House of Commons

Business, Energy and Industrial Strategy Committee

Executive rewards: paying for success

Eighteenth Report of Session 2017–19

HC 2018

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Business, Energy and Industrial Strategy Committee

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Contents

Summary

This report examines progress on the Government's attempts to address the gap that it acknowledges between the pay of chief executives on the one hand and company performance and employee pay on the other. It is part of our scrutiny of corporate governance and follows our report on gender pay gap reporting in 2018.

We find that the "say on pay" reforms introduced in 2014 have had some impact in curbing levels of new pay awards, which have remained fairly flat over the last decade. However, there continue to be regular examples of excessive payments, which are reputationally damaging and serve to fuel a perception of institutional unfairness that, if not addressed, is liable to foment hostility and undermine social cohesion and support for the current economic model.

Over the last decade chief executives' earnings in the FTSE 100 have increased four times as much as national average earnings. FTSE 100 chief executives earn around £4 million per annum while average pay is under £30,000. These huge differentials have been baked into the pay system, in part by a heavy reliance on over-generous, incentive-based pay and partly by the weakness of remuneration committees which design ever more complicated and opaque pay packages for their peers. The acceptance of a £75 million payment by the chief executive of Persimmon, based more on a Government initiative to encourage house-ownership rather than his own performance, was only the most egregious of a number of shaming decisions.

We conclude that the structure of executive pay has become too dominated by incentive-based elements that do not effectively drive decision making in the long-term interests of the company. Whilst welcoming evidence of a shift to extended terms for Long -Term Incentive Plans (LTIPs) we advocate a simpler structure based on fixed term salary plus deferred shares, vesting over a long period, and a much- reduced element of variable pay, which should be more aligned to the wider social responsibilities of companies. We also argue for a much stronger link between executive and employee pay, for example by the greater use of profit-sharing schemes. We recommend an employee representative on the remuneration committee to strengthen this link.

We welcome the proposed replacement of the underpowered and passive Financial Reporting Council and recommend that the new regulator is given the tools and encouragement to be tough on those companies that behave unreasonably on executive pay and fail to adhere to the tighter requirements of the revised UK Corporate Governance Code on higher quality pay reporting. We welcome the introduction of pay ratio reporting but call for it to be applied much more broadly.

A tougher, more proactive regulator is needed because we do not have confidence in remuneration committees, or institutional investors in exercising their stewardship functions, in a way that consistently bears down on executive pay. We believe that the primary responsibility for changing the environment on executive pay rests with asset owners–the pension funds that invest our money for the long-term. We call for greater transparency in the way they set investment objectives, including on executive pay, and that the regulator is given powers to take effective action against those who do not meet their responsibilities under a revised Stewardship Code.

Greater transparency, accountability and responsibility are required throughout the investment chain if the gap between pay at the top and the bottom is to be reduced and companies are compelled to pay their whole workforce reasonably and responsibly.

1 Introduction

1. In her one campaign speech before becoming Prime Minister, Theresa May criticised "an irrational, unhealthy and growing gap between what the companies pay their workers and what they pay their bosses."[1] The Government's subsequent 2016 Green Paper acknowledged "a widespread perception that executive pay has become increasingly disconnected from both the pay of ordinary working people and the underlying long-term performance of companies."[2] Since then there have been a number of high profile pay awards by leading companies that appear both extremely generous and patently unjustified. At a time of slow wage growth—when public attention is more focussed on fairness in pay—these awards have served to undermine the reputation of British business and accentuate perceptions of unfairness.

2. This report covers the second strand of our inquiry into *Delivering on fair pay*, following our report on the Gender Pay Gap in 2018.[3] It provides an update on trends on executive pay and examines the Government's performance in addressing the pay gap it previously identified. Our predecessor Committee made a number of recommendations relating to the structure, agreement and public reporting of executive pay in its report on *Corporate Governance* in 2017.[4] Our report tracks the implementation of those recommendations and aims to hold the Government to account for its response to continuing bouts of corporate excess. At a time when the role of regulators is under scrutiny and reforms are imminent, we propose further measures to assist the Government in delivering on its ambitions.

3. In the course of this inquiry we took evidence from a range of investors and analysts, selected companies, interest groups, professional advisory firms, the TUC, the Financial Reporting Council and Ministers. We also held private meetings, organised by The Investment Association, with investors and corporate governance leads. We also benefited from the advice of Katharine Turner of FIT Remuneration Consultants. We are grateful to all those who submitted evidence or otherwise contributed to this inquiry.

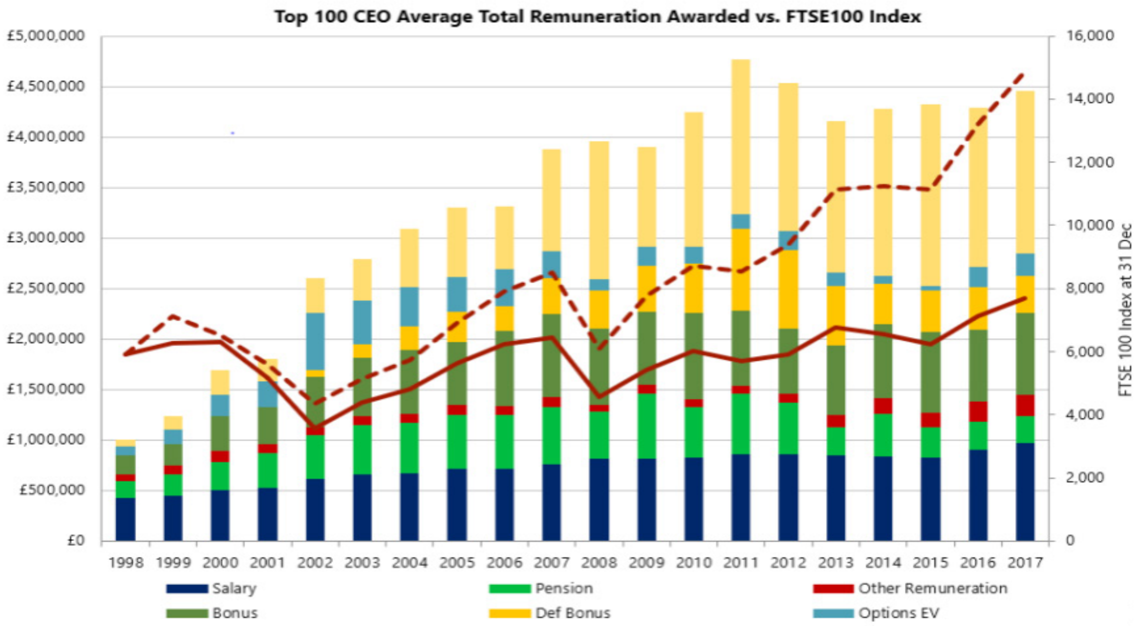
1 Rt Hon Theresa May MP, speech, 11 July 2016
2 BEIS, Corporate Governance Reform Green Paper, November 2016, p16
3 BEIS Committee, Thirteenth Report of Session 2017–19, *Gender Pay Gap Reporting*, HC 928
4 BEIS Committee, Fourth Report of Session 2016–17, *Corporate Governance*, HC 702.

2 Recent developments

Trends in executive pay levels

4. Executive pay is complex, and there are a variety of ways in which trends in pay levels can be measured and represented. The membership of the FTSE is also changing, so the target being measured is moving. Taken as a whole, the weight of evidence suggests that awards made to FTSE 100 chief executives have remained largely unchanged since the financial crisis of 2008–09[5] but all too frequent abuses persist. This stability followed a steady rise in the pay of FTSE 100 chief executives from an average around £1 million twenty years ago to around £4 million today.

Figure 1: trends in levels and structure of pay



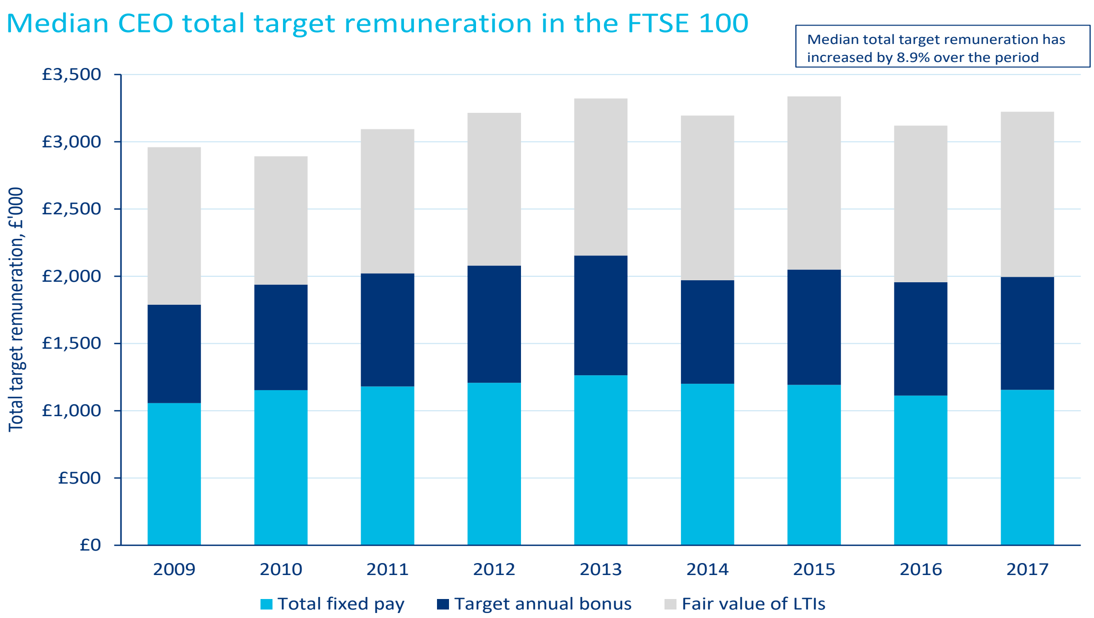
Source: Minerva Analytics

An increase in average pay in 2017 on the previous year was caused by a few substantial pay-outs under incentive schemes agreed before 2014, such as at Persimmon, and also changes in FTSE 100 membership.[6] Figure 1 indicates that whilst base salaries have stayed fairly flat, other elements of pay packages, notably Long-Term Incentive Plans (LTIPs), have gradually been increasing as a proportion of the overall figure. This chart shows pay *awarded*. It includes an "expected value" for annual bonuses and for LTIPs awarded by remuneration committees at the start of the reporting period and which vest in future years. It does not show *realised* pay—the sums eventually paid out, as represented in the Single Total Figure (STF) for remuneration.[7] This STF has been rising over the last decade. Figure 2 indicates that target remuneration (pay awarded) has increased by only 9% since 2009, but realised pay (the Single Total Figure) for median remuneration has increased

5 See Box after paragraph 44 for summary of 2014 reforms. Q519 [Gosling] [Hildyard], Q236 [Chapman], Q365 [Wilson]
6 See paragraph 7; Q230 [Cotton]
7 The analysts Minerva Analytics Ltd (CGP0042) explain that this STF can underestimate the amount paid out by long-term schemes, if executives choose not to cash in share options initially and they subsequently rise in value.

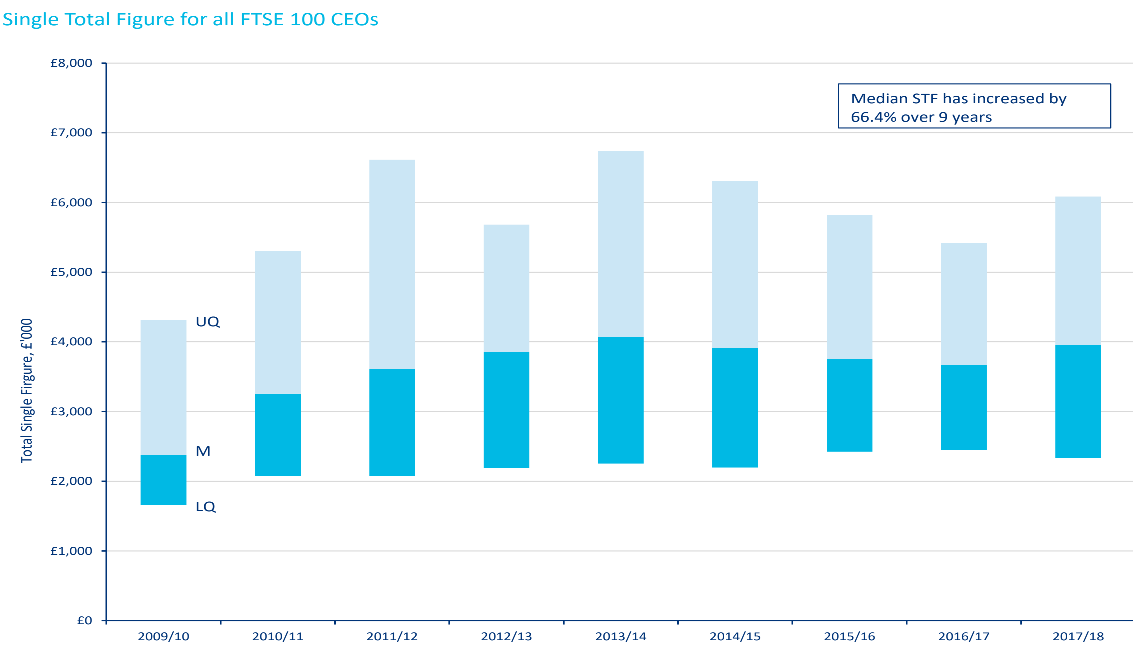
by 66% over this period, as indicated by Figure 3.[8] The corresponding increase in average weekly earnings is only 17%.[9] The widening of the gap over this period is clear. This increase in realised pay for executives is primarily due to performance-related elements delivering more than originally estimated, an issue with the structure of pay we discuss further in Chapter 3.

Figure 2: target remuneration in FTSE 100



Source: FIT Remuneration Consultants

Figure 3: actual remuneration in FTSE100



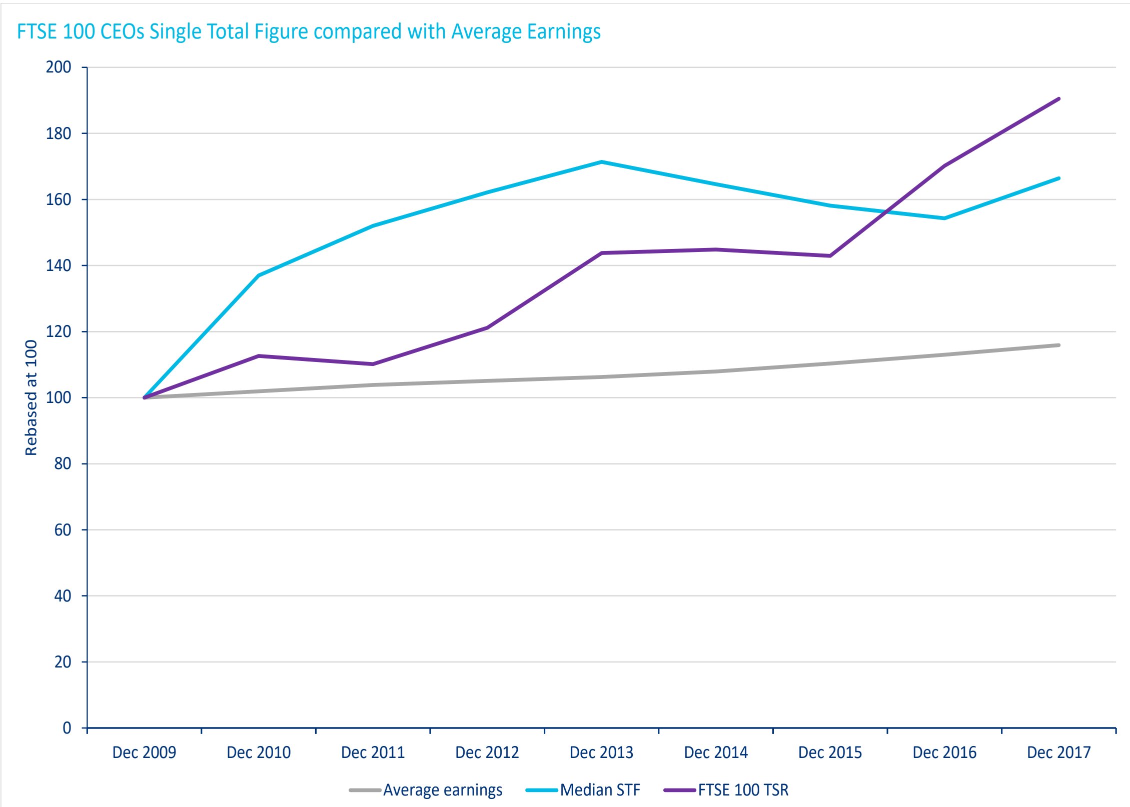
Source: FIT Remuneration Consultants

8 The year 2009 is used because it is the first year that the Single Total Figure was published and so can be compared on a consistent basis.

9 FIT Remuneration Consultants and ONS Annual Survey of Hours and Earnings.

5. One purported explanation for these persistently high levels of executive pay is that in an open and globalised economy ever-larger multinational companies have to offer generous pay to attract the best of a limited talent pool. The UK certainly pays well. In European terms, only in Switzerland are chief executive officers (CEOs) paid more than in the UK. All European countries pay less than in the US,[10] where the structure of pay is much more heavily weighted in favour of long-term share-based incentive plans than basic salary.[11] Within Europe, pay structure also differs, with greater emphasis being placed on pensions in other European countries than in the UK. Here, the pensions element has been steadily decreasing and pay has become more incentive driven, as we discuss in Chapter 3.[12] These differences are largely historic and cultural, rather than indications of a thriving international competitive market for limited talent.[13] In most countries, under 20% of top CEOs are foreign nationals; the figure is 40% in the UK for the FTSE100, reflecting the fact that many of these companies are multinational and choose to be listed here.[14] Only 1% of CEOs are poached from rival firms; promotion from within is far more common.[15] There is little evidence of a cut-throat international transfer market in top jobs driving up pay.[16] The root causes of high executive pay, whilst not immune from global economic forces, are to be found, and fixed, at home.

Figure 4: executive pay and average earnings



Source: FIT Remuneration Consultants

10 UK executive pay is 30%-40% lower in the UK than in the US, we were told by Clare Chapman Q236
11 See Global Top 250 Compensation Survey 2018, pp 18- 19,
12 Q524
13 Q524 [MacDougall], Minerva Analytics Ltd (CGP0042)
14 Q524 [Gosling]
15 Q524 [Hildyard]
16 Q529 [MacDougall]

6. Another explanation for high executive pay is that large increases for UK chief executives have flowed from the growth of companies and their success in increasing value to shareholders. Figure 4 shows that total shareholder return has increased in reasonably close step with executive pay in the FTSE100 between 2009 and 2018. Total market capitalisation (or shareholder value) for the FTSE 100 has increased from £3.4 billion to £9 billion in the same period.[17] Given that executive pay is generally linked to an extent to company success, as demonstrated by increased returns to shareholders, it is to be expected that executive pay will be pulled upwards in times of economic growth and good company profitability. But the spoils of this economic success have not been fairly shared. Executive pay increases have comfortably outstripped those in average earnings. The Minister for Small Business, Consumers and Corporate Responsibility, Kelly Tolhurst MP, told us that "inequality levels are of course a concern" and that in some instances, executive pay "is too high".[18]

Excessive pay

7. Ministers have not specified those instances in which pay has been too high. But since the Prime Minister's comments on corporate excess in 2016 the media has regularly reported on large awards and shareholder revolts. A sample is listed below.

Persimmon: Three executives were paid a combined total of £104 million in 2017, including £47 million for Chief Executive, Jeff Fairburn, an increase from £2.1 million the previous year.[19] His total payment under an LTIP agreed by shareholders in 2012 was initially worth £100 million in shares, a sum he agreed to reduce to £75m after shareholders objected.[20] Performance targets included in the LTIP were hit much earlier than expected owing to the company benefiting from a huge volume of new builds resulting directly from the Government's taxpayer-supported help-to-buy scheme. In December 2017, the company's chairman and chair of the remuneration committee resigned over the scheme, acknowledging that it was poorly designed and should have included a cap. Jeff Fairburn was forced to resign in November 2018, because his remuneration had been a distraction and that it continued to have "a negative impact on the reputation of the business and consequently on Jeff's ability to continue in his role."[21]

Unilever: in May 2018, there was a significant shareholder revolt against (36% objecting) the proposed pay policy after the CEO, Paul Polman saw his pay (single total figure) increase by 51% from £6.75 million to £10.18 million between 2016 and 2017.[22] The proposed new pay policy included increased potential compensation for the CEO, from £9.6 million to £11.2 million.

Royal Mail: in 2018 the new Chief Executive of Royal Mail Group, Rico Back, was paid a £5.8 million "golden hello" to buy him out of his previous contract as CEO of General Logistics Systems (GLS), also a part of the Royal Mail group. His new basic salary was to be 17% higher than that of his predecessor, Moya Greene, who herself received a pay-out

17 Figures from FIT Remuneration Consultants
18 Q610
19 The Guardian, Persimmon paid three executives a combined £104m in 2017, 19 March 2018
20 Aberdeen Standard Investments (CGP0039); The 2018 Annual Report showed Jeff Fairburn's total pay in 2017 and 2018 to be £84.7 million.
21 City AM, Farewell Fairburn: Persimmon boss asked to leave after £75 bonus backlash, 7 November 2018
22 Financial Times, Unilever faces potential shareholder unrest over pay policy, 13 April 2018; Unilever Annual Report 2017

of around £915,000 upon her departure.[23] There was a 70% vote against the remuneration policy at the AGM. The Chair of the remuneration committee, Orna Ni-Chionna, told us that they must have been "listening to the wrong shareholders" when engaging and that she was "embarrassed that we got this engagement with shareholders so wrong."[24]

BT: in July 2018 there was a significant shareholder vote against the pay report (34%) following the publication of the Chief Executive, Gavin Patterson's 2017 pay package, only weeks after he had unveiled a new strategy that included 13,000 job losses. His pay included a performance bonus of £1.3 million. His final pay package of £2.3 million, before he stood down, represented a £1 million rise on the previous year.[25]

Melrose: the four top executives at the company that took over GKN were each paid over £40 million in 2017, as a result of their LTIP paying out. A shareholder revolt against the Directors' Remuneration Report of 22% was not sufficient to defeat it.[26]

Foxtons: profits dropped by 64% and dividends collapsed but the chief executive was awarded a £218,000 bonus in 2017 for achieving "personal and strategic objectives".[27]

8. Whilst these examples indicate a degree of shareholder discomfort, this has not prevented them from being made. Payments of this magnitude seem incomprehensible to the public and a very long way removed from ordinary people's experiences of recruitment, reward and responsibility. It is why witnesses described that perceptions of excessive pay are "pervasive" and that the problem is "systemic and endemic."[28] The average pay of FTSE 100 chief executives is well over one hundred times UK average earnings of around £29,600. In many cases, the sums being paid to CEOs were so large that they could have instead financed significant investment in the business or provided meaningful rewards for employees if shared more evenly.

9. Executive pay is cited in surveys as one of the biggest threats to the reputation of business in the UK.[29] One shareholder representative argued that "big disparities in how a company manages its workforce can undermine a sense of solidarity in the company, and ultimately productivity and success".[30] Huge pay awards, and pay inequality in general, can only contribute to disengagement by employees.[31] The way in which long-term awards pay out mean that too often, there is no perceivable link between corporate financial performance and the sums paid out to CEOs. There is academic evidence to suggest that this link is in any case statistically weak or non-existent[32] and also some evidence to

23 Royal Mail Annual Report 2017 and correspondence between Chair of Committee and Chair of the Remuneration Committee, July 2018
24 Q477
25 BT Annual Report 2017; The Guardian, BT hit by shareholder revolt over outgoing chief's £2.3m pay, 11 July 2018
26 Financial Times, Melrose hit by 'significant revolt' over executive pay, 10 May 2018
27 Independent, Foxtons boss Nic Budden gets paid despite annus horribilis, 4 April 2018
28 ICAEW (CGP0033)
29 See Institute of Directors survey, in High Pay Centre report, *Performance-related pay - what does business think?*, March 2015; in the Edelman 2019 survey, 62% of employees cite high pay and bonuses of senior management as an important issue to address.
30 Q561 [Howarth]
31 Q273 [Cotton] A CIPD survey in 2015 found that six out of ten employees were discouraged by high levels of CEO pay and felt it was bad for a company's reputation (cited in Deborah Hargreaves, *Are Chief Executive overpaid?*)
32 See, for example, Lancaster Business School, An analysis of CEO pay arrangements and value creation for FSTE 350 companies, 2016

indicate that pay inequality is negatively correlated with productivity.[33] This debate will continue, but the public perception will remain whilst these bad examples appear with depressing regularity.

10. Even after a decade of relative stability, executive pay levels amongst UK listed companies remain at a level that appears disproportionate. Many of our witnesses concurred that there is evidence that the reforms implemented in 2014 have had some impact in curbing new, excessive pay increases in listed companies.[34] That said, there have still been decisions made since 2014 that are clearly not reasonable and have resulted in considerable reputational damage. **Taken as a whole, since 2014 companies have continued to share the rewards of their success largely with their shareholders, in the form of dividends, and with the senior management in the form of multi-million pound pay packages, rather than sharing the proceeds more evenly amongst their workforce, who sustain the business, through pay and pension contributions. Huge differentials in pay between those at the top and bottom remain the norm. Executive greed, fed by a heavy reliance on incentive pay, has been baked in to the remuneration system. With that comes a public perception of institutional unfairness that, if not addressed, is liable to foment hostility, accentuate a sense of injustice and undermine social cohesion and support for the current economic model.**

Effectiveness of recent reforms

Review of the Financial Reporting Council

11. Excessive executive pay can be seen as a symptom of a weak board or management within the company—in other words, of poor corporate governance. Overall responsibility for operating the UK's system of corporate governance rests with the Financial Reporting Council (FRC). Following repeated criticisms of the performance of the FRC, notably from this Committee in our joint report on the collapse of Carillion,[35] the Government launched an independent root and branch review of the FRC in April 2018, led by Sir John Kingman. It looked at the role, governance and powers of the FRC and published its report on 18 December 2018. The report was highly critical of the FRC and recommended its replacement with a new body, the Audit, Reporting and Governance Authority (ARGA).[36] We will report in more detail on the Kingman Review and regulation in the context of our inquiry into the future of audit.[37] However, in the light of our findings in relation to Carillion, **we are fully supportive of the case for a more empowered, aggressive and proactive regulator that has the ability to take decisive action, where necessary, on executive pay and its reporting. We look forward to the establishment of the new regulator as soon as possible.** Many of our recommendations are directed at the new regulator that we expect to be established in place of the FRC.

33 IPPR, Prosperity and Justice, A plan for the new economy, September 2018; see, for example Harvard Business School, Ethan Rouen, Rethinking Measurement of Pay Disparity and its relation to firm performance, 2017
34 Qq617–618 [de Lima], Q555 [Williamson] [George]
35 BEIS and Work and Pensions Committees, Second joint report of Session 2017–19, *Carillion*, HC 769
36 Independent Review of the FRC (Kingman Review), December 2018
37 BEIS Committee website, inquiry into The future of audit

Revised Corporate Governance Code on remuneration

12. The Financial Reporting Council published its new Corporate Governance Code in July 2018, following extensive consultation. At present, there is little meaningful reporting on broader workforce issues and employment practices in companies' annual reports.[38] The previous BEIS Committee called for listed companies to include in them clear explanations of their people policy, including the rationale for the employment model used, and their overall approach to investing in and rewarding employees at all levels of the company.[39] The revised FRC Code does not quite go that far, instead stating that the Board "should include an explanation of the company's approach to investing in and rewarding its workforce" and, specifically, of the link between individual awards and "the delivery of the strategy and long-term performance".[40] It also states that companies should ensure that "reputational and other risks from excessive rewards—and behavioural risks that can arise from target-based incentive plans—are identified and mitigated."[41]

13. More comprehensive and meaningful reporting on pay is long overdue. An analysis by the High Pay Centre found that in 2017 only 18% of FTSE100 companies included information about staff turnover in annual reports, only 7% of FTSE 100 report on the use of agency workers and less than 10% report on use of agency workers and staff sickness rates.[42] PwC agree, saying that "few companies seek to provide insight by going significantly beyond minimum regulatory requirements."[43] Others noted that the personal performance targets of CEOs were seldom articulated and, when they are, there is scope for improvement in the disclosure of performance against them.[44]

14. The new wording on the reputational risks of excessive reward is apposite but may not be enough to win an argument in the boardroom, given recent history. We believe that the Code should be much more prescriptive in articulating basic principles of fairness and in identifying acceptable and unacceptable practices, for example, on the use of "golden hellos", limiting pay-outs, withholding and clawing back awards, all of which have featured in recent pay scandals. For example, at Persimmon it was the absence of adequate provisions in contracts for the capping of pay-outs and for withholding or clawing back payments meant that the huge awards due could not legally be stopped.[45] Our joint report on Carillion called for consideration of minimum standards for bonus clawbacks but has not yet been taken forward.[46] The new Corporate Governance Code does set out that provisions for use of discretion and for withholding/clawing back pay should be included, but no detail has been agreed on the circumstances in which these provisions should be applied. Investors agreed that some form of standardised wording would be very helpful.[47]

15. Similarly, the revised Code provides high level guidance on the principles for setting pay, but no indication on what might be considered "excessive", nor on appropriate structures and bonus objectives. The Code continues to operate on a "comply or explain"

38 Q584 [Howarth], Q588 [Williamson]
39 Fourth Report of Session 2016–17, HC 702, para 112.
40 FRC, Corporate Governance Code, paras 2 and 40.
41 FRC, Corporate Governance Code, para 40.
42 High Pay Centre (CGP0038)
43 PwC (CGP0026)
44 Hermes Equity Ownership Services (CGP0031)
45 Qq360–363 [Sears and Chapman]
46 BEIS and W&P Committees, Second Joint report of 2017–19, Carillion, HC 769; see The Investment Association (CGP0029)
47 Q394 [Stirling]

basis, so there are no explicit sanctions available to the FRC. Instead, the regulator engages in a dialogue with companies to improve reporting, where necessary. The new Code provides some more detail on remuneration than its predecessor, with stronger wording on the need for policy to be aligned with company purpose and values and be linked to the company's long-term strategy. **We welcome the revised Corporate Governance Code's improvements on remuneration guidance, such as the requirements to consider the long-term remuneration across the whole workforce and potential reputational risks. But the Code alone is unlikely to be an effective driver of change.** ***We recommend that the new regulator clarifies and strengthens its guidance on executive remuneration with a view to exerting significant downward pressure, avoiding unjustifiable payments and ensuring that, if they are made, they can be readily recovered.***

New reporting requirements on remuneration

16. Following a recommendation from our predecessor Committee, the Government introduced legislation[48] in 2018 which requires companies to provide more detailed narrative reports of how they have fulfilled their requirements under section 172 of the Companies Act 2006 to promote the success of their company for the benefit of the members as a whole, but having regard to a wide range of stakeholders, including employees and suppliers.[49] The legislation applies to reports on periods beginning from January 2019. This represents a welcome attempt to move away from the formulaic "tick box" type of reporting to a more narrative approach that requires companies to be more publicly accountable for their actions, including on pay.[50] More transparency and justification will be required on remuneration. Companies will have to specify the potential impact of a 50% increase in share price on executive pay awards, improving the visibility of outcomes for shareholders and reducing the risk of vast but "unforeseen" pay-outs.[51] Any company awarding huge bonuses that prove damaging to reputation should have to explain how this can be consistent with their legal obligations to promote the success of the company while at the same time having regard to the interests of their employees, at the risk of legal challenge.[52] Formulaic and legalistic wording will not do. **We welcome the new reporting requirements but are not convinced that they alone will lead to greater alignment between remuneration and company objectives.** ***We recommend that the new regulator monitors how remuneration reports and better reporting against section 172 of the Companies Act meet the aims of increased transparency and alignment of pay with objectives.***

Engagement with employees on pay

17. The Government stepped back from the Prime Minister's initial support for worker (and consumer) representation on boards.[53] Instead, it floated three options in its Corporate Governance Green Paper,[54] which subsequently were included in the

48 The Companies (Miscellaneous Reporting) Regulations 2018
49 Companies Act 2006
50 Q376 [Wilson], Q556 [George]
51 See para 7 on Persimmon.
52 See Q383 [Stirling]
53 Rt Hon Theresa May MP, speech, 11 July 2016
54 BEIS, Corporate Governance Green Paper, November 2018

FRC's revised Corporate Governance Code. This requires listed companies to improve engagement with employees by adopting one or more of three ways, or to report on what alternative arrangements they have made:

- a director appointed from the workforce;
- a formal workforce advisory panel;
- a designated non-executive director.[55]

The Code took effect from 1 January 2019, so it is too early to see how many companies adopt the more ambitious and, we would argue, more effective option of appointing an employee to the board.[56] The previous Committee did not recommend mandating the appointment of workers on boards, in the light of a number of practical difficulties, but instead encouraged more companies to consider it, with a view to it becoming the norm eventually. A more prominent role for employees in company decision making is likely to have a restraining influence on executive pay. They may, for example, want to ensure that all staff are being paid the real living wage before signing off bonuses of tens of millions of pounds for senior executives.[57] It is difficult to believe that some of the more egregious pay awards that we outline in paragraph 7 would have been readily agreed by a board including the challenge of an employee able to represent the concerns of the workforce. ***We recommend that the new regulator monitors companies' compliance with the Corporate Governance Code with a view to making an assessment of which method of engagement proves most effective and recommending changes.***

Employee representation on remuneration

18. If there is to be no mandatory employee representation on the board, the presence of an employee as an ex officio member of the remuneration committee would be a useful alternative. The FRC rejected the recommendation of the previous Committee that this option should be included in the revised Code. Instead, the Code states that the remuneration report should include explanations of:

- what engagement has taken place with shareholders and the impact this has had on remuneration policy and outcomes; and
- what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy.[58]

19. Given the reluctance of the FRC to recommend employees on the board or the remuneration committee, it was not surprising to learn that companies have not yet done so.[59] The TUC argued for a minimum of two elected workforce representatives to be included on remuneration committees and that these committees should consider how pay policy affects the entire workforce, not only those directly employed.[60] **The explanations**

55 FRC, UK Corporate Governance Code, para 5.
56 We heard that Mears Group has appointed an employee to the board as an (non-executive) "Employee Director".
57 For example, in December 2017, it was reported that 450 workers at Persimmon received less than the real living wage of £8.75 an hour or £10.20 an hour in London.
58 FRC, Corporate Governance Code, para 41
59 Q357 [Cotton], CIPD (CGP0030)
60 TUC (CGP0037)

on workforce engagement sought by the revised Code are an improvement, but they are not an adequate substitute for the permanent engagement achieved by remuneration committee membership. ***We recommend that companies should be required to appoint at least one employee representative to the remuneration committee to ensure that there is full discussion of the link between executive pay and that of the workforce as a whole.***

Pay ratio reporting

20. The Government also accepted the recommendation from the previous Committee to introduce a statutory requirement for companies to publish pay ratios between executives and employees. The new Regulations will require quoted companies of over 250 employees to publish and explain the CEO's total annual remuneration, as measured by the Single Total Figure, to be compared with the equivalent at the median and each quartile for UK employees across the group.[61] Companies are required to keep statistics from January 2019 and to start to report them in 2020.

21. Witnesses generally welcomed the publication of pay ratios as a useful measure, up to a point.[62] Pay ratios between CEOs and their employees are typically around 80:1 but can be much higher.[63] Some expressed scepticism that a few words of explanation in a report after the event would have any impact on behaviour, noting that it will not allow meaningful comparisons across companies and sectors owing to the very different nature of organisational structures.[64] Year-on-year comparisons will also be subject to large fluctuations of CEO pay because it comprises a substantial proportion of performance-related pay.[65] A minority of witnesses argued for a legally binding maximum pay ratio: a range between 20:1 and 75:1 were suggested.[66]

22. We believe that pay ratio reporting should also include a requirement to publish a figure for the ratio between CEO and the lowest pay band, as well as the bottom quartile, to reinforce the link between pay at the top and the bottom. We also see no reason why the reporting requirements should be limited to the listed sector, rather than reflecting the reach of the gender pay gap reporting requirements, which apply to all organisations with more than 250 employees—over 10,000 employers.

23. **We welcome the introduction of new requirements to publish pay ratios, which will allow meaningful comparisons to be made, at least within sectors, and require companies to explain when and why they have chosen to pay above reasonable expectations. Over time, we expect sector norms to develop, potentially with the active intervention of the regulator. By highlighting the link between executive and employee pay, the gap between them should, with public and peer pressure over time, reduce. To assist and broaden this objective,** ***we recommend that pay ratio reporting requirements be expanded to include all employers with over 250 employees and that the lowest pay band be included alongside the quartile data required.***

61 The Companies (Miscellaneous Reporting) Regulations 2018

62 Q596 [Williamson], Q599 [George] Q601 [Howarth]

63 Mr Michael Nisbet (CGP0043); Higher figures, for example quoted by the High Pay Centre, can be obtained using mean rather than median pay rates: eg 145:1. Median rates are generally considered to be the more meaningful figure. See CIPD/HPC report, Executive pay: review of FTSE 100 executive pay, August 2018.

64 Institute of Directors (CGP0035)

65 Q444. For example, Persimmon told us in a letter of 3 July 2018 that because of the vesting arrangements of the 2012 LTIP the pay ratio rose from 62:1 in 2016 to 1,320:1 in 2017.

66 The High Pay centre suggested 40:1, the Association of Accounting Technicians 20:1. John Lewis example of 75:1 was also cited by Association of Accounting Technicians (AAT) (CGP0016)

24. We were disappointed that the new requirements, like those relating to gender pay gap reporting,[67] do not apply to partnerships, such as the UK's main law firms and professional service providers. We note that since 2016 The Investment Association has been asking companies to voluntarily disclose pay ratios, and that only a few have done so.[68] In this context, we welcome the undertaking given to us by all the Big Four professional service firms that they would publish their pay ratios, notwithstanding the complications arising from the partnership model.[69] ***There is no reason why companies, including major legal partnerships, that can readily calculate these pay ratios should not report them first in their 2019 annual reports and we recommend that they do so. We further recommend that the new regulator takes to task any company or firm that fails to explain adequately how they have taken into account pay ratios when determining levels of remuneration, particularly when pay ratios significantly exceed sector norms.***

Revised Stewardship Code

25. The Stewardship Code is published by the FRC and contains guidance, on a "comply or explain" basis, for investors and asset owners on how to discharge their stewardship functions in respect of the listed companies in which they invest. After some delay, the FRC issued for consultation a revised Stewardship Code in January 2019.[70] This is the first update to the Code since 2012. The Code includes guidance for investors and asset managers on a range of issues, including pay, but, like the Corporate Governance Code, it is not mandatory and carries no sanctions. The Kingman Review of the FRC describes the Stewardship Code as "not effective in practice".[71] It argued that it should focus on outcomes and effectiveness, rather than "boilerplate" policy statements and that, if this cannot be achieved, "serious consideration should be given to its abolition".[72] We consider the effectiveness of the proposed revised Code in Chapter 4 on engagement.

Register of dissent

26. Following a request by the Government, The Investment Association established a public register[73] in December 2017, listing All-Share companies that have received a vote of more than 20% of shareholders against a resolution at an annual general meeting (or other general meeting). The register includes an indication as to whether companies have responded to the opposition. The aim of the register is to expose those companies that do not respond to shareholder concerns and to promote better dialogue. Pay is the most frequent subject of dissent (42% of resolutions).[74] As at December 2018, there were 151 companies and 294 individual resolutions on the register. There was a 67% increase in the number of FTSE 100 companies appearing on the register for pay-related resolutions from 2017 to 2018.[75] The Investment Association maintains a list of all those companies which incur a vote against for the same resolution in consecutive years, and in December 2018

67 Thirteenth Report of Session 2017–19, *Gender pay gap reporting*, HC 928, para 43.
68 The Investment Association (CGP0029)
69 Qq 490-1, oral evidence from KPMG, Deloitte, EY and PwC on the Future of audit, 30 January 2019.
70 FRC, Proposed revision to the UK Stewardship Code, January 2019
71 Independent Review of the FRC (Kingman Review), December 2018, para 12.
72 Independent Review of the FRC (Kingman Review), December 2018, page 11.
73 The Investment Association, Public Register
74 Figures from The Investment Association, updated from (CGP0029)
75 Figures from The Investment Association.

it wrote to all 32 of such companies suggesting that they respond better to investor views. There were 15 companies on this "repeat offenders" list in respect of remuneration reports in both 2017 and 2018.[76]

27. Whilst supported by most organisations, others argue that appearance on the register does no lasting reputational damage and is unlikely to be effective in changing behaviour.[77] Some even argued that it could be counter-productive and could make companies less likely to pursue progressive, but risky reforms, for fear of appearing on the register.[78] We believe that better engagement and explanations of changes should mitigate any potential damage of appearing on the register. **We welcome the development of the Public Register by the Investment Association as it provides greater transparency for investors on how companies engage with their shareholders. It has demonstrated that remuneration remains a key source of discontent for shareholders.** ***We agree that the focus should remain on those companies which ignore shareholder concerns on pay and recommend that the new regulator explores more effective sanctions than a letter from the Investment Association.***

Corporate governance code for private companies

28. One of the limitations of imposing restraint on executive pay via the Corporate Governance Code is that it only applies to around 800 premium listed companies. Witnesses pointed out that hedge fund managers, and many in the sports and entertainment industries get lavishly rewarded without enduring the same degree of public scrutiny.[79] The reason for that is that there is an obvious market for public figures and these individuals do bear the wider responsibilities that companies do. Also, behaviour in the publicly quoted sector sets the tone and benchmarks for other companies to follow. In this context and following a recommendation from our predecessor Committee, the Government appointed a business-led panel to develop a Governance Code for large private companies. The report of the Wates Review was published on 12 December 2018.[80] Qualifying companies will have to start reporting in line with the new Principles from 2020. The new Principles apply to all companies that have more than 2,000 employees, a turnover of more than £200 million, and a balance sheet of more than £2 billion. Under the regulations, companies are not required to adopt the new Principles or any governance code but must explain if and why they have not done so in a statement of corporate governance arrangements.[81]

29. On remuneration, the guidance in the new Principles is in line with those of the Code for listed companies, suggesting that pay policies may include "robust consideration of the reputational and behavioural risks to the company that can result from inappropriate incentives and excessive rewards". It is entirely permissive in tone: "Additional transparency could extend to commenting on how executive remuneration reflects general practice within the sector or voluntary disclosure of pay ratios."[82] Witnesses agreed that the new

76 The Investment Association, Repeat Offenders List, December 2018. The full list is: Astrazeneca, Centamin, Clarkson, Entertainment One Ltd, GC Holdings, Inmarsat, Playtech, Premier Oil, Raven Property Group Ltd, Rotork, Safestore Holdings, Sophos Group, Tarsus Group, Telecom Plus and WPP.

77 CIPD (CGP0030), Hermes Investment Management (CGP0045), Association of Accounting Technicians (AAT) (CGP0016), Big Innovation Centre, The Purposeful Company (CGP0024)

78 PwC (CGP0026)

79 ICSA: The Governance Institute (CGP0034), Letter from Clare Chapman, 15 June 2018

80 FRC, The Wates Corporate Governance Principles for large private companies, December 2018

81 The Companies (Miscellaneous Reporting) Regulations 2018, para 26.

82 FRC, The Wates Corporate Governance Principles for large private companies, December 2018

Principles are a welcome first step but could have been much stronger,[83] particularly on reporting.[84] Paul George, from the FRC, accepted the limitations of the regulatory rather than a fully legislative approach, and acknowledged that there is too much flexibility in the Code for it to be as effective as it might be.[85] **We welcome the publication of the corporate governance principles for private companies as a foundation upon which the new regulator should build robust and more enforceable guidance on pay and other matters.** ***We recommend that the new regulator takes on responsibility for monitoring the impact of the Code and examines the case for greater disclosure around remuneration and for expanding its application more widely.***

Share buy backs

30. The Government commissioned an independent review of the use of share buy backs in January 2018.[86] This followed growing criticisms that companies, and chief executives in particular, were using carefully-timed share buy backs to artificially inflate the price of shares, so as to maximise the proceeds of bonuses delivered via shares.[87] It is argued that such activity has a detrimental impact on investment and other, more productive or long-term expenditure.[88] We understand that the review reported to Ministers some time in 2018, but no publication or announcement has yet been made.[89] In response to our written request for an indication of progress, the Secretary of State told us that there would be an announcement "in due course".[90] ***We cannot understand why the Secretary of State would want to block the publication of an independent study and recommend that the review of share buy backs is published without further delay. We further recommend that remuneration reports include analysis of the impact on executive remuneration of any share buy backs during the reporting period.***

83 Q574 [Howarth]

84 Q574Q574 [Williamson]

85 Under the Corporate Reporting (Miscellaneous Provisions) Regulations 2017 large private companies are merely required to explain their corporate governance arrangements, including whether they follow a code. There is no prescription.

86 Share buy backs describes the practice of companies buying back shares from the market, potentially in order to inflate the share price in the short term.

87 See, for example, *Financial Times*, Record share buy backs should be raising alarms, 7 November 2018

88 IPPR, Commission on Economic Justice and Prosperity, 2018, citing Lazonick W (2014) 'Profits without prosperity', Harvard Business Review, September 2014

89 ICAEW (CGP0033)

90 BEIS Committee website, letter from Secretary of State, 28 February 2019

3 Structure of pay

Introduction

31. Whilst the causes of upward pressure on executive remuneration are many and varied, the structure of pay packages also plays a part. Figure 1 demonstrates how, over time, basic salary has formed a slowly shrinking proportion of pay, but this has been more than compensated by increases in other elements, such as annual bonuses and longer-term share-based pay (LTIPs).[91] Since the 1990s, shareholders have increasingly pressed for the pay of chief executives (and all executive directors) to be linked to company performance. Consequently, ever more complex incentive schemes have been developed and have driven the rise in executive pay.[92] The FRC acknowledged that the greater uncertainty in the current remuneration structure has led to an increase in rewards available.[93] Too often in the past the system has been gamed: if downward pressure is applied in one area, such as LTIPs, it is compensated for somewhere else.[94]

LTIPs and Restricted shares

Long-Term Incentive Plans (LTIPs) are an element of remuneration that provides a number of shares, realisable over a time period, usually three years. The number of shares is based upon sometimes complex performance measures including a range of company performance indicators, such as sales growth, profits and cash flow. LTIPs were introduced to help strengthen the link between remuneration and performance over the longer-term and replaced tax-effective share options originally introduced in the 1980s. Critics argue that LTIPs work against transparency (they cannot be valued when awarded) and can distort executive behaviour, who may take decisions in order to meet specific performance targets but are not in the long-term interests of the company.

Restricted shares (sometimes called deferred pay) are an element of share-based remuneration which can be realised only after a set period of time (normally greater than three years). The value realised is determined by share price at the time of vesting. The release of the shares is not contingent on performance targets being met. The aim is to encourage and reward decision-making for the long-term benefit of the company, rather than the pursuit of specific financial targets.

Greater certainty and encouraging long termism

32. The greater uncertainty and longer-term nature of these incentive-based elements have led executives to demand—and boards to award—packages which include higher pay opportunities. If performance targets linked to these LTIPs are insufficiently stretching, or, to put it another way, if company performance exceeds expectations, pay outs will inevitably rise. Upward pressure on executive remuneration has been largely a reaction to investor demands over many years to link pay to performance and to defer awards over longer and longer periods of time. As an increasing proportion of pay has been linked

91 See paragraph 4.
92 Q554 [Williamson]
93 Q580 [George]
94 Professor Alex Edmans (CGP0028), Q391 [Wilson]

to performance, pay packages need to be well designed to avoid external economic or political events producing vast and undeserved awards, as at Persimmon. The strength of the link between CEO performance and Total Shareholder Return in the short term is in any case debatable, given the impact of external factors and the performance of other decision makers within the business. **In principle, we believe that there should be greater certainty in executive pay. This should be balanced by a significant reduction in the maximum that may be earned and that the rewards from good performance should be more evenly shared: there should be a stronger and more visible link between rewards at the top and bottom.**

33. The previous Committee argued for a move away from LTIPs, on the basis that they can distort decision making, towards long-term restricted share plans.[95] Provided they vest over a sufficiently lengthy period, this approach should encourage and reward genuine long-term decision making. There is some academic evidence suggesting that long-term restricted share plans have a causal link with both innovation and profitability.[96] The shift away from LTIPs is supported by some institutional investors,[97] but by no means all, particularly those in the US, where there remains a strong attachment to incentive-based pay and where time-vested restricted shares are deemed to be insufficiently performance-related.[98]

34. We heard evidence that LTIPs are not generally long-term enough, or effective in influencing executive behaviours and, worse, allow for gaming.[99] Some witnesses argued that more companies have been adopting policies based on restricted shares rather than LTIPs, but we have found that so far there are very few.[100] Others had withdrawn proposals after talking to shareholders.[101] Clare Chapman, remuneration committee Chair at Weir Group, told us how difficult it had been to persuade a disparate group of shareholders of the benefits of moving towards longer term restricted share schemes that linked rewards of executives to those of investors more closely.[102] Many companies are reluctant to propose alternations to pay policies which risk being unpopular with investors: they are concerned that the weaker direct link to company performance can lead to a perception of "rewards for failure".[103]

35. The FRC, in its proposed revisions to the UK Corporate Governance Code, sets out that remuneration schemes should promote long-term shareholdings that support alignment with long-term shareholder interests. In line with a recommendation of the previous Committee, it suggests that vesting periods should normally be at least five years. We welcome this improved wording, and were told that most companies bringing forward new pay policies in 2018 are indeed including a vesting period for LTIPs of at

95 See Fourth Report, *Corporate Governance*, HC 702, paras 87-94.
96 Professor Alex Edmans (CGP0028)
97 Eg Hermes and Norges.
98 Eg Hermes, Q495, Q507 [Duguid]; Q270 [Chapman], Q391 [Wilson], Q504 [Ni-Chionna], Q547 [Marshall], PwC (CGP0026), Employment Lawyers Association (CGP0023)]; a consultation by proxy agent ISS in 2017 indicated more favourable attitudes amongst investors to restricted shares (47% of respondees) but still indicated a significant split.
99 Q548 [MacDougall], Professor Alex Edmans (CGP0028)
100 The Investment Association (CGP0029) cites examples of Premier Oil, Kenmare Resources and Pets at Home, as well as Weir Group; Institutional Shareholder Services (ISS) (CGP0041)
101 The Investment Association (CGP0029), ICSA: The Governance Institute (CGP0034), Big Innovation Centre, The Purposeful Company (CGP0024), Hermes Investment Management (CGP0006), Q368 [Ninian]
102 Q270, Q285, Q358 [Chapman]
103 ICSA: The Governance Institute (CGP0034), PwC (CGP0026), Glass Lewis (CGP0040)

least this long.[104] Some argued that the FRC should be more explicit in recognising the validity of other incentive models to LTIPs, such as restricted shares.[105] The FRC Code stops short of giving a general view on the use of LTIPs or structure of pay. Similarly, whilst the Minister was among witnesses who saw a case for greater simplicity, she did not see a role for Government in determining levels or structure of pay.[106] Fund managers, as we discuss later, are unlikely to press hard for change even though, according to The Investment Association, there are some concerns around the increased pay potential with higher proportions of variable pay.[107] These are accentuated by the evidence that long-term institutional investors are gradually being replaced by funds whose managers are seeking short-term gains rather than the creation of longer-term value.[108] **We recognise that most listed companies will not be putting new pay policies before shareholders in a vote until 2020. However, without external pressure before then, and given the different views on the use of incentives in pay packages, any reform is likely to be slow.**

36. We do not subscribe to the "superstar CEO" theory, under which it is natural for ever larger companies devote relatively tiny proportions of their profits to recruiting the most expensive CEOs on the market. We do not believe that there is a shortage of talented people prepared to lead organisations in return for high but not excessive pay.[109] There are so many variables in large organisations competing in an unpredictable global market, and the evidence is at best ambiguous on the impact of individual CEOs on company performance.[110] Executive pay does not operate as a normal market due to the lack of open competition in recruitment and limited financial impact of paying what are exorbitant amounts for an individual. Companies typically choose to benchmark executive pay offers to the external market in their sectors rather than their own internal pay structures, thereby further entrenching the disconnect between pay at the top and amongst the general workforce. There are exceptions. Witnesses were supportive of greater use of profit-sharing schemes, including executive directors, and limits on the pay ratio between CEO and workforce, such as that used by John Lewis.[111] We agree with the Minister that we should not be too prescriptive, but firmly believe that everyone in a business contributes to its success and should share in the profits, rather than seeing the top executives enjoying unimaginable riches. Fair pay is also a signal of good corporate governance: "companies who do not treat their own people fairly may find it hard to persuade customers and suppliers that they can expect a better experience."[112]

37. **We believe that executive pay should be simplified, more obviously geared to promoting companies' long-term objectives, and be linked more closely to that of the workforce as a whole. Greater transparency and simplicity will help shareholders hold boards to account. We favour a simple structure based on fixed basic salary plus deferred shares, vesting over a long period, but subject to conditions to avoid "rewarding failure". Care needs to be taken to ensure that reforms are coherent as a**

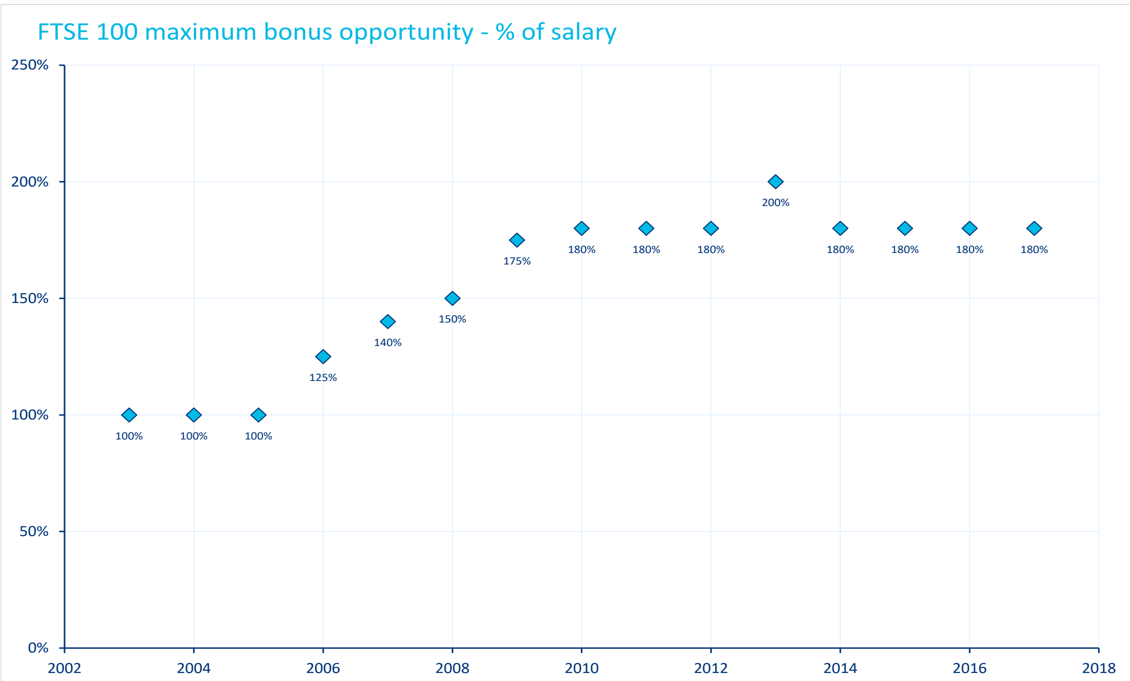
104 Big Innovation Centre, The Purposeful Company (CGP0024), ICAEW (CGP0033)
105 PwC (CGP0026)
106 Q573 [Williamson], Q609, Q618, Q623 [Tolhurst], PwC (CGP0026)
107 The Investment Association (CGP0029)
108 IPPR Commission on Economic Justice, *Prosperity and justice: A plan for the new economy 2018*, citing Stirling A and King L (2017) Financing investment: Reforming finance markets for the long-term and Haldane A (2016) *The costs of short-termism*, in Jacobs M and Mazzucato M (eds), *Rethinking capitalism: Economics and policy* for sustainable and inclusive growth.
109 Q275 [Cotton] citing LSE research on this point.
110 Professor Alex Edmans (CGP0028)
111 Trades Union Congress (CGP0037), Qq583–584
112 ICAEW (CGP0033)

package and do not permit gaming. We also support the greater use of profit sharing or other schemes designed to share profits more evenly. Over time, the proportion of variable pay (including bonuses, share options and profit sharing) should be reduced substantially. The increase in certainty associated with proportionately more fixed pay should, if well managed, lead to a reduction in total remuneration awarded. ***As a matter of practice, and to reduce the risk of Persimmon-type awards and associated reputational damage, we recommend that remuneration committees should set, publish and explain an absolute cap on total remuneration for executives in any year. The new regulator should be more prescriptive and interventionist, where necessary, in pursuit of these objectives and be prepared to publicly call out poor practice or behaviours.***

The nature of annual bonuses

38. We have argued that the element of pay that is not basic salary should move away from annual bonus towards share ownership, so as to better align pay with long-term shareholder outcomes. Figure 1 supports the premise that over-generous annual bonuses have been used to help suppress basic salaries without impacting on overall rewards. When 80% of executive pay is incentive driven, as is typically the case,[113] the scope for generous engineering is wide. Whilst increases in base salary have been modest, annual bonuses have continued to pay out well above expectations (or target levels).

Figure 5: bonus pay outs in FTSE 100 as a proportion of bonus opportunity



Source: FIT Remuneration Consultants and New Bridge St

For the last nine years, the median maximum bonus opportunity for FTSE100 CEOs has generally been around 180% of basic salary (200% in 2013). The actual amount paid (target achieved) has tended to average around 75% of the maximum available. Thus, typically,

113 Q551 [Gosling]

a FTSE 100 CEO earning a basic salary of £1 million could expect to receive an annual bonus of a further £1.35 million, in addition to share awards, which may add a further £1.5 million.[114]

39. We recognise the value of an annual bonus in encouraging progress towards specific short-term targets and in rewarding genuinely outstanding performance, but do not believe that it should remain such a major component of pay. As one witness summarised: "[t]he evidence seems to suggest that the kind of financial incentivisation everybody is trying to operate does not actually produce the goods."[115] Following the financial crash, EU regulations in the financial services sector capped bonuses at 100% of fixed pay and 200% with explicit shareholder approval.[116] There is a strong case for a similar cap to be applied via the Corporate Governance Code, if not legislation.

40. This reduced level of annual bonus should be less focused on financial performance measures based on profits and more aligned with the social responsibilities of companies and engagement with the full range of stakeholders, including employees, not just investors seeking a return in the short-term.[117] At present, performance metrics for bonuses are maintained on a scorecard approach, featuring a range of criteria, but are generally most heavily weighted towards financial performance such as profits, rather than measures aimed at driving increased productivity in the longer term, such as those relating to investment and skills.[118] Typical weightings for non-financial measures, for example, relating to employee engagement, workforce development, community or health and safety goals account for only around 10%-15% of total bonus opportunity.[119] This may be partly due to shareholder preferences and proxy agents' tendency to advise that financial targets should form the majority of total bonus opportunity.[120]

41. We heard that "very few" FTSE100 companies have linked their long-term and short-term incentive plans to broader corporate responsibilities rather than financial targets, although there have been some discussions between companies and shareholders on making targets simpler and more stretching,[121] and limited evidence of improved reporting.[122] Analysis suggests that only 15% of FTSE100 companies include customer satisfaction as a bonus objective.[123] One investor told us that the incentive system used in the UK is "too short term".[124] Others argue for incentives to relate more to environmental, social and governance (ESG) objectives, particularly in the light of growing evidence of a positive correlation between strong ESG policies and good financial performance.[125] We heard that some companies had now increased to 30% the proportion of its bonus scheme

114 Q271 [Cotton]
115 Q551 [MacDougall], Q391 [Wilson]
116 The EU Capital Requirements Directive IV took effect from 1 January 2014.
117 Q278 [Cotton], CORE Coalition & Oxfam GB (CGP0027)
118 Q488
119 Q279 [Cotton]
120 For example, ISS, UK and Ireland Proxy voting guidelines, December 2018.
121 CIPD (CPG0030)
122 Glass Lewis (CGP0040)
123 Purposeful Company (CGP0024)
124 Q492 [Duguid]
125 CORE Coalition and Oxfam (CGP0027)

tied to long-term measures such as innovation, technology and customers.[126] The TUC advocates a 10% limit in the amount of total pay subject to incentive pay and that any incentive schemes for executives should be open to all staff on similar terms.[127]

42. We recognise that a move away from hard financial targets towards softer metrics which may be more difficult to measure has the potential, if not managed properly, to enable bonuses to become less challenging to secure. This risk can be mitigated by careful benchmarking by the remuneration committee and limiting the overall amount of performance-related pay.[128] Clear reporting of performance against personal objectives will also provide a safeguard against gaming. **Chief executives, and shareholders, should be stewards of the long-term and broad interests of their companies rather than pursuing short-term financial goals: they should be rewarded accordingly. We believe that the performance measures governing the payment of annual bonuses should be aimed at encouraging and rewarding increased productivity and also support the company's wider responsibilities under section 172 of the Companies Act to have regard to the interests of its customers, suppliers and workforce.** ***We recommend that the new regulator engages with investors to develop guidelines on bonuses to ensure that they are genuinely stretching and a reward only for exceptional performance, rather than being effectively an expected element of annual salary.***

Pensions

43. We have advocated greater alignment in the way in which profits are shared between executives and employees. The same should apply to pension contributions. As we have seen, there has been a tendency for a crackdown on one element of pay to lead to corresponding increases in other elements.[129] Pension contributions is one such area, where chief executives in the FTSE 100 have enjoyed pension contribution rates around 25-30%, while their employees receive around 9%-10%:[130] an unacceptable example of weak corporate governance and flagrant disregard for any notion of fairness. The new Corporate Governance Code contains a provision that pension contribution rates should be aligned with the workforce and this is amplified in The Investment Association's remuneration principles.[131] This has not stopped two major banks, Lloyds and HSBC, seeking to flout the spirit of the Principles by offering substantial alternative pensions advantages to their chief executives, to compensate for the alignment of pensions contributions.[132] It is reassuring to see that investors and staff have protested. There are indications that some companies are now acting to ensure greater alignment.[133] This should have happened much sooner. **We welcome The Investment Association's announcement in February 2019 that it will monitor and flag up any company that pay pension contributions to new directors in a way not aligned to the majority of the workforce and** ***we recommend that the new regulator seeks public explanations from any company that fails to deliver alignment on pensions contributions.***

126 Q285 [Chapman], Q291 [Sears]
127 Trades Union Congress (CGP0037)
128 PwC (CGP0026)
129 Qq391–393 [Ninian] [Stirling]
130 Financial Times, Investors warn executives that pensions fairness is vital, 16 February 2019
131 Investment Association website, 21 February 2019
132 See The Times, HSBC chiefs bow to pressure and cut pension payments, 17 March 2019, and Lloyds comes under fire over boss's pension perks, 19 March 2019
133 PwC (CGP0026), Trades Union Congress (CGP0037)

4 Engagement by companies on pay

The challenge of stewardship

44. Whilst responsibility for devising policy on executive pay rests with the board, ultimately the approval of investors is required through votes on policy and annual reports at each AGM. For their part, investors want to ensure that decisions taken by the board are in the interests of the company and therefore their own investment and ultimate beneficiary. The challenge for the board is to align their objectives with those of investors, or at least to engage sufficiently to ensure that its proposals will not be defeated. The reforms of 2014[134] were aimed at improving the ability of investors to engage and to give them more influence. In the era of what have been called "ownerless corporations"[135] the challenge on pay is how best to secure a commitment across all players in the investment chain (asset owners, asset managers, advisors etc) to a goal that not only meets the objectives of the company, but also delivers on the company's wider social responsibilities that the public expect them to meet. To put it simply, if the company's owners (shareholders) agree that paying the CEO £25 million a year is in the best interests of the company, how and why can this view be challenged? We explore below the roles of different players in the decision-making process on pay in the context of meeting the objectives of the 2014 reforms.

2014 reforms on shareholder engagement on pay

Under the reforms that took effect from 2014, premium listed companies are required to have votes on **remuneration policies every three years. These votes are binding.** The policies establish the structure of remuneration packages and set out how they will be implemented throughout the business. Most companies had this remuneration policy vote first in 2014, and then again in 2017, but around one third of the current FTSE 100 companies held a policy vote in 2018.

Companies are required to hold a vote on **remuneration reports every year**. These set out the decisions on remuneration and their outcome made during the year, under the overall policy. **These votes are non-binding.** The reports set out the results of the implementation of the policy during the year and how much performance-related pay has been achieved. Any discretion applied may also be mentioned. These votes on pay reports can be used by shareholders to signal dissatisfaction with performance or the implementation of pay policy more generally.

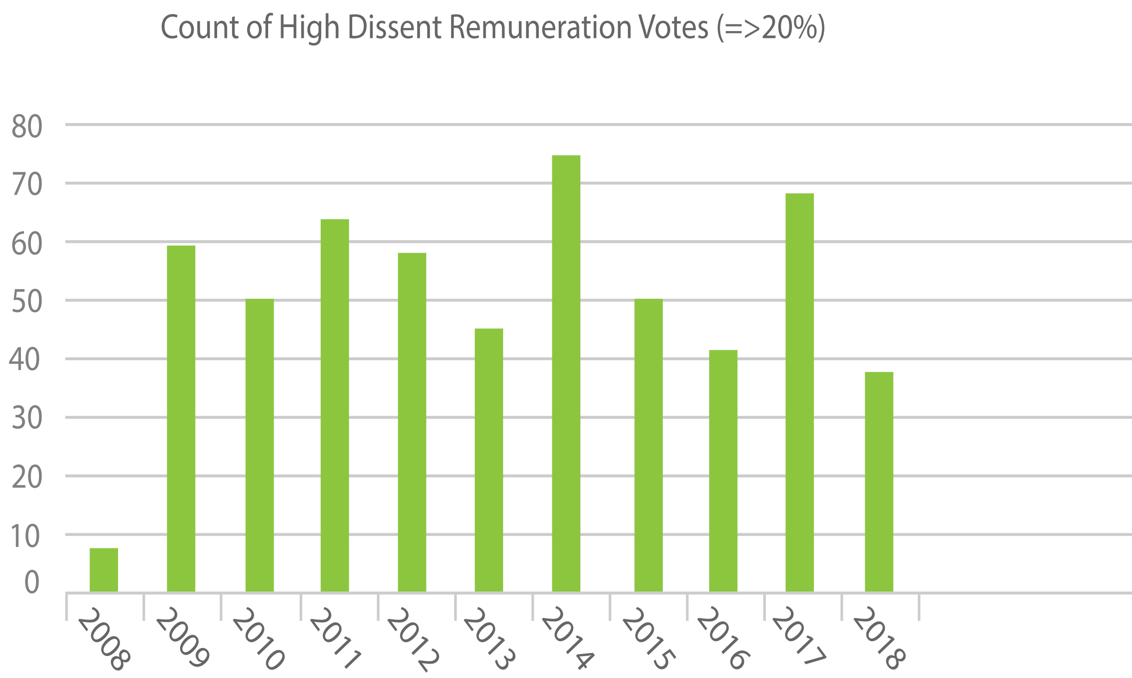
Increased shareholder activity

45. The evidence we gathered suggests that there has been an increased focus on executive pay amongst shareholders since 2016, in part caused by parliamentary pressure.[136] We heard that that they were now seeking simpler pay packages, with lower proportions of variable pay, and are now making clear that excessive pay increases—above inflation or company-wide increases—are not acceptable.[137]

134 See Box below for summary.
135 Lord Myners used this term to describe the UK's large listed companies, characterised by fragmented shareholding which prioritises short-term, risky profit over long-term value, both financial and social. See Andy Haldane *'Who owns a company?'*, speech at the University of Edinburgh, 22 May 2015.
136 Q409 [Ni-Chionna] [Duguid], Q264 [Sears], Q371 [Stirling], Q555 [Williamson], Minerva Analytics Ltd (CGP0042)
137 PwC (CGP0026); Q262 [Chapman]

46. Most stewardship goes on behind the scenes throughout the year; it does not just materialise at AGMs.[138] This perhaps explains why the anecdotal evidence of increased shareholder engagement does not translate obviously into an increase in significant dissenting votes since 2014 (See Figure 6). The spikes of dissenting votes in 2014 and 2017 reflect the fact that for most companies there were votes on pay policies as well as on annual pay reports in these years.

Figure 6: shareholder dissent on remuneration



Source: Minerva Analytics

47. Whilst we found that in general stewardship is not working as well as it should,[139] but that there is evidence that increased activity is having some impact.[140] The Purposeful Company argues that 75% of companies receiving a dissenting vote of over 20% in a given year took action the following year and achieved an average vote of 94% in favour of pay reports.[141] The proxy agent, ISS, agreed that institutional investors are becoming less tolerant of excessive pay and more likely to challenge boards.[142] The Investment Association notes higher levels of dissent in the FTSE 250 than the FTSE 100.[143] Dissent is by no means always effective: we referred earlier to the 15 companies that have experience significant dissent on pay for two consecutive years.[144] It is instructive that whilst there have been many significant displays of dissent on pay reports (which are non-binding) there were only two pay-related resolutions actually defeated in 2018.[145] **We welcome the increased attention on executive pay but recognise that much more than engagement will be required to drive a more enlightened and acceptable approach on executive pay.**

138 CIPD (CGP0030)
139 Qq566–568
140 Aberdeen Standard Investments (CGP0039)
141 The Purposeful Company (CGP0024)
142 Institutional Shareholder Services (ISS) (CGP0041)
143 The Investment Association (CGP0029)
144 See paragraph 26.
145 Institute of Directors (CGP0035), Q539

Responsibilities of remuneration committees

48. We traced in Chapter 2 the new requirements on the remuneration committees to have oversight of workforce pay and to provide more rounded reporting of pay policy throughout the company. In the light of some of the controversial pay awards listed in paragraph 7, we explored with witnesses, including both Royal Mail and Unilever, the processes that led to the proposals being put before shareholders in the first place. The consensus in the evidence we received was that remuneration committees have largely been unwilling to curb or challenge excessive pay awards, and some have simply not engaged well enough.[146] One investor told us that "[i]t is the company executives themselves in many cases" who were responsible for raising pay–they can be "successful and proficient negotiators".[147] The Investment Association's Principles of Remuneration advise that schemes should avoid "excessive remuneration pay out" but do not provide any indication as to what excessive might be, nor on pay structure.[148] There are no effective sanctions: remuneration committees can award what they wish. Given historic trends and recent excesses, we cannot help but agree with the verdict of Catharine Howarth, Director of ShareAction, that "remuneration committees have failed in practice and failed, in a way, as a structure."[149]

49. Some of the dissenting votes at AGMs have been the result of inadequate engagement and misjudgement by the board of the potential reaction to pay proposals. This was clearly the case at Royal Mail: the Chair of the Remuneration Committee, Orna Ni-Chionna, acknowledged that it was "a big mistake" not to have engaged at the right level with investors, so the 70% vote against the pay report came as a "huge disappointment and indeed a shock to us".[150] Investors complained about the difficulties in securing meetings with companies to discuss these issues[151]—one witness referred to a "breakdown in communications"[152]—and most agreed that companies should do much more to engage earlier and more extensively to test out new pay policies or potentially controversial pay awards.

50. The Chair of the remuneration committee is responsible for the quality of the information provided in the annual report. We heard that "few companies seek to provide insight by going significantly beyond the minimum regulatory requirements" and nor do they disclose sufficiently useful information on pay, for example in relation to the metrics around bonuses.[153] Too often, lengthy remuneration reports appear designed to obfuscate more than inform. For example, the payment of £5.8 million by Royal Mail to the new CEO as a "golden hello" was included only in the notes to the consolidated financial statements instead of being included, more transparently, in its remuneration report.[154]

51. It is clearly up to the boards to set the overall tone on matters of remuneration throughout the company but equally, it is up to the Non-Executive Directors, including those who are also members of the remuneration committee, to challenge robustly

146 Q564 [George], ICAEW (CGP0033); Association of Accounting Technicians (AAT) (CGP0016)
147 Q367 [Stirling]
148 Investment Association, Principles of Remuneration
149 Q592 [Howarth]
150 Qq462–463
151 Q544
152 Minerva Analytics Ltd (CGP0042)
153 PwC (CGP0026)
154 See BEIS Committee website, letters between Rachel Reeves MP and Orna Ni-Chionna, July 2018

where necessary. We heard conflicting evidence about the extent to which remuneration committees are prepared to exercise restraint[155] but, overall, we are far from convinced that they do so. The incentives to bear down on pay are simply not there. The pressure from shareholders is weak and unpredictable and all too often members of the remuneration committee will be board members of other companies or will have served in executive capacities enjoying similar remuneration packages to the ones they are supervising. They are not a diverse or representative group. There is a circuit of self-serving excessive generosity. **Remuneration committees have helped fuel the excessive levels of executive pay we see today. *We recommend that remuneration committees engage early and meaningfully with major investors on executive pay, be prepared to make the case for pay reform and restraint in the interests of avoiding reputational damage. We recommend that the new regulator seeks to ensure that these activities are properly explained in remuneration reports.***

Role of asset managers

52. The role of asset managers, who handle the day to day investment decisions of their clients, is central to executive pay reform. We have concerns about how they fulfil their role under current arrangements.

53. We heard that levels of engagement by the best asset managers with large companies is generally good[156] but also that too few institutional investors such as pension funds are active enough.[157] For most asset managers, remuneration will simply not be a priority, compared to the other reasons on which investment decisions are taken.[158] Given the complexity of executive pay and the difficulty of securing a consensus for change, there are understandable practical disincentives to engagement. We cannot rely on shareholders to exert pressure.[159] One witness told us "they care about levels of executive pay a little less than the public probably does" and therefore will apply less pressure here than the public might like.[160]

54. This is not just a matter of priorities. Asset managers are extremely highly paid and tend to be rewarded with large bonuses based on performance against a benchmark index on a one or two year basis.[161] Investment decisions made by companies may generate returns after one, two or more decades. In these circumstances, it may be awkward, if not hypocritical, for them (or the corporate governance teams which engage directly with companies) to criticise pay policies for prioritising short-term financial incentives. But it is by no means impossible for institutional investors to take a principled stand, and we heard from one who voted against the Persimmon remuneration report on grounds relating to the reputation of the business and its position in society.[162]

55. The previous Committee recommended that the Stewardship Code should be revised to require investors to explain how they have exercised their stewardship functions and include more explicit guidelines on what quality engagement with investors should

155 For example, PwC (CGP0026), CIPD/HPC, Executive pay, review of FTSE 100 executive pay, August 2018.
156 Q412, Q418
157 Q534
158 Q553 [Howarth], Q554 [George]
159 Q571 [Williamson], Q602 [Howarth], Letter from Clare Chapman, 15 June 2018
160 Q541 [Gosling]
161 Q572 [Howarth]
162 Q372 [Stirling]

include. The existing Stewardship Code includes a provision for investors to disclose voting records,[163] but compliance is patchy.[164] An analysis by the High Pay Centre suggests that "significant numbers" of signatories to the Code are not declaring records, making it difficult to examine the extent and direction of investor pressure on executive pay.[165] Under the revised Stewardship Code, investors will be expected to publicly disclose their voting records and also to provide a rationale for their decisions, particularly where they are not in line with policy.[166] However, there are no sanctions for failure to comply with the voluntary Code. Recent history across many regulatory areas demonstrates that without active enforcement, we cannot expect good compliance. Asset managers may be signatories to the Stewardship Code, but they are regulated by the Financial Conduct Authority (FCA). The FCA is currently consulting on proposals[167] to improve engagement with companies, consistent with the requirements of the EU Shareholder Rights Directive.[168] However, the proposals only require asset managers to publicly disclose a policy on shareholder engagement, including on corporate governance issues, but there is no prescription on what such engagement should aim to achieve.

56. Whilst there are channels of communication, such as the Investor Forum, for investors to co-ordinate their views, such co-operation is not the culture and it is relatively rare for investors to go public with views on excessive pay,[169] at least in advance of corporate collapses, as we saw at Carillion.[170] **The Minister made it clear that she sees the role of Government is to provide shareholders with the tools to hold boards to account. We do not have confidence that they will use these tools and create the competitive market in stewardship that should ideally develop. We understand that investors can exert valuable influence behind the scenes but we believe that their stewardship role includes a wider responsibility to help set the boundaries of acceptable practice on executive pay and to promote long-term performance. This should include a commitment to comment publicly when necessary and a requirement to explain their policies and voting records. The final Stewardship Code should make this explicit and be applied strictly and consistently by relevant regulators, including the Financial Conduct Authority.**

Role of asset owners

57. Asset managers are accountable to asset owners: primarily the pension funds that invest our money for the long-term. They are perhaps the least visible but potentially the most influential player in the investment chain. They provide high level instructions for the asset managers—the mandate—on their investment strategies and objectives. These can include the types of companies to invest in, the degree of commitment to Environmental, Social and Governance (ESG) considerations and other factors associated with responsible investment, plus contractual arrangements. Ultimately, it is up to asset owners to give any direction on the stance to be taken by asset managers on corporate governance issues,

163 FRC, UK Stewardship Code, 2012
164 Q542; High Pay Centre (CGP0038)
165 High Pay Centre (CGP0038)
166 Q535; FRC, Proposed Revision to the UK Stewardship Code, Annex A
167 See Financial Conduct Authority, Consultation on proposals to improve shareholder engagement, January 2019
168 The EU Shareholder Rights Directive, due to be enshrined in UK law by June 2019, will require institutional investors and asset managers to be more transparent about their engagement with companies, voting actions and the way in which they align the interests of their clients with companies.
169 Q415
170 Second joint report of Session 2017–19, *Carillion*, HC 769

including executive pay, and to hold them to account.[171] However, these mandates are rarely made public and it is therefore extremely difficult for asset owners to be held to account for the way in which they direct our savings to be invested. Paul George from the FRC acknowledged that asset owners could engage better with asset managers and meet their responsibilities to think long-term. He said that: "We have not been very good at making that link between the ultimate beneficiaries—wider society, by and large—and the work of the fund management industry."[172] We agree.

58. Under the EU Shareholder Rights Directive, from June 2019 asset owners will be required to disclose certain information regarding the mandates they give asset managers, including how the mandate incentivises the asset manager to make investment decisions about medium to long-term financial and non-financial performance of the investee company, and to engage with investee companies in order to improve their performance in the medium to long-term.[173] This is a welcome step forward. The proposed revisions to the Stewardship Code do not appear to reflect the ambition of the Directive. They require asset owners to disclose their "investment beliefs" but not to provide details of their investment mandates or the link between pay and long-term performance.[174] The absence of such detail seriously constrains accountability and therefore effective stewardship. The voluntary nature of the Code is another weakness: we understand that less than half of asset owners are signatories.[175] **We believe that primary responsibility for changing the environment on executive pay rests with asset owners, rather than asset managers. In this context, *we recommend that the guidance in the new Stewardship Code includes a requirement for asset owners to provide much more detailed information about their objectives, including those in relation to executive pay. Given that the Stewardship Code is only advisory, and that existing Code has been widely ignored, we recommend that the new regulator is given the necessary powers to take effective action against those asset owners that do not sign up to, or meet their responsibilities, under the Code.***

Role of proxy advisors

59. Proxy advisors provide company performance analysis for a wide range of institutional and small shareholders and offer advice on voting at AGMs. It is difficult to track the extent to which their advice is followed but they are widely thought to be influential in the voting behaviour of many, if not all investors who use their services.[176] They provide broad principles which underpin their advice, but these lack detail and are subject to the generic advice that decisions should be taken on a case by case basis. One such advisor, ISS, is alone thought to hold at least 60% of the proxy agents' market. Whilst there is a debate over the extent to which shareholders are effectively outsourcing their stewardship responsibilities by using the services of proxy agents, and there are questions over the quality of their advice on pay, given their resources,[177] few would dispute that their advice on pay is without influence.[178] In this context, we welcome the warning by ISS that many

171 High Pay Centre (CGP0038), Aberdeen Standard Investments (CGP0039)
172 Q566, Q573 [George]
173 Government Response to BEIS/W&P committees second joint report on Carillion, HC 1456
174 FRC, Proposed Revision to the UK Stewardship Code, Annex A
175 Investment Association and the Pension and Lifetime Savings Association, Stewardship in Practice: Asset owners and asset managers, September 2016; no later figures are available.
176 Q378 [Stirling]
177 Big Innovation Centre, The Purposeful Company (CGP0024)
178 Q537 [MacDougall]; Purposeful Company, *FRC's Review of the UK Stewardship Code*, February 2018; PwC, *ISS: friend or foe to stewardship*, January 2018.

companies have continued to award relatively generous bonus pay-outs even cases of "mediocre or poor performance", and that the target for bonuses should typically be no more than 50% of bonus potential rather than the 75% that appears to be the norm.[179]

60. There are differences in views amongst the proxy advisors on the best structure for executive pay, with some more favourable towards LTIPs than others.[180] Whilst the major institutional investors should be engaging directly on pay, we recognise that many investors do not have the resources nor expertise to analyse pay proposals in detail, so will continue to rely on the services of proxy agents.[181] ***We recommend that proxy agents tailor their policy guidelines and advice to individual investors so as to resist excessive and poorly designed pay policies and awards.***

Conclusions on stewardship

61. Investors need to help shift the bar on what is acceptable practice in terms of executive pay. This is all the more important in the context of a market that is shifting towards passive, index-linked funds: there is a much greater onus on the remaining active fund managers to send the right signals on pay with their votes.[182] **At present, we do not believe that the incentives of all those involved in the investment chain are sufficiently aligned and attuned to the wider social responsibilities of companies. Nor do we believe that it is realistic to expect better stewardship to be an effective driver of reform of executive pay. We agree with the Kingman Review that, even its revised version, the Stewardship Code is not fit for purpose.** ***We recommend that the new regulator revises the Stewardship Code to ensure that it is able to not just encourage, but deliver, genuine and effective engagement between companies and their shareholders on executive pay in a way that requires both parties to discharge their responsibilities transparently and accountably.***

179 ISS, UK and Ireland Proxy voting guidelines, December 2018. See Figure 5.
180 PwC (CGP0026), Glass Lewis (CGP0040),Institutional Shareholder Services (ISS) (CGP0041)
181 Q418 [Newhouse], Hermes Investment Management (CGP0006)
182 Q552

5 Conclusion

62. In times of stagnant or minimal pay growth for the ordinary worker in particular, business leaders have a responsibility to avoid the eye-watering and unjustified executive pay awards that have recently too often embarrassed companies and damaged the reputation of British business. The stakes could scarcely be higher: the UK's model of capitalism could quite conceivably be undone by ill-disguised corporate excess and naked greed. The UK should leverage its reputation as a leader on corporate governance and great place to do business to drive reform of executive pay practice of multi-national businesses.

63. A closer link between executive pay and that of employees is in the interests of both and will serve to increase trust in business more generally. The publication of pay ratios from 2020 will help this process but needs to be extended further. There is little point in Ministers regretting levels of inequality if they are not prepared to exert any influence in reducing it. We agree that it is not for Government to intervene directly to determine pay, but it can send strong signals on pay reform and give the regulator the powers and remit to ensure the highest standards of engagement with shareholders and with other stakeholders, particularly employees.[183] This will not be enough though. Investors have the powers but neither the will nor incentives to exert downward pressure on executive pay. Better stewardship alone cannot be expected to achieve acceptable outcomes. Asset owners need to be more responsible, and more accountable, for the way in which our investments are deployed. A requirement for there to be employees on remuneration committees should help ensure that disastrous decisions not to cap bonuses made by the likes of Persimmon do not happen again.

64. More prescriptive guidance should encourage a further move away from short termism in pay policies. We have set out our case for a simpler, more transparent structure based primarily on basic salary and long-term incentives. Bonuses should, in principle, be shared more evenly throughout the workforce and should recognise wider goals of companies than financial performance, such as environmental and social factors. Whatever structure is adopted, there should be a stronger emphasis on clear explanation to shareholders and the public on the justification for pay structure and any increases in executive pay.

65. Ideally, all companies should be able to show sensitivity to the society in which they are able to flourish by keeping pay reasonable. The 2014 reforms have had some positive impact, and post-2016 measures will take us slightly further; but we are far from there yet. Consequently, we believe that the climate for excessive executive pay needs to be made sufficiently hostile and damaging to reputations that no-one in the decision-making chain would be prepared to countenance it. Our recommendations are aimed at this objective and we urge the Government and the regulators to support them.

183 Big Innovation Centre, The Purposeful Company (CGP0024); Letter from Clare Chapman, 15 June 2018.

Conclusions and recommendations

Recent developments

1. Taken as a whole, since 2014 companies have continued to share the rewards of their success largely with their shareholders, in the form of dividends, and with the senior management in the form of multi-million pound pay packages, rather than sharing the proceeds more evenly amongst their workforce, who sustain the business, through pay and pension contributions. Huge differentials in pay between those at the top and bottom remain the norm. Executive greed, fed by a heavy reliance on incentive pay, has been baked in to the remuneration system. With that comes a public perception of institutional unfairness that, if not addressed, is liable to foment hostility, accentuate a sense of injustice and undermine social cohesion and support for the current economic model. (Paragraph 10)

2. We are fully supportive of the case for a more empowered, aggressive and proactive regulator that has the ability to take decisive action, where necessary, on executive pay and its reporting. We look forward to the establishment of the new regulator as soon as possible. (Paragraph 11)

3. We welcome the revised Corporate Governance Code's improvements on remuneration guidance, such as the requirements to consider the long-term remuneration across the whole workforce and potential reputational risks. But the Code alone is unlikely to be an effective driver of change. *We recommend that the new regulator clarifies and strengthens its guidance on executive remuneration with a view to exerting significant downward pressure, avoiding unjustifiable payments and ensuring that, if they are made, they can be readily recovered.* (Paragraph 15)

4. We welcome the new reporting requirements but are not convinced that they alone will lead to greater alignment between remuneration and company objectives. *We recommend that the new regulator monitors how remuneration reports and better reporting against section 172 of the Companies Act meet the aims of increased transparency and alignment of pay with objectives.* (Paragraph 16)

5. *We recommend that the new regulator monitors companies' compliance with the Corporate Governance Code with a view to making an assessment of which method of engagement proves most effective and recommending changes.* (Paragraph 17)

6. The explanations on workforce engagement sought by the revised Code are an improvement, but they are not an adequate substitute for the permanent engagement achieved by remuneration committee membership. *We recommend that companies should be required to appoint at least one employee representative to the remuneration committee to ensure that there is full discussion of the link between executive pay and that of the workforce as a whole.* (Paragraph 19)

7. We welcome the introduction of new requirements to publish pay ratios, which will allow meaningful comparisons to be made, at least within sectors, and require companies to explain when and why they have chosen to pay above reasonable expectations. Over time, we expect sector norms to develop, potentially with the active intervention of the regulator. By highlighting the link between executive and

employee pay, the gap between them should, with public and peer pressure over time, reduce. To assist and broaden this objective, *we recommend that pay ratio reporting requirements be expanded to include all employers with over 250 employees and that the lowest pay band be included alongside the quartile data required.* (Paragraph 23)

8. *There is no reason why companies, including major legal partnerships, that can readily calculate these pay ratios should not report them first in their 2019 annual reports and we recommend that they do so. We further recommend that the new regulator takes to task any company or firm that fails to explain adequately how they have taken into account pay ratios when determining levels of remuneration, particularly when pay ratios significantly exceed sector norms.* (Paragraph 24)

9. We welcome the development of the Public Register by the Investment Association as it provides greater transparency for investors on how companies engage with their shareholders. It has demonstrated that remuneration remains a key source of discontent for shareholders. *We agree that the focus should remain on those companies which ignore shareholder concerns on pay and recommend that the new regulator explores more effective sanctions than a letter from the Investment Association.* (Paragraph 27)

10. We welcome the publication of the corporate governance principles for private companies as a foundation upon which the new regulator should build robust and more enforceable guidance on pay and other matters. *We recommend that the new regulator takes on responsibility for monitoring the impact of the Code and examines the case for greater disclosure around remuneration and for expanding its application more widely.* (Paragraph 29)

11. *We cannot understand why the Secretary of State would want to block the publication of an independent study and recommend that the review of share buy backs is published without further delay. We further recommend that remuneration reports include analysis of the impact on executive remuneration of any share buy backs during the reporting period.* (Paragraph 30)

Structure of pay

12. In principle, we believe that there should be greater certainty in executive pay. This should be balanced by a significant reduction in the maximum that may be earned and that the rewards from good performance should be more evenly shared: there should be a stronger and more visible link between rewards at the top and bottom. (Paragraph 32)

13. We recognise that most listed companies will not be putting new pay policies before shareholders in a vote until 2020. However, without external pressure before then, and given the different views on the use of incentives in pay packages, any reform is likely to be slow. (Paragraph 35)

14. We believe that executive pay should be simplified, more obviously geared to promoting companies' long-term objectives, and be linked more closely to that of the workforce as a whole. Greater transparency and simplicity will help shareholders hold boards to account. We favour a simple structure based on fixed basic salary

plus deferred shares, vesting over a long period, but subject to conditions to avoid "rewarding failure". Care needs to be taken to ensure that reforms are coherent as a package and do not permit gaming. We also support the greater use of profit sharing or other schemes designed to share profits more evenly. Over time, the proportion of variable pay (including bonuses, share options and profit sharing) should be reduced substantially. The increase in certainty associated with proportionately more fixed pay should, if well managed, lead to a reduction in total remuneration awarded. *As a matter of practice, and to reduce the risk of Persimmon-type awards and associated reputational damage, we recommend that Remuneration Committees should set, publish and explain an absolute cap on total remuneration for executives in any year. The new regulator should be more prescriptive and interventionist, where necessary, in pursuit of these objectives and be prepared to publicly call out poor practice or behaviours.* (Paragraph 37)

15. Chief executives, and shareholders, should be stewards of the long-term and broad interests of their companies rather than pursuing short-term financial goals: they should be rewarded accordingly. We believe that the performance measures governing the payment of annual bonuses should be aimed at encouraging and rewarding increased productivity and also support the company's wider responsibilities under section 172 of the Companies Act to have regard to the interests of its customers, suppliers and workforce. *We recommend that the new regulator engages with investors to develop guidelines on bonuses to ensure that they are genuinely stretching and a reward only for exceptional performance, rather than being effectively an expected element of annual salary.* (Paragraph 42)

16. We welcome The Investment Association's announcement in February 2019 that it will monitor and flag up any company that pay pension contributions to new directors in a way not aligned to the majority of the workforce and *we recommend that the new regulator seeks public explanations from any company that fails to deliver alignment on pensions contributions.* (Paragraph 43)

Engagement by companies on pay

17. We welcome the increased attention on executive pay but recognise that much more than engagement will be required to drive a more enlightened and acceptable approach on executive pay. (Paragraph 47)

18. Remuneration committees have helped fuel the excessive levels of executive pay we see today. *We recommend that remuneration committees engage early and meaningfully with major investors on executive pay, be prepared to make the case for pay reform and restraint in the interests of avoiding reputational damage. We recommend that the new regulator seeks to ensure that these activities are properly explained in remuneration reports.* (Paragraph 51)

19. The Minister made it clear that she sees the role of Government is to provide shareholders with the tools to hold boards to account. We do not have confidence that they will use these tools and create the competitive market in stewardship that should ideally develop. We understand that investors can exert valuable influence behind the scenes but we believe that their stewardship role includes a wider responsibility to help set the boundaries of acceptable practice on executive

pay and to promote long-term performance. This should include a commitment to comment publicly when necessary and a requirement to explain their policies and voting records. The final Stewardship Code should make this explicit and be applied strictly and consistently by relevant regulators, including the Financial Conduct Authority. (Paragraph 56)

20. We believe that primary responsibility for changing the environment on executive pay rests with asset owners, rather than asset managers. In this context, *we recommend that the guidance in the new Stewardship Code includes a requirement for asset owners to provide much more detailed information about their objectives, including those in relation to executive pay. Given that the Stewardship Code is only advisory, and that existing Code has been widely ignored, we recommend that the new regulator is given the necessary powers to take effective action against those asset owners that do not sign up to, or meet their responsibilities, under the Code.* (Paragraph 58)

21. *We recommend that proxy agents tailor their policy guidelines and advice to individual investors so as to resist excessive and poorly designed pay policies and awards.* (Paragraph 60)

22. At present, we do not believe that the incentives of all those involved in the investment chain are sufficiently aligned and attuned to the wider social responsibilities of companies. Nor do we believe that it is realistic to expect better stewardship to be an effective driver of reform of executive pay. We agree with the Kingman Review that, even its revised version, the Stewardship Code is not fit for purpose. *We recommend that the new regulator revises the Stewardship Code to ensure that it is able to not just encourage, but deliver, genuine and effective engagement between companies and their shareholders on executive pay in a way that requires both parties to discharge their responsibilities transparently and accountably.* (Paragraph 61)

Formal minutes

Tuesday 19 March 2019

Members present:

Rachel Reeves, in the Chair

Vernon Coaker	Albert Owen
Drew Hendry	Mark Pawsey
Stephen Kerr	Antoinette Sandbach
Ian Liddell-Grainger	Anna Turley
Sir Patrick McLoughlin	

Draft Report (*Executive rewards: paying for success*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 65 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Eighteenth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Tuesday 26 March at 9.15 am

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Wednesday 6 June 2018	*Question number*
Charles Cotton, Senior Performance and Reward Adviser, Chartered Institute of Personnel and Development; **Clare Chapman**, Remuneration Committee Chair, Weir Group; **Marion Sears**, Remuneration Committee Chair, Persimmon	Q229–364
Andrew Ninian, Director, Stewardship and Corporate Governance, Investment Association; **Robert Hodgkinson**, Executive Director, Technical, ICAEW; **Sarah Wilson**, Chief Executive, Minerva Analytics Ltd; **Euan Stirling**, Global Head of Stewardship and ESG Investing, Aberdeen Standard Investments	Q365-408
Tuesday 16 October 2018	
Orna Ni-Chionna, Chair, Remuneration Committee, Royal Mail Group; **Peter Newhouse**, Director, Executive Vice President for Reward, Unilever; **Bruce Duguid**, Head of Stewardship, Hermes Equity Ownership Services	Q409–518
Luke Hildyard, Director, High Pay Centre; **Georgina Marshall**, Head of Global Research, Institutional Shareholder Services (ISS); **Alan MacDougall**, Managing Director, Pensions & Investment Research Consultants Ltd (PIRC); **Tom Gosling**, Partner, PwC	Q519–552
Tuesday 22 January 2019	
Paul George, Executive Director, Corporate Governance and Reporting, Financial Reporting Council; **Janet Williamson**, Senior Policy Officer, TUC; **Catherine Howarth**, CEO, ShareAction	Q553–605
Kelly Tolhurst MP, Minister for Small Business, Consumers and Corporate Responsibility, Department for Business, Energy and Industrial Strategy; **Sanu de Lima**, Deputy Director, Corporate Governance Reform, Department for Business, Energy and Industrial Strategy	Q606–654

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

CGP numbers are generated by the evidence processing system and so may not be complete.

1 Aberdeen Standard Investments (CGP0039)

2 Association of Accounting Technicians (AAT) (CGP0016)

3 Big Innovation Centre, The Purposeful Company (CGP0024)

4 CIPD (CGP0030)

5 CORE Coalition & Oxfam GB (CGP0027)

6 Employment Lawyers Association (CGP0023)

7 Glass Lewis (CGP0040)

8 Hermes Equity Ownership Services (CGP0031)

9 Hermes Investment Management (CGP0045)

10 High Pay Centre (CGP0038)

11 ICAEW| (CGP0033)

12 ICSA: The Governance Institute (CGP0034)

13 Institute of Directors (CGP0035)

14 Institutional Shareholder Services (ISS) (CGP0041)

15 Minerva Analytics Ltd (CGP0042)

16 Mr Michael Nisbet (CGP0043)

17 Mr Michael Romberg (CGP0044)

18 Professor Alex Edmans (CGP0028)

19 PwC (CGP0026)

20 Taylor Wimpey plc (CGP0036)

21 The Investment Association (CGP0029)

22 Trades Union Congress (CGP0037)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website. The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2017–19

First Report	A framework for modern employment	HC 352 (HC 966)
Second Report	Leaving the EU: implications for the civil nuclear sector	HC 378 (HC 881)
Third Report	The safety of Electrical Goods in the UK	HC 503 (HC 920)
Fourth Report	Pre-legislative scrutiny of the draft Domestic Gas and Electricity (Tariff Cap) Bill	HC 517 (HC 865)
Fifth Report	The impact of Brexit on the automotive sector	HC 379 (HC 1018)
Sixth Report	The impact of Brexit on the aerospace sector	HC 380 (HC 1049)
Seventh Report	The impact of Brexit on the processed food and drink sector	HC 381
Eighth Report	Pre-appointment hearing with the Government's preferred candidate for Chair of the Competition and Markets Authority	HC 985
Ninth Report	The impact of Brexit on the pharmaceutical sector	HC 382
Tenth Report	Carillion	HC 769
Eleventh Report	Pre-appointment hearing with the Government's preferred candidate for Chair of Ofgem	HC 1353
Twelfth Report	Draft National Policy Statement for Geological Disposal Infrastructure	HC 1092
Thirteenth Report	Gender pay gap reporting	HC 928
Fourteenth Report	Electric vehicles: driving the transition	HC 383
Fifteenth Report	Small businesses and productivity	HC 807
Sixteenth Report	The response from business to the Withdrawal Agreement and Political Declaration	HC 384
Seventeenth Report	Industrial Strategy: Sector Deals	HC 663
First Special Report	Industrial Strategy: First Review: Government Response to the Committee's Second Report of Session 2016–17	HC 337

Second Special Report	Corporate governance: Government Response to the Committee's Third Report of Session 2016–17	HC 338
Third Special Report	Apprenticeships: Government Response to the Second Joint Report of Session 2016–17	HC 450
Fourth Special Report	Leaving the EU: negotiation priorities for energy and climate change policy: Government Response to the Committee's Fourth Report of Session 2016–17	HC 550
Fifth Special Report	Pre-legislative scrutiny of the draft Domestic Gas and Electricity (Tariff Cap) Bill: Government Response to the Committee's Fourth Report	HC 865
Sixth Special Report	Leaving the EU: implications for the civil nuclear sector: Government response to the Committee's Second Report	HC 881
Seventh Special Report	The safety of Electrical Goods in the UK Government Response to the Committee's Third Report	HC 920
Eighth Special Report	A framework for modern employment: Government response to the Second Report of the Work and Pensions Committee and First Report of the Business, Energy and Industrial Strategy Committee of Session 2017–19	HC 966
Ninth Special Report	The impact of Brexit on the automotive sector: Government Response to the Committee's Fifth Report	HC 1018
Tenth Special Report	The impact of Brexit on the aerospace sector: Government Response to the Committee's Sixth Report	HC 1049
Eleventh Special Report	The impact of Brexit on the pharmaceutical sector: Government Response to the Committee's Ninth Report	HC 1426
Twelfth Special Report	Carillion: Responses from Interested Parties to the Committee's Tenth Report	HC 1392
Thirteenth Special Report	Carillion: Government response to the Committee's Tenth Report	HC 1456
Fourteenth Special Report	The impact of Brexit on the processed food and drink sector: Government Response to the Committee's Seventh Report	HC 1461
Fifteenth Special Report	Electric vehicles: driving the transition: Government Response to the Committee's Fourteenth Report	HC 1881
Sixteenth Special Report	Gender pay gap reporting: Government Response to the Committee's Thirteenth Report	HC 1895