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high pay centre

REPORT | *January 2019*

RemCo reform:
governing successful organisations that benefit everyone

The CIPD is the professional body for HR and people development. The not-for-profit organisation champions better work and working lives and has been setting the benchmark for excellence in people and organisation development for more than 100 years. It has 150,000 members across the world, provides thought leadership through independent research on the world of work, and offers professional training and accreditation for those working in HR and learning and development.

The High Pay Centre is an independent, non-partisan think tank focused on the causes and consequences of economic inequality, with a particular interest in top pay. It runs a programme of research, events and policy analysis involving business, trade unions, investors and civil society focused on achieving an approach to pay practices that enjoys the confidence of all stakeholders.

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Report

RemCo reform: governing successful organisations that benefit everyone

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Acknowledgements

This report was researched and written by Luke Hildyard, Director of the High Pay Centre.

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1 Foreword

We're delighted to publish this report with the High Pay Centre exploring reform of how CEO remuneration is determined, in association with our sponsor, the Joseph Rowntree Foundation.

Businesses shape every aspect of our lives as workers, consumers and citizens. Through the creation of jobs and the development of life-enhancing products and services, they are key engines of prosperity. For these reasons, economic policy is rightly focused on ensuring that businesses can flourish.

At the same time, there are grounds for concern that the outcomes business is delivering are falling short of societal expectations. According to the Ipsos Mori veracity index, trust in business leaders remains slightly higher than estate agents and politicians (currently a low bar), but far below nurses, doctors, teachers, civil servants and the ordinary man or woman in the street.[1]

Overly generous executive pay awards are one of the major factors responsible for low levels of trust in business – particularly in an era when pay has been stagnating across the wider workforce – and therefore represent a grave threat to businesses' ability to thrive in the long term.

Regulators and policy-makers have recognised the need to better align business practices with the interests of wider society. That is essentially the objective of the reforms to the Corporate Governance Code and corporate reporting requirements introduced this year.

However, it will not be an easy task; it will require changes to culture as well as regulation. This is the challenge we have set in this report – designing a model for the remuneration committee that will help to create a business culture focused on delivering good outcomes for all stakeholders, not just increasing pay-outs for executives and investors.

Given the close relationship between pay distribution and corporate culture – the two both shape and reflect each other – it will be impossible to improve the reputation of business without improving the workings of the remuneration committee.

This report suggests that this could be achieved by replacing the remuneration committee with a new committee responsible for governing not just executive pay, but an organisation's people and culture more broadly. This new arrangement should help to ensure that CEO pay reflects executives' contribution to corporate success relative to the contributions of all employees throughout the organisation, and that the measures of success take into account the impact of the organisation on its customers, community and colleagues.

By improving governance through the creation of this committee and through better transparency and disclosure, we hope that this will foster a greater appreciation and understating about how people create value within the organisation. By recognising the opportunity and risk represented by employees, this should encourage a focus not just on how the workforce is being rewarded, but how it's being managed and developed as well. Not only should this focus improve company performance, it should also improve trust in business.

Both the CIPD and the High Pay Centre would welcome feedback on our proposal and we would be happy to talk with organisations in terms of the support that they would like from us in helping them to develop a committee with a broader remit for people and culture. Please email me your feedback at **c.cotton@cipd.co.uk**

Charles Cotton

Senior Adviser, Performance and Reward

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2 Executive summary

Insights and conclusions from research into the workings of remuneration committees

Background

Executive pay has become a controversial topic in recent years. Pay levels for a FTSE 100 CEO have rocketed from roughly 60 times the average UK full-time worker at the turn of the millennium to nearly 150 times today.[2] There are good grounds to think that this will lead to significant socio-economic damage. Excessive executive pay awards are harmful to the reputation of UK companies; they represent a serious corporate governance failure with much wider implications; and they reflect a wider system that bestows a disproportionate share of rewards on those at the top, to the detriment of low- and middle-income earners.

In this report, we examine how the remuneration committees that set executive pay currently work, the outcomes they deliver, and what a more effective model for them might be. Our recommendations are focused on delivering a more stakeholder-oriented UK business culture, aligned more closely with the interests and values of wider society.

The new corporate governance regime

Studies show that the increases in CEO pay that have taken place in recent years have not been matched by a corresponding improvement in any of the typical measures of company performance.[3]

Rising public concern about top pay and inequality, together with a series of high-profile corporate governance failures at major UK companies, have prompted a series of government reforms, through new regulations and a revised edition of the Corporate Governance Code. Key changes include:

- mandatory disclosure of 'pay ratios' between CEOs and their employees at UK-listed companies
- stronger reporting requirements in relation to directors' fulfilment of their legal responsibilities to different stakeholder groups
- new mechanisms for stakeholder representation in corporate governance structures
- increased emphasis on company purpose and values as drivers of corporate governance.

The widespread perception of flawed executive pay practices is probably in itself justification for a radical reform of the role of the remuneration committee. But these changes make the task even more imperative.

Research findings

To this end, the High Pay Centre and the CIPD undertook a review of the current operation of remuneration committees, covering the practices they undertake, the challenges they face, and the different stakeholder perspectives involved. Interviews with committee members, the colleagues they work with, investors and independent experts revealed the following key insights:

- The myth of 'super talent' continues to drive excessive pay – remuneration committees continue to fear that executives will walk out on the company if their pay demands are refused, and worry about stock market reactions to an abrupt departure. This is despite questionable evidence of the impact of a single executive on company performance.

- 'Unknown unknowns' keep directors awake at night – it's difficult for the non-executives on remuneration committees to properly understand what's happening on the front line of their companies. This creates the risk that major failures in culture and governance are not spotted until too late.
- Group think and a lack of professional diversity abound – committee members are drawn from narrow professional backgrounds. The absence of people management expertise is a key concern.
- Narrow focus leads to 'non-system' thinking – the lack of professional diversity means that committees tend to judge company performance in narrow financial terms, and set pay accordingly.
- The work of the remuneration committee is resource-intensive – the executive pay-setting process involves considerable contribution, including from HR departments, financial and legal teams, investor relations and PR teams, as well as from external consultants and shareholders. This is a considerable drain on resources for the purpose of setting pay for a small number of individuals and leads to more important issues being neglected.
- Companies are likely to reject workers on boards – there was little appetite amongst current committee members for worker representation. Committees are more likely to appoint a non-executive director with responsibility for stakeholder representation.

Conclusions and recommendations

Our research identifies a number of flaws with the existing model of the remuneration committee. It seems clear there is an 'opportunity cost' to the considerable resources companies expend on determining the pay of a small number of executives. Remuneration committees' conceptions of company performance are also too narrow. This undoubtedly results from the narrow range of professional backgrounds from which committee members are drawn.

On this basis, we make the following recommendations. They are aimed primarily at the boards and shareholders of the major UK-listed companies covered by our research. However, they should also be considered by policy-makers and regulators charged with guidance and oversight of corporate governance in the UK. Similarly, corporate culture, people management and fair pay practices are as important to privately owned companies as to those listed on public markets. Therefore, boards and owners of private companies should also consider implementing these recommendations.

1. Companies should consider establishing a formal 'people and culture' committee in place of their remuneration committee. Those that choose not to do so should still demonstrate clearly, in their annual reports, how company pay practices relate to their strategy for people management and corporate culture. We have provided a draft 'Terms of Reference' to act as a template for those wishing to formally expand their remuneration committee's remit to 'people and culture'.
2. Companies should formally assess their non-financial performance – for example, by looking at their impact on different stakeholder constituencies, and reviewing their social and environmental performance. They should explain their methodology for this assessment – and the results – in their annual report. Performance in this respect should be a key consideration when making annual pay awards.
3. Succession planning and development of long-term executive capability within the organisation should be explicitly included in the committee's remit, as should organisational fairness in relation to pay.

4 To this end, professionals with people management experience should be appointed to remuneration committees – or people and culture committees – as well as representative of the company's stakeholder communities, including its workforce.

5 Long-term incentive plans should be replaced as the default model for executive remuneration with a less complex system based on basic salary, with an incentive to deliver sustainable long-term performance provided by a much smaller restricted share award.

3 Introduction

Reforming the RemCo: an approach to governance of pay that everyone believes in

Levels of executive pay in the UK have become an increasingly controversial topic in recent years. The previously obscure remuneration committees (RemCos) at the heart of the pay-setting process for UK-listed companies have been propelled to political prominence.

There are good grounds to think that the executive pay packages awarded by remuneration committees are doing significant socio-economic damage. They are harmful to the reputation of UK companies; they represent a serious corporate governance failure with much wider implications; and they reflect a wider system that bestows a disproportionate share of rewards on those at the top, to the detriment of low- and middle-income earners.

These concerns have prompted a series of corporate governance reforms aimed at rebuilding public and stakeholder confidence in the pay-setting process. These include:

- mandatory disclosure of 'pay ratios' between CEOs and their employees at UK-listed companies
- stronger reporting requirements in relation to directors' fulfilment of their legal responsibilities to different stakeholder groups
- new mechanisms for stakeholder representation in corporate governance structures
- increased emphasis on company purpose and values as drivers of corporate governance.

There is considerable debate about the merit of these reforms, and whether they will be sufficient to restore trust in the UK's leading businesses, reduce the risk of the corporate governance failures that have occurred in recent years and help address economic challenges, including low productivity, pay stagnation and economic inequality. However, the changes will certainly have a profound impact on the work of remuneration committees.

The widespread perception of flawed executive pay practices is probably in itself justification for a radical reform of the role of the remuneration committee. But these changes make the task even more imperative.

In this report, we examine how remuneration committees currently work, the outcomes they deliver, and what a more effective model for them might be. Our recommendations are focused on delivering a more stakeholder-oriented UK business culture, aligned more closely with the interests and values of wider society.

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Methodology

To better understand the work of the remuneration committee, we conducted interviews with representatives from the remuneration committees and HR/reward teams from 20 different UK-listed companies. We also spoke to a range of other stakeholders, including investors, trade unions, and independent or academic experts in corporate governance and board effectiveness. Following these initial meetings, we held a research seminar with another group of stakeholders to test the themes that emerged during the interviews.

In addition, we analysed remuneration committee reports, looking in particular at committee membership and the performance measures used to calculate incentive payment awards. We also reviewed other relevant publications, from stakeholder groups, policy-makers and independent/academic experts, on the topic of executive pay and corporate governance.

4 Background to the executive pay debate and the role of the remuneration committee

This section of the report sets out the background to the executive pay debate, and details recent trends in executive pay levels. Readers familiar with these subjects may wish to skip to section 5.

Two particular assumptions regarding executive pay trends provide ammunition for critics of current practices:

1. First, executives as a group are being paid more and more in comparison with ordinary workers.
2. Second, overall executive pay increases have occurred without any corresponding improvement in performance.

Both assumptions are largely accurate.

CEO/worker pay

It is hard to be precise about the increase in CEO pay over time because, until relatively recently, publicly listed companies were not required to disclose a single figure for total executive remuneration.

Using the best available information, Figure 1 shows how the gap between CEO and employee pay in FTSE 100 companies has widened since 1999: the pay of a FTSE 100 CEO has gone from being 59 times their average employee in 1999 to nearly 145 times in 2017.

This is based on average (mean) salaries, because median salary data is not available for FTSE 100 employees, and we only have median CEO salary data from 2009 onwards. While the mean is not as good as the median in indicating the typical amount of pay enjoyed by a chief executive, it does give a good indication about what has been happening to the total amount of money spent by FTSE 100 firms on their CEOs' remuneration.

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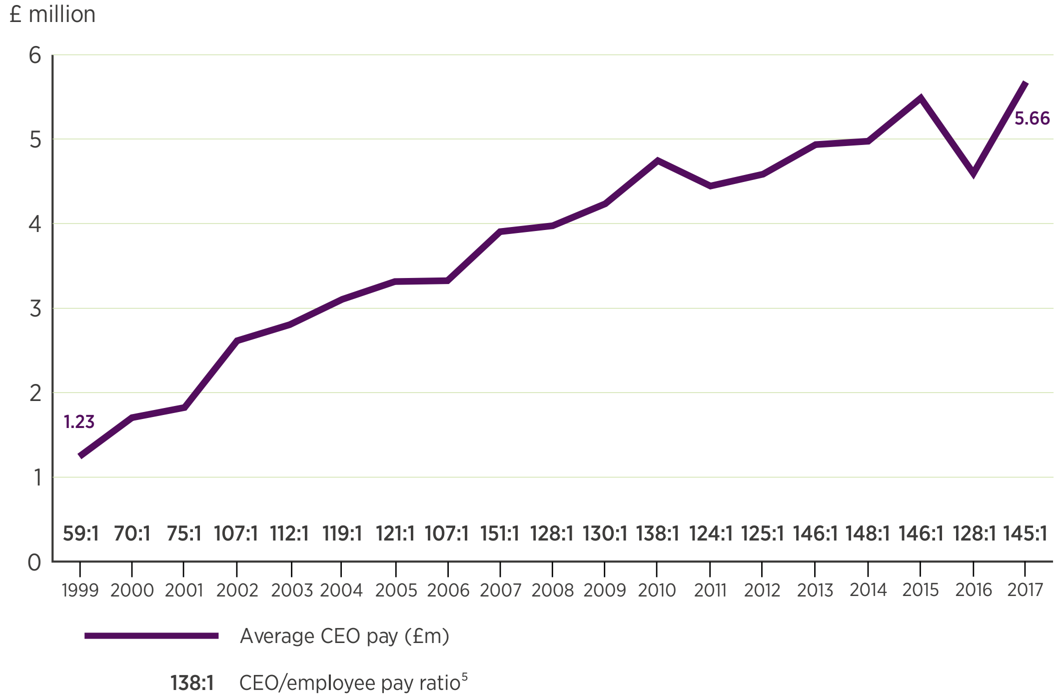
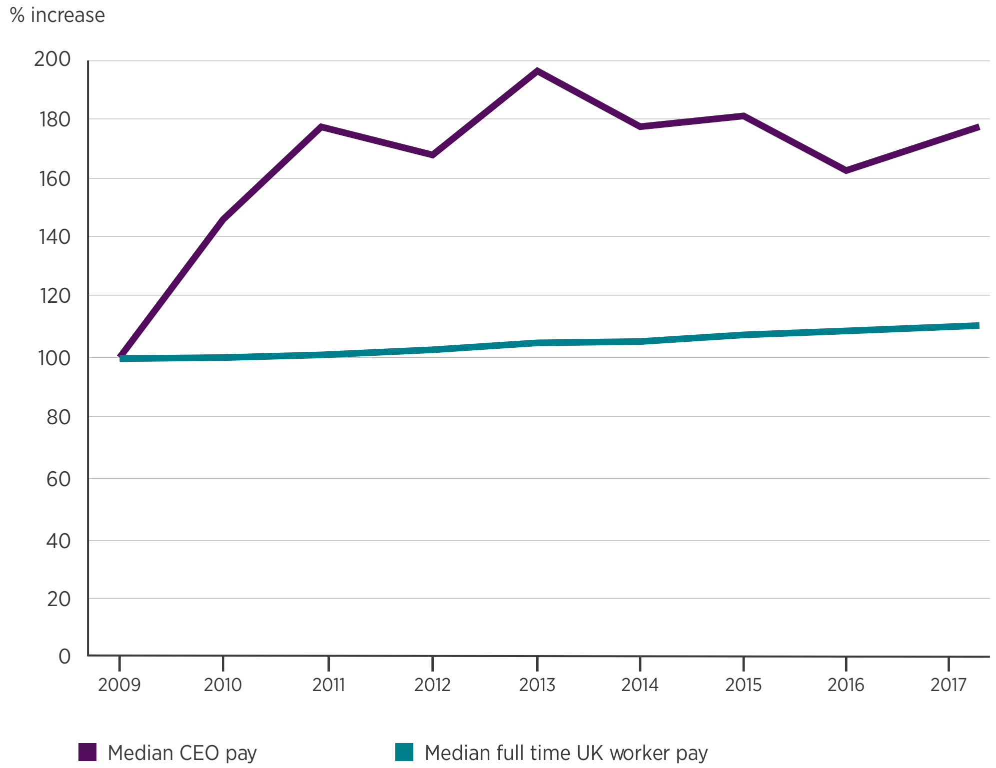
Figure 1: Relative increases in pay – FTSE 100 CEOs and their employees[4]



Using the median salary data we do have, Figure 2 shows a similar picture. It looks beyond FTSE 100 companies, comparing the increase in median FTSE 100 CEO salaries with the increase in median pay for full-time workers across the UK economy as a whole (because there has been no requirement for listed companies to disclose the median pay of their staff). Comparing the median with the mean figures for FTSE 100 CEO pay shows that there is a considerable skew, indicating that the reward behaviours of some firms have a significant impact on the total that FTSE 100 firms spend on their CEOs.

Figure 2: Relative increases in pay – FTSE 100 CEOs and full-time UK workers[6]



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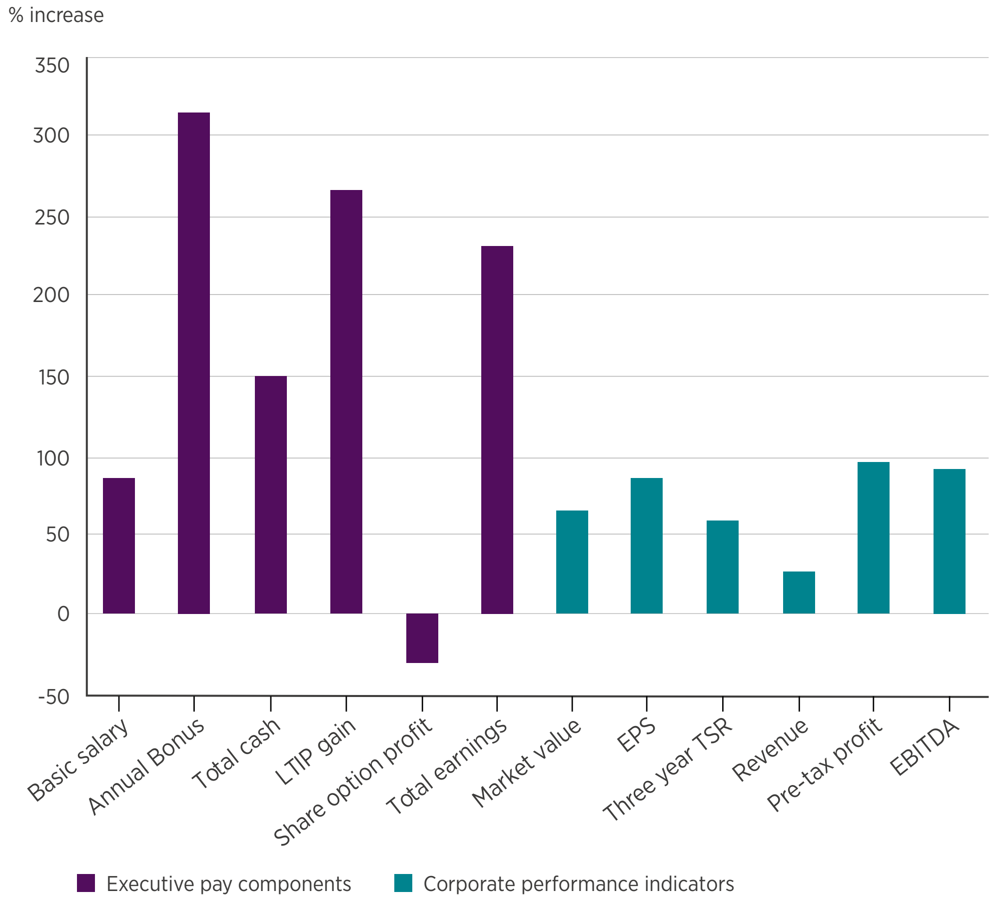
Although the data available limits the ability to make like-for-like comparisons, it's clear that the overall direction of travel has been the same whether you look at mean or median figures. Perhaps more importantly, it should be noted that the widening gap between the pay of CEOs and that of the rest of the workforce is taking place against a backdrop where rises in the cost of living[8] have outpaced the growth in UK employee earnings for the past ten years. For most workers, real pay levels are still behind what they were in 2008.

Pay for performance?

Increases to each of the different components of typical FTSE 350 executive pay awards have been found to be much greater than any improvements in company performance, as measured by the metrics commonly used in most executive pay packages (see Figure 3).

Figure 3: Percentage change in median remuneration of FTSE 350 companies and selected corporate indicators, 2000–13[9]

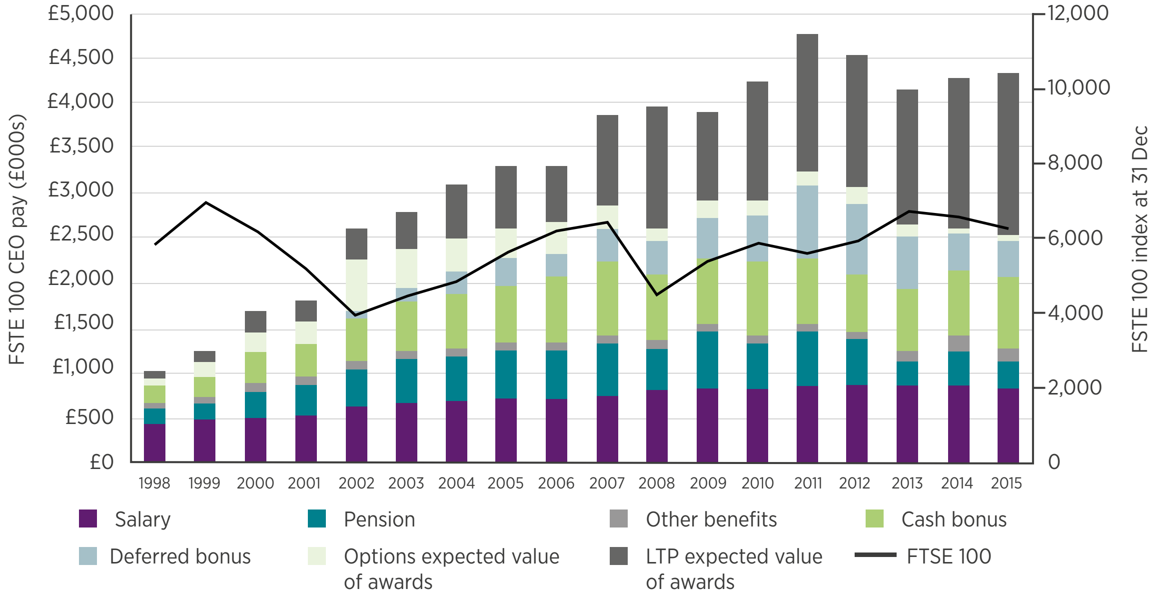


These independent findings are accepted by industry and government analyses. For example, a working group convened by the Investment Association, the trade body for the asset management industry, concluded that:

> *'Rising levels of executive pay over the last 15 years have not been in line with the performance of the FTSE over the same period.'*[10]

This argument is borne out by Figure 3, taken from the Department for Business, Energy and Industrial Strategy's Corporate Governance Reform Green Paper, showing the extent to which growth of FTSE 100 CEO pay has outpaced growth of the FTSE 100 index.

Figure 4: FTSE 100 CEO pay and company value[11]



Despite the fact that pay has exploded while performance has remained flat, Figure 4 shows that it is largely growth in performance-related elements of pay packages that has delivered the increase in total pay.

Why does this matter?

There are a number of reasons why pay for a small number of top executives has much wider implications.

First, the perception of undeserved and disproportionate pay awards to a small number of top executives is doing **serious damage to the reputation of business**.

Public opinion surveys consistently show the scale of public disapproval of very high executive pay packages.

In recent years:

- A poll for the Legatum Institute think tank found that, when presented with two competing statements, survey respondents were significantly more likely to agree that senior executive pay should be capped than they were to say that businesses should be free to pay what they like.[12]
- Eighty per cent of respondents to a poll commissioned by the High Pay Centre agreed with the proposition that gaps between high earners and those on low and middle incomes are too high and should be reduced.[13]
- Fifty-seven per cent of respondents to a poll for the *Independent* newspaper supported plans to cap executive pay at 20 times the level of the lowest-paid worker. Just 30% opposed.[14]

The Edelman Trust Barometer put trust in business at 43% in 2018, higher than trust in government (36%) or the media (32%) but lower than that for NGOs (46%) and two points down on the levels recorded in 2017.[15] Executive pay was the most commonly cited factor for a lack of trust in business, identified by 58% of respondents.[16]

These figures are not sustainable. They create the real risk of a backlash against business that will be much more damaging in the long term than addressing the problem now.

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Second, the fact that executive pay has reached such controversial levels is indicative of **poor corporate governance and culture more generally**. Any serious economist would be sceptical of the functionality of any market in which the price of the product or service were to increase in value as dramatically as executive pay has done in recent decades. The figures suggest that boards are failing to assert proper scrutiny over the executives and companies they are supposed to oversee.

There have been too many corporate governance scandals at UK companies over the past decade to dismiss them as isolated failings. Cases such as the LIBOR manipulation scandal, the BP Deepwater Horizon oil spill or accountancy malpractices at BT and Tesco ultimately relate, at least in part, to ethical failings and corporate culture. Executive pay is perhaps the most visible proxy for culture. Such high levels of top pay, so widely opposed by the public, reflect lax governance and a business culture at odds with public expectations more generally.

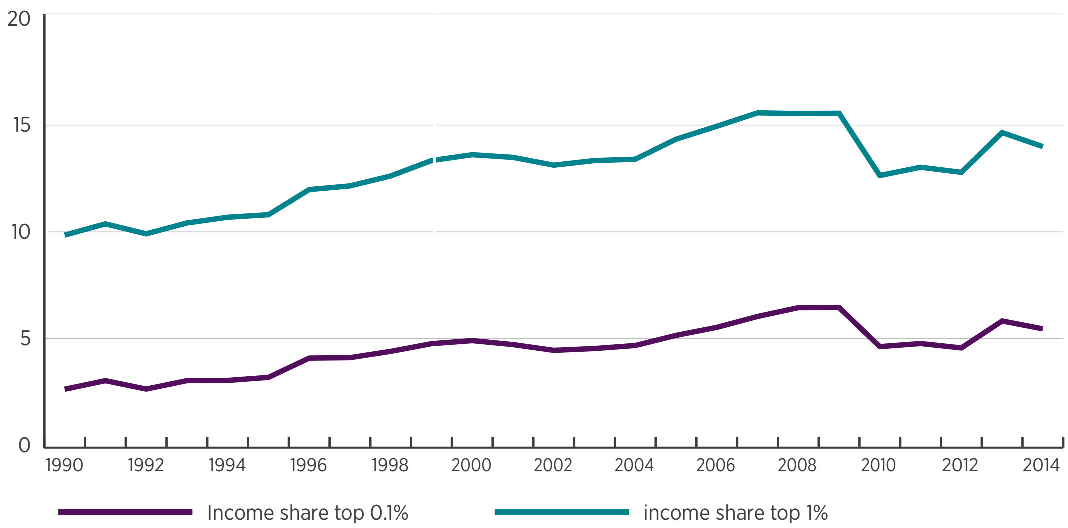
Therefore, current executive pay practices suggest a need for wider reform of business culture and governance. Fairer, more proportionate levels of pay would foster much greater confidence in their culture, values and governance more widely.

Finally, high executive pay awards are a major driver of economic inequality across the UK economy as a whole, with **negative consequences for the incomes of low- and middle-earners**.

Though headline executive pay awards represent sums of money that are non-material to major companies, this doesn't tell the full story of the costs of rising top pay. The trend towards higher CEO pay, with bigger bonuses and more generous share awards made through long-term incentive plans (LTIPs), has also been reflected in the pay packages for other top earners.

Figure 5 reveals that the top 1% of earners account for 14% of total earnings across the UK today. In the late 1970s, this was just 6%.[17] The share going to the top 0.1% has risen from 3% in 1990 to 6% today.

Figure 5: Income distribution in the UK



Thomas Piketty estimates that around 70% of the top 0.1% of earners in developed countries comprises so-called 'super-managers' – that is, business executives, plus other highly paid professionals in industries such as law, finance and management consultancies.[18]

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If the increased share of income going to these top earners across the economy as a whole reflects a pattern occurring at individual companies, this represents a substantial cost for companies. The difference between spending, for example, 14% and 6% of the wage budget on the top 1% of earners has a significant impact on how much is left over for the remaining workers. Similarly, it could affect how much is available for research and development or investment in new technologies. Advocates of high executive pay might counter that higher pay for those at the top enables the company to attract better managers and thus produce higher revenue, meaning increased top pay makes economic sense. But this is a contestable assertion. There is a strong argument that redistributing from the highly paid to middle and lower earners or other forms of business investment would be beneficial to the business.

Therefore, very high executive pay is not solely a moral question of whether the widening of pay gaps within organisations is appropriate or fair. It also both reflects and causes major issues in terms of the reputation of business, weak corporate governance, and stagnating living standards across the UK economy.

The Government's response

The Government has acknowledged the need to address prevailing pay practices through a series of corporate governance reforms.

Both the 2018 Companies (Miscellaneous Reporting) Regulations and the new UK Corporate Governance Code, applicable from 1 January 2019, mandate more detailed reporting of how company directors have fulfilled their responsibilities under the 2006 Companies Act. Section 172 of the Act says that directors should act in the interests of the company's 'members' (that is, shareholders), but should also have regard for other stakeholder groups including workers, customers or wider society. This could have implications for thinking about how pay is distributed throughout the organisation.

The first principle of the new Corporate Governance Code relates to purpose and leadership, with an emphasis placed on values and culture, of which pay practices are one of the clearest expressions.

The new Code explicitly requires remuneration committees to review pay across the wider workforce. When setting executive pay, reasons must be given for why pay policies are appropriate using internal and external measures. This is complemented by the requirement to publish intra-company pay ratios between the chief executive and their median UK employee, introduced as part of the miscellaneous reporting regulations. In addition, remuneration committees must report on what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy.

The new Code also requires companies to implement one of three mechanisms for incorporating stakeholder voice into corporate governance structures:

- worker directors – a representative (or representatives) of the company's workforce elected onto the company board
- a non-executive director with specific responsibility for stakeholder-related issues
- a stakeholder committee, comprising representatives of the company's identified stakeholder constituencies.

Whichever mechanism companies choose, those elected are likely to take an interest in the issue of executive pay, so again, this reform is relevant to the executive pay debate.

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5 Key insights from research into the work of the remuneration committee

This section details the principal findings from the interviews with stakeholders in the pay-setting process, and how they relate to the wider executive pay debate.

The myth of 'super talent' continues to drive excessive pay

> *'It's nuts … and nuts has become the benchmark.'*
> **(remuneration committee chair)**

Our interviews revealed widespread recognition that levels of top pay have become problematic. Many interview participants acknowledged public opposition to current pay practices. We were also told that reputational impact was a consideration when making pay awards:

> *'We do consider "the Daily Mail test" – how is this going to look externally?'*
> **(remuneration committee chair)**

At the same time, both company representatives and investors were wary of the impact of reducing executive pay to a level that might be deemed acceptable to wider society. It was suggested that the risk of losing a key business leader to a rival willing to pay more was considerable – some participants claimed that their company had first-hand experience of this – and that the market reaction to such a loss would also be negative:

> *'A good management with a strong track record is part of the investment case. … If the CEO walks away suddenly, that creates a lot of speculation and uncertainty in the market.'*
> **(remuneration consultant)**

> *'It is real, not just from other [UK-listed] companies but from private equity, from the US.'*
> **(remuneration committee chair)**

Though the appointment of a new CEO might seem an opportunity to begin the process of bringing top pay back to more proportionate levels, it was also suggested that 'American-style' pay packages may be necessary to recruit outstanding candidates in a global market:

> *'We had an American who everyone was agreed on was the right person, but he expected an American-style pay package. They don't have the same debate about pay as over here. … We very nearly lost him.'*
> **(company secretary)**

Clearly this risk-aversion is the key barrier to addressing problems with executive pay. It is understandable that companies (and investors) are wary of any upheaval resulting from the loss of key members of their leadership team.

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However, there are strong grounds to think that they are being overly cautious. Analysis suggests that the risk of losing executives to international rivals over pay is exaggerated. Even if a CEO were to depart for a higher-paying role elsewhere, this ought not to have a detrimental impact on a well-run, well-governed business.

A study by the High Pay Centre found that less than 1% of the world's largest companies had poached their CEO from an international rival.[19] CEO pay is notoriously high in the US, yet it is rare for a UK business leader to be recruited by a US company. This is confirmed by insiders to the executive appointment process – see Box 1. The pressure to attract and retain supposed rare talent is much lower than often suggested.

Box 1: The insider view on CEO pay

Research by the LSE, *Headhunter Methods for CEO Selection*, based on interviews with the top ten international recruitment firms behind 70–90% of chief executive appointments in recent years, found a consensus that levels of remuneration for the most senior executives are 'absurdly high'.

The headhunters claimed that, for every appointment of a CEO, another 100 people could have filled the role just as ably, and that many chosen for top jobs were 'mediocre'.

Max Steuer, reader emeritus at the LSE and author of the research paper, has said his research shows there is little evidence that lower pay would see a 'brain drain', as has been suggested.[20]

Similarly, the notion that executives are the key determinants of company success is hotly contested, particularly in the long-established businesses typical of the UK-listed market.

As the business leader Sir Philip Hampton put it, when being interviewed for another High Pay Centre study:

> *'The bigger the system, the more the system counts rather than the person at the top of it. … Sometimes you just get lucky. Perhaps you joined an industry at the right time, maybe you were promoted at the right time, and then the circumstances of your industry suddenly become favourable. Even if you are a half-wit, you are going to do quite well in this situation. So many financial incentives rely on luck, the evolution of markets, rather than on people's contribution.'*[21]

In other words, as the size of an organisation increases, it is increasingly difficult to attribute its performance to the actions of a single individual or small number of individuals at the top. Other factors, such as the contributions of the wider workforce across different divisions and markets, changes in the economic context, or to the circumstances facing competitors, are all much more likely to be important.

The case of Persimmon, perhaps the most high-profile executive pay controversy to have engulfed a UK company, exemplifies how executives can benefit from circumstances over which they have little control. Its former chief executive, Jeff Fairburn, made a reported £75 million from an LTIP awarded in 2012, including total annual pay of £47.1 million in 2017. The large payment resulted from a dramatic increase in the company's share price and profits between 2012 and 2017. However, this period coincided with the recovery of the UK housing market, stimulated by the UK Government's 'Help to Buy' programme. All

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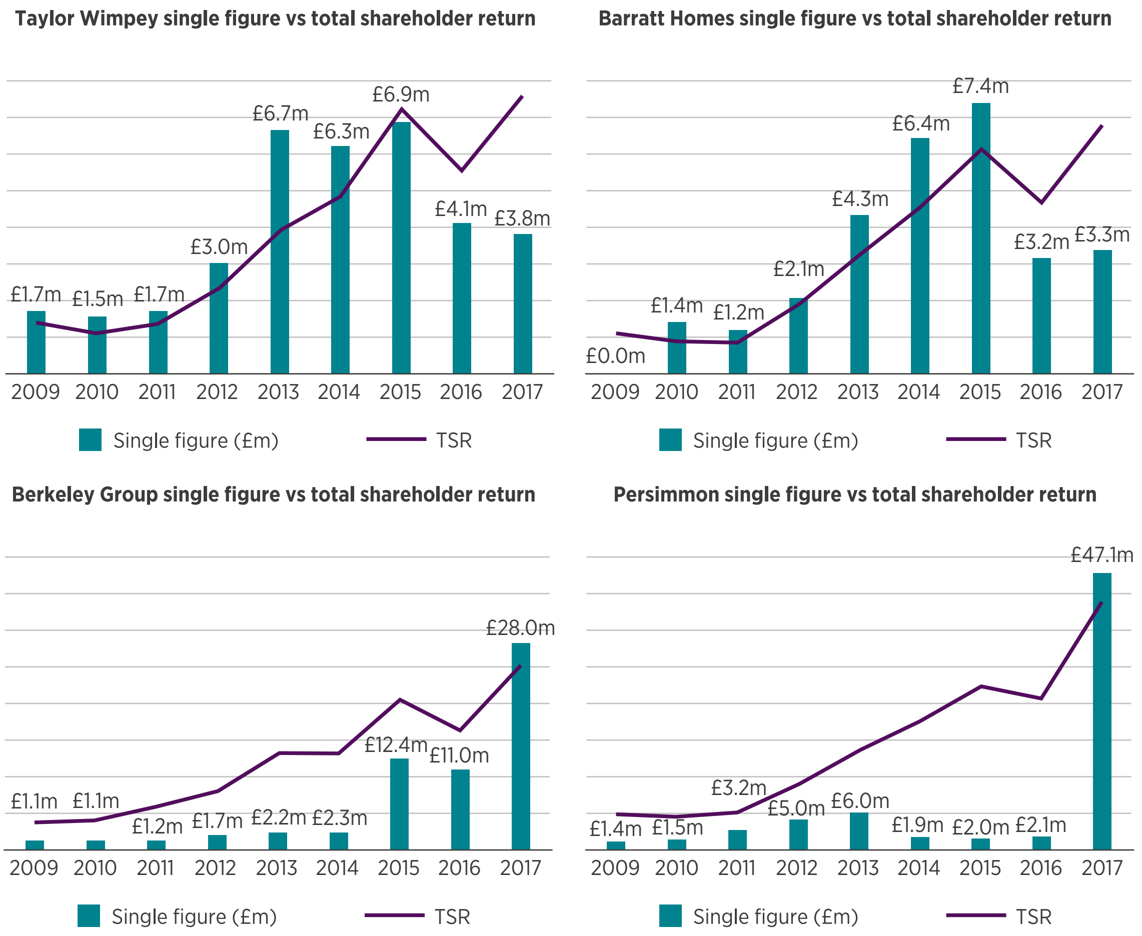
the major UK house-building companies flourished over the same timeframe, even though Persimmon's competitors did not need to incentivise or reward this performance with such generous pay practices.

Figure 6: Pay versus performance at UK house-builders



Persimmon's experience suggests that remuneration committees are insufficiently sceptical of the importance of their CEO. Fairburn left the company by mutual consent in late 2018 as a result of ongoing criticism of his pay award.

'Unknown unknowns' keep directors awake at night

> *'As a director, what would keep me up at night would be the thought of something terrible happening somewhere in the company that nobody knows about and suddenly it blows up without warning.'*
> **(board effectiveness consultant)**

Different participants suggested variations on Donald Rumsfeld's notion of the 'unknown unknowns' – that a potential unpredicted disaster or scandal involving their company may be in train or could suddenly occur without their knowledge – as a significant risk. This has implications for executive pay awards, which may be made on the basis of a narrow and shallow definition of good performance that ignores or fails to understand the culture of the company:

> *'It can be pot luck. … Culture is driven by the chief executive, not the non-executives on the RemCo, and how you measure and monitor it is very difficult.'*
> **(remuneration committee chair)**

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‘There are fewer and fewer execs on boards, and non-execs don’t know what’s going on.’
(remuneration committee member)

As noted in the previous section, numerous major UK companies have been afflicted by scandals with major financial and reputational costs (both for themselves and UK business as a whole) that were not identified in advance and ultimately relate to corporate culture and ethics.

Table 1: Selected corporate governance scandals at major UK companies

Company	Scandal
BAE Systems	Alleged bribes[22]
Barclays	Market manipulation[23]
BP	Health and safety failure[24]
BT	Accountancy malpractices[25]
Carillion	Insolvency[26]
GSK	Alleged bribes[27]
HSBC	Market manipulation, money laundering[28]
Lloyds	Market manipulation[29]
Rolls-Royce	Alleged bribes[30]
Sports Direct	Exploitative employment practices[31]
Tesco	Accountancy malpractices[32]

These cases provide a valuable lesson to remuneration committees in demonstrating the fallibility and vulnerability of the CEO. To an extent, the different scandals were not the fault of the executives – in a number of cases the boards argued in their aftermath that they could not know everything that goes on in large, diverse global organisations with tens of thousands of employees.

This is a valid argument, but it also inadvertently shows that corporate success is collegiate and that pay structures should reflect this, rather than being predicated on the notion of a superstar CEO.

At the same time, the different scandals and the views expressed by interview participants also show that a positive corporate culture is fundamental to a company’s sustainable success, and that instilling and monitoring culture is a vital part of the board and CEO’s role:

‘Culture can be corrosive … the tone is set from the top.’
(remuneration committee chair)

Therefore, the remuneration committee needs to understand and consider culture – and the leadership and people management factors that affect it – when assessing the executive’s performance.

Group think and a lack of professional diversity abound

‘The breadth of knowledge of people management is narrow. It isn’t seen as a strategic business issue.’
(HR director)

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Another issue repeatedly emphasised in our interviews related to the narrow range of expertise on RemCos. Some interviewees suggested that the membership of the committees needs to encompass a much wider range of backgrounds and perspectives that are less instinctively sympathetic to very generous CEO pay awards and more challenging of assumptions regarding the risk and impact of losing a CEO over pay:

> *'Diversity is starting to be pushed but it's not being done proactively or meaningfully. ... It's seen as a "we have to do this" rather than an opportunity. ... Getting in three female Cambridge graduates doesn't improve diversity.'*
> **(HR consultant)**

Our analysis for this report found that, based on the company's own profiles of their directors, only 26% of FTSE 100 remuneration committees included someone who had primarily spent a significant proportion of their senior career (excluding non-executive positions and voluntary work) in a non-business environment. Those committee members with a background outside large businesses were nearly always former senior politicians or regulators, probably appointed for the commercial value of their knowledge of the workings of relevant governments or regulatory bodies.

In terms of gender balance, across all FTSE 100 companies, 38% of all remuneration committee members were female in the FYE 2017. The number of females on remuneration committees is steadily rising, with 158 females now on FTSE 100 remuneration committees compared with 148 last year. However, there were still five firms with no women on their remuneration committees in the FYE 2017.[33]

Only one company, Standard Chartered, includes someone with substantial leadership experience at an NGO. TUI, an Anglo-German group, therefore also subject to German corporate governance regulations, is the only company to give its workers any formal role in the pay-setting process, through the workers' representatives on the supervisory board that oversees the company and decides executive pay.

In the biographies and CVs of directors that companies provide on their websites, SSE is the only company to relate the value that a remuneration committee member adds in terms of stakeholder outcomes rather than in solely commercial terms, noting that a former local government director on the board possesses:

> *'strategic and operational experience of leading organisations, with large numbers of employees, significant assets, construction projects and an important place in the community they serve.'*

Of course, one would expect the overwhelming majority of company directors of large businesses to have a background in large businesses, giving them directly relevant experience. However, the number of alternative perspectives does seem low, in light of the increasing recognition that (a) boards comprising diverse backgrounds and perspectives make better decisions, and (b) that companies' social licence to operate requires them to have regard for the outcomes they deliver for all stakeholders, not just the returns they make for shareholders.

It is also striking to note the small number of committee members with an HR background, given the importance of motivation, retention, development and reward to the committees' work. Just 16% of companies mention HR or people management experience in their profiles of remuneration committee members. To put this figure in perspective, 27% of companies have at least one committee member with a background in sales or marketing! This was reflected in the experience of the HR professionals we interviewed:

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> *'It's normally people from a finance or operations background. It needs a broader understanding of people issues across the organisation.'*
> **(HR director)**

The lack of HR expertise on remuneration committees is particularly surprising, given that one of the most important determinants of executive pay (and the costs it imposes on companies) is the supply of potential candidates for executive roles. A higher supply ought to mean lower levels of pay and lower costs. The company, through recruitment, people management and development practices and prudent succession planning, has considerable agency to ensure a plentiful pipeline of potential executives. Therefore, a far-sighted remuneration committee ought to be monitoring how the organisation is seeking to recruit, manage and retain a more diverse workforce at all levels of the business and how it is identifying and training its next generation of leaders.

While HR teams may provide insights or analysis for the remuneration committee, their role is secondary to the external remuneration consultants. This suggests that committees are more concerned with external benchmarking – looking at how their CEO's pay compares with the lead executives of other organisations, despite the difficulties of making like-for-like comparisons between distinct organisations – rather than with internal fairness and the impact of pay gaps within the internal company structure.

Again, this is surprising, given that pay distribution within a company also has a significant impact on culture and morale throughout the organisation, with consequences for company performance.

Research from the CIPD found that 45% of UK workers feel their CEO is paid too much (just 4% felt they weren't paid enough and 30% didn't know), while 38% said they felt their CEO's pay was not aligned with organisational performance, against 32% who said it was.[34] The survey found that 59% of respondents felt demotivated by levels of CEO pay.[35]

This suggests that the impact of executive pay on employee engagement and industrial relations should also be a consideration for remuneration committees. Research participants suggested that committees do discuss the impact of CEO pay on employee engagement, and we were also told in some interviews that views on executive pay are sometimes sought in staff surveys. However, consultation with workers is largely not currently part of the executive pay-setting process:

> *'They do look at how many are at the minimum wage, how many are in a bonus plan, and try to measure engagement.'*
> **(remuneration consultant)**

> *'We do site visits, town hall meetings, staff surveys and anyone that has views can feed them in, and we do sometimes get them. However, we don't go out and formally consult.'*
> **(remuneration committee chair)**

Narrow focus leads to 'non-system' thinking

> *'I'd say there is a long way to go…'*
> (**remuneration consultant** on remuneration committee interest in non-financial issues)

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This lack of diversity also means too few committees are thinking about the organisation or system as a whole when making their decisions. The company's performance is conceived solely in narrow financial terms. This seems at odds with the new emphasis on purpose in the new Corporate Governance Code, or section 172 of the Companies Act, outlining directors' duty to have regard for their other stakeholders beyond their shareholders.

For example, while workforce-related issues are becoming increasingly discussed at board level, they are often not regarded as a top priority:

> *'I don't recall ever being asked about that.'*
> **(remuneration committee chair)**

> *'It's becoming more commonplace in recent years, but there's still a wariness about it. They don't look at the workforce in a strategic way.'*
> **(board effectiveness consultant)**

Despite the obvious relevance of a company's employment models and working practices to its long-term strategy and performance (and therefore to the success, or otherwise, of its leadership), research from the Pensions and Lifetime Savings Association noted how little information of this nature was documented in FTSE 100 companies' annual reports.[36] For example:

- Just four FTSE 100 companies provide a breakdown of workforce by full-time and part-time workers. In addition, only seven provide data or policies on their use of agency workers.
- Twenty-one provide concrete data in relation to investment in training and development of their workforce or the number of workers trained.
- Thirty-four companies provide a meaningful narrative discussion on the ways in which they foster and measure employee engagement in their annual report. Sixty-five provide figures on sickness absence rates. Only 18 disclose figures on staff turnover.

This contrasts with the US, where 'compensation committees' are increasingly incorporating people and culture into their formal remit. Companies that have done so include Caterpillar, Cisco, JP Morgan Chase & Co., The Home Depot and Walmart.[37]

The lack of information on a company's non-financial performance is all the more surprising given the substantial growth in interest in companies' 'impact'.

For example:

- the development of the 'benefit corporation' or 'b-corp' in the USA and, internationally, of private companies that are constituted with the intention of delivering positive social and/or environmental objectives and pursue a profit in order to sustain this
- the concept, established over 25 years ago, of 'triple bottom line' reporting, which seeks to quantify a company's social and environmental performance alongside its financial value and performance
- the proliferation of environmental, social and governance (ESG) or socially responsible investment (SRI) indexes that weight or screen companies based on financial risks/opportunities relating to social and environmental factors, demonstrating investors' belief in the materiality of these issues
- the rise of 'impact investing' – an amalgam of investment and philanthropy, whereby investors prioritise projects that will deliver positive social or environmental change, alongside a financial return.

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Even investors, who are dependent on a company's profitability in order to make a return on their own investments, recognise the importance of non-financial performance:

> *'Nobody is giving us an amount of money and saying they don't mind if they get less back. They still want us to make money. But how we make money is becoming increasingly important, especially to millennials. We get people who have developed an app or whatever … we hardly ever have a conversation now where the impact doesn't come up.'* **(investor)**

The work of the remuneration committee is resource-intensive

> *'It's a very thorough and challenging process to get it right.'*
> **(reward director)**

One of the most striking observations regarding the executive pay-setting process related to its complexity, and the significant demands involved were disproportionate to the importance of the output they delivered (that is, the pay of a very small number of people at the top of the company).

Complex and time-consuming processes identified by interview participants included:

- three to four remuneration committee meetings a year, including meeting planning and the preparation of papers
- time allocated to executive-remuneration-related issues at full board meetings
- issuing tenders for remuneration consultants and subsequent commissioning process
- designing complicated performance-related pay plans – our analysis of pay plans detailed in remuneration committee reports found that many involve in excess of 20 different performance targets, measured over one- to five-year timeframes and each subject to different weightings
- calculating performance and pay-outs in accordance with these performance-related pay metrics, involving data analysis (and qualitative insights) from, for example, the company's HR and reward or finance departments
- programme of shareholder outreach and engagement, involving multiple meetings and phone calls
- reviewing and refining proposed pay policies and awards in light of issues raised during any of the above processes
- writing the remuneration report, which our analysis found to be an average of 22 pages long, demonstrating how difficult it is for companies to communicate how they pay their executive team
- media/stakeholder management, following publication of pay awards and AGM votes.

> *'It is difficult to say how many people feed in, but there is a lot of back and forth, and with the shareholders as well.'*
> **(remuneration committee member)**

> *'It is discussed rigorously with a lot of challenge. … We get a lot of different insights … it's all-year round.'*
> **(remuneration committee chair)**

These processes require the involvement of the board, executive team, and company secretary's office, as well as HR, reward, finance, investor relations, legal and communications departments. It's difficult to argue that this is the most productive use of key strategic staff members' time. Similarly, investors also feel they spend time engaging with companies on executive pay that could be dedicated to more important topics. The Investment Association stewardship survey found that executive remuneration was ranked second (out of 12) amongst issues over which investors spent time engaging with companies, but only fifth for those they thought were most important for engagement.[38] This suggests that overly complex and excessive pay practices are crowding out more important matters:

> *'It must take up more of the board's time than any other issue.'*
> **(investment manager)**

Indeed, the 'opportunity cost' of complex executive pay practices is perhaps an under-discussed aspect of the pay debate. Simplified pay structures, such as the restricted share awards proposed by the Investment Association's working group on executive pay, would eliminate the need for many of these processes. Furthermore, the behavioural science behind the case for so-called LTIPs (which have increased both the size and complexity of pay awards) based on different performance criteria measured over particular timeframes, is less than robust (see Box 2).

Box 2: The pitfalls of performance-related pay

As the CIPD report *Show Me the Money: The behavioural science of reward* illustrates, the longer an individual has to wait for a reward, the less value they place on it.[39] Also, the less they are able to influence the outcome that this reward is linked to, the less they rate the final payout. Similarly, the less an individual understands what they must do to get the reward, the less it is valued. The only way to overcome these effects is, in effect, to offer a reward so large that CEOs find it tempting.

Unfortunately, such large payments may encourage 'crowding out' of intrinsic motivation by extrinsic motivation and result in inappropriate behaviour. As the CIPD report *The Power and Pitfalls of Executive Reward: A behavioural perspective* suggests, the current approach of using long-term incentives to reward CEOs for corporate performance is failing. Instead, what is needed is an approach based on the insights from behavioural science as to how people actually respond to financial rewards and incentives.[40]

CEO pay packages, comprising a basic salary plus a small, share-based payment – perhaps subject to certain performance conditions and deferred for a period of three to five years – would require far less discussion at board and committee meetings, while also reducing the burden on internal staff and removing a lot of the need for external consultants. If subject to greater control and paying out lower amounts, the public controversy around pay would also be significantly reduced:

> *'Because of the public and media interest, we do have to think about this really carefully.'*
> **(remuneration committee chair)**

Thus, there would be more time to focus on key issues such as corporate culture, people management and long-term strategy and performance.

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Scepticism towards workers on boards

> *'I would think that most companies are likely to go down the NED [non-executive director] route.'*
> **(board effectiveness consultant)**

As previously noted, the new Corporate Governance Code requires companies to introduce one of three new mechanisms for stakeholder representation in corporate governance structures (while also allowing them the option of choosing their own alternative mechanisms):

- worker directors – a representative (or representatives) of the company's workforce elected onto the company board
- a non-executive director with specific responsibility for stakeholder-related issues
- a stakeholder committee, comprising representatives of the company's identified stakeholder constituencies.

Whichever mechanisms firms opt for, those appointed as stakeholder representatives will be expected to take an interest in pay distribution throughout their organisations, meaning that remuneration committees will have to think about how they interact with these bodies.

Our interviews demonstrated little enthusiasm for the worker director model. Objections included the difficulty in appointing the worker in question – for example, when a company runs a number of different types of business with worldwide operations, what might an individual worker in a particular country and division contribute to the running of the company as a whole? There was also the question of workers' capacity to understand complex issues facing the board:

> *'We deal with very many complex subjects. It is difficult to see how one person could cover it all.'*
> **(remuneration committee chair)**

> *'How would it work for international companies? They [the worker directors] would quickly find themselves very isolated.'*
> **(remuneration committee member)**

Counterarguments put forward by trade unions relate to the fact that worker directors are intended to provide insights and perspectives from the front line of the company that may not be apparent to directors, rather than act as representatives in a parliament of different interests or provide expertise on every item facing the board (more generally, most directors would be expected to contribute specific areas of expertise rather than be an expert authority on every aspect of the company's work).

The High Pay Centre has been a long-standing advocate of worker representation on boards for these reasons. Nonetheless, it seems unlikely that many companies will adopt this model. Therefore, most remuneration committees will need to think about how they engage with non-executive directors with stakeholder responsibilities and stakeholder committees. Without a worker director on the full board to whom the remuneration committee is accountable, committees will also need to reflect on whether or not they will need to incorporate workforce or stakeholder perspectives into the pay-setting process via other means, in order to demonstrate that they are taking their workers' views seriously.

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6 Conclusions and recommendations

Corporate governance and our understanding of what constitutes good performance are changing. Companies must therefore embrace changes to the way in which remuneration committees work.

Our research identifies a number of flaws with existing practice. It seems clear there is an ‘opportunity cost’ in terms of governance, ethics and corporate culture to the considerable resources companies expend on determining the pay of a small number of executives. Remuneration committees’ conceptions of company performance are also too narrow and they place too much importance on external benchmarks while giving too little consideration to internal fairness. This undoubtedly results from the narrow range of professional backgrounds from which committee members are drawn.

Businesses depend on their social licence to operate. It’s clear that the public expects them to demonstrate a greater focus on outcomes, beyond financial measures. Our research suggests that they still currently pursue the simplistic objective of returns to shareholders rather than the more complex balance of priorities and stakeholder interests that companies should seek to manage. In particular, companies that are financially successful but deliver poor-quality working lives for their workers add limited value to society.

This is now increasingly acknowledged by corporate governance policy reform. Fair pay and pay distribution are key drivers of people’s sense of well-being at work, and the new Corporate Governance Code requires companies to monitor pay practices throughout their companies, to ensure that executive pay levels are fair and proportionate. It will be impossible to fulfil this remit without reflecting on factors such as the diversity, skills, capabilities, stability and morale of the company workforce, which both determine pay levels and are shaped by them.

As such, we recommend that remuneration committees should undertake a much fuller assessment of their businesses’ impact on different stakeholder constituencies – for example, workers, suppliers or the environment – when reviewing performance.

This effectively makes the remuneration committee a body for oversight of people, culture and impact rather than the narrow topic of executive pay.

We recommend that UK companies should consider formally establishing a ‘people and culture committee’ with remuneration included amongst its responsibilities. Those that continue with the existing remuneration committee should make clear the relationship between pay and corporate culture and people/stakeholder outcomes. Those companies that choose a stakeholder committee from the Government’s options for corporate governance reform should incorporate responsibilities for oversight of pay and culture into the committee’s remit.

In each case, the committee should see it as their responsibility to ensure that pay, people and culture issues are priorities for the full board. They should not see their committee as a vehicle to which these issues can be outsourced.

Whatever model or title the company chooses, there is clearly a need for the committee overseeing pay to incorporate a much wider range of background and perspectives. We recommend that professionals with experience of people management should be a priority for recruitment and, as the High Pay Centre has long argued, the committee should also include members of the company’s workforce itself.

There is also a strong case for abandoning complex, time-consuming long-term incentive plans for CEOs. We recommend that companies should consider whether such remuneration arrangements are actually worthwhile for them. If not, we recommend that they should be replaced with a system based on basic salary, plus a small deferred share award to align executives' long-term financial interest with shareholders, to enable committees to concentrate on the more meaningful issues that both boards and investors want to prioritise.

Taken together, these reforms to remuneration committee membership and practice would benefit boards, workers and investors alike. They would help deliver corporate cultures focused on positive outcomes for all stakeholders, shattering perceptions that big business is a tool for the enrichment of an elite few and boosting the public confidence that our leading companies need to flourish in the long term.

Summary of recommendations

1. Companies should consider establishing a formal 'people and culture' committee in place of their remuneration committee. Those that choose not to do so should still demonstrate clearly, in their annual reports, how company pay practices relate to their strategy for people management and corporate culture. We have provided a draft 'Terms of Reference' as an appendix to this report to act as a template for those wishing to formally expand their remuneration committee's remit to people, pay and culture.
2. Companies should formally assess their non-financial performance – for example, by looking at their impact on different stakeholder constituencies, and reviewing their social and environmental performance. They should explain their methodology for this assessment – and the results – in their annual report. Performance in this respect should be a key consideration when making annual pay awards.
3. Succession planning and development of long-term executive capability within the organisation should be explicitly included in the committee's remit, as should organisational fairness in relation to pay.
4. To this end, professionals with people management experience should be appointed to remuneration committees – or people and culture committees – as well as members of the company's stakeholder communities, including its workforce.
5. Long-term incentive plans should be replaced as the default model for executive remuneration with a less complex system based on basic salary, with an incentive to deliver sustainable long-term performance provided by a much smaller restricted share award.

These recommendations may seem bold and radical, but we do believe they are achievable. It is clear from faltering public confidence in top pay practices, and corporate culture and employment models more generally, that a radically different approach to the remuneration committee is needed.

Ultimately, it is in the long-term interest of business to act in a way that is aligned with the interests of wider society and commands their support. Business leaders themselves recognise that their job satisfaction and public esteem derives from the workplaces and career opportunities that they create, rather than from the size of their pay package. Therefore, we do not believe that it will be impossible to convince far-sighted boards and policy-makers of the merits of our recommendations, and we will be dedicating our work in 2019 and beyond to that cause.

Appendix: Draft terms of reference for a 'people and culture' committee

Membership

1 The committee shall include at least [three] independent non-executive directors, one of whom will serve as chair. The chairperson of the board may also serve on the committee as an additional member if he or she was considered independent on appointment as chairman. These members shall be appointed by the board, on the recommendation of the nomination committee and in consultation with the chairman of the committee.

2 The committee shall also include [four] members of the company's stakeholder communities as identified in the annual report in fulfilment of the company's reporting obligations in respect of how the directors have carried out their responsibilities regarding section 172 of the Companies Act. These members shall include at least [two] members of the company's workforce and a member of the senior management team with responsibility for people management. A formal mechanism shall be agreed for the election or appointment of stakeholder members to the committee. Stakeholder members shall be subject to the same requirements to act in the long-term interests of the company, rather than their stakeholder constituency, as the non-executive directors.

3 Only members of the committee have the right to attend committee meetings. However, other individuals such as the chief executive, the head of human resources and external advisers may be invited to attend for all or part of any meeting, as and when appropriate and necessary.

4 Appointments to the committee shall be for a period of up to three years extendable by no more than two additional three-year periods, so long as members (other than the chairman of the board, if he or she is a member of the committee) continue to be independent.

5 The board shall appoint the committee chairman, who shall be an independent non-executive director. In the absence of the committee chairman and/or an appointed deputy, the remaining members present shall elect one of themselves to chair the meeting who would qualify under these terms of reference to be appointed to that position by the board.

Duties

The committee should carry out the duties detailed below for the parent company, major subsidiary undertakings and the group as a whole, as appropriate.

The committee shall:

1 Have responsibility for setting, monitoring and reviewing the remuneration policy for all executive directors and the company's chairman, including pension rights and any compensation payments, as well as overseeing and providing recommendations where appropriate on pay for other senior managers and throughout the group. The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. No director or senior manager shall be involved in any decisions as to their own remuneration.

2 In determining such policy, take into account all factors which it deems necessary, including relevant legal and regulatory requirements, the provisions and recommendations of the Code and associated guidance. The policy shall be designed to support the long-term strategy and purpose of the company in the interest of all

stakeholders including shareholders, workers, customers, suppliers and wider society. It shall incentivise and reward management of the quality required to run the company successfully and sustainably, while guarding against rewards for failure and supporting distribution of pay that meets both internal and external expectations of fairness.

3 In consultation with the chairman and/or chief executive, as appropriate, determine the total individual remuneration package of each executive director, the company chairman and other designated senior executives taking responsibility for all components of pay and all benefits awarded. The committee shall be guided by the remuneration policy but retain discretion to amend the final pay award in order to protect the reputation of the company and maintain the confidence of all stakeholders.

4 Analyse performance in terms of the executives' contribution to the financial performance of the company, but also in relation to their contribution to the company's societal and environmental impact, ensuring these are key considerations in the level and structure of pay awarded.

5 Evaluate the impact of the company's reward practices throughout the organisation, for example by examining whether pay and benefits are aligned with the company's purpose; whether they incentivise appropriate behaviours and performance; and whether differences in pay and reward levels are fair and proportionate.

6 Monitor and review all issues relating to the organisational culture and values of the company, drawing as necessary on data and narrative insights from the human resources division, employee surveys and forums, site visits and external information sources such as trade unions and employer perception audits, in order to ensure that the culture of the company and well-being of the workforce are consistent with the long-term strategy and purpose.

7 Use this information to set out strategic objectives in relation to the culture and people management, designed to ensure the long-term success and sustainability of the company and to support the well-being of its workforce. The committee, where warranted, shall undertake or instigate reviews of specific working practices and set standards and principals in relation to people management and workforce well-being where these are applicable across the company in its entirety.

8 Obtain reliable, up-to-date information about pay, people management and organisational culture in other companies of comparable scale and complexity. To help it fulfil its obligations in this respect, the committee shall have full authority to appoint external advisers, such as remuneration consultants or social or environmental auditors, and to commission or purchase any reports, surveys or information which it deems necessary at the expense of the company but within any budgetary restraints imposed by the board.

9 Work and liaise as necessary with all other board committees and report on the committee's activities via the annual report and to the board, ensuring that all strategic issues relating to pay, people management and organisational culture are given the appropriate consideration by all members of the company's leadership.

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