membership in the private sector was driven by a decrease in membership of defined benefit (salary-related) occupational pension schemes, from 34 per cent in 1997 to 11 per cent in 2010.
- Membership of defined contribution (money purchase) occupational pension schemes also fell slightly, from 11 per cent to 9 per cent. However, 14 per cent of employees in the private sector belonged to workplace personal (including stakeholder) pension schemes in 2010, compared with 1 per cent in 1997. *Source: Office for National Statistics*

However, with the rate of boardroom turnover on the rise, it is not uncommon for top executives to have accrued pension benefits with several companies over the course of a career. By only disclosing their own contributions to directors' pension arrangements, companies often obscure the wider trends in pension provision.

Bearing these caveats in mind, a comparison between the level of boardroom pension provision and the rate of provision in the wider workforce reveals a severe contrast. While the

ONS survey found that only one-third of UK private sector employees receive a company-sponsored pension, Graph 1 above shows that the vast majority of FTSE 350 companies have formal pension arrangements in place for their executive directors, with only 2.7 per cent of FTSE 100 companies and 2.3 per cent of mid-250 companies reporting no formal arrangements in place.

¹ Source: AEGON pension calculator. Figure based on a single-life plan; assumes a retirement age of 65 with no provision for escalation or a guaranteed pension term.

Value of defined contribution scheme contributions

As well as giving an overview of the range of pension practice, the latest accounts also allow us to gain an insight in the amounts being paid into different types of retirement scheme. Although companies are not obliged to publish DC contribution levels, we have collected information on how much employers and employees are paying into the pension pots expressed as a percentage of salary. A summary of our results can be found in **table 1**, which breaks down both the employer and employee contribution rates by market listing.

Table 1 shows that at the median, employer contribution rates varied from 17 per cent of salary in FTSE 100 companies to 15 per cent in mid-250

firms. In contrast, across all markets median employee contribution rates were uniform at 5 per cent of salary.

But this is not the only information in the latest annual accounts on DC contribution levels. Instead of reporting contribution rates, many accounts disclose the cash amounts paid by companies into directors DC pensions and these can be calculated as a percentage of actual salary to provide an alternative perspective. Our findings are given in **table 2**, which shows that the highest median employer's DC cash contribution was in the FTSE 100 at £88,000. The corresponding median proportional value was 22.1 per cent of salary.

TABLE 1 EMPLOYER AND EMPLOYEE CONTRIBUTIONS AS PERCENT OF SALARY TO DIRECTORS' DEFINED CONTRIBUTION PENSIONS BY MARKET LISTING 2010 (SOURCE: IDS/HPC)

		No.	Lower quartile (%)	Median (%)	Upper quartile (%)	Average (%)
FTSE 100	Employer contributions	80	10	17	25	19.4
	Employee contributions	19	4	5	6	5.7
Mid-250	Employer contributions	151	10	15	20	16.4
	Employee contributions	17	5	5	6	5.8

Box 2: UK employee pensions contributions - the official picture

Total contributions to private (non-state) pension schemes fell at the start of the recession, from £86 billion in 2007 to £82 billion in 2008. The fall was driven by a decrease in employer contributions to funded occupational pension schemes, which fell from £37 billion in 2007 to £33 billion in 2008, as company finances came under pressure. Employer contributions to personal pensions and to unfunded (public sector) occupational pension schemes rose in 2008, but not enough to prevent a drop in total contributions.

There is a difference between employer contribution rates in private sector defined benefit (salary-related) and defined contribution (money purchase) occupational pension schemes.

In 2008, the average employer contribution rates were:

- 16.6 per cent of salary for defined benefit schemes
- 6.1 per cent of salary for defined contribution schemes

At present, employers do not have to contribute to group personal pensions (GPPs) and stakeholder pension schemes. In smaller private sector employers (less than 100 employees), 6 per cent of employees with GPPs and 14 per cent of those with stakeholder pensions received no employer contribution in 2009. *Source: Office for National Statistics*

TABLE 2 ACTUAL REPORTED EMPLOYER'S CONTRIBUTIONS TO DC PENSIONS OF EXECUTIVE DIRECTORS BY MARKET LISTING 2010 (SOURCE: IDS/HPC)

		No.	Lower quartile (£)	Median (£)	Upper quartile (£)	Average (£)
FTSE 100	Employer contributions	77	35780	88000	199500	159762
	Employer contributions as a % of salary	72	12	22	30	25.3
Mid-250	Employer contributions	235	25000	43000	64000	53590
	Employer contributions as a % of salary	222	10	15	20	16.2

But this is not the only information in the latest annual accounts on DC contribution levels. Instead of reporting contribution rates, many accounts disclose the cash amounts paid by companies into directors DC pensions and these can be calculated as a percentage of actual salary to

provide an alternative perspective. Our findings are given in **table 2**, which shows that the highest median employer's DC cash contribution was in the FTSE 100 at £88,000. The corresponding median proportional value was 22.1 per cent of salary.

Value of defined benefit schemes

Of all the different types of pension scheme that employees can participate in, DB plans are recognised as the most valuable, but as our analysis suggests these are becoming less common, even for directors. Despite this, where they do exist, whether still open or closed to new members, they are still considered 'gold-plated' schemes. A key measure of the value of a DB scheme is the accrual rate, the proportion of pay members receive as a pension for each year of service

they have worked. An accrual rate of 1/60th, for example, indicates that a pension equal to 1/60th of final salary will be received for every year of service in the scheme.

An indication of the range of DB accrual rates disclosed in the accounts can be seen in **table 3**. This shows that with an accrual rate of 1/30th the most generous schemes are in the FTSE 100, while in the mid-250 the median accrual rate was 1/45th.

TABLE 3 ACCRUAL RATES OF EXECUTIVE DIRECTORS' DEFINED BENEFIT PENSION SCHEMES BY MARKET LISTING 2010 (SOURCE: IDS/HPC)

		No.	Lower quartile (ths)	Median (ths)	Upper quartile (ths)	Average (ths)
FTSE 100	DB accrual rate	36	30	30	60	41.0
Mid-250	DB accrual rate	40	34	45	60	47.8

TABLE 4 ACCRUED AND TRANSFER VALUES OF EXECUTIVE DIRECTORS' DEFINED BENEFIT PENSION SCHEMES BY MARKET LISTING 2010 (SOURCE: IDS/HPC)

		No.	Lower quartile (£)	Median (£)	Upper quartile (£)	Average (£)
FTSE 100	Accrued value	138	56000	174963	329000	243966
	Transfer value	137	748000	2798000	5445000	3555386
Mid-250	Accrued value	172	23948	49663	113541	86432
	Transfer value	189	327000	719000	1790000	1398723

Pension cash supplements

Another way of measuring the value of DB schemes is by looking at accrued and transfer values which it is mandatory for firms to disclose in their accounts where directors participate in such arrangements. Although imperfect measures as they depend on varying factors such as age and length of service, accrued values indicate the value of the annual pension that a director would be entitled to, while the transfer value represents the total value of the retirement pot. Accepting these limitations, table 4 shows that at the median a FTSE director could be expected to receive an annual pension worth £174,963 on retirement, while by comparison a mid-250 director could expect £49,663. The median transfer values totalled £2,798,000 in the FTSE 100 and £719,000 in the mid-250.

Despite the differences in generosity, however, both DB and DC schemes are traditional types of retirement plan, but since the introduction of the new simplified pension rules in 2006 a new element has increasingly featured in top remuneration deals – pension cash supplements. These tend to be paid instead of a pension contribution when the total retirement pot – the lifetime allowance – has reached the tax beneficial limit. After this point, there are significant tax penalties making further additions to the pot financially disadvantageous.

KEY FACTS: Employee defined benefit pension schemes

No comprehensive data is available on employee DB schemes, but a key source of information is an annual survey conducted by the National Association of Pension Funds (NAPF). The latest 2010 edition shows that:

- for open and closed final salary schemes 61 per cent of respondents used an accrual rate of 1/60ths; 11 per cent used 1/80ths. Slightly more than a quarter, 28 per cent used a different rate;
- the annual average pension paid from a private sector DB pension scheme was £7,467. The median was £5,860. *Source: NAPF Annual Survey 2010*

To capture these developments, over the last few years we been collecting and analysing pension cash supplement information and details were last included in our *Directors' Pay Report 2009/10*, published October 2010. Since then we have collected more up-to-date data and the latest results are given in **tables 5 and 6**. The first table documents the cash value of the payments by FTSE market and board position, while the second table provides the same analysis showing the value of the supplements as a percentage of salary. From **table 5**, it can be seen that in cash FTSE 100 lead executives received pension supplements worth £160,817 at the median, while the corresponding figure for their mid-250 counterparts was £121,500. Proportionally, the respective values were 24.5 per cent and 21.2 per cent of salary.

TABLE 5 CASH VALUE OF FTSE 350 DIRECTORS' PENSION SUPPLEMENTS 2009/10 (SOURCE: IDS/HPC)

		No.	Lower quartile (£)	Median (£)	Upper quartile (£)	Average (£)
FTSE 100	Lead executive	35	98500	160817	270000	173288
	Finance director	20	96518	141500	177500	147784
	Other director	33	63000	105000	188000	142270
	ALL FTSE 100 DIRECTORS	88	87500	141250	193000	155860
Mid-250	Lead executive	56	75188	121500	189000	136017
	Finance director	44	51750	65500	98835	77682
	Other director	44	41487	65000	118344	81718
	ALL MID-250 DIRECTORS	144	54059	84000	136500	101601

TABLE 6 VALUE OF FTSE 350 DIRECTORS' PENSION SUPPLEMENTS AS A PERCENTAGE OF SALARY 2009/10 (SOURCE: IDS/HPC)

		No.	Lower quartile (%)	Median (%)	Upper quartile (%)	Average (%)
FTSE 100	Lead executive	35	11.4	24.5	32.0	22.3
	Finance director	20	22.5	25.0	30.0	26.2
	Other director	33	19.3	24.9	30.2	29.3
	ALL FTSE 100 DIRECTORS	88	17.2	24.9	30.1	25.8
Mid-250	Lead executive	56	15.4	21.2	30.0	23.8
	Finance director	43	15.0	20.0	26.0	22.3
	Other director	44	12.8	19.9	30.0	20.9
	ALL MID-250 DIRECTORS	143	15.0	20.0	30.0	22.5

Appendix I: Definitions

DEFINED BENEFIT

Defined benefit, or final salary, schemes commit to paying an agreed amount to employees at retirement. The eventual value of the plan is calculated using a formula which incorporates employees' age and years of service as well as environmental factors such as life expectancy. Though employers contribute a regular amount to the plan, it is the final projected sum of the pension fund that determines the annual contribution. Companies are liable for ensuring that the pension funds are sufficient to meet retirement benefits they have agreed to provide. Accrued value indicates the value of the annual pension that a director would be entitled to upon retirement, while the transfer value represents the total value of the retirement pot.

DEFINED CONTRIBUTION

Also referred to as a 'money purchase' pension. The final value of the pension will be the aggregation of a constant, defined contribution by the employer (usually based on a fixed proportion of salary). However, unlike in defined benefit schemes, the amount received by the employee upon his/her retirement is not pre-determined.

CASH SUPPLEMENT

Pension cash supplements tend to be paid in lieu of other pension contributions when the lifetime pension allowance has reached the limit for providing tax benefits.