Inspiring business

Business Manifesto Part II

Reforming Corporate Governance

Enhancing Britain's competitive advantage

Election 2017 | *Let's push things forward*

Overview

The quality of UK corporate governance is one of our competitive advantages as an economy, but these standards must constantly be reinforced. It is impossible for the regulatory system alone, no matter how complex and well-meaning, to guarantee the sort of corporate behaviour we would all like to prevail. However with the correct balanced framework in place, behaviours can develop organically and in tune with the needs of the time. We believe that good corporate citizenship is determined by the structures, culture and attitudes of boards.

Proposals for all parties:

1. Develop a Code of Governance for the largest unlisted companies

Currently, only listed firms have to follow a governance code of practice: the Corporate Governance Code overseen by the Financial Reporting Council. This forces them to either comply with the rules, for example on the number of independent directors, or explain why they haven't. For the vast majority of unlisted companies, most of which are small or medium-sized businesses, a code would be excessive and unnecessarily bureaucratic. However, there are a number of large unlisted companies – BHS was a prominent example before it collapsed – whose size means that some additional scrutiny is justified. A code for large private companies which is similar to, but not as prescriptive as, the FRC's main code, would open up the 'black box' of corporate governance in these firms.

2. Strengthen power of shareholders over executive pay

There have been several shareholder rebellions over executive pay this year, but this activism remains a rarity. In 2016 only 3% of FTSE 100 companies saw more than 50% of shareholders vote to reject pay proposals. To strengthen investor oversight, where a vote on pay has been opposed by at least 30 per cent of shareholders, the IoD is calling on the next government to compel premium listed companies to amend their policy and offer a second vote. This will force boards to consult shareholders more before voting begins, and encourage them to pre-emptively address concerns over pay.

3. Encourage director training and board evaluation

Directors, and particularly non-executive directors, require knowledge and skills to perform the role, beyond commercial experience. Independent non-execs have a vital function in holding the management to account and constructively probing their decision. Directors at companies of all sizes can benefit from job-specific training, and after the election, the IoD would urge to Government to increase the focus in this area. Revising the Corporate Governance Code to increase the expectation that directors had undertaken some formal training would be a positive step.

Context

The credit crisis led to widespread public questioning about the roles and responsibilities of business leaders. As a natural part of this, the UK corporate governance framework has undergone substantial change with both UK and EU law makers playing a much more intrusive role in governance. There have also been wide-ranging changes to the UK Corporate Governance Code, UK company law, FCA regulation and EU legislation which affect companies in all sectors of the economy. For example, in recent years, there have been regulatory proposals (either implemented or pending) relating to executive remuneration, narrative reporting, beneficial ownership, employee ownership, audit market reform, accounting standards, and institutional investor stewardship. In the last six months both the House of Commons BEIS Select Committee and current Government have launched widespread consultations into governance following corporate scandals at Sports Direct and BHS. Despite this increased focus on corporate governance and behaviours we are still seeing critically low levels of public trust in business, and negative stories regarding executive pay still dominate the media. While we shouldn't make policy off the back of occasionally alarmist headlines, more still needs to be done to reassure the public that companies are engaged in good governance and focussing on the long-term benefit of the organisation and society in which they operate.

Policy-makers should seek to promote and incentivise greater stewardship and ownership behaviour within the investment management industry. Fund managers and other institutional investors play a key role in shaping the governance incentives and accountability faced by public companies. Their ability to exercise a long-term ownership role will be crucial to the performance of UK corporate governance in the years ahead. This is of particular importance given the rise of tracking funds where investment selection is simply determined by an index and the investor intention is to remain passive.

1. Develop a Code of Governance for the largest unlisted companies

An incoming Government should strive to encourage governance best practice amongst SMEs while eschewing the imposition of greater regulatory and compliance burdens on all but the very largest non-listed companies. The Business, Energy and Industrial Strategy Select Committee recommended that a corporate governance code for unlisted companies is established and monitored and enforced by the Financial

Reporting Council. In terms of the threshold for companies to participate, we would envisage starting with the largest employers; say those with over 2,000 employees. This threshold may be lowered over time as the Code gains credibility and becomes something that private companies actively want to comply with for reputational reasons. The government should take this recommendation forward in order to promote higher standards of corporate governance amongst large listed firms and to prevent the kind of corporate governance scandals that we have seen in recent years. As mentioned by the last Government in the Green Paper, the IoD produced a set of guidelines for unlisted companies in 2010 and this could provide the framework for any code going forward.

2. Encourage Government to consider the principle of incentivising – not legislating – for a longer-term approach to executive pay and shareholder behaviour

The investment management community plays a crucial role in encouraging such good governance as part of their service to clients. Fund managers invest in and engage with companies in order to promote sustainable long-term returns at the expense of short term opportunities. However, more oversight is required by fund managers, and the Government should look at working with the Financial Reporting Council to incentivise institutional funds to do more to promote long termism in the market and promote a longer-term approach to executive pay.

Many pay schemes contribute to short-term incentives either through the annual bonus or LTIPs (long-term incentive plans). This is part of a much broader problem involving short-term focused shareholders. Indeed, executive pay within the FTSE 100 has risen considerably over the last 10 years. The FTSE 100 is now trading at about 5% above its dotcom bubble peak, but executive pay over the same period has more than trebled and there is an increasingly-visible disparity between average wages and executive wages. This misalignment has resulted in widespread scepticism and loss of public confidence.

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.

3. Attach greater importance to the issue of director training and board evaluation processes

A new government should look to promote director training in order to improve corporate governance and boardroom diversity without the need for excessive and costly regulation. The government and the Financial Reporting Council both have an obligation to ensure that non-executive directors at our largest listed and unlisted companies are adequately trained. Insufficient attention has thus far been paid to this area and yet it remains a crucial issue. At the moment, the UK Corporate Governance Code places only limited emphasis on the importance of training, stating that all directors should “regularly update and refresh their skills and knowledge”. Regardless of their years of experience, all directors need help to understand the latest legal and regulatory parameters, as well as understanding their role, responsibilities and limitations at board level. We have called on the Financial Reporting Council and the Bank of England to place more emphasis on the professional development of directors. We would urge the next government to acknowledge the benefits of regular training and development for NEDs.

The IoD can provide particular guidance here in the form of our recently published Director Competency Framework. This framework outlines the knowledge, skills and mind-set we believe to be the essential requirements for effective board performance, and which every director can use to guide their professional development. We believe this framework is a significant contribution to establishing a recognised set of professional standards for directors, and is particularly notable for its broad application across sectors and industries and to any role on the board. It incorporates knowledge of director duties and compliance but goes beyond this in recognising the importance of interpersonal skills, ethical behaviour and a professional mind-set in delivering good governance.

Conclusion

The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company. Over two decades of constructive usage of the UK Corporate Governance Code has contributed to improved corporate governance in the UK. As part of a framework of legislation, regulation and best practice, the UK listed market has one of the best developed governance frameworks in the world and the quality of that framework remains a clear competitive advantage for the UK. The forthcoming Government should seize on this success and make strides towards promoting more long-termism in the equity markets, attaching greater importance to the training and development of non-executive directors through recognised training providers, such as the IoD, and working with shareholders to ensure they understand their roles and responsibilities as asset owners of listed companies.

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