Introduction

The TUC exists to make the world of work a better place for everyone. We bring together more than 5.5 million working people who make up our 48 member unions. We support unions to grow and thrive and stand up for everyone who works for a living.

The TUC has long been concerned about the scale and rate of increase of executive pay. We have been particularly concerned that the gap between average workforce pay and average executive pay has widened sharply over time, as set out in the BEIS Committee’s 2017 report on Corporate Governance. We believe that this growing gap creates significant problems in terms of fairness, holds back company performance and has done possibly irreversible harm to the public reputation of UK business.

The past 18 months has seen considerable debate over corporate governance issues, including executive pay, with significant policy interventions including the BEIS Parliamentary Committee’s inquiry and report of 2017, the government’s corporate governance green paper consultation of November 2016 and its response to this consultation published in August 2017. Many of the policy recommendations set out by the government in August 2017 are still work in progress and have not yet been fully implemented.

In light of this state of flux, this submission will focus in particular on policy recommendations that are not being taken forward in the government’s proposals of August 2017 but that we continue to believe merit further consideration and implementation.

Incentive pay

The BEIS Parliamentary Committee corporate governance report of 2017 (henceforth BEIS Committee report) included discussion of the arguments for and against incentive pay (or performance-related pay). While it did not propose an end to incentive pay, it did propose an end to the use of long-term incentive plans or LTIPs, concluding “that LTIPs should be phased out as soon as possible. No new LTIPs should be agreed from the start of 2018 and existing agreements should not be renewed.” (Paragraph 90)

The TUC is opposed to what we regard as the over-reliance on incentive pay within executive remuneration packages for reasons that relate both to fairness and effectiveness, as set out in our submissions to the BEIS Committee’s corporate governance inquiry (attached as an appendix to this submission).

There has been increasing recognition over recent years among a range of company stakeholders, including investors, of the problems with incentive pay and in particular LTIPs. Both the written and oral evidence submitted to the BEIS Committee corporate governance inquiry from a large number of organisations argued that executive remuneration packages, and LTIPs in particular, had become too complex and were in need of reform.

The TUC believes that this growing consensus in favour of simplifying executive pay and the widespread recognition of the problems of LTIPs presented a golden opportunity for the
government to act to curb the use of LTIPs in its corporate governance proposals of August 2017. We remain disappointed that the government chose not to do so.

The case for reform of incentive pay remains as strong as ever. It is the incentive elements of pay that have fuelled the escalation of executive pay over the last two decades and contributed most to the growing gap between executive pay and workforce pay (as shown clearly in figure 6 in the BEIS Committee report). Incentive schemes for Chief Executives and other board members fail to recognise that company performance is based on the contribution of all staff, not just those at the top. The TUC believes that if incentive pay is to be used, schemes should be open to all staff on the same terms.

The theoretical argument for the use of incentive pay is to motivate and reward executives for strong performance. In terms of rewarding performance, it is widely acknowledged that the link between executive pay and company performance is completely broken. For example, research for the High Pay Centre found that LTIP payments to FTSE 350 Directors increased by over 250 per cent between 2000 and 2013, roughly five times as fast as returns to shareholders, and found a negligible link between LTIP payments to executives and shareholder returns1.

In terms of the impact on executives’ motivation, research by PWC has found that less than half executives think that their LTIP is an effective incentive. The research also suggests that reforms to the design of packages such as adding additional, perhaps broader, performance targets and requiring schemes to have longer vesting periods, make the schemes less effective in terms of their impact on motivation, as both ambiguity and deferral lead executives to value pay less2.

Yet there is a more profound argument against incentive pay – which goes to the heart of whether using performance-related pay to motivate key staff is desirable in the first place. The vast majority of working people, including those in very senior roles, carry out their job to the best of their ability for a fixed salary, and work hard each day to fulfil their role without needing financial targets to encourage them to do a good job. Throughout the public and voluntary sectors this is largely the case, including within the most senior echelons of government. Surely we want those running UK companies to be motivated by the desire to do their best for their company, and to be paid fairly for doing so, rather than motivated to act by the size of their bonus.

The risk of relying heavily on financial incentives to reward and motivate staff is that you may end up attracting people whose primary goals are personal enrichment, rather than company performance. The dangers of this can be seen in the financial sector, in particular in the run-up to the crash.

The government’s corporate governance paper of August 2017 notes the problems with LTIPs, but rather than acting decisively to abolish them instead proposed a new requirement for quoted companies to report on the potential range of rewards from LTIPs and complex, share-based incentive schemes. This is in the process of being implemented.

1 http://highpaycentre.org/pubs/no-routine-riches-reforms-to-performance-related-pay
2 PWC, Making executive pay work - the psychology of incentives, 2012
The TUC believes that the problems with incentive pay cannot be solved through additional reporting requirements and believes that the government missed a golden opportunity to take decisive action to address the problems of LTIPs and move towards a simpler system for executive pay. Simpler remuneration packages would be easier for remuneration committees to design and manage and for shareholders and other stakeholders to understand and monitor. Simpler and more predictable executive pay packages could contribute towards addressing the low levels of public trust in business (although this would also depend on the absolute levels of executive pay being reduced – which would be a likely but not inevitable consequence of moving away from LTIPs) and would free up the time of investors and non-executive directors to focus on issues relating to long-term strategy and value creation.

The TUC recommends that:

- LTIPs should be phased out, as recommended by the BEIS Committee’s report.
- The reliance on incentive-pay within remuneration packages should be reduced, with incentive-pay comprising no more than ten per cent of total pay.
- If incentive-pay is retained for executives, schemes should be open to all staff on the same terms.

**Fair pay, the role of remuneration committees and workforce reporting**

The BEIS Committee’s 2017 report recommended that companies should be required to publish pay ratios, and the TUC is pleased that the government is in the process of taking this forward. We believe, however, that further action is required to address the issue of very high pay differentials within companies; the publication of pay ratios should not be carried out in isolation and should be part of a wider package of measures to promote fair pay.

It has long been a requirement of the UK Corporate Governance Code that remuneration committees should take into account pay and conditions of the company’s staff when setting executive pay. Unfortunately, this has been largely ignored by remuneration committees and has had no discernible impact on the design or levels of executive pay.

Following the government’s proposals of August 2017, the draft revised Corporate Governance Code stipulates that remuneration committees should ‘oversee remuneration and workforce policies and practices, taking these into account when setting the policy for director remuneration’. This could provide an opportunity for greater alignment between workforce and executive pay - but this cannot be guaranteed and will depend on the approach taken by remuneration committees. The proposal for a broader remit for remuneration committees is being implemented through revisions to the Corporate Governance Code, and the Financial Reporting Council (FRC) has recently consulted on its proposed revised Code.

It is important that remuneration committees ensure that they gather and assess a comprehensive picture of the company’s workforce practices in order properly to fulfil their new role. There have been notable cases of board members pleading ignorance of their
own workplace practices (indeed, this was one theme of Mike Ashley's evidence to the BEIS Committee's Sports Direct inquiry in 2016). Failure on the part of remuneration committees to ensure that they have a full picture of workforce practices at their company will render them unable to carry out their new expanded role effectively. As well as undermining the measure’s success, this risks further tarnishing the reputation of UK business.

**Workforce representation on remuneration committees**

The BEIS Committee 2017 report said that 'Employee representation on remuneration committees would represent a powerful signal on company culture and commitment to fair pay. This option should be included in the Code and we expect leading companies to adopt this approach'. The TUC has argued for many years that workforce representatives should be included on remuneration committees and welcomed the Committee’s support for putting this into practice.

The expanded remit of remuneration committees strengthens still further the case for including workforce representatives among their members. Remuneration Committee members are not experts in workforce practices and many have little experience of employment issues. Workforce representatives will be able to understand workforce policies and practices and how they are experienced by ordinary workers within the company. This will provide invaluable input to remuneration committees, strengthening their ability to carry out their expanded role.

Unfortunately, despite the Committee’s previous recommendation, the draft revised Corporate Governance Code makes no mention of remuneration committees including workforce representatives. This is another missed opportunity which is likely to undermine the effectiveness with which remuneration committees will be able to carry out their broader role.

The TUC recommends that:

- A minimum of two elected workforce representatives should be included on remuneration committees.

**Workforce practices that should be considered by remuneration committees**

It is important that remuneration committees consider a comprehensive range of workforce practices and issues that contribute to the relationship that a company has with its workforce when determining executive pay and in order to oversee workforce policies and practices effectively. It is vitally important that remuneration committees consider the company’s relationship with its indirectly, as well as directly, employed workforce.

The TUC recommends that:

- Issues for consideration by remuneration committees should include the following:
  
i) Are workers directly employed or are they employed through an intermediary such as an agency, umbrella party or personal service company? Does the company make use of self-employment as a means of employing people?
ii) If employed through an intermediary, what is the justification for this and what has the company done to assure the terms and conditions under which the workers are employed? If the company makes use of self-employment, can the company provide a justification for this? What role do these employment patterns play in the company’s employment model?

The considerations below should apply to the entire workforce, not just those who are directly employed.

iii) Variable hours contracts, such as zero-hours and short-hours contracts - how many and what proportion of workers are on these, and do they have the option of transferring to a standard contract within the organisation? How much control do staff have over their working hours and what notice is given of shifts patterns? Are staff paid for shifts cancelled at short notice?

iv) If variable hours contracts are used, what is the justification for this and what role do these employment patterns play in the company’s employment model?

v) Levels of pay - what are the median and lowest decile of workforce pay? Is the company a Living Wage employer? What is the company’s pay ratio?

vi) Workforce pension arrangements, including the employer contribution level, appropriateness of scheme design and auto-enrolment opt-out rates. If opt-out rates are high, what is the reason for this?

vii) Does the company recognise trade unions and negotiate with them over pay and conditions for the workforce? Does the company consult the workforce and its representatives over a) pay and pensions b) wider workforce terms and conditions c) work organisation d) company plans and strategy?

viii) Training - what proportion of the workforce received training or started an apprenticeship in the last year and five years, and how was training distributed? Did senior staff receive more training?

ix) Does the company have family-friendly and flexible working practices available for all its workers?

x) What is the company’s record on health and safety? Does it have a health and safety committee that includes trade union representatives?

xi) What is the company’s record on diversity at all levels of the company? Are there strategies in place to address areas of weakness? What is the company’s gender pay gap and what steps have been taken to close it?

xii) Does the company have robust policies and practices to address bullying? What is the evidence that these are working?

Where applicable, the remuneration committee should compare the terms and conditions of staff with those of company directors, including in relation to pay, the level of pension contributions, holiday and other leave entitlements3 and notice periods. Remuneration

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3 USDAW negotiated an increase in paid maternity leave for shop floor workers at Tesco from eight to 14 weeks, equalising maternity arrangements between shop floor staff and managers – see
committees should ensure that the company's pay ratio is no higher than twenty to one and that there is parity in terms of the level of pension contributions and notice periods.

**Reporting on workforce issues**

The BEIS Committee’s 2017 report recommended 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.”

The theme of improved reporting on their workforce practices by companies was picked up in *Good Work: The Taylor Review of Modern Working Practices*\(^4\) carried out by Matthew Taylor. The Taylor Review recommended that companies should be required to report on their employment model and use of employment agency services and report information on requests for fixed hours from zero hours contracts workers and requests for permanent positions from agency staff.

The TUC is very disappointed that the government has not followed the recommendation of both the Taylor Review and the BEIS Committee to require companies to report on their employment model and other key information relating to their workforce. This is another missed opportunity, in this case to increase transparency from companies about one of their greatest stakeholder impacts – how they employ, pay and treat their workforce. In the context of the broader remit that remuneration committees will now take on, it would have been a logical and supportive step to improve the quality of workforce reporting.

The TUC recommends:

- Companies should be required to report on their directly and indirectly employed workforce, including on the following issues:
  
  i) Are workers directly employed or are they employed through an intermediary such as an agency, umbrella party or personal service company? Does the company make use of self-employment as a means of employing people?

  ii) If employed through an intermediary, what is the justification for this and what has the company done to assure the terms and conditions under which the workers are employed? If the company makes use of self-employment, can the company provide a justification for this? What role do these employment patterns play in the company’s employment model?

  The considerations below should apply to the entire workforce, not just those who are directly employed.

  iii) Variable hours contracts, such as zero-hours and short-hours contracts - how many and what proportion of workers are on these, and do they have the option of transferring to a standard contract within the organisation? How much control do staff have over their

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working hours and what notice is given of shifts patterns? Are staff paid for shifts cancelled at short notice?

iv) If variable hours contracts are used, what is the justification for this and what role do these employment patterns play in the company’s employment model?

v) Levels of pay - what are the median and lowest decile of workforce pay? Is the company a Living Wage employer? What is the company’s pay ratio?

vi) Workforce pension arrangements, including the employer contribution level, appropriateness of scheme design and auto-enrolment opt-out rates. If opt-out rates are high, what is the reason for this?

vii) Does the company recognise trade unions and negotiate with them over pay and conditions for the workforce? Does the company consult the workforce and its representatives over a) pay and pensions b) wider workforce terms and conditions c) work organisation d) company plans and strategy?

viii) Training - what proportion of the workforce received training or started an apprenticeship in the last year and five years, and how was training distributed? Did senior staff receive more training?

ix) Does the company have family-friendly and flexible working practices available for all its workers?

x) What is the company’s record on health and safety? Does it have a health and safety committee that includes trade union representatives?

xi) What is the company’s record on diversity at all levels of the company? Are there strategies in place to address areas of weakness? What is the company’s gender pay gap and what steps have been taken to close it?

xii) Does the company have robust policies and practices to address bullying? What is the evidence that these are working?

**Conclusion**

There have been some developments in public policy in relation to executive pay since the BEIS Committee’s corporate governance report of 2017, notably the forthcoming requirement for quoted companies with over 250 employees to publish pay ratios, which we welcome. We are disappointed, however, at the lack of progress in other areas, and believe that this represents a missed opportunity to promote fair pay in the UK’s companies.

As set out in this submission, the TUC recommends that

- LTIPs should be phased out, as recommended by the BEIS Committee’s report.
- The reliance on incentive-pay within remuneration packages should be reduced, with incentive-pay comprising no more than ten per cent of total pay.
- If incentive-pay is retained for executives, schemes should be open to all staff on the same terms.
• A minimum of two elected workforce representatives should be included on remuneration committees.

• When considering executive pay, remuneration committees should take into account a range of workforce practices covering both their directly and indirectly employed workforce, including the nature of the employment contract, control over working hours, levels of pay, pension arrangements, trade union recognition and collective bargaining, training, family friendly and flexible working practices and the company’s record on health and safety, diversity and bullying. In addition, remuneration committees should compare the terms and conditions of staff with those of company directors.

• Companies should be required to report on their directly and indirectly employed workforce, including on the nature of the employment contract, control over working hours, levels of pay, pension arrangements, trade union recognition and collective bargaining, training, family friendly and flexible working practices and the company’s record on health and safety, diversity and bullying.

10 May 2018
Appendix – extract on executive pay from TUC submission to BEIS Committee inquiry on corporate governance October 2016

What factors have influenced the steep rise in executive pay over the past 30 years relative to salaries of more junior employees?

In brief, the TUC considers the main factors to be as follows:

- Remuneration committees and company boards have paid insufficient attention to the issue of quantum in executive pay and the related issue of the growing gap between the pay of company directors and their own staff (and throughout the economy). This tendency has been encouraged both by public policy and the use of remuneration consultants.

- Remuneration committees have been required to ‘be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases’ since 1995, a provision largely ignored by companies. Recognising the poor compliance with this provision, the Coalition government strengthened reporting requirements in this area in its reforms of October 2013 and disclosure of the relative rates of increase of employee pay and executive pay in remuneration reports is now a legal requirement. However, many companies are choosing to comply in a limited way, for example by using salary for the directors’ pay element, despite the fact that for many directors their variable pay is many times higher than their salary. No evidence has emerged to date that these new reforms have made any difference to overall levels of executive remuneration.

- Public policy since the mid-1990s has encouraged remuneration committees to make an increasing proportion of executive pay incentive or ‘performance’ related. It is the incentive-related elements of pay that have contributed most to the significant and growing gap between workforce pay and directors’ pay. Too much attention has been focussed (unsuccessfully) on how to make executive pay reflect performance, rather than taking a step back and asking whether this approach to executive pay makes sense.

- The performance indicators used to for incentive-related pay have not been sufficiently stretching to ensure that schemes pay out only for good or exceptional performance. However, the TUC does not believe that this problem can be fixed simply through better design of targets, and believes that it is misguided to see remuneration policy as the means through which directors should be given guidance and motivation.

- Despite the Combined Code of Corporate Governance explicitly warning against this, remuneration committees frequently use comparisons with other companies to set pay

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6 Supporting Principle D.1 of the Combined Code includes: ‘The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.’
for directors in the upper median or upper quartile. This leads to a continual upwards ratchet in executive pay which is entirely self-generating and bares no relation to performance or any other factor that the Combined Code asks remuneration committees to consider.

_How should executive pay take account of companies' long-term performance?_

It has proved extremely difficult to set stretching targets that pay out only for good or outstanding performance, and incentive-related elements of pay continue to reward mediocre and even poor performance on a regular basis. This is partly because the difficulty of finding one indicator that encapsulates ‘good’ performance has led to incentive schemes becoming more and more complicated, which in turn has had the effect of creating so many different incentives that directors regard them as neither aligned with business strategy nor within their control.

This makes incentive-related pay ineffective both in terms of shaping the behaviour of executive and in terms of rewarding good (or otherwise) performance. The lack of an effective link between incentive-related pay and performance means that it is the incentive-related elements of pay that have contributed most to the growing gap between directors’ pay and that of ordinary workers. There are therefore strong practical reasons against the over-reliance on performance-related pay given the demonstrable difficulties in setting appropriate targets.

However, the TUC also believes that there is a more fundamental question about whether the reliance on financial incentives to encourage directors to do a good job is the best way of building successful and innovative companies led by talented and dedicated directors. There have been many directors who have rejected the idea that they only do a good job because of the amount or the way in which they are paid; indeed, to suggest that the only reason directors do their best at work is because of their LTIPs or bonus is in the TUC’s view insulting.

While the TUC does not believe that the majority of directors are motivated primarily by financial motives, there is a danger that incentive-related pay could become self-fulfilling and will attract to the role people who are motivated primarily by individual greed rather than a commitment to their company and dedication to their role. Indeed, it could be argued that in the financial sector remuneration design has affected both behaviour and the type of person attracted to the industry, with disastrous consequences for the sector and the wider economy.

There is convincing academic evidence that performance-related pay does not generate higher levels of motivation or performance. This should not be a surprising finding. People in many walks of life are expected to do (and indeed do) their best at work for a fixed salary; and the TUC can see no reason why directors should be any different in this regard. Surely it is desirable that those running Britain’s companies should be motivated by a commitment to their company and a desire to do a good job, and to be fairly rewarded for doing so, rather than driven by money above these other motivations.

We believe that the approach promoted by public policy since the Greenbury Committee of trying to improve the link between pay and performance has failed. It is time for a different approach.
The TUC would like to see a step-change in relation to incentive-related pay:

- the incentive-related element of remuneration should be a much lower proportion of total remuneration than is generally the case at present (we suggest around 10%) and should not dominate the total package;
- no more than one incentive-related element should be used;
- targets should be long-term only (at least five years) and should include non-financial indicators.

**Should executive pay reflect the value added by executives to companies relative to more junior employees? If so, how?**

Companies succeed based on the hard work and dedication of their whole workforce; the idea that company success is based on the performance of one person is a myth. The TUC supports incentive schemes that benefit all staff on the same terms.

In addition, it is vital that pay rises for company directors reflect those offered to the rest of their workforce; otherwise, companies signal a ‘one rule for us, another for them’ mentality and the already large gap between directors and their staff will continue to rise. Given that incentive-related pay makes up the bulk of directors’ remuneration, there should be parity in the increases in total pay, rather than just salary.

**What evidence is there that executive pay is too high? How, if at all, should Government seek to influence or control executive pay?**

There is clear academic evidence that high wage disparities within companies harm productivity and company performance. For example, one study of 4,735 companies between 1991 and 2000 found that within-firm pay inequality is significantly associated with lower firm performance. A second study of over 100 companies found that low pay differentials were associated with higher product quality. The clear and negative impact of high pay differentials on company performance shows that this is an issue that government and shareholders should take extremely seriously.

The TUC supports worker representation on remuneration committees and believes that this would bring important benefits:

- Workers would bring a fresh perspective and common sense approach to discussions on remuneration, in contrast to the current culture that presides on remuneration committees.
- As already noted, remuneration committees are required to take account of pay and conditions elsewhere in the company but have notably failed to do so. Company workers would clearly be extremely well placed to ensure that issues relating to pay and

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conditions elsewhere in the group were brought to the remuneration committee’s attention.

- Workers’ interests are inextricably linked to the long-term success of their company; they are therefore well placed to contribute to discussions on an appropriate remuneration strategy to serve the long-term interests of the company.

- Including workers on remuneration committees would engender a higher degree of buy-in from employees on pay arrangements at their company. This should contribute to employee engagement, which is shown to be linked to higher company productivity and performance9.

- Research has shown that worker representation does have an impact on directors’ remuneration. One study showed that, among the largest 600 European companies, the presence of board level worker representation is correlated with lower CEO pay and a lower probability of stock option plans. A second study showed that, within large German companies, stronger employee representation on the board led to lower CEO pay and less use of stock-based remuneration10.

- If this proposal were implemented, the TUC would work with suitable partners to provide accredited training and organise a network for worker representatives on remuneration committees. This would help to ensure that worker representatives were able to contribute effectively to remuneration committee discussions.

- In addition, the TUC supports the introduction of the mandatory disclosure of the pay ratios between company directors and their workforce. We would support both median pay and the lowest decile of pay (or another indicator that would accurately reflect low pay within the company) being used to create the ratios.

- While such ratios would need to be used with care, particularly in relation to differences between sectors, we do not believe that this is a valid argument against their disclosure. We believe that the publication of pay ratios would play a useful role in focussing the attention of remuneration committees and the corporate sector more broadly on the need for fair pay across the company as a whole.

Do recent high-profile shareholder actions demonstrate that the current framework for controlling executive pay is bedding in effectively? Should shareholders have a greater role?

The TUC believes that shareholders have had the opportunity over many years to address executive pay and have comprehensively failed to do so. We do not support a greater role for shareholders in this area.

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9 Engaging for Success: enhancing performance through employee engagement by David MacLeod and Nita Clarke, July 2009
10 Board Level Employee Representation, Executive Remuneration And Firm Performance In Large European Companies, Sigurt Vitols, March 2010; and Arbeitspapier 163, Beteiligung der Arbeitnehmervertreter in Aufsichtsratsausschüssen, Auswirkungen auf Unternehmensperformance und Vorstandsvergütung, Studie im Auftrag der Hans-Böckler-Stiftung, Sigurt Vitols 2008; both available from the TUC