

Background

The High Pay Centre is an independent, non-partisan think tank focused on pay and employment practices, corporate governance and responsible business .

Recent examples of HPC work include:

- [Research for the CIPD](https://highpaycentre.org/the-value-of-people-expertise-on-corporate-boards/) examining the skills and professional backgrounds of board members of UK companies
- A report with the ABRDN Financial Fairness Trust examining the extent of worker voice in corporate governance at UK companies, and how mechanisms for worker voice can be operate more effectively
<https://highpaycentre.org/6-in-10-believe-the-main-priority-of-business-should-be-delivering-better-pay-for-their-workers/>
- An analysis of the impact of pay ratio disclosures, their effectiveness and the quality of contextual reporting, also in partnership with the ABRDN Financial Fairness Trust
<https://highpaycentre.org/high-pay-centre-analysis-of-ftse-350-pay-ratios/>

Corporate governance structures and practices, and the regulations and guidance that shape them are vitally important:

- They play a key role in determining how major employers distribute their expenditure on pay
- They shape the extent of worker involvement in business strategy and high-level decision-making.
- And they influence how strategy, decision-making and ultimately business practice aligns with the interests of wider society.

For these reasons we believe the Corporate Governance Code is of the utmost importance to the UK's economic life, and welcome the new edition published by the FRC. Our response to the consultation focuses on the questions relevant to pay, worker voice and responsible business, our areas of interest and expertise.

For more information visit highpaycentre.org.

Response to consultation questions

Q3: Do you have any comments on the other changes proposed to Section 1?

A) Provision 1 - Amend *“the board should describe in the annual report... how environmental and social matters are taken into account”* to *“the board should describe in the annual report... how the company understands and measures its environmental and social impact, and how this informs decision-making and business practice.”*

While it's positive that the Code now sets an expectation that annual reports will set out “how environmental and social matters are taken into account” (Provision 1) this is vaguely worded and likely to encourage vague and insubstantial reporting.

Meaningful reporting of how a company engages with environmental and social issues might cover, for example:

- The quantified environmental and social impact of their business model and operational practices;
- the challenges and uncertainties involved with measuring the business's environmental and social impact;
- and the extent to which better environmental and social outcomes might conflict with the objective of delivering returns for shareholders, and how the business manages this tension

Unfortunately, the experience of recent reporting initiatives on related areas suggests that it is very difficult to promote this kind of objective, reflective and self-critical reporting.

[Previous High Pay Centre research](#) on reporting of workforce-related issues has shown that while the quantity of workforce-related information has increased in recent years, it is still largely presented in an uncritical way unlinked to past or future targets that is designed to present the company in a positive light than report in a fair and balanced manner.

(see <https://highpaycentre.org/how-do-companies-report-on-their-most-important-asset-2/> for more info)

The Code already contains a very similarly worded provision requiring Remuneration Committees (RemCos) to take pay and conditions across the workforce into account when setting executive pay. Again, this tends to result in meaningless, boilerplate claims of compliance with this provision without any evidence as to how they do so. Examples from recent FTSE 350 annual reports emphasise this point. The following statements are taken from annual reports published in the last three months. Whether or not well-intentioned, they have no value in terms of insight into how the pay and working conditions of the wider workforce are taken into account when setting executive pay at the companies in question.

“The Committee considers pay and employment conditions across the wider Group when determining pay for Executive Directors.” (Capital and Counties)

“The Committee considers the remuneration and employment conditions elsewhere in the Group when determining remuneration for Executive Directors” (Halma)

“The Committee considers pay and employment conditions across JD when reviewing the remuneration of the Executive Directors and other senior employees” (JD Sports)

Disclosures of this nature are a waste of everyone's time. There is a risk that the wording of the draft code risks producing something similar in relation to companies simply stating that they take environmental and social matters into account, without properly demonstrating how. It would not represent a major escalation of the burden on companies to amend the wording of this provision in line with our recommendation above, but it would be likely to yield far more useful and informative reporting.

B) Provision 5 - Amend *“if the board has not chosen one or more of these methods, it should explain what alternative arrangements are in place and why it considers that they are effective”* to *“the board should provide a high level explanation of how it has considered each of these options when deciding the best mechanism for workforce engagement and explaining its decision”*

The FRC’s own research shows that nearly a third of companies have not chosen to adopt one of the three suggested mechanisms for workforce engagement suggested in the Code. Even though there is considerable research evidence highlighting the benefits that worker directors can bring to businesses, they are widely supported in public opinion polling and they operate successfully in most other European countries they are still extremely rare in the UK. It is hard not to believe this is because of change resistance and ‘hassle aversion’ on the part of existing directors who are not the constituency who stand to benefit from greater worker voice in corporate governance. At the very least companies should be encouraged to take a more open-minded approach to worker directors.

(For more information see

<https://cdn-suk-railpencom-live-001.azureedge.net/media/media/gztltyqki/investor-guidance-on-workforce-directors-v8.pdf> and

<https://highpaycentre.org/6-in-10-believe-the-main-priority-of-business-should-be-delivering-better-pay-for-their-workers/>)

Q7: Do you support the changes to Principle I moving away from a list of diversity characteristics to the proposed approach which aims to capture wider characteristics of diversity?

Principle I - Amend *“Both appointments and succession plans should be based on merit and objective criteria. They should promote equal opportunity, and diversity and inclusion of protected characteristics and non protected characteristics including cognitive and personal strengths...”* to *“Both appointments and succession plans should be based on merit and objective criteria. They should promote equal opportunity, and diversity and inclusion of protected characteristics and non-protected characteristics including personal strengths, professional background and life experience. Board composition should strengthen understanding of the company’s key stakeholders, including its workforce and customers, and provide genuine diversity of skills, experience and perspective in order to create a culture of open-mindedness, challenge and rigour.”*

We appreciate the intent behind the changes to Principle I, which seek to broaden conceptions of diversity from a specific list of diversity characteristics to an approach that encompasses a broader array of diversity attributes beyond protected characteristics. This is the right way to ensure an approach to board composition that doesn’t seek to tick boxes, but instead encourages genuine cognitive diversity and safeguards against complacency and groupthink.

However, as the principle currently stands, we have reservations about its potential effectiveness. Generally, we believe that greater clarity and specificity enhance understanding and impact, while vague language may have a reduced impact.

Personal and cognitive strengths are important but very subjective characteristics that can be interpreted in a lot of different ways. Possible examples might include good time management or strong verbal or written communication skills. Very few boards would not be able to convincingly claim that they contain a range of these kinds of capabilities, but this isn't really the type of diversity that necessarily enables a culture of challenge at board level, and the range of perspectives and skills that supports better decision-making and oversight of the business. It's very easy to imagine a board that theoretically fulfils the criteria outlined in the draft code but is comprised of people with very similar social, education and professional backgrounds who are likely to think about business issues in similar ways.

To ensure a comprehensive understanding of diversity, it would be beneficial to explicitly reference diversity in terms of background, skills, and experience. This specificity would provide a clearer and more actionable framework for organisations.

Additionally, in the context of diversity in senior management, we see an opportunity to emphasise the benefits of having a worker director. This role can contribute to a more diverse and inclusive decision-making process within an organisation, and add a unique and vital perspective in terms of their operational understanding of the business.

Q8: Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior appointments?

Provision 24 - Amend *“succession planning for both board and senior management positions, in order to deliver the company’s strategy, including an explanation of how the committee has overseen the development of a diverse pipeline for succession”* to *“succession planning for both board and senior management positions, in order to deliver the company’s strategy, including an explanation of how the committee has overseen the development of a diverse pipeline for long-term succession.”*

We support changes to Provision 24 that aim to deliver greater transparency in the work of the nomination committee by requiring greater detail of their work in the annual report. Succession planning and senior appointments are important both intrinsically and instrumentally, therefore a more transparent and fairer system is favourable.

However, whilst the importance of long-term ‘grassroots’ succession planning is potentially implicit in the phrase “development of a diverse pipeline for succession”, we believe it should be emphasised directly. Specifically stating the long-term nature of succession planning would help in this respect.

Rather than a pipeline from management to the C-suite, succession planning and senior appointments should explicitly include the longer-term process of overseeing the training and career progression of all future potential leaders within the organisation, from entry level graduates and trainee recruitment.

The debate about CEO pay often assumes that there is a very small pool of people capable of filling senior management roles, necessitating controversial high executive pay awards (at substantial cost to the company). This is despite the fact that large companies have substantial budgets for training and development, and they hire numerous capable and ambitious young professionals every year. Therefore, it ought to be within their own gift to ensure that the supply of potential executives meets the demand. When boards and investors complain about the impact of scrutiny over top pay and the limits this places on their ability to recruit from an apparently small number of plausible candidates for executive roles, they are admitting their own failure to maximise the potential of their own workforce.

A reference in the code to succession planning from entry level up would encourage companies to think about the root causes of their difficulty finding great leaders and the need to pay huge sums to recruit the right candidate. It would encourage a focus on improving the development of their own staff internally, throughout the organisation. This could result in greater competition for senior roles and therefore result in better quality management, as well as potentially addressing the contentious issue of very high executive pay.

Q12: Do you agree that the remit of audit committees should be expanded to include narrative reporting, including sustainability reporting, and where appropriate ESG metrics, where such matters are not reserved for the board?

Provision 26 - Amend "*The main roles and responsibilities of the audit committee should include: ... monitoring the integrity of narrative reporting, including sustainability matters, and reviewing any significant reporting judgements*" to "*Board level oversight of corporate reporting should include: ... monitoring the integrity of narrative reporting, including the company's environmental and social impact, and reviewing any significant reporting judgements*"

Obviously, the value - or costs - that a company generates for society is important information for a range of stakeholders. In some cases, the negative externalities certain companies or industries produce may outweigh the value they generate for employees, customers, suppliers, shareholders and others. Certainly, if all negative externalities were borne by companies themselves, this would have a major impact on their profitability.

Understanding these environmental and social impacts has huge implications for how companies are taxed and regulated and whether investors might invest in them. So it is important that the companies themselves try to assess and report on their environmental and social impact in as much reliable detail as possible. For these reasons, we believe the code should use the term 'environmental and social impact' because it encourages the most comprehensive reporting to stakeholders in a way that terms like 'sustainability matters' or 'environmental and social objectives' do not. The environmental connotations of 'sustainability' also make it likely that the important social impact of business practices will largely be ignored.

Precisely quantifying environmental and social impact is an extremely difficult task that few companies will be able to do in an uncontested or uncomplicated way. For example,

companies in industries such as retail and hospitality create large numbers of jobs, which undoubtedly has a high social value. However, many critics would argue that they could pay higher wages for these jobs, and note that very often taxpayer-funded in-work benefits are required to top up the pay of the employees. Similarly, pharmaceutical companies provide much needed medical research but are subject to criticism over the prohibitive costs they charge for their products.

Despite these challenges, it is important to understand the environmental and social impact as best as possible, in order to work towards achieving the best possible outcomes from business practice for society as a whole. Indeed, the challenges of measuring social and environmental impact are likely to only be ameliorated by better disclosure by business of how they attempt to do so, leading to informed stakeholder dialogue.

In terms of how boards should provide oversight of environmental and social reporting, audit committees possess expertise in measuring, assuring and disclosing information on company performance. As we have noted above, however, reporting on environmental and social outcomes is not an exact science and will involve subjective judgements and stakeholder dialogue in order to reach conclusions that will continually be assessed and reviewed. This may require a different culture and approach to those most appropriate to the financial audits that audit committees are used to overseeing.

At the same time, many companies now operate environmental and social committees (or those with a related remit) who may possess superior expertise on these specific issues and their measurement.

There is currently very little regulatory oversight of these committees, despite:

- their proliferation (over 40% of FTSE 350 companies according to recent High Pay Centre research);
- the acknowledged major environmental and social impact of large companies;
- and the growing stakeholder interest in these environmental and social impacts

(see <https://highpaycentre.org/the-value-of-people-expertise-on-corporate-boards/> for more information)

We think it is now time for these committees to be mandated and incorporated into the Corporate Governance Code, through a requirement to have a committee with a remit to review the firm's environmental and social impact.

While environmental and social impact should be a matter for the entire board, having a regular committee reporting into the board on these topics - plus board members who regularly think about these issues through membership of the environmental and social impact committee - is likely to raise rather than diminish the prominence of environmental and social issues at the full board.

Q22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?

A) Principle P - Amend “*remuneration outcomes should be clearly aligned to company performance, purpose and values, and the successful delivery of the company’s long-term strategy including environmental, social and governance objectives*” to “*if performance-related pay is used, remuneration outcomes should be clearly aligned to the company’s environmental and social impact as well as the company’s financial performance, purpose and values, the successful delivery of the company’s long-term strategy.*”

There is an ongoing debate about the effectiveness of performance-related pay. Though very few listed companies do so, there’s no real reason why companies should not pay their senior managers a basic salary and expect them to perform the job competently in return, in the same way it works for almost every other worker across the economy, including those in many senior roles. So for the code to implicitly mandate incentive payments is perhaps mis-guided. Simple salary-based payments would certainly enable boards and investors to dedicate more time to issues beyond executive pay.

If performance-pay is to be used, the code should directly recognise that performance should be assessed holistically in terms of the value (or costs) that the company generates for society as a whole, rather than in terms of the company’s subjective “ESG objectives.”

Where better ESG performance also results in better financial performance, the company is already likely to set and manage ESG objectives and does not need to be mandated to do so by the Code. Conversely, when worse ESG performance results in better financial outcomes (for example by using cheaper but more polluting energy, or through exploitation of underpaid workers), the company is incentivised to act in a manner contrary to the interests of society and regulators need to act.

A principle of the code stating that the pay should be linked to the company’s environmental and social objectives does not ensure good outcomes for society because the company will not necessarily set itself objectives aligned with the interests of society. A principle stating that any performance-related pay package should be aligned with the company’s environmental and social impact, on the other hand, sets an expectation that the company should conceive of its performance in respect of its environmental and social impact, as well as the financial returns it generates, and incentivise socially and environmentally responsible conduct.

B) Provision 34 - Amend “*the policy should be clear, identify and mitigate risks associated with remuneration, and ensure outcomes are proportionate and do not reward poor performance*” to “*the policy should be clear, identify and mitigate risks associated with remuneration, and ensure outcomes are proportionate to internal and external pay outcomes and do not reward poor performance.*”

The term “proportionate” in provision 34 here is vague and open to interpretation. Proportionate to what? The obvious benchmarks are pay within the company, across the economy generally, pay for external leadership roles and the value generated for the company by the executive specifically while recognising the contribution of other workers

and the company's economic context. These factors that affect proportionality could be communicated more clearly in the Code.

Q24: Do you agree with the proposed changes to Provisions 40 and 41?

Provision 43 (formerly 41) - *There should be a description of the work of the remuneration committee in the annual report, including... Re-insert reasons why the remuneration is appropriate using internal and external measures, including pay ratios and pay gaps;*

We believe that the deletion of this provision is not advisable and sends the wrong signal. Pay data, including pay ratios, is a critical metric for assessing executive remuneration and corporate governance practices. How major employers distribute their expenditure on pay is a major determinant of living standards in the UK. Pay for senior managers of large businesses is an acknowledged driver of the UK's comparatively high levels of inequality and the large share of total incomes accruing to the richest 1% of the population. There is a growing body of academic literature showing that high levels of income inequality increase instability (Berg and Ostry, 2011), debt (Iacoveillo, 2008), inflation (Beetsma and Ploeg, 1996) and decrease productivity (Stiglitz, 2009). In light of this, there is no conceivable reason for discouraging disclosure of this relevant benchmark for CEO pay, or for making pay gaps less visible and harder to find.

(For a summary of studies highlighting links between inequality and economic problems see <https://equalitytrust.org.uk/economic>)

While gender pay gap reports and disclosures may be available elsewhere, this just means companies have calculated the information - which as we have said, is important to stakeholders for a great many reasons - and should be disclosed in the annual report which is the first and most obvious resource for anyone wanting to understand a company, its corporate culture and business practices.

Q25: Should the reference to pay gaps and pay ratios be removed, or strengthened?

As noted above, we do not think the reference to pay gaps or pay ratios should be removed. The understanding of the socio-economic consequences of income inequality as a potential threat to businesses has become increasingly clear (as referenced above). There is no justifiable reason why pay data, including pay ratios, should not be included in the annual report, especially when considering that it is a critical benchmark for evaluating CEO pay and its alignment with the broader workforce.

Narrative reporting on pay ratios (effectively, compliance with this provision and the legal requirement to provide narrative reporting contextualising the pay ratios within a wider pay policy) is typically poor quality. Companies tend to simply write that the pay ratio is consistent with the policy without actually saying how.

(for more information see

https://highpaycentre.org/wp-content/uploads/2020/12/0.1_MUL1564-FOUNDATION-Pay-ratios-report.pdf (pages 36-38).

However, that does not mean we should disregard any attempt to encourage companies to reflect on intra-firm pay gaps, problems they might cause (either to the company or in the form of negative externalities for society) and the reasons they might be justified. Instead, this suggests that better guidance is needed. In particular, we would recommend that reporting should explain to what extent workers and investors are pro-actively informed of pay gaps within the organisation, and how their views are taken acted upon. It would also be useful to encourage companies to set out their future expectations in terms of pay ratios, and whether there is any concern about existing pay gaps or desire/intention to reduce them.

Finally, it is worth noting that while CEOs are usually the highest earning worker within an organisation, and their pay is highly symbolic, the pay of other top earners is also of considerable interest. Most large organisations will employ a large number of senior staff whose pay is very high in comparison with other employees and workers across the economy as a whole (keep in mind that pay of around £150,000 is enough to put the recipient in the top 1% of UK earners, making more than 99% of the country's workforce). The amounts paid to these high earners contribute to inequality and represents a meaningful proportion of expenditure to the company, with potential opportunity costs in terms of pay for low and middle earners, investment in training and productivity or returns to shareholders. Better disclosure of pay for those at the top beyond the CEO would enable a better discussion of the value generated in return for such generous pay. The Code should therefore include a requirement to provide data on expenditure on high earners beyond the executive team.