Executive pay

1. The principal points that we wish to make to the Committee are as follows:
   - Most of the previous Committee’s recommendations on executive pay are in the process of being actioned by the Government or by the Financial Reporting Council (FRC).
   - Those that have not relate to structural issues which it is unreasonable to expect to have been addressed in the time since the previous Committee reported and are, perhaps, less important.
   - It is too early to identify what improvements have been made to the reporting of executive pay since the previous Committee’s report. Similarly, both remuneration committees and institutional investors are tied by the remuneration policy that shareholders have approved and relatively few companies have presented a new policy to investors that was not in the final stages of preparation before the previous Committee report.
   - We have been encouraged this year to see more companies taking policies based on restricted shares to their shareholders. The use of restricted shares can also facilitate these opportunities being offered to all employees, rather than a small number of executives. Wider all-employee share ownership should be encouraged and companies should consider whether performance based incentives and other employee benefits should not be offered on an equal basis to all employees. We believe that restricted shares are the way forward for most companies but, as outlined in paragraphs 16 and 17 below, there are some practical difficulties that both companies and investors need to consider.
   - Our message on executive pay, as it was on the gender pay gap, is that it is still too soon to say whether or not the recent changes have been effective, or for changes that are in the process of development by the Government or the FRC to have been introduced.
   - We would urge the Committee to resist the siren call to recommend further changes until the impact of those that have been, or are being, made can be properly assessed.

2. We welcome the Committee’s decision to launch this inquiry focusing on executive pay and the gender pay gap in the private sector, and this opportunity to respond. An informed and robust examination of these important issues will be helpful although we are concerned that it may be too
early for this review to have its full beneficial effect.

3. In this submission, we are addressing, as requested by the Committee, only the issue of executive pay and, in particular, the progress that has been made in the last twelve months.

**About ICSA: The Governance Institute**

4. ICSA: The Governance Institute\(^1\) is the international professional body for governance, with more than 125 years’ experience and with members in all sectors. Our purpose is defined in our Royal Charter\(^2\) as ‘leadership in the effective governance and efficient administration of commerce, industry and public affairs’, and we work with regulators and policy makers to champion high standards of governance, providing qualifications, training and guidance. We are the membership and qualifying body for governance professionals and chartered secretaries, which includes company secretaries.

5. The company secretary, the governance professional in UK companies, is at the forefront of governance arrangements within businesses, supporting the board in its decision-making. Similar governance professional roles can be found across all sectors, including charities, the NHS and sports bodies. Our members are, therefore, ideally placed to bring the benefit of their diverse perspectives to understanding the complex issues involved and the need to think through the changes that need to be made to minimise the risk of unforeseen consequences, some of which have bedevilled previous governance reform initiatives.

6. In that role, our members are closely involved in the support of the remuneration committee, attending and minuting its discussions. They are also the principal conduit of governance engagement between companies and their investors. This gives them a privileged view of both aspects of the executive pay debate – seeing issues from both the corporate and investor perspectives.

**The Committee sought evidence on:**

What progress has been made on implementing the recommendations on executive pay by the previous Committee in its 2017 report on Corporate Governance?

7. The previous Committee made seven recommendations on executive pay in its 2017 report on

\(^1\) [www.icsa.org.uk](http://www.icsa.org.uk)

Corporate Governance.

8. Of these, the recommendation relating to the mandatory publication of pay ratios has been addressed by the Government which indicated, in its response to the green paper on corporate governance, published in August 2017, that it will ‘introduce secondary legislation to require quoted companies to … Report annually the ratio of CEO pay to the average pay of their UK workforce, along with a narrative explaining changes to that ratio from year to year and setting the ratio in the context of pay and conditions across the wider workforce’

9. Of the remaining six recommendations, those relating to the alignment of ‘bonuses with broader corporate responsibilities and company objectives and … [ensuring] that they are genuinely stretching’, together with the recommendation that ‘any Chair of a remuneration committee should normally have served on the committee for at least one year previously’ and that ‘companies should set out clearly their people policy, including the rationale for the employment model used, their overall approach to investing in and rewarding employees at all levels throughout the company, as well as reporting clearly on remuneration levels on a consistent basis.’ have been addressed in the FRC’s proposals for changes to the UK Corporate Governance Code. Section 5 of the proposed Code deals with this in some detail.

10. We support these measures. Companies would argue that remuneration policies – which must be approved by shareholders – already align bonuses with corporate responsibilities and are genuinely stretching. If they were perceived not to be, the policy would not be approved by shareholders. Where problems arise is where market conditions change such that a target either ceases to be stretching or becomes impossible to achieve. These might, traditionally, have been addressed through the exercise of discretion by the remuneration committee, but this is unpopular with some investors on the assumption that discretion is only used to increase pay, not to reduce it. Our experience is that there are examples of discretion being used in both directions, and that it is an important balance where the application of a remuneration policy produces an outcome that is unreasonable in all the circumstances. The specific reference to the importance of discretion in the proposed provision 37 is, therefore, one that we particularly welcome.

11. As noted above, the previous Committee’s recommendation that the Chair of a remuneration committee should have at least one years’ experience in such a role has been carried forward by the FRC, but the associated recommendation that ‘the Chair of a remuneration committee be expected to resign if their proposals do not receive the backing of 75 per cent of voting shareholders’ has not been progressed. In our view, the Code requirement that the chair of the
remuneration committee, in common with other directors, is usually subject to annual election by shareholders, renders this recommendation largely redundant and so we do not believe that it needs further action.

12. This leaves two of the previous Committee’s recommendations which have not been carried into effect: one around the replacement of Long Term Incentive Plans (LTIPs) with deferred stock in remuneration policies and one requiring a binding vote on executive pay awards where more than 25% of votes were against the resolution in the previous year.

13. The Committee recommended that “the FRC consults with stakeholders with a view to amending the Code to establish deferred stock rather than LTIPs as best practice in terms of incentivising long-term decision making. Overall, we recommend that this consultation should develop guidelines for the structure of executive pay with the following features:
   o A simpler structure based primarily on salary plus long-term equity, to divest over a genuinely “long-term” period, normally at least five years, without large steps;
   o Limited use of short-term performance-related cash bonuses, which should be aligned, where possible, to wider company objectives or corporate governance responsibilities;
   o Clear criteria for bonuses: they should be genuinely stretching and be aimed to provide incentives rather than just reward.(Paragraph 95)"

14. The FRC has gone some way to progressing this recommendation in the proposals for revisions to the Code, by saying that “Remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests. In normal circumstances, shares granted or other forms of long-term incentives should be subject to a vesting and holding period of at least five years. Longer periods, including post-employment periods, may be appropriate.” But this does not go as far as the previous Committee wished in terms of preventing the use of LTIPs.

15. We had some sympathy with the view expressed by the previous Committee that Long Term Incentive Plans should be phased out. As we noted in our response to the previous inquiry (paragraph 33), these emerged as one of a number of attempts to align executive pay more closely with company performance and investor experience, moving from a primarily salary-based structure to one where basic salary is, for many, a relatively small part of overall pay. “We have heard from a number of members that senior executives do not always fully understand their complex pay packages, particularly undervaluing deferred payments. Consequently, there is a tendency to demand higher levels of deferred payment which, because they frequently reference
share price, sometimes result in high incentive payments in poorly performing years as they are rewarding better performance some years earlier. Any comparison of senior executive pay with that of junior employees will always be distorted by this fact. We firmly believe that pay should be linked to performance, but simplicity is a key criteria. We are seeing some encouraging signs of reductions in complexity, with more companies moving to having only one long-term plan, although this has been partially counter-balanced by retention requirements.”

16. Although we are seeing some change in terms of the use of deferred pay, as recommended by the Committee, this has not yet been widely adopted, we believe this to be for two principal reasons:
   o companies are reluctant to propose alterations to their remuneration policies more often than required, as they know that doing so is unpopular with investors and, often, presented as an attempt by the company to increase payments to directors;
   o deferred pay, whilst it has the merit of being less volatile and so not indicating such high payments as some (in our view, poorly designed) LTIPs, it is much less susceptible to being linked to performance conditions. Like investors, many remuneration committees prefer to see a clear link between shareholder experience or, at least, company performance and the payments made to executives.

17. As the Government noted in its green paper response (Paragraph 1.42), “A number of companies said they would prefer to be more innovative in their approach to LTIP design, or even to replace or augment LTIPs with ‘restricted share awards’, in which executives automatically receive share options each year without specific performance conditions but at a lower level than they would have received under LTIPs. However, they expressed concern that shareholders and their advisers would not support an approach to executive share awards that differed significantly from current market practice. This concern was partly borne out by the responses of the investment community to this question. Many said that LTIPs had become too complicated and did not always provide assurances on the link to longterm company performance. However, a significant number of investors, and other respondents, also expressed concern at removing performance targets entirely from share awards, and said restricted share awards could end up rewarding poor performance”.

18. On balance, we believe that this is a much more complex issue than is susceptible to a quick and simple response. The needs of companies differ and it is for the remuneration committee to explain to the satisfaction of investors why they choose the remuneration structure that they recommend in their policy. In our view the recommendation of the previous Committee, whilst
well-intentioned, was too broad-brush to be implemented effectively.

19. Finally, we come to the previous Committee’s recommendation that “the FRC revises the Code to include a requirement for a binding vote on executive pay awards the following year in the event of there being a vote against such a vote of over 25 per cent of votes cast. This requirement should be included in legislation at the next opportunity. (Paragraph 106)"

20. Quite candidly, this recommendation did not make sense to us when the previous Committee made it. Although it has the merit that it would have greater effect on the minority of companies that do receive significant votes against their pay structures, our experience of binding votes on pay to date did not fill us with confidence that this will be effective. As we said in our paper on Untangling Corporate Governance, published in January 2017\(^3\), “It is over 20 years since the Greenbury report first recommended that companies report to their shareholders on [executive pay], and since that time the reporting and voting regimes have been regularly strengthened and, it seems, may be about to be strengthened further. This regulatory approach has arguably benefitted shareholders by enabling them to put pressure on companies to align pay with performance, and may therefore be worth preserving for those reasons. But in over twenty years it has done nothing to slow the increase of executive pay – some would argue it has contributed to it – or to reduce income inequality. There is no evidence to support the view that those objectives can now be achieved by adding more reporting requirements and voting rights.”

21. Furthermore, the logic of a binding vote on pay awards defeats us. There is already a binding vote on the remuneration policy at least every three years. This sets the structure under which executives will be paid in the coming period. The intervening years’ votes represent approval of how the directors have implemented that policy. Either they have implemented the policy or not. If they have, then they are simply carrying out shareholders’ instructions; if they haven’t, then they are personally liable for payments that cannot be recovered from the directors and can be pursued through the Courts. If this resolution is lost, then the policy must be put to shareholders again for another binding vote at the next AGM. The effect of this recommendation is, therefore, to lower the threshold at which that provision bites – turning it into a special resolution. We are not persuaded that this is a proportionate response to the minority of companies where this is an issue. Shareholders have the power to dismiss directors who are not carrying out their wishes.

What improvements have been made to reporting on executive pay in the last 12 months?
What steps have been taken by Remuneration Committees and institutional investors to combat

22. The problem here, in both cases, is the shortness of the timescale. We have seen some improvements in the reporting of executive pay, particularly in terms of explaining the potential outcomes with greater clarity, but it is only now, in early May, that 31 December year-end companies’ reports are being published and it is too early to conduct a full review of these. We will be undertaking our usual review prior to our awards event in November, and are happy to offer the Committee a report on improvements that we identify in that process.

23. In the same way, both remuneration committees and institutional investors are tied by the remuneration policy that shareholders have approved and relatively few companies have presented a new policy to investors that was not in the final stages of preparation before the previous Committee report.

24. That said, we have been encouraged this year to see more companies taking policies based on restricted shares to their shareholders. The use of restricted shares can also facilitate these opportunities being offered to all employees, rather than a small number of executives. Wider all-employee share ownership should be encouraged and companies should consider whether performance based incentives and other employee benefits should not be offered on an equal basis to all employees. We believe that restricted shares are the way forward for most companies but, as outlined in paragraphs 16 and 17 above, there are some practical difficulties that both companies and investors need to consider.

What further measures should be considered?

25. Herein lies our one concern about the Committee’s inquiry. Whilst the committee’s focus on these important issues is helpful, not least in that it keeps them firmly in the government’s mind, and will prevent them being overlooked, both issues merit detailed thought and a more considered programme of government action.

26. The Committee will, no doubt receive representations on this final question from a wide variety of respondents, all of them convinced that their solution to the executive pay conundrum, be it the senior shareholder committee, the retail shareholder committee, employees on the remuneration committee, or something else, is a panacea. It won’t be.

27. Before meaningful action can be taken about the fact that executive pay is sometimes excessive,
it is essential first to be clear about the ill that we are seeking to cure, because not all of those who talk about ‘high pay’ are coming at the question from the same viewpoint. Is it that pay is disassociated from performance; that there is income inequality in our society; or that some people are simply paid too much? Whichever it is, and I believe it is a combination of these factors, the case has not been made for what appears to be an exclusive focus on executives in public companies. For good reason, their pay is visible to all, but the same cannot be said of the income of those in equivalent positions in private companies, professional firms or private equity and other investment firms, to say nothing of entertainment or sports stars, or those who receive income from inherited investment.

28. Our message on executive pay, as it was on the gender pay gap, is that it is still too soon to say whether or not the recent changes have been effective, or for changes that are in the process of development by the Government or the FRC to have been introduced.

29. We would urge the Committee to resist the siren call to recommend further changes until the impact of those that have been, or are being, made can be properly assessed.

30. I hope that our comments are useful. If it would be helpful for me to appear before your Committee to discuss them in more detail, I should be happy to do so.

Simon Osborne
Chief Executive
9 May 2018