

Business, Energy and Industrial Strategy Committee
House of Commons
London
SW1A 0AA

Tuesday 8th May 2018

Call for evidence: Executive Pay

Thank you for giving the Institute of Directors (IoD) the opportunity to participate in this call for evidence concerning executive pay. The below answers the questions outlined by the committee as well as providing further thinking on the topic of executive pay from the IoD.

About the IoD

The IoD was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of approximately 33,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 49% of FTSE 100 companies and 45% of FTSE 350 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises (SMEs), ranging from long-established businesses to start-up companies. IoD members' organisations are entrepreneurial and growth-orientated, and more than half (61%) export goods and services internationally.

The IoD has long been an advocate of high standards of corporate governance. According to our Royal Charter, one of the IoD's key objectives is "to promote the study, research and development of the law and practice of corporate governance, and to share findings." We strongly believe that an effective system of corporate governance is a key underpinning of UK economic performance and business legitimacy. Our response to this consultation is divided into three sections:

i) Summary of our view

ii) Responses to the specific consultation questions

Summary of our view

Background:

- While a perception of excessive executive pay has been an issue for a number of years, public disquiet over the issue has increased in recent years as executive pay at the UK's very largest listed companies has continued to rise. The previous committee highlighted in its report that nearly three quarters of employees believe that CEO pay in the UK is generally too high; survey evidence also suggested that public anger over pay remains the most pressing threat to the reputation of business.¹

¹ [House of Commons Business, Energy and Industrial Strategy Committee Corporate governance Third Report of Session 2016–17](#)

- Various attempts to address the issue over the past two decades through regulation do not appear to have had the effect desired by policy makers. While there has been some recent ‘slowing’ in the pace of remuneration increases, the median pay package of top bosses has still risen by 82% in the past 13 years.²
- Attempts to tie pay to performance have focused on share price and earnings per share as indicators of success, primarily through their use in the construction of Long Term Incentive Plans (LTIPs).
- It should be noted that a report by the CIPD and the High Pay Centre has shown that average pay for a FTSE 100 CEO has dropped to £4.53 million in 2016, a decrease from £5.44 million in 2015, but still higher than the £4.13 million posted in 2010. In 2016, the average pay ratio between FTSE 100 CEOs and their employees was 129:1. In 2015, the ratio was 148:1.³

IoD position on high pay:

- We recognise that excessive executive pay is an issue and it can have a damaging effect on companies, especially in terms of public trust in business. Increasingly complex methods of remuneration have in fact raised scepticism.
- IoD members are among the many business leaders who share this public unease concerning executive pay. The majority are SME business owners whose own remuneration bears no similarities with those packages enjoyed by senior executives in the FTSE 100.
- We believe that companies should retain the right to set executive pay and should be free to do so in a manner which allows them to attract, retain and reward talent. Furthermore, as the principle providers of risk capital, shareholders have a legitimate role in influencing pay practices.
- Over a decade of well-intentioned policy reforms aimed at influencing executive remuneration, policies have had little impact on levels of pay. Some of them have also had unintended consequences, contributing to rising pay in some cases. For example, the move to make pay more transparent, rather than ‘shame’ firms into reducing pay, has in some cases led to a ratcheting of remuneration as companies may compete with each other to pay the most.
- While we understand where the impetus for reform to the system of executive pay comes from, and indeed that there are individual examples where the subsequent public anger is justified, the IoD would caution any rush in implementing further legislation while the impact of the last round of reforms is still ‘bedding in’.
- Steps should be taken by remuneration committees and boards to make pay packages more legitimate and transparent. Shareholders should also exercise sufficient stewardship over pay policies and packages.

Key recommendations

- One major issue is that some companies’ remuneration packages are opaque and difficult to fully understand. This could lead to misinformed votes by shareholders on proposed pay policies and a lack of meaningful oversight from other stakeholders. A push for simplified and easy to understand pay packages is therefore desirable and the investment community should be encouraged to demand this from companies they are invested in.
- Remuneration committees should seek to model the potential highs and lows of a proposed package clearly so that shareholders are aware of what they are voting for.

² [CFA Society of the United Kingdom \(CFA UK\) An Analysis of CEO Pay Arrangements and Value Creation for FTSE-350 Companies. Dec 2016](#)

³ [CIPD & High Pay Centre: Executive pay: review of FTSE 100 executive pay packages](#)

- The UK Corporate Governance Code should also be amended to require boards to report on the use of share ‘buybacks’ and any impact this has had on executive bonuses.
- The Code should also be amended to encourage boards to give greater specificity on the circumstances where they would seek to ‘claw back’ bonuses and ensure that this wording is in line with that found in executive employment contracts.

Specific responses to Consultation Questions

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

Our approach to this question will be to list each of the recommendations which the previous Committee made in its 2017 report on Corporate Governance and then evaluate the degree to which it was implemented, highlighting subsequent reforms which, if not fully matching the previous Committee’s recommendation, at least captures the ‘spirit’.

Recommendation: *We recommend that companies make it their policy to align bonuses with broader corporate responsibilities and company objectives and take steps to ensure that they are genuinely stretching. Policy in this respect would be considered by the FRC in their corporate governance rating system.*

In the most recent consultation on revisions to the UK Corporate Governance Code⁴, the Financial Reporting Council has continued to develop the recommendations regarding remuneration which companies will have to comply with. One of the recommendations includes:

- *Provision O. The board should satisfy itself that company remuneration and workforce policies and practices promote its long-term success and are aligned with its strategy and values.*

This is then further complimented by the following Principles:

- *Principle 33. The remuneration committee should have delegated responsibility for determining the policy for director remuneration and setting remuneration for the board and senior management. It should oversee remuneration and workforce policies and practices, taking these into account when setting the policy for director remuneration.*
- *Principle 40. Executive remuneration should support long-term company performance and value generation. When determining executive director remuneration policy and practices, the remuneration committee should address the following:*

- *Clarity – remuneration arrangements should be transparent and facilitate effective engagement;*
- *Simplicity – remuneration structures should avoid complexity; their rationale and operation should be easy to understand;*
- *Predictability – the range of possible values of rewards to individual directors should be identified and explained at the time of approving the policy;*
- *Proportionality and reward for individual performance – there should be a demonstrable link between individual awards and the long-term performance of the company. Outcomes should not reward poor performance and total rewards available should not be excessive; and*

⁴ [FRC – Proposed Revisions to the UK Corporate Governance Code – Appendix A Revised UK Corporate Governance Code](#)

- *Alignment to culture – incentives should drive behaviours consistent with company purpose, strategy and values.*

We believe that Principle O alongside Provisions 33 and 40 capture some of what the previous Committee was calling for in this recommendation. They task the remuneration committee to factor in consideration of the company’s wider strategy, values and wider workforce policies and practices. We suggest that these changes to the Code are given time to bed into organisations before further changes are put forward. The Committee may be minded to evaluate the quality of reporting on these provisions and principles further down the line.

Recommendation: We recommend that the FRC consults with stakeholders with a view to amending the Code to establish deferred stock rather than LTIPs as best practice in terms of incentivising long-term decision making. Overall, we recommend that this consultation should develop guidelines for the structure of executive pay with the following features:

- **A simpler structure based primarily on salary plus long-term equity, to divest over a genuinely “long-term” period, normally at least five years, without large steps;**
- **Limited use of short-term performance-related cash bonuses, which should be aligned, where possible, to wider company objectives or corporate governance responsibilities;**
- **Clear criteria for bonuses: they should be genuinely stretching and be aimed to provide incentives rather than just reward.**

There has been progress relating to this recommendation. Namely through the proposed revision to the UK Corporate Governance Code:

- *Provision P. A formal and transparent procedure for determining director and senior management remuneration should be established. Performance-related elements should be clear, stretching, rigorously applied and aligned to the successful delivery of the strategy.*

Furthermore the move from three to five year vesting periods is seen in the following proposed provision:

- *Provision 36. Remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests. In normal circumstances, shares granted or other forms of long-term incentives should be subject to a vesting and holding period of at least five years. Longer periods, including post-employment periods, may be appropriate.*

The IoD firmly supports a move away from LTIPs as the preferred vehicle for performance related pay in listed companies. Policy makers, remuneration committees and shareholders should be encouraging companies to explore more transparent alternatives, particularly focusing on the replacement of LTIPs with cash and restricted equity awards which vest over a relatively long period of time and which are subject to reasonable claw back criteria. Examples of companies which have chosen to approach the issue differently should be examined and, where successful, highlighted to the market. One FTSE constituent, Weir Group, recently implemented a scheme such as this and we would suggest the Committee looks to speak to both company representatives and major shareholders in Weir to learn from their experience.

Recommendation: We recommend that the FRC revises the Code to include a requirement for a binding vote on executive pay awards the following year in the event of there being a vote against such a vote of over 25 per cent of votes cast. This requirement should be included in legislation at the next opportunity.

While not in specific reference to shareholder votes on pay, the FRC in its revision to the UK Corporate Governance Code sets out the following:

- *Provision 6. When more than 20 per cent of votes have been cast against a resolution, the company should explain, when announcing voting results, what actions it intends to take to consult shareholders in order to understand the reasons behind the result. An update should be published no later than six months after the vote. The board should then provide a final summary in the annual report, or in the explanatory notes to resolutions at the next meeting, on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed.*

As well as this, the Investment Association has begun to produce a public register of companies receiving a vote against a resolution of 20% or more.

These two changes in tandem embrace the spirit of the previous Committee recommendation and the IoD believes that time should be given to see if this encourages change.

Recommendation: *We recommend that any Chair of a remuneration committee should normally have served on the committee for at least one year previously. To further incentivise strong engagement, we recommend that the Chair of a remuneration committee be expected to resign if their proposals do not receive the backing of 75 per cent of voting shareholders.*

The first part of this recommendation has been broadly taken up. The proposed revisions to the UK Corporate Governance Code include the following:

- *Provision 32. The board should establish a remuneration committee of independent non-executive directors with a minimum membership of three. The chair of the board should not chair the committee and can only be a member if independent. Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months.*

We do not agree with this new addition to the Code. It is too prescriptive and we are not convinced that it will do much to improve remuneration outcomes. Furthermore, if such a recommendation were to apply to the chair of remuneration committees, there is a case for introducing similar conditions for the chairs of other board committees, e.g. the audit committee. We note that a similar experience requirement is not being applied to the chairs of these other committees, and believe that the remuneration committee chair should not be singled out for a different approach.

The recommendation by the previous Committee to require chairs to step down where a proposal has failed to receive 75% or more support is overly formulaic and could lead to undue turnover and disruption to the remuneration committee. It would surely be preferable to have the architect of the proposal in place to respond to minority shareholder dissent. There is already a well-established mechanism for shareholders to remove a director and this should remain.

Recommendation: *We recommend that companies should set out clearly their people policy, including the rationale for the employment model used, their overall approach to investing in and rewarding employees at all levels throughout the company, as well as reporting clearly on remuneration levels on a consistent basis. The FRC should consult with relevant bodies to work up guidance on implementing this recommendation for inclusion in the Code*

This recommendation has been taken up to a degree in the reporting requirement proposed by the FRC in the revision to the UK Corporate Governance Code;

- *Provision 41. There should be a description of the work of the remuneration committee in the annual report which should include:*
 - *an explanation of the strategic rationale for executive directors' remuneration policies, structures and performance metrics;*
 - *reasons why the remuneration is appropriate using internal and external measures;*
 - *whether the remuneration policy operated as intended in terms of company performance and quantum, and, if not, what changes are necessary;*
 - *what engagement has taken place with shareholders and the impact this has had on remuneration policy and outcomes;*
 - *an explanation of the company's approach to investing in, developing and rewarding the workforce, and what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company policy; and*
 - *to what extent remuneration outcomes have been affected by board discretion.*

Recommendation: We recommend that the FRC works with other relevant stakeholders on the detail and amends the Code to require the publication of pay ratios between the CEO and both senior executives and all UK employees. We further recommend that the Government requires that equivalent pay ratios should be published by public sector and third sector bodies above a specified size.

The Government has outlined plans to require that companies report on the pay ratio between the CEO and average employee.

We are sceptical about the impact that the publication of executive pay ratios will have on the issue of executive pay at individual companies. Companies differ greatly in terms of their average level of pay depending on their size and sector. For example, the average level of pay at an investment bank is likely to be significantly higher than at a supermarket group. Hence it will be difficult to compare pay ratios across companies and draw conclusions about whether executive pay at a specific company is too high or too low.

Where the pay ratio is perhaps of most interest as an economic indicator is at the level of the overall economy. This aggregate figure does tell us something interesting about the development of executive pay over the last couple of decades - namely that overall rates of increase at major listed companies have been excessive relative to the rewards enjoyed by other stakeholders

Overall, the IoD feels that the right balance has been struck in terms of implementation of the previous Committee's recommendations which can have a meaningful and positive effect on the issue of executive pay, and ensuring there is not an overly prescriptive approach. While there is still work to be done on the issue, especially in relation to ensuring that pay is tied to long-term performance and that it is presented in a clear and simple manner to all stakeholders, we would argue that the current raft of changes, many of which are still to be implemented, should be given time to bed in and be evaluated before any further action is taken from a regulatory or legislative approach.

2) What improvements have been made to reporting on executive pay in the last 12 months?

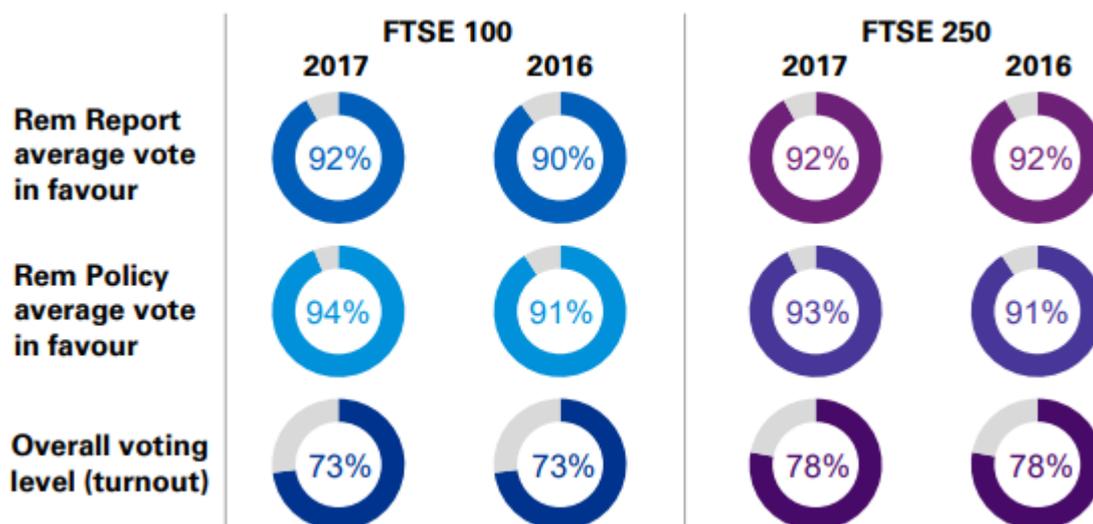
This has by and large been covered in the previous answer. That being said, two trends in executive pay reporting which the events of the past 12 months have thrown up are mentioned below:

-Claw back provisions; In the wake of the Carillion collapse, we believe that the Code should be more explicit about the circumstances in which claw back of executive bonuses should occur. As a minimum, claw back should be required in cases of gross misconduct, material accounting restatements and corporate insolvency. Furthermore, boards should ensure that any wording in relation to the claw back of bonuses in their remuneration report is in line with that found in director’s service contracts.

-Share buy backs: We recommend that remuneration reporting should include an indication of the extent to which executive remuneration outcomes have arisen due to share buyback activities. The Government has also announced that it will be looking into this issue.

3) What steps have been taken by Remuneration Committees and institutional investors to combat excessive executive pay in the last 12 months?

The graphic below shows the voting patterns for executive pay resolutions at FTSE 100 and 250 companies for 2016 and 2017.



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This shows that both turnout levels and votes in favour remained broadly the same and just two remuneration reports were voted down across the FTSE 350 in 2017 (at Pearson and Crest Nicholson) and all remuneration policy resolutions were passed by shareholders.⁶

While this may give the impression of continuity in board and shareholder engagement on the issue, anecdotal evidence points towards a higher level of dialogue occurring before votes in part due to 2017 being a year where binding votes on pay policies were required by a large number of companies.

4) What further measures should be considered?

In addition to our call for further action on claw back provisions and the use of share buy backs - which can be found in our response to the FRC consultation of the UK Corporate Governance Code⁷ - we have the following suggestion;

⁵ [KPMG / Makinson Cowell – The 2017 AGM Season Final Review](#)

⁶ [KPMG / Makinson Cowell – The 2017 AGM Season Final Review](#)

⁷ [IoD Response to Proposed Revisions to the UK Corporate Governance Code](#)

-Encourage the take up of simpler alternatives to LTIPs in executive pay. Policy makers and shareholders should encourage companies to follow the example of those companies that have moved from the LTIP system to a simpler more plural form of executive incentive packages. Weir Group, as already mentioned, recently received 92% shareholder approval for a resolution to change its incentive plan for executives. Under its new scheme, executives are given shares that pay out over seven years, without the three-year performance conditions found in most long-term plans. The overall potential award level is significantly lower as a result of the certainty of pay out the new scheme gives executives and there is also a mechanism which allows the board to reduce the amount if necessary to avoid paying for failure.

While it is naturally far too early to measure the success of this particular scheme, the high shareholder approval level and positive media reaction displays an appetite for such reform.

That said, we firmly believe that the ultimate decision for what scheme a company wishes to use should remain with the board of directors and be approved by shareholders.

I hope you have found our comments helpful. If you require further information about our views, please do get in touch.

Kind regards,

Dr. Roger Barker
Head of Corporate Governance
Institute of Directors
Tel: +44 (0)7814 386 130
Email: roger.barker@iod.com

James Jarvis
Corporate Governance Analyst
Institute of Directors
Tel: +44 (0)7718584191
Email: james.jarvis@iod.com