House of Commons

Business, Energy and Industrial Strategy Committee

Executive rewards: paying for success: Government Response to the Committee's Eighteenth Report of Session 2017–19

Twentieth Special Report of Session 2017–19

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Business, Energy and Industrial Strategy Committee

The Business, Energy and Industrial Strategy Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Business, Energy and Industrial Strategy.

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Publication

Committee reports are published on the Committee's website at www.parliament.uk/beis and in print by Order of the House.

Evidence relating to this report is published on the inquiry publications page of the Committee's website.

Committee staff

The current staff of the Committee are Chris Shaw (Clerk), Alison Groves (Second Clerk), Ian Cruse, Becky Mawhood and Ashleigh Morris (Committee Specialists), James McQuade (Senior Committee Assistant) and Gary Calder (Media Officer).

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Twentieth Special Report

On 26 March 2019, the Business, Energy and Industrial Strategy Committee published its Eighteenth Report of Session 2017–19, on Executive rewards: paying for success (HC 2018). The response from the Government was received on 3 June 2019. The response is appended below.

Letter from Minister for Small Business, Consumers & Corporate Responsibility, 3 June 2019

Dear Rachel

BEIS Select Committee Report – 'Executive rewards: paying for success'

I would like to thank you and the BEIS Select Committee for your report on executive pay. As I said to the Committee when I attended the hearing in January, we appreciate the Committee's continuing interest in and contribution to the executive pay debate.

As the report acknowledges, the Government has recently overseen the implementation of a major package of reforms to strengthen the framework within which companies set executive pay. They include the introduction of pay ratio reporting requirements and stronger UK Corporate Governance Code provisions requiring remuneration committees to engage with the wider workforce to explain how executive pay fits with wider employee pay.

Our immediate priority is to focus on the effective implementation and then assessment of these reforms before considering any significant further changes. However, Government was clear in its response to the consultation on the Corporate Governance Reform Green Paper in 2017 that it would consider further action unless there is clear evidence that companies are taking active and effective steps to respond to significant shareholder concerns about executive pay outcomes.

The UK is rightly recognised as having a leading business environment and responsible business practices, but we will not hesitate to act where there is a need to do more to secure the Government's Industrial Strategy aim of ensuring our business environment and corporate governance continue to be world leading.

The Committee's recommendations are a useful contribution to the continuing public debate on high levels of executive reward and we look forward to future engagement with the Committee on this important issue.

Kelly Tolhurst MP

Minister for Small Business, Consumers & Corporate Responsibility

Appendix: Government Response

Introduction

The Government welcomes the Business, Energy and Industrial Strategy Committee's report on executive pay.

As the report acknowledges, the Government has recently overseen implementation of a major package of reforms to strengthen the framework within which companies set executive pay. They include:

- the introduction of a pay ratio reporting requirement under which public companies now have to disclose and explain the ratio of their CEO's annual remuneration to the average pay of the company's employees;
- stronger UK Corporate Governance Code provisions requiring remuneration committees to engage with the wider workforce to explain how executive pay fits with wider employee pay; and
- the establishment of a public register by the Investment Association which is shining a light on companies encountering significant shareholder opposition to their executive pay and how they are responding.

Very recently, the Government has legislated through The Companies (Directors' Remuneration Policy and Directors' Remuneration Report) Regulations 2019 to implement the executive pay aspects of the revised Shareholder Rights Directive. These regulations will give shareholders further useful information that they can use to assess how rewards to directors are matched by performance and to compare the annual change in directors' remuneration to the annual change in average employee pay over a rolling five-year period.

In addition, when the recommendations made in the Independent Review of the Financial Reporting Council have been implemented, the new regulator is expected to have stronger powers to monitor and enforce companies' compliance with relevant reporting requirements on executive pay and corporate governance. These are areas of reporting that are not fully within the scope of the regulator's current corporate reporting review powers.

These recent measures build on reforms introduced in 2013 under which public companies are required to disclose the total remuneration for each director every year and to bring forward a directors' remuneration policy at least once every three years which is then subject to a binding shareholder vote.

Taken together, the current UK framework gives shareholders the information and the powers with which to hold companies to account on executive pay. Shareholders are increasingly demonstrating their readiness to voice their dissatisfaction over executive pay when it is poorly structured or not matched by performance. There was a sharp rise in shareholder objections to FTSE100 executive pay last year—18 of the FTSE100 attracting shareholder opposition of 20% or more, double the number of the previous year.

The Government's immediate priority is to focus on the effective implementation and then assessment of the most recent reforms before considering significant further changes.

However, the Government was clear in its response to the consultation on the Corporate Governance Reform Green Paper in 2017 that it would monitor the impact of the reforms and would consider further action at a future point unless there is clear evidence that companies are taking active and effective steps to respond to significant shareholder concerns about executive pay outcomes.

The Committee's recommendations are a useful contribution to the continuing public debate on high levels of executive reward.

Recommendation 1[1]

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)

Government response

The governance of directors' remuneration is largely dealt with in the law. The Directors' Remuneration Report requires companies to disclose where any discretion has been exercised in respect of an award, how it was exercised and how the resulting level of award was determined. Recent changes to the Regulations now also require the remuneration committee chair to make a statement about any discretion exercised.

The revised UK Corporate Governance Code ("the Code") complements the Regulations. It expects executive remuneration policies to enable the use of discretion to override formulaic outcomes. If companies comply with this, it should ensure that remuneration committees are able to withhold performance-based remuneration which, in their judgement, is unjustifiable. Remuneration policies should also include provisions to enable the company to recover awards that have already been made and to specify the circumstances in which it would be appropriate to do so.

The Code applies on a "comply or explain" basis, so any company which does not provide for the use of discretion or clawback as a part of its remuneration policy has to explain publicly why that is the case in its annual corporate governance statement which forms part of the annual report.

Shareholders have powers to ensure that remuneration policies provide for the exercise of discretion and clawback because since 2013, companies have been required to put executive remuneration polices to a binding vote of shareholders at least once every three years.

Recommendation 2

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)

1 Note that the recommendations in the Committee's report were not numbered – numbers have been added in this response document for ease of reference

Government response

The Government will expect the new regulator to monitor remuneration reports and reporting against section 172 of the Companies Act as part of the expanded and strengthened corporate reporting review function recommended in the Independent Review of the FRC.[2]

In addition, the Government has committed to reviewing the impact of the new executive pay and other reporting requirements introduced through the Companies (Miscellaneous Reporting) Regulations 2018 after 5 years to assess their impact on businesses and the wider economy.[3]

Recommendation 3

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 [employee] engagement proves most effective and recommending changes. (Paragraph 17)

Government response

The revised Code applies from 1 January 2019, which means that companies will report on their compliance in 2020. The Government envisages the new regulator prioritising an assessment of how effectively companies are reporting against the new provisions in the revised Code. Further, based on that reporting, the regulator will be able to investigate the range of engagement techniques that companies have adopted in response to the revised Code. However, assessing the effectiveness of the engagement mechanisms themselves is a matter for the company and is an area on which shareholders should be ready to challenge a company’s management based on the new information being provided in annual reports.

Recommendation 4

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)

Government response

The Committee’s report acknowledges the strengthening of the Code which now expects remuneration reports to include an explanation of “what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy.” Companies are currently giving active consideration to how best to respond to this provision, and what form of engagement would be most effective. The range of methods adopted will become clear when companies first start reporting against this provision next year. The Government is aware that several companies are already considering inviting an employee representative to attend at least one meeting of the remuneration committee each year.

2 Independent Review of the Financial Reporting Council, recommendation 29

3 Explanatory Memorandum to the Companies (Miscellaneous Reporting) Regulations 2018 (paragraph 12.1). https://www.legislation.gov.uk/ukdsi/2018/9780111170298/memorandum/contents

The Government is clear, however, that the huge variety of UK companies and group structures mean one method will not suit all. That was a clear conclusion from our extensive consultation on the Corporate Governance Reform Green paper.

Recommendation 5

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)

Government response

The introduction of a pay ratio reporting for quoted companies is a significant reform. The Government intends to monitor the impact of this new requirement when reporting first begins next year before considering any potential extension to other types of employer or extending pay ratio reporting to include the lowest pay band.

The Government welcomes the decision of some limited liability partnerships and other employers to disclose pay ratios on a voluntary basis as a way of building trust with stakeholders.

The Wates Corporate Governance Principles for Large Private Companies which were developed at the Government's request and published last year should also encourage more voluntary disclosure. Principle five calls on boards to promote executive remuneration structures aligned to the long-term success of a company, taking account of pay and conditions elsewhere in the company. This principle also asks boards to consider the benefits of greater transparency about remuneration structures and suggests that this could extend to the voluntary disclosure of pay ratios.

Recommendation 6

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)

Government response

It is for quoted companies to decide whether to publish their pay ratios this year on a voluntary basis in anticipation of mandatory reporting next year. The Government, however, welcomes the fact that many quoted companies have decided to report their ratios on a voluntary basis. According to research carried out by Thomson Reuters Practical Law, 66 out of 185 FTSE350 company annual reports published and reviewed by Practical Law so far in 2018/19 have included pay ratio figures on a voluntary basis.

The Independent Review of the FRC recommended that the new regulator's corporate reporting review process should extend to cover the entire annual report, including corporate governance reporting and remuneration. The Government intends to implement this recommendation which will strengthen the regulator's ability to ensure compliance with reporting requirements.

Recommendation 7

We welcome the development of the Public Register by the Investment Association. . . 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)

Government response

The introduction of the Public Register is an important development focusing attention on companies who respond inadequately to shareholder concerns.

It is given added strength through provision 4 of the new Code which expects companies who have encountered shareholder opposition of 20% or more to any resolution to report publicly on three occasions on how they are responding to that opposition:

i) When the voting results are announced, the company must explain what actions it intends to take to consult shareholders to understand the reasons behind the result;

ii) No later than six months after the shareholder meeting the company should publish an update on the views received from shareholders; and

iii) The board should provide a final summary in the annual report or in the explanatory notes to resolutions at the next shareholder meeting, on whether the board has taken any action or proposed new resolutions following the feedback received.

The Government expects companies to respond to shareholder concerns. It was clear in its response to consultation on the Corporate Governance Reform Green Paper that it would monitor the impact of both the IA's public register and the stronger Code provision and would "consider further action at a future point unless there is clear evidence that companies are taking active and effective steps to respond to significant shareholder concerns about executive pay outcomes".[4]

Recommendation 8

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)

4 https://www.gov.uk/government/consultations/corporate-governance-reform (paragraph 1.46)

Government response

The Government expects that the new regulator along with the Coalition Group which developed the Wates principles will monitor the take up and impact of the new principles, building on plans already being developed by the FRC. We also expect that there will be wider stakeholder and academic interest in the impact of the principles and the new legal requirement for large private companies to report on their corporate governance arrangements.

Recommendation 9

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)

Government response

The Government is still considering the empirical research in the share buybacks study. We will be making an announcement in due course.

The Government expects that the impact of share buybacks should be taken into account by remuneration committees when determining whether a performance measure or target has been satisfied to ensure that remuneration outcomes reflect a directors' substantive contribution.

The FRC's revised Guidance on Board effectiveness[5] underlines this point. It suggests that circumstances such as currency fluctuations and the impact of a share repurchase schemes should lead remuneration committees to consider using discretion to ensure that remuneration outcomes are reasonable.

Recommendation 10

We believe that executive pay should be simplified . . . 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" . . . 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. . . 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)

5 https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code/frc-guidance-for-boards-and-board-committees

Government response

The Government encourages companies to consider a wider range of remuneration structures which take into account the particular circumstances of the company. It also supports the emphasis in the revised Code on remuneration committees addressing the need for simplicity and clarity in remuneration structures and arrangements.

There are clear and encouraging signs of more companies and shareholders being ready to consider and adopt alternatives to LTIPs. However, the Government believes that it is for companies and their shareholders to decide which model is most appropriate to each individual company.

As the Committee's report mentions, the Government's recent pay reporting legislation requires companies to set out the impact of a 50% increase in share price on remuneration outcomes. This is intended to be a prompt for companies and shareholders to consider whether potential outcomes are reasonable and whether a cap would be appropriate.

There are also other mechanisms for ensuring that pay remains reasonable and tied to an individual's performance. A provision in the Code states that remuneration schemes and policies should enable the use of discretion to override formulaic outcomes and companies are now required to state whether remuneration outcomes have been affected by the exercise of discretion. So too is the Code provision which requires companies to consider the predictability of outcomes from pay policies and the range of possible values of rewards to individual directors.

The Government believes, however, that it is for Remuneration Committees and shareholders to decide whether executive pay policies should set an absolute cap on total remuneration with the shareholders having a say through the binding vote on executive pay policies which is required at least every three years.

Recommendation 11

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)

Government response

The Independent Review of the FRC recommends that the regulator should engage at more senior level in a much wider and deeper dialogue with UK investors, including both fund managers and representatives of end-investors. It will be a matter for the new regulator, in liaison with investors to decide the extent to which it should be involved in developing guidelines on bonuses, taking into account the current legal requirements and the regulator's changing role.

Recommendation 12

We welcome The Investment Association's announcement in February 2019 that it will monitor and flag up any company that pays 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 pension contributions. (Paragraph 43)

Government response

The Committee's recommendation has already been met.

Provision 38 of the revised Code states that "the pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce." Code provisions apply on a "comply or explain" basis so any company which does not comply will have to explain the reasons as part of its corporate governance statement which forms part of the annual report.

Recommendation 13

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)

Government response

The Code expects boards to engage effectively with shareholders. There is also a specific Code provision which requires a description of the work of the remuneration committee in the annual report, including what engagement has taken place with shareholders and the impact this has had on remuneration policies and outcomes.

The Government agrees that the new regulator with stronger powers to review the entire annual report should ensure that these activities are properly explained.

Recommendation 14

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)

Government response

The Government believes it is the role of asset owners and asset managers as well as companies to consider pay and performance. The Stewardship Code is for both asset owners and asset managers, and the proposed revised guidance expects signatories to provide much more detailed information about their objectives, engagement and voting policies on a range of governance issues including executive pay.

The existing Code, and the tiering exercise undertaken in 2014, has ensured that more information is available about signatories' stewardship activities. The Government is now looking for the revised Code to place a significantly stronger emphasis on the outcomes and effectiveness of stewardship activity. The FRC is currently analysing responses to its recent consultation and will be bringing forward its plans for a new Code in due course.

Chapter 1b of the revised Shareholder Rights Directive which deals with institutional investors (in particular, pension and insurance funds), asset managers and proxy advisers will provide further impetus to more transparency about arrangements between the main participants in the investment chain. Chapter 1b includes new obligations on institutional investors to disclose and report annually on their investment strategy, including how they incentivise asset managers to engage with investee companies in order to improve their performance in the medium to long-term. This part of the Directive is due to be transposed on 10 June 2019.

The FRC's consultation on a revised Stewardship Code also invited views on the recommendation in the Independent Review of the FRC that consideration should be given to whether the regulator needs new powers to assess and promote compliance with the Code. The Government will be working with the FRC to ensure that the revised Code fully addresses this and other recommendations about the existing Code in the Independent Review.

Recommendation 15

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)

Government response

The Government does not have any comment to make on this recommendation.

Recommendation 16

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)

Government response

Revisions to the Stewardship Code are already in train designed to strengthen engagement between investors and the companies they are invested in and with a sharper focus on the outcomes and effectiveness of this stewardship activity. Areas included in the guidance on engagement include executive remuneration and other important matters such as strategy, culture and audit.