



The Business Secretary's Announcements on Executive Pay made 23 January 2012: An analysis.

Summary

The Business Secretary's policy announcements on executive pay, made in the ministerial statement of 24th January and his appearance in parliament on 23rd January, were necessary but not sufficient.

Greater powers for shareholders to hold companies accountable, and allow them to make informed and timely interventions, are welcome. However, there are policies that should have been announced and were not. These include measures – beyond transparency – including initiatives to tackle remuneration consultants' vested interest in inflating remuneration recommendations, mandatory employee representation and mandatory pay ratio reporting. We have provided responses to the reasons given by Dr Cable for rejecting the latter two measures.

We are also concerned that there is insufficient focus on the pay and performance of the whole workforce (beyond directors) and on the adverse impacts on companies and the economy of top pay which is out of proportion with employee pay.

Overall approach

The business secretary's "four fronts" to tackle the issue of excessive executive pay ("greater transparency; more shareholder power; reform of remuneration committees; best practice led by the business and investor community") are welcome and necessary:

It is true that executive pay reporting is too often ambiguous, over-complicated and not comparable between companies, shareholders are not sufficiently empowered to engage in a meaningful and timely manner, remuneration committees are insufficiently diverse (as well as being composed and advised by individuals who may have adverse vested interests), and businesses and investors often do not effectively ensure that executive remuneration meets the best interests of the company.

However, the "four fronts" are not sufficient. In order to ensure the best long-term performance for the company - and wider economy – it is necessary to introduce measures which recognise and address the importance of pay and performance levels in the wider workforce and the relationship between productivity and pay dispersion.

It is good that the Business Secretary recognised that "*the big [income] disparities between top and bottom are widening in Britain*". However, he said little in recognition of the evidence that excessive pay differentials are damaging to the performance of both companies and the economyⁱⁱⁱ. This evidence suggests that measures to prompt companies to report and manage pay ratios, and to give greater consideration to whole-workforce pay and performance, should also be implemented.

Specific proposals

The following are proposals outlined in the Business /Secretary's written ministerial statement on Executive Pay, published 24 January 2012

1) *“Through secondary legislation later this year the Government will require companies to publish clearer and more informative information about how executives are being rewarded. This starts with remuneration reports being split into two sections: one detailing the proposed future policy for executive pay; the other setting out how pay policy has been implemented in the preceding year.”*

This proposal is welcome – it will allow investors and other stakeholders to assess remuneration packages in advance, and to address any concerns with companies in advance, rather than merely voting on pay deals which are *fait accompli*.

2) *“When outlining future policy, remuneration committees will be expected to explain why they have used specific benchmarks and how they have taken employee earnings - including pay differentials – into account in setting pay. They will have to explain how they have consulted and taken into account the views of employees.”*

Although it is good that companies should be required to explain how they have taken pay differentials into account and how they have consulted employees, it is likely that - without requirements to report pay differentials or to give employees a formal role in remuneration committees – these requirements will prompt companies to produce anodyne statements designed to meet the letter of the law rather than prompting them to properly consider workforce pay and the views of employees. It is widely recognised that many companies do routinely react to such requirements by producing such boilerplate' statements, as a recent study by PWC^{iv} makes clear.

3) *“Companies will be required to say clearly and succinctly how the proposed pay structures reflect and support company strategy; how performance will be assessed; and how it will translate into rewards under different scenarios.*

When reporting on pay for the previous year, companies will have to provide a single figure for total pay for each director and to explain how the pay awards relate to the performance of the company. To provide context, companies will be mandated to produce a distribution statement, outlining how executive pay compares with other dispersals such as dividends, business investment, taxation and general staffing costs.”

This is welcome – such measures are necessary if investors and other stakeholders are to properly assess pay packages.

4) *“Alongside more information, shareholders need new powers to hold the board to account. I will consult shortly on proposals to reform the current voting arrangements and give shareholders a binding vote, enabling them to exert more pressure on boards. The consultation will include the following options:*

A binding vote on future pay policy, including details of how performance will be judged and real numbers on the potential pay outs directors could receive. Companies will have to include a statement on how they have taken account of shareholder views and the result of previous votes.

A binding vote on any directors notice period which is longer than one year and on exit payments over one year's salary.

[...] I will consider whether there should be further sanctions when a Remuneration Committee report attracts significant dissent on an advisory vote.”

These proposed options are welcome initiatives, promoting the principle of empowering shareholders to engage in an informed and timely manner.

5) *“The consultation will also look at what level of shareholder support companies should have to get in order to pass pay proposals, and consider raising the threshold for a successful vote to 75% of share votes cast for the motion.”*

This too is welcome. Currently, many shareholders (or to be more accurate, the asset managers who in most cases hold and vote shares on their behalf) automatically vote in line with management recommendations in most cases^v.

6) *“The Government will address fundamental conflicts of interest in the paysetting process. We will require greater transparency around the role of consultants, how they are appointed and paid, and to whom they report and advise.”*

Greater transparency in this area is necessary, but (as the Business Secretary has said) “transparency only gets us so far”^{vi}. There are other issues to address, including the pressure put on remuneration consultants to inflate pay deals if they want to retain clients.^{vii}

More effective requirements could include:

- Remuneration consultant(s) to report to and to be appointed solely by the remuneration committee, as opposed to the executive (NB: the efficacy of such an initiative would be seriously limited unless initiatives were taken to broaden the composition of remuneration committees to include individuals who do not have an interest in inflating top pay);
- The maximum tenure of the remuneration consultant(s) - both company and individual consultant - to be set at three years for any one organisation;
- The remuneration consultant to be employed on condition of having signed the Remuneration Consultants Group's (RCM) code of conduct.

7) *“I will also ask the Financial Reporting Council to amend the UK Corporate Governance Code to put an end to the practice of serving executives sitting on the remuneration committees of other large companies.”*

This should be welcomed, as a step towards removing any temptation towards ‘back-scratching’ and the vested interests of executives to inflate the remuneration deals of individuals against whose pay their own is partly benchmarked.

Items mentioned by the Business Secretary in Parliament on 23 January 2012

8) *“In October a new provision in the UK corporate governance code will come into force requiring companies to report on their policy on boardroom diversity, how they propose to deliver it and what progress has been made.”^{viii}*

This is another area where transparency, though welcome, “only gets us so far” and where there is a likelihood of producing boilerplate statements rather than meaningful action.

9) *“we will ask the Financial Reporting Council to revise the corporate governance code in order to require all large public companies to adopt clawbacks.”^{ix}*

This is a useful tool in combating “rewards for failure”.

10) *“initiatives being promoted in respect of encouraging John Lewis-type arrangements”^x*

Initiatives to facilitate companies adopting employee ownership are welcome – this model is a valuable part of a healthy mix of business types. Excellent information on this issue is available from the Employee Ownership Association^{xi}.

11) *“The Chancellor has already initiated action, in the form of a proposed regulation through the Financial Services Authority which will require financial institutions to declare the highest pay of employees who are not on the boards of those companies.”^{xii}*

This is helpful in allowing investors and other stakeholders to address top pay beyond the boardroom.

Missing proposals

A) The Business Secretary chose not to require companies to allow employees to sit on remuneration committees.

This is a lost opportunity to adopt an initiative which would:

- Bring to remuneration discussions the views of individuals who do not come from social groups where multi-million pound annual pay packages are seen as commonplace and are therefore more likely to regard exceptional pay as something that should be justified by exceptional performance.
- Encourage a focus on the pay and performance of the whole workforce, and reduce the risk that pay policy and practice is based on an excessive focus on the pay and performance of the CEO and other directors.
- Create more of a focus on the long-term financial sustainability of the company. Put crudely, employees' livelihoods depend upon it.
- Deliver benefits in terms of increased employee engagement (because employees would feel represented in pay decisions).
- Counteract the problem of some remuneration committee members having an interest in inflating directors' pay.

Academic analysis^{xiii} has found that employee representation is correlated with more moderate levels of CEO pay, and that economies with stronger employee participation also see other positive outcomes including :

- A much lower rate of days lost to strikes (9.7 days per 1000 workers in economies with strong employee participation, compared to 104.8 days in economies with weak employee representation).
- A higher average ranking in the business competitiveness index (the average rank of economies with strong employee participation is 6.8, compared to an average rank for economies with weak employee participation of 19.9).
- Higher labour productivity per hour (6% higher in economies with 'strong' employee participation, compared to those with 'weak' employee representation).
- No negative impact of W[orker]P[articipation]at the board level on firm performance

A good summary of the benefits of including employee representatives on remuneration committees is found in the Hutton Review of Fair Pay in the Public Sector: *“an employee representative on the remuneration committee [...] will help ensure that decisions can be justified to all employees [... and] could also improve the quality of executive pay decisions, both by contributing information on the working of the organisation that is independent of its management, and by increasing the diversity of remuneration committee membership. Indeed, employees have an incentive to monitor executive pay and performance since they have so much staked on the success of the organisation – arguably even more than shareholders”^{xiv}.*

Responding to the Business Secretary's doubts about employee representation:

Dr Cable referred to “companies whose employees are predominantly overseas” and asked “How would the work force be selected?”^{xv}.

These questions have found practical answers in Germany, where employees are involved in

remuneration decisions, including in companies with overseas employees.

Workforce representatives could be selected in the same way as they are currently selected for the trustee boards of occupational pension funds, which are now required to include a number of member-nominated trustees (i.e. employees and/or former employees).

B) The Business Secretary chose not to require companies to report on the ratio between the pay of directors and that of the workforce, saying that “those are useful metrics, and that we should encourage their use. However, companies have very different structures, and pay ratios mean different things. Therefore, mandating them is a different matter.”

It is good that Dr Cable recognises that ratios are useful metrics, but his view that different company structures serve as an argument against mandatory pay ratio reporting is misplaced. A good response to this has been made by investment advisors PIRC: *“It is true, as some have argued, that investment banks may look like they have a ‘better’ ratio than supermarkets, because the latter have a large number of low-paid workers. But why would anyone compare an investment bank and a supermarket in the first place? On a whole range of issues that are analysed investors know they need to take account of factors such as industry sector, company size etc. Why would they do any different in respect of pay dispersion? It is a poor argument against greater transparency”^{xvi}.*

If ratios are ‘useful metrics’, then making reporting mandatory will remove the tendency for those companies in each sector with the worst record to also be those least likely to report.

About One Society

One Society’s work is based on a wealth of research which shows that large divides in income at the top and bottom of society – beyond ‘proportional rewards’ – are damaging to our economy and society, not just those at the bottom but right the way up. We work to promote policy and practice which reduce excessive income inequality. One Society works in partnership with The Equality Trust.

We argue that there is more than enough room for the monetary recognition of ‘due desert’ 2, and the requirements of competitive markets (e.g. in pay scales), while still reducing the UK’s overall rate of income inequality.

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- i Written ministerial statement; Rt Hon Vince Cable, Secretary of State for business, innovation and skills; department for business innovation and skills; executive pay; 24th January (<http://bit.ly/zgW4ra>)
- ii Hansard, HC 23 Jan 2012; Column 30
- iii See Appendix 1 in our response to the BIS discussion paper on Executive pay (<http://www.onesociety.helencross.co.uk/wp-content/uploads/2011/08/One-Society-Response-to-Executive-Remuneration-discussion-paper1.pdf>)
- iv PWC (website), “Boilerplate governance reporting fails both investors and companies, says new study” (http://www.pwc.co.uk/north/press_releases/boilerplate_governance_reporting.html)
- v See FairPensions, “Stewardship in the Spotlight; UK asset managers’ public disclosure practices on voting and engagement” (http://www.fairpensions.org.uk/sites/default/files/uploaded_files/whatwedo/StewardshipintheSpotlightReport.pdf)
- vi Vince Cable speech on Executive Remuneration, Social Market Foundation, 24 January 2012 (<http://nds.coi.gov.uk/content/Detail.aspx?ReleaseID=422961&NewsAreaID=2>)
- vii Quotations from consultants which illustrate this point can be found in our response to the BIS discussion paper on Executive pay (<http://www.onesociety.helencross.co.uk/wp-content/uploads/2011/08/One-Society-Response-to-Executive-Remuneration-discussion-paper1.pdf>)
- viii Hansard, HC 23 Jan 2012; Column 24
- ix Hansard, HC 23 Jan 2012; Column 24-5
- x Hansard, HC 23 Jan 2012; Column 26
- xi See <http://www.employeeownership.co.uk/>
- xii Hansard, HC 23 Jan 2012; Column 36
- xiii See S Vitols, “Prospects for trade unions in the evolving European system of corporate governance”, 2005, ETUIREHS, p2
- xiv Hutton Review of Fair Pay, Hutton Review of Fair Pay in the public sector: Final Report, March 2011, page 68
- xv Hansard, HC 23 Jan 2012; Column 27
- xvi PIRC: “Pay ratios aren’t that difficult” (website <http://www.pirc.co.uk/news/pay-ratios-aren%E2%80%99t-difficult>)