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# HOW TO RUN A COMPANY:

## CHECKS AND BALANCES ON EXECUTIVE POWER

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## About the High Pay Centre

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The High Pay Centre is an independent non-party think tank established to monitor pay at the top of the income distribution and set out a road map towards better business and economic success.

We aim to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre is resolutely independent and strictly non-partisan. It is increasingly clear that there has been a policy and market failure in relation to pay at the top of companies and the structures of business over a period of years under all governments. It is now essential to persuade all parties that there is a better way.

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## Foreword

**By Deborah Hargreaves**

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*“High-quality corporate governance helps to underpin long-term company performance. The UK has some of the highest standards of corporate governance in the world, which makes the UK market attractive to new investment.”*

The Financial Reporting Council's proud declaration that British standards of governance are the best in the world has been challenged by many commentators in the wake of the financial crisis. Indeed, fines levied on the banks by overseas regulators for rigging interest rates and assisting money laundering, suggest that our governance is not held in the highest esteem abroad.

John Kay's review<sup>1</sup> of equity markets for the government found short-termism was rife among UK companies. This leads to under-investment and hyperactive behaviour by executives who focus on restructuring, financial engineering and mergers and acquisitions rather than building the capabilities of the business.

Trust in business among the public is also at record lows. In the Edelman trust barometer<sup>2</sup> only 18% of those polled trusted business leaders to tell the truth.

In the midst of a national debate about responsible capitalism and how our companies should be run, this collection of essays is aimed at looking at corporate governance issues, what needs to change and how employees can play a bigger role in workplace democracy.

Deborah Hargreaves is director of the High Pay Centre. ■

<sup>1</sup> <https://www.gov.uk/government/policies/making-companies-more-accountable-to-shareholders-and-the-public>

<sup>2</sup> <http://www.edelman.com/insights/intellectual-property/trust-2013/>

# Time to stop talking about corporate governance and do something about it

By Stefan Stern

They say that the pace of business life has speeded up. But when it comes to modernising our boardrooms progress has been less than rapid. Sitting (as a “teenage scribbler”) at the launch of Sir Adrian Cadbury’s report “Financial Aspects of Corporate Governance”, over 20 years ago, I did not anticipate having the opportunity to discuss the same topic two decades later, with many of the problems identified by Cadbury still requiring debate, reform, and action. Less naive attendees that day may have had more foresight.

Since that launch a procession of great and good men (and they were all men) – Cadbury, Greenbury, Hampel, Turnbull, Myners, Higgs, Smith, Myners (again), Walker – has pronounced. A combined code for corporate governance has been drawn up, with a Stewardship Code added for investors. Discussions have been extensive, and printers have been kept busy. This is one part of the British economy which has not disappointed in terms of its productivity.

And yet – which of the “wicked issues” has been resolved? Are boards vibrant and diverse? Are discussions at board level vigorous, well-informed, challenging? Are company

management teams being well-advised, inspired and properly supervised by directors, warding off scandal and collapse? Are shareholders’ legitimate concerns being listened to? And is top pay reasonable and fair?

If the corporate governance industry were to be subjected to a performance appraisal it seems unlikely that the feedback would be entirely positive.

## Resistance to change

Stasis and inertia are powerful factors in organisations as well as in society generally. City institutions may resist change, sometimes rightly. But it is clear there has been reluctance among those at the top of business to accept the spirit as well as the letter of such limited governance reforms as have been put in place. Take the “comply or explain” mechanism. Some investors maintain that, far from wanting unthinking compliance with the combined code from companies, they are ready to listen to convincing explanations of why a company is acting in the way that it is. And yet grudging or automatic compliance, rather than thoughtful engagement, is common.

## Apply and explain

As the Association of British Insurers pointed out in its recent report, Improving corporate governance and shareholder engagement:

*“Governance should be a means to an end and not an end in itself. The objective should be to underpin and facilitate a more successful and sustainable enterprise over the long term. Absent-minded compliance without consideration of the underlying principles is unlikely to achieve this. Lord Hampel recognised this in his report in 1998, when he emphasised that a compliance-driven approach was the easy option, compared with a more thoughtful and diligent consideration of how to apply the principles. He correctly predicted that companies with 100% compliance, on paper, might fail in the future. This message was not heeded.”*

*“Companies often follow the Code with insufficient regard to how the main principles should be applied given the nature of their business model, culture, key priorities and, ultimately, what enables the board to make effective and well-tested decisions in the long term interests of shareholders. In the same vein, shareholders may have historically focused excessively on the letter, rather than the substance, of the Code.”*

The ABI argues that “apply [principles] and explain” might prove a more effective approach than “comply or explain”. Evidence of more vigorous thinking on boards would certainly be welcome.

## Chaps prefer chaps

Consider also the question of the proportion of women directors on company boards. Lip-service has been paid to this issue for years. A final push at achieving higher levels of female representation on boards has been led by Lord Davies, who has threatened corporate UK with the imposition of quotas if inadequate progress is made.

Again, there has been some limited, grudging, change. But this too has now stalled. New figures suggest that women made up only 16.5% of board appointments to FTSE 100 companies in 2013, up to July. This rate has halved since last year. The government’s target, of having 25% of board positions held by women by 2015, is looking ever more remote. The voluntary route, as advocated by the 30% club for women on boards, is failing. When the chaps are left to themselves they seem to prefer the company of other chaps rather like themselves. Are we surprised? “We may not like quotas,” as Cherie Booth and others have said, “but we would like what they’d do.” For the culture and effectiveness of companies to change, of course, there have to be more women in senior management roles as well as on boards.

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The letter but not the spirit of Derek Higgs' report on non-executive directors has been complied with, too. Yes, there are now more non-execs. But how effective are they? Do they get given the information they need? Are they paid enough? And how independent are they? This is a role that, by and large, is still not being taken seriously enough. In my opinion people should not be accepting several NED roles, but they should probably be getting paid more for the ones that they do. It is a serious role. But it might help if the name of that role could be changed to "independent". Who wants to do a job whose title begins with the word "non-"?

### **Greed and vanity push up pay**

Lastly, what about top pay? The explosion in executive remuneration has taken place over the very same 20-year period in which Britain's corporate governance reforms have been discussed. If you were being fanciful you might imagine that pay has been ratcheted up as a defiant response to the perceived loss of autonomy experienced by boardroom leaders.

Pay has got out of control in the now familiar process in which executives bid each other's price up, with the help of pay consultants, placid remuneration committees and acquiescent shareholders. Talk of a "shareholder spring" proved illusory. In fact, it was plain

wrong. Attempts are now being made to justify ever higher top salaries by stating that they are merely a natural consequence of the sheer size of global business – an unconvincing argument. Leadership matters, but the success of big businesses depends on lots of people, not just a few at the top.

In a soon-to-be-published paper Greg Mankiw, an economics professor at Harvard, suggests that:

*"The most natural explanation of high CEO pay is that the value of a good CEO is extraordinarily high".*

I might have believed that 20 years ago as I sat there waiting for Sir Adrian to start talking, but not now. Other forces, such as greed and vanity, are at play, pushing top salaries ever higher. Employee representation on remuneration committees might have some restraining effect on top pay, but it will take a change in attitude from shareholders and pay consultants too to slow the apparently unstoppable upward rise in salaries.

Corporate governance is a heavy and slightly off-putting label for something that is vitally important. After 20 or so years we have probably talked enough about it. Sensible mechanisms are, with one or two exceptions, largely in place. What we lack is the will to change. And this probably means

that a bit more legislation will be needed, to be put in place by a new government.

The writer is a former FT columnist and Visiting Professor of management practice at Cass Business School, London. ■

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## Monitoring the management: why we need stronger non-execs

By Nadhim Zahawi

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Questions about board composition and competence have always existed in the business world, but after the most serious financial crisis since the Great Depression it should be no surprise that corporate governance has again come under scrutiny. If nothing else, the failure of boardrooms to safeguard against excessive risk-taking in the boom years clearly shows that current arrangements are not fit for purpose.

In the rush to fix the problem it is easy to get caught up in the headline-grabbing stories of those in the executive suites, but it is just as important to examine the critical role played by non-executive directors (NEDs). Good corporate governance is critically dependent on the abilities, experience and collaboration of the individuals involved, but there is a real danger of 'group-think' which does little to test executive judgement.

It is a myth that people and businesses always act in their own best interests; if we are to change the traditional laissez-faire culture of the boardroom we need to see the return of effective oversight and strong accountability, with checks and balances to ensure that poor judgements are challenged.

### **Non-exec role should not be a retirement plan**

While the perception of a board role as the traditional retirement plan for 'the great and the good' may be an exaggeration, everyone knows there is still an element of truth to the idea. The former Lehman Brothers bank board provides one striking example of this once widespread attitude; at time of collapse nine of the ten member team were retired, four were over the age of seventy-five, and only one had current knowledge of the financial sector. If we are to ensure that directorships are a full time job, not a pension plan, current realities must change to meet new expectations.

Robust risk management is vital in any business and it is the NEDs' responsibility to ensure that they have the relevant information to challenge decisions. While NEDs can never know as much about the business as the management, they should know how much risk a company can take, when to abandon executive plans, and how to make the case for doing so. Fundamentally, a culture should exist where questions can be asked.

In recent history there has been little motivation for NEDs to

thoroughly test the management, and at the same time it has been all too easy to move on to other positions when it all goes horribly wrong. But the legal duties and responsibilities of NEDs from major financial institutions should not be minimised, their stewardship has serious implications for financial stability.

Responsibility must be shared in an equitable way, with boards collectively bearing the repercussions of their failure. If a bank blows up, everyone should be liable, not just the chairman and chief exec. Such accountability is an incentive for boards to regulate their own behaviour.

### **Serious sanctions required**

During the crisis, despite abdicating much of their responsibility, NEDs successfully evaded much of the criticism levelled at the management, and bore few of the consequences. In the case of Northern Rock, despite a clear failure to heed the warnings of the Bank of England and regulator, the Financial Services Authority, half of the directors have continued to serve on other boards, and former CEO, Adam Applegarth, hires out his services as an 'advisor' - a designation that allows him to evade the FSA's all too limited ban on working at a regulated financial institution.

Similarly at HBOS, despite the Parliamentary Commission on Banking Standards declaring that

the NEDs 'lacked the experience or expertise to identify many of the core risks that the bank was running,' only an executive, Peter Cummings, the former head of corporate banking, has been fined and banned from working in the City.

In other sectors, those in a position of trust are held accountable for their actions, and if we want NEDs to behave like professionals they must be treated as such. This means negligence, inattention and gross incompetence must be met with serious sanctions.

Current law states that a director cannot be legally barred from sitting on the board of a corporate institution unless the institution becomes insolvent. Yet thanks to state support, no British bank went into receivership in 2008. To combat this, the law needs to be changed so that any financial institution requiring public funds is de facto bankrupt, and directors can therefore be banned.

Such liability would command a more realistic time commitment from directors, where they should expect, and be expected, to put the hours in. At twenty-five days a year, the typical attendance of NEDs at a major British bank is nowhere near sufficient to gain enough insight and knowledge into company strategy, conduct serious risk analysis, and put decisions under the microscope.

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### Limit number of directorships

The Walker Review's recommended increase in time commitment and cap on the number of directorships (at five) does not go far enough. Those of systemically important institutions, such as banks, should spend more time at the companies they govern and only be allowed one directorship; the NEDs of less important public institutions should also be capped.

These changes would make the task of being a NED more

demanding, and while some may suggest that this will leave companies struggling to find qualified directors, to me it would act to encourage boards to look outside of their normal (somewhat incestuous) search pools.

From the economic turmoil of the past five years what has become clear is that non-executive directorships are no longer a role for the gifted amateur. Today it is a professional role and financially compensated as such; the liabilities, responsibilities and commitment should now reflect that.

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### Why two chief execs are better than one

More effective corporate leadership and oversight can also be encouraged by rethinking the single CEO model. Recent evidence and years of anecdote suggest that there is a cult of personality surrounding most CEOs, particularly those in banks, this, combined with the culture of the average boardroom, means that there is little opportunity for NEDs to challenge executive decisions. The simple solution therefore is to shift the role of the CEO to be more collaborative.

Traditionally co-CEOs have been held up as a cautionary tale, with stories of confused strategy, personality clashes and muddled authority emerging

from high profile companies like Citigroup, TimeWarner and Research in Motion. Yet this anecdotal evidence contrasts with the research of the University of Missouri's Professor Stephen Ferris, who has found that the market reacts favourably to the presence of co-CEOs and can increase firm valuation. It is also far from my own experience.

Stephan Shakespeare and I founded and built YouGov – the political and business information gathering group - in partnership; it was a business managed by equals, both formally and informally, and while there were certainly disagreements and challenges to our Co-CEOship, I firmly believe that we were both the better for it.

Despite our success, when we first talked to investment banks about taking YouGov public, their first piece of advice was always to pick a single CEO. It was their belief that institutional investors would find our dual leadership unsettling.

While I eventually took the role, thankfully, our co-CEO approach to management remained. It was hugely beneficial to the challenge-friendly culture of both the business and the board - something which saved us more than once.

It is a fundamental truth that the culture of an organisation is affected by its leadership. While co-CEOs are not necessarily the solution for everyone, increasing the presence of dual leadership can go a long way to tackling the cult of the all-powerful CEO.

Co-CEO success requires a willingness to leave egos at the door, a division of labour based on strengths, and communicating as a unit. Any CEO who is incapable of such compromise is likely to be dismissive of the board, and uncooperative in the face of probing questions; sadly we have already experienced the consequences of such stubbornness.

Not only does a co-CEOship facilitate open debate within a firm, it also brings a dual perspective. Two heads are better than one, and what better way to ensure that company leadership has a range

of approaches and experiences to draw on.

The challenges faced by organizations in the twenty-first century are vast, with many firms increasingly diverse, in both geography and product. This is a lot of responsibility for a single individual, and it is frankly rare that the skills required for such solo management will be present in all but a few leaders. Corporate structures should be designed for the majority, not the extraordinary.

As an alternative leadership structure it may not be for everyone, but the City needs to change its attitude towards co-CEOs, look behind the scare stories and really consider the benefits for governance that two individuals can bring to the table. Over time I hope that small leadership groups at the top will not be considered as rare or unusual, but as a normal option for corporate political design.

Nadhim Zahawi is the Conservative MP for Stratford-on-Avon. He is co-author – with Matthew Hancock MP - of the book about the banking crisis *Masters of Nothing* and former chief executive of YouGov. ■

## How banks are trying to regain trust

By Anthony Browne

In recent years the banking industry has been condemned by politicians, the media, and in pubs and homes up and down the country. Frequently, this condemnation was completely justified – following a taxpayer bail-out, a series of scandals has rocked the industry and rightly sickened many.

However, things have changed substantially, and are changing still. Some of the most significant reforms in the industry are around corporate governance. On June 19, the most significant Parliamentary report into the banking industry for a generation was published by the Parliamentary Commission on Banking Standards (PCBS).

*“Too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibility,” it said.*

The banks recognise this and our absolute priority is to work to regain the trust of customers, taxpayers and shareholders.

### Placing individual responsibility at the heart of corporate governance

Personal responsibility and individual accountability are

crucial to effective corporate governance. This is because it motivates people to behave ethically and in a way that supports the long-term sustainability of their bank.

Accordingly, the PCBS have recommended the replacement of the FCA’s Approved Persons Regime – in which the regulator ensures that people who work in the key roles in the banking industry are ‘fit and proper’ – with a Senior Persons Regime and a Licensing Regime. This would extend personal responsibility to a broader range of individuals and, backed up by a new series of banking standards rules, provide a basis for more effective regulatory enforcement action.

The expectation is that under the new Senior Persons regime banks would assign responsibility for key parts of their operations to a specific, named individual. This will place personal responsibility – and accountability – at the heart of decision-making processes, incentivising people to act ethically and in the longer term interest of their organisation.

And because it is assigned to an individual, if responsibility is shirked, the regulator can use their powers to fine them, restrict their activities, or even ban them from the industry. Indeed,

the Parliamentary Commission recommended – and the government agreed – that if senior bankers engage in “reckless misconduct” they may be prosecuted and sent to prison.

These reforms will be tough, and they will present huge challenges for the industry. But banks know that they have to live up to their responsibilities. That is why we have pledged to work with the government and the regulators to take forward the constructive recommendations in the report.

### Getting remuneration right

An important backdrop to these reforms is the wholesale change that has taken place in the way bank employees are paid. Getting the approach to pay – and the incentives it instils – right is central to successful corporate governance. As Martin Taylor, former chief executive of Barclays, said to the PCBS,

*“you cannot tell people to operate to professional standards on Monday and then, on Tuesday, give them the kind of sales target that requires them not to operate to such standards.”*

To that end, over the past five years huge remuneration reforms have been introduced that make risk and reward much better aligned. This means that bankers are not rewarded for failure but are incentivised to make decisions that benefit their

customers, businesses, shareholders and the broader economy.

For example, there has been a significant shift away from cash bonuses to rewarding staff with shares. All senior bankers and risk-takers like traders have to have at least half their bonus paid in shares. This makes employees much more invested in the long term health of the company, making them less likely to take unreasonable risks. It also means that when employees are rewarded they are more likely to have made decisions that benefit the broader economy.

To reduce risky behaviour further, senior bankers and risk takers have to have a significant proportion of their bonus deferred for three years; and the most senior bankers have the majority of their bonus deferred for five years. This serves to ensure that their personal financial interests are aligned with the long-term interest of the bank.

If it transpires that any employee took reckless risks or behaved illegally, then the deferred bonus can be cut or cancelled. This removes the asymmetry that existed previously where bankers were rewarded for immediate success but not penalised for subsequent failure.

On the retail side, in order to prevent further mis-selling, banks are reforming sales incentives. Rather than rewarding people

for the size and number of sales they make, the emphasis is being put back on good customer relationships and on helping customers find the product that best suits their needs.

Further reforms are in the pipeline: from 2014 bonuses will be capped at no more than fixed salary, rising to twice the salary if shareholders give their approval (under EU reforms). Even then, shareholders will continue to vote on the board's remuneration report, and the regulator will continue to sign off senior remuneration packages – no other industry is subject to such intrusive pay supervision.

### Supporting whistleblowers

There are also big changes in place so that the management or regulator can intervene if things do go wrong. Banks face tough regulators who scrutinise firms' activities to ensure they are acting responsibly. Possibly more significant, are proposed changes that should mean bank employees are not scared to hold their own organisations to account.

For example, as well as already ensuring that whistleblowers are protected from subsequent detriment – something that is in a firm's own long-term interest – banks are seeking to generate an environment in which employees can raise concerns when they feel discomfort about products or practices, even where they are not making a specific allegation

of wrongdoing. It is, after all, the employees of a firm who know most about its operations. Staff must believe that if they have concerns they will be listened to by management and by regulators, taken seriously, and if necessary, acted upon.

Banks must work in the interests of their customers, their investors, and their employees. Getting corporate governance right is central to this, and it is only by doing so that we will be able to restore confidence in the banks and trust in the industry.

Anthony Browne is chief executive of the British Bankers' Association and a former banker, mayoral advisor and journalist. ■

## Employees on boards can help address the democratic deficit

By Deborah Hargreaves

Corporate governance reformers often talk of the need to broaden the pool of non-executive directors on boards, beef up their role and require them to devote longer hours to their work. However, in the UK we have shied away from looking to a group of potential directors who are extremely well-informed about the business and motivated to ensure its long-term success – the workforce.

The idea that employees might have a sensible contribution to make about the way the business is run is controversial in the UK, although it is commonplace in many other European countries. It makes business sense to listen to the workforce. The shop floor generally knows more about what is going on at the heart of the company than many of those in the boardroom.

### Blow the whistle

Employees on bank boards for example, would provide a hotline to people lower down the ranks. If Barclays had had a couple of bank staff on the board, former chief executive, Bob Diamond, might have heard an early warning that key interest rates were being rigged or that not all customers would benefit from payment protection insurance.

Similarly, RBS was fined £390 million for Libor fixing charges where an employee voice on the board might have blown the whistle before regulators stepped in.

British businesses are unusual in giving staff few opportunities to voice their views. In an EU index compiled by European trade unions on formal and informal consultation in the workplace, the UK is second from bottom- beaten only by Lithuania.<sup>3</sup>

Executives, it seems, are reluctant to speak to their own employees. When business secretary, Vince Cable, consulted on executive pay reforms last year, the idea of employees on boards or remuneration committees received short shrift from the business lobby.

But Cable is still keen to see more diversity on boards. What better way to achieve that than to elect a few ordinary people who understand the business better than most of the non-executives sitting at the top table?

Directors' claim that employees won't understand the important business that goes on in the boardroom is a bit demeaning when all non-execs need preparation for a new board role. First Group is the only UK FTSE 100 company with an employee

<sup>3</sup> <http://www.worker-participation.eu/>

director and according to the chairman, it works well.

### German lessons

In Germany, employee directors on the supervisory board that monitors the management, make important contributions to discussions about business strategy and executive pay as well as more traditional employee concerns.

Germany also revised its corporate governance code in 2009 in response to the financial crisis, to give companies a broader set of responsibilities other than just a duty to shareholders. The code reads:

*The management board is responsible for independently managing the enterprise in the interest of the enterprise, thus taking into account the interests of the shareholders, its employees and other stakeholders with the objective of sustainable creation of value.*

While criticisms have been directed at the German way of working, they run often counter to those heard in Britain. German companies are sometimes accused of being slow to reach decisions and to react to changing circumstances. However, in the UK, short-term decision-making is highlighted as a particular problem.

In interviews with the High Pay Centre, German employee directors said they provided a bridge between the management and the workforce.

*“We look at the strategic plan for the next five years and we look at where VW is investing. Of course, if you want to be the top auto company in the world, you have to invest in China, but we want a significant part of the investment to go to German companies.”*

says Hartmut Meine, union representative at carmaker, Volkswagen and Continental, the tyre and car components company.

*“It’s not just about profit, there is a general understanding at VW that we don’t shut plants: job security and profitability are the two goals of this company.”*

The VW supervisory board also cut the pay-out for its chief executive last year by 20% to €14million after a public outcry over excessive top pay.

### In-work poverty and income inequality

Business opponents of employee directors suggest they will focus too narrowly on workforce issues. However, that is not necessarily the case and their remit could be the same as the other non-execs.

David Coats, director of WorksMatter Consulting who is an expert on workplace democracy, says the UK labour market has three profound weaknesses:

*“stagnant earnings growth, rising levels of in-work poverty and severe income inequality.”*

He believes more worker representation at board level can help address these issues.<sup>4</sup>

In Germany, many employee directors pay 90% of their fees to unions which fund the Hans-Boeckler foundation. This in turn provides back-up, accountancy advice and financial analysis for the worker directors on boards, enabling them to better understand the technicalities of boardroom discussion.

Employee directors would not be miracle workers and would not solve all of our corporate woes overnight, but with the appropriate backing and training, they could provide a useful challenge to an all-too cosy debate in the boardroom.

Deborah Hargreaves is founding director of the High Pay Centre and a former business journalist at the Guardian and FT. ■

<sup>4</sup> Just Deserts? Poverty and income inequality: can workplace democracy make a difference? <http://www.smith-institute.org.uk/file/Just%20Deserts.pdf>

# FirstGroup and John Lewis lead the way with employee directors

By David Bolchover

FirstGroup and The John Lewis Partnership represent a rare breed in the British corporate environment. Both have board directors elected by employees. These directors also play a role within the companies' remuneration committees. Why were employee directors instituted, and what have been the benefits and drawbacks of this grass roots representation, most specifically with regard to executive pay?

An appreciation of the value of employee opinion is deeply embedded within the culture of both companies. FirstGroup, the UK-based transport company, has had a director elected from the rank and file since 1989 after one of its predecessor companies, Grampian Regional Transport, was purchased in a management-led employee buyout. Mick Barker, a train driver with First Capital Connect, was appointed to the board in January 2012, and also sits as an observer on the remuneration committee. He is currently the only employee director within a FTSE 100 company.

The roots of employee involvement in the management of The John Lewis Partnership, which operates John Lewis department stores, Waitrose supermarkets and some other services, go back much

further. Following the original democratic vision of its founder, John Spedan Lewis, the company is owned by a trust on behalf of its employees (termed "partners") who have a say in the running of the business and receive a share of annual profits, often a considerable addition to their salary (17% of salary in 2013).

Partner influence and the importance of partner viewpoints are enshrined in the company's constitution. For example, the Partnership publishes in-house journals which "encourage well-informed and fair opinion among partners about their business." Any letter from a partner can be submitted anonymously and must be published, "with any comment from the appropriate member of management", within 21 days. Furthermore, an elected Partnership Council has the power to dismiss the chairman if it thinks that he is failing to fulfil his responsibilities; and the latter must also appear before the Council twice a year to answer questions on the running of the Partnership.<sup>5</sup>

Five partners are elected to the management board. Two of these partners – Kim Lowe, Managing Director of John Lewis, Glasgow and Steve Gardiner, Branch Manager of Waitrose, Cirencester – currently sit on the remuneration committee.

## Two-way communication

UK remuneration committees predominantly consist of either current or former executives, or bankers. A 2012 High Pay Centre report found that only 10% of the members of FTSE 100 remuneration committees are from backgrounds that are not corporate or financial.<sup>6</sup> This extremely limited range of experience naturally gives rise to fears that a "group-think" mentality will simply rubber stamp high executive pay packages, and that employees and the general population, the ultimate owners of public companies, are being completely disenfranchised from this process.

This sense of detachment in turn creates concerns about the motivation of employees, who may feel their company is run in the interests of a self-serving clique. Perhaps more worryingly, it may serve to undermine public faith in an economic system deemed to have been captured by a small elite group. A 2012 survey for the High Pay Centre found that just 1% believes that chief executives of FTSE 100 companies should be paid more than £4 million per year.<sup>7</sup> According to a study by Manifest, the proxy voting agency, and MM&K, a remuneration consultancy, the average 2012 total remuneration for these executives was £4.25 million.<sup>8</sup> By ensuring that a broader range of opinions are heard, employee participation on the

remuneration committee can act as a safety valve, defusing the potential for anger and reducing feelings of disaffection. "My presence must help to bring an employee viewpoint," says Mick Barker of FirstGroup. "The committee will clearly be interested in understanding how my fellow employees will view the executives' pay packets."

Opening up communication may also relieve what is now intense scrutiny on the executives themselves. After all, if they are genuinely worth what they are paid, why wouldn't an employee director who can witness that value at first hand spread the message throughout the organisation? "I am uniquely positioned to be able to see what the role of the CEO and other executives involves", continues Mr Barker. "I see the stresses on them, and the volume of work and decisions that they have to take – and I can help to communicate that understanding to others." Given his employee status, that message is likely to have greater resonance than if delivered by another board member.

## Executing fairness

The task of defending executive pay to the broader workforce will perhaps be a more straightforward task for employee representatives on the remuneration committee of The John Lewis Partnership. The company is unique among large companies in the UK in fixing a ceiling on top pay which

<sup>5</sup> The Constitution of The John Lewis Partnership, April 2012

<sup>6</sup> "The New Closed Shop: Who's Deciding on Pay?", High Pay Centre, April 2012

<sup>7</sup> "Executive pay survey for the High Pay Centre", ICM, January 2012

<sup>8</sup> "Share price windfall reignites debate over executive pay", Financial Times, June 9 2013

is linked to earnings lower down the organisation. Rule 63 of the company's constitution states that "the pay of the highest paid partner will be no more than 75 times the average basic pay of non-management partners, calculated on an hourly basis."<sup>9</sup>

In practice, the highest-paid partner is normally the Chairman, currently Charlie Mayfield who was paid a basic salary of £825,000 in 2012, 60 times larger than the average of non-management Partners. He was also awarded the 17% bonus - the same as the rest of the staff - and other benefits which took his package to almost £1.5 million, not much more than a third of the average of his counterparts in FTSE 100 public companies.<sup>10</sup>

The remuneration committee, including the two elected partners, receive advice from external consultants on the market rates for senior directors. This advice relates to basic pay only, as The John Lewis Partnership does not award the often opaque long-term incentives (LTIPs) which normally serve to ramp up executive pay. The median basic pay of chief executives in FTSE 100 companies was £856,000 in 2012, a very similar figure to that received by Mayfield.<sup>11</sup>

The article in the John Lewis Partnership constitution which states that "the Partnership sets pay ranges which are.... sufficient to attract and retain

high calibre people" is a direct challenge to those who habitually defend annual CEO pay several times greater than that received by Mayfield. The remuneration committee clearly believes that it is in a position to recruit very able executives who are strongly motivated by the responsibility of doing the best possible job over the long-term on behalf of fellow partners. Certainly, the performance of the company does not seem to have suffered recently. In an environment where several well-known UK retailers have collapsed, the Partnership's profits surged by almost 16% in 2012.<sup>12</sup>

### **Delicate balance**

The employee director may need to negotiate intricate challenges that require a high level of diplomatic skill. There is a danger, for example, that the remuneration committee might attempt to use the wider credibility of the employee director to push through a potentially unpopular pay decision, placing him or her under considerable pressure in the process. "Exposure to the decision-making process could put the employee director in a difficult situation personally," agrees Martin Gilbert, the outgoing chairman of FirstGroup.

Mr Gilbert also says that employee directors may not possess all the necessary skills at the outset of their appointment to the Board. However, he stresses that they pick up those skills very quickly

with the right training and mentoring. "Other companies may fear the unknown," he says, "but we have always had employee directors on board. Once others realise how well the system works, they won't fear it either."

Given the level of public disquiet about the level of executive pay, companies may end up feeling they have more to fear from a process which excludes all but a tiny, unrepresentative few. Very public reputational damage, possibly resulting in a dampening of consumer enthusiasm for products and services, certainly poses a commercial threat to companies which issue pay awards that prove difficult to justify. Injecting a democratic flavour to the decision-making process can counteract the dangers of uncritical acceptance within the hierarchy, and help to persuade employees and the general population that they have a genuine say in the operations of companies which they either work hard for, or own though their pensions and investments.

David Bolchover is a writer on management and the workplace. He is the author of three business books, the latest being *Pay Check: Are Top Earners Really Worth It?* ■

<sup>9</sup> The Constitution of The John Lewis Partnership, April 2012

<sup>10</sup> "John Lewis chairman paid 60 times average salary", The Scotsman, 10 May 2013

<sup>11</sup> "Revolts over top pay see fewer bosses get rises", The Guardian, 21 September 2012

<sup>12</sup> "John Lewis announces 17% staff bonus as profits rise", BBC News website, 7 March 2013

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# Works Councils in the UK: never, or not soon enough?

By Mike Clancy

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Apparently we believe in 'employee voice' as an essential component of successful corporate engagement. Conversely, it also seems like we don't agree about how to make it happen.

The financial crisis created a new appetite for accountability: we now want to tame unjustified executive reward; we worry about widening inequality and depressed incomes undermining consumer confidence. And, we are even concerned about declining union influence; the absence of a workplace countervailing force and the wealth-sharing aspects of collective bargaining.

But is it individual voice we need to hear or collective as well? Do we contemplate giving authority to workplace representatives, let alone independent unions? Do we consult only on the employer's agenda or are some issues so important they should be jointly decided, balancing shareholder, workforce and other interests?

The most successful companies focus on 'voice' in all forms; they engage with individuals and their representatives. They recognise that sharing decisions about corporate performance, future opportunities and threats gives competitive advantage. They act

not out of moral philanthropy but because it makes sense.

## Collective voice

As we search for game changing answers to our various economic challenges I think collective 'voice' will move centre stage. Recession has caused more people to question how we run companies and the wider economy. This does not necessarily herald union renaissance: the case for responsible trade unionism delivering for members through contemporary collective solutions, is still to be won. However, private sector union roll back and declining collective bargaining, leaves alarming workplace deficits where only the employer voice is heard. And we know what happens when employers are left to their own devices-short term decision-making, fuelling excessive compensation packages.

## Spectres and winged angels

This explains why many are looking again at the Nordic/German models of co-determination based on works councils underpinned by legal powers. Not just because they deliver employee voice but also their acknowledged contribution. We have visited here before and UK unions have perceived

as many spectres, as winged angels. Preference for adversarial free collective bargaining and suspicions about 'employee' as opposed to 'union' rights, was only just sustainable when public policy accepted the role of unions in the economy. This all changed from the 1980s and since then our employee relations system has eroded. The political right prefers atomized individualism and the political left is unsure- it fears charges of being old-fashioned 'statists' should they interfere with corporate freedoms.

Consequently the UK has no coherent system of collective employee relations. In the private sector where unions still exist engagement and bargaining continues; there are also examples of employer sponsored collective voice that are valued, but the norm is minimal statutory consultation, rather than genuine joint decision-making.

Does this matter? Well clearly unions think so and perhaps so do some who may form the next government. But so should anyone who pauses to reflect. We tried heavily deregulated, financially leveraged capitalism, with little support to manufacturing. Surely we must fundamentally reappraise our approach to the workplace as an element of a sustainable corporate environment? Employee voice that is respected, influential and strong is crucial to that new vision.

The economic performance of Nordic countries and Germany attracts attention and far from being an impediment, strong voice through work councils and unions continues despite challenges, to be a cornerstone. When viewed from outside the answer as to why seems clear; works councils system or similar have a legal basis and rights are ultimately enforceable. Works councillors are not just reliant on exhortations to companies to be good corporate citizens and plan for the long term: they can intervene if they are not listened to.

## Timid proposals for corporate change

It is remarkable how timid many UK proposals are for corporate change. We fear telling companies to behave better and rely on - at best - embarrassing them into it or hoping they will do it voluntarily. When you have become accustomed to unilateral control you are not inclined to change simply because you are asked nicely.

## Adversarial approach

If works councils were a means of vetoing change, the German and Nordic economies would grind to a halt, but a delicate balance of granting voice and its responsible use is involved. Works councils are heavily engaged in the fabric and future of their organisation and operate within social policy that requires accountability and evidence as the basis for corporate

or operational decisions. Therein lies the biggest challenge to a comparable UK system. Our employee relations, either does not exist or is too readily adversarial. Whilst hostile media generally highlights calls for industrial action rather than broader union work, there are still plenty of unions favouring adversarial approaches. So could UK Unions given our 'traditions' adapt to 'works councils'? Yes if they genuinely extended voice and augmented existing bargaining. In my experience industrial action often arises due to inadequate means of workplace resolution that makes employers accountable and business decisions more effective. Moreover, we need far-reaching change that will not come from unions fighting recognition battles workplace by workplace.

For UK employers it involves a fundamental attitude shift; accepting employee collective engagement that exposes to scrutiny, issues currently decided by prerogative. Given this background, the premise of mandatory works councils at workforce request, in companies over a given size, with those bodies having real rights to hold companies to account, seems fantasy. However, if we continue as at present - whilst union demise is always exaggerated - the majority of the UK private sector workforce, will be denied voice that is common across

Europe and our search for a productive long term capitalism, that serves all citizens not just a financial and hereditary elite, will remain elusive.

Mike Clancy is the General Secretary of Prospect union. ■

## All Aboard: workers' participation in corporate governance across Europe

By Janet Williamson

In the UK, worker representation on company boards is commonly associated with the German system of co-determination. However, in reality Germany is just one of 19 European countries that have rights for workers to be represented on company boards. It is countries like UK with no rights for worker representation within their corporate governance systems that are in the minority and out of step with the rest of Europe.

It is also significant in terms of the UK debate that workers have board representation rights in countries with a unitary board system, as well as those like Germany that operate with a two-tier board system. There are also a number of countries where companies can choose between the two board structures, and in these countries workers' board representation rights generally apply regardless of which is chosen.

Across the European Economic Area (EEA), there are 15 countries where workers have significant rights to be represented on company boards. These are Austria, Croatia, the Czech Republic, Denmark, Finland, France, Germany, Hungary, Luxembourg, the Netherlands, Norway, Poland, the Slovak Republic, Slovenia and Sweden.

There are an additional four countries where workers have more limited rights to representation on company boards, mainly at state-owned enterprises. These are Greece, Ireland, Portugal and Spain.

There are 12 countries in the EEA with no provisions for workers' representation on company boards. These are Belgium, Bulgaria, Cyprus, Estonia, Iceland, Italy, Latvia, Liechtenstein, Lithuania, Malta, Romania and the UK. However, in two of these countries workers have other rights to 'voice' within their corporate governance systems. In Romania, workers have the right to attend board meetings and receive the papers but cannot vote, while in Bulgaria workers have the right to be represented in a consultative capacity at company AGMs.

There are significant variations in how workers' board representation rights operate across the different countries where they are in place. The varying approaches reflect differences of corporate governance, culture, industrial relations systems, history and political choice.

This article draws on two forthcoming TUC publications: Aline Conchon, *Workers' voice in corporate governance: a European perspective*, TUC, forthcoming, and Janet Williamson, *Workers on Board: the case for workers' voice in corporate governance*, TUC, forthcoming

## Eligibility of worker representatives

Most countries stipulate that worker representatives must be company employees. However, this is not universally the case, and some countries have no eligibility restrictions at all. Austria restricts eligibility to works council members while in Germany and Luxembourg eligibility varies according to sector, and is restricted to external trade union representatives in some sectors and to company employees in others. The Netherlands is unique in that representatives cannot be a company employee, nor a trade union representative. The role is therefore carried out by people sympathetic to the labour movement but one step removed, such as academics.

## Voting for workers

In nearly all countries, worker representatives are elected by the workforce. There are exceptions, and in the Netherlands and Hungary the appointment is at the company AGM. In a majority of countries, unions have nomination rights or are involved in the nomination of candidates in some way. There are also examples of works councils having nomination rights, sometimes alongside union nomination rights.

## Companies covered

There is considerable variation across countries in the scope of

requirements on workers' board representation. In most countries the provisions apply to both private and listed companies, but in the Czech Republic, Luxembourg and Slovakia they apply only to listed companies. As mentioned above, there are four countries that restrict the rights to state-owned enterprises.

What is striking is that in many countries, requirements for workers' participation on boards cover a wide range of companies. There are significant variations nonetheless. In eight countries, workers' participation rights apply at state-owned enterprises regardless of size and in Croatia and Austria they apply to all plcs. Most countries, however, do apply a minimum size threshold, at least for private sector companies. These vary from 25 to 50 employees in Sweden, Denmark, the Czech Republic, Slovenia, Slovakia and Norway; to 50 to 500 employees in Croatia, Finland, Hungary, the Netherlands, in Austrian private companies and certain sectors in Germany and Spain; and to 1,000 in Luxembourg. The highest threshold is found in France, which in May 2013 adopted a law extending mandatory worker representation on boards to plcs with at least 5,000 employees in France or 10,000 employees worldwide.

In the Nordic countries, workers' rights to board representation must be triggered by an initiative

from the trade union or company workers (in Norway the trigger is required only for companies with less than 200 employees).

## Number of worker representatives

The most common provision is that worker representatives should make up one third of the board. There are four countries where worker representatives make up half the board in some cases, most notably in Germany in companies with over 2,000 employees. However, even in these cases the worker representatives cannot exert a blocking vote against the whole of the rest of the board.

## Unitary or two-tier board

As already noted, workers' rights to representation on boards apply in countries that operate with a unitary board structure as well as those that operate with a supervisory or two-tier structure. Five countries – Sweden, Norway, Spain, Greece and Ireland – combine a unitary board structure with provisions on worker board representation. Five other countries – Austria, the Czech Republic, Germany, Poland and the Slovak Republic – combine a two-tier board structure with workers' board representation rights. There are also a growing number of countries where unitary and two-tier board systems operate alongside each other and in these countries workers' participation rights generally

apply regardless of whether the company has a unitary or two-tier board (Denmark, Finland, France, Hungary, Luxembourg, the Netherlands, Portugal and Slovenia).

## Duties of worker representatives

Directors' duties vary from country to country and according to whether the board is unitary or a supervisory board. However, what is important is that worker representatives have the same legal duties as other members of the board on which they sit and are subject to the same requirements of confidentiality as other board members.

In conclusion, there is no one model of workers' board representation across Europe; there are significant variations in how workers' rights to board representation operate from country to country. In considering options for how workers' board participation could work in the UK, there is much to learn from existing systems, but it is clear that there is no 'one size fits all'. It would, however, be entirely possible to combine elements from different existing systems with new provisions to create a system of workers' board representation that was uniquely suited to the UK. Looking across Europe, countries with stronger workers' participation rights – meaning widespread rights and practices for board representation, workplace

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representation and collective bargaining – do better in terms of their employment rate (broken down by age and gender), expenditure on R&D, and the risk among the population of poverty or exclusion, plus a range of other indicators.<sup>14</sup> While correlation does not prove causality, this finding is nonetheless striking and adds weight to the argument that worker representation on boards is worthy of serious consideration by policy makers and all those with an interest in the economic and social performance of the UK.

Janet Williamson is senior policy officer at the TUC. ■

<sup>14</sup> Vitols (2010), available at <http://www.worker-participation.eu/About-WP/European-Participation-Index-EPI>

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