The direction of travel of remuneration governance
MM&K Remuneration Committee Dinner

November 2017

Overview of the evening

MM&K recently held one of its regular Remuneration Dinners for CEOs and Non-Executive Directors. On this occasion, the theme for discussion was: ***"The direction of travel of remuneration governance in the UK and what the regulatory environment might look like in 5 years' time"***. The theme was introduced by Paul Norris and the full text of his introduction can be found in the accompanying November edition of *Board Walk.*

As with all our dinners, a lively and thought provoking debate followed. Given the breadth of scope allowed by the theme for the evening, the conversation was wide ranging and many topics were covered. From the course of the evening, we were able to pick out four key areas that were of particular interest:

- What does the future hold?
- Considering wider stakeholders
- The changes needed to remuneration philosophy
- The relationship between government and business.

Whilst the Chatham House Rule prevents us going into specific details, the rest of this note summarises the points raised and, where appropriate, provides unattributed commentary.

What does the future hold?

There was some discussion on the use of discretion by remuneration committees and that, going forward, it would be important that discretion was seen to go both ways, with committees feeling able to reduce remuneration if it is not justified in the circumstances. The recent example of potential payments to management at Persimmon (and the resulting negative press) was such an example. One individual felt strongly that no-one was worth the level of money and that the remuneration committee should take steps where executives are seen to get rich just due to favourable circumstances.

The Government's setting up a consultative group to look at corporate governance in private companies was also mentioned. Whilst there was wide agreement that this was a reaction to the events at British Home Stores, guests agreed that inclusion of private companies in the corporate governance rules will inevitably happen.

Going forward, there was also concern expressed that fund managers are a dying breed, with more and more investors using tracker funds. As a consequence, proxy houses, such as ISS, are getting more and more powerful. This leads fund managers to operate in a defensive system and causes companies also to operate "defensively".

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One guest said that his company has not complied with shareholder guidelines, but they have still brought their shareholders along with them – however, it had taken quite a number of conversations with the shareholders to get their backing. Another said this is easier if you take things by gradual steps rather than massive changes – they expect to get a 99% vote from the company's shareholders. However, the "right" course of action for the company commercially would have been to make a big change, but it would be too difficult to get shareholder support as it would be a position that the proxy agents were likely to red flag under their current guidelines.

Considering wider stakeholders

It was suggested that the proposed new emphasis in corporate governance (under Section 172 of the 2006 Companies Act), requiring boards to explain how they take the interests of wider stakeholders into account, gives a good opportunity for companies that do the right thing to communicate this more widely and there was a number of voices who were of the belief that the increased need for transparency in this area gives companies an opportunity to explain the business and use it as a positive tool both in the press and within the workforce.

This was summarised by one dinner guest, who having served as both a corporate chief executive and a NED, expressed a view that there are more people who count in corporate governance than just shareholders. But people in business who wanted to do the right thing always did anyway.

It was contended by one guest that considering the wider stakeholders in the context of executive remuneration principally means considering employees. Customers are concerned with product price, availability and quality; suppliers are concerned with getting paid and companies being financially sound. It's mainly employees who are concerned with remuneration. But employees are less concerned about what the executives are paid than their own pay, relative with their workmates, and also they are more concerned with career progression. This seemed to be supported by the results of employee engagement surveys (which almost every large organisation does).

The conversation, unsurprisingly, also included the future requirement for companies to report the CEO/employee pay ratio. One diner said it is a ridiculous comparison as you cannot compare between industries. Another said the relevant thing is the year on year change within one company. One suggested there is a danger of firms outsourcing low cost jobs to improve the ratio. The Labour party manifesto proposed a 20 times cap on the ratio. One participant suggested companies will have to put up with this blunt instrument from the Government as they have not curbed and controlled excesses themselves.

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Finally, in terms of remuneration and wider stakeholders, it was felt that, historically, the deal on remuneration had always really been between management and the shareholders – or is it now management, shareholders and the remuneration committee as a separate and distinct "person"? Whilst it was not overtly discussed, the future requirement for large companies to have some sort of employee representation in the mix hung over the conversation with some expressing a view that this would fall to the remuneration committee and therefore entrench them as a separate group of stakeholders.

In terms of internal communication on remuneration, one person suggested that it might be appropriate going forwards to produce remuneration reports at all levels in the company. It had to be assumed that full disclosure of pay happens internally anyway, so it is better to get ahead of it and make a virtue of the facts. Ultimately, if a business is being run for the benefit of everyone, the company should be proud of this.

The changes needed to remuneration philosophy

There was a general feeling amongst those attending that whilst pay ratios (and the like) were generally too blunt an instrument to be effective, they represented a wider perception of excessive remuneration and the "unfairness" of high remuneration packages.

One participant made the point that in the UK we do not so much have increasing income inequality; but we do have increasing *wealth* inequality. Essentially, this means that those lower down in a business had few assets that would, over time, generate future wealth for them.

This was supported by another dinner guest who said capitalism is essentially under threat from people who do not have capital. The solution, in part, is to promote wider ownership of capital. The John Lewis model might be spread wider. One participant said that in every company he had worked for or served shareholding is cascaded down the company. Remuneration committees should therefore consider whether to include wider shareholder ownership within its brief.

In terms of the increased public interest in executive remuneration and what is the "right" amount of pay, the level of negative reporting shows that large private businesses really have not managed their public relations.

The (at the time) unpublished Manifest executive pay survey for 2017 shows that the Single Total Figure of Remuneration (the Government defined realisable remuneration figure) for FTSE 100 chief executives dropped by 15% compared to the previous year (mostly due to lower LTIP payments). This message could be shared widely, but it is hampered by the fact that the survey also shows that salaries rose by 10%, giving a very mixed picture.

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The relationship between Government and business.

During the evening, the issue of how the Government was approaching executive remuneration was touched upon. It was noted that there was a real tension between the government positions of being pro the free market, whilst at the same time introducing more and more rules and regulations which inhibit this freedom. It was felt unavoidable that this approach to rules would lead to increasing regulation of private businesses.

It was felt that the current state of the economy and politics means that the politicians believe that the public are looking for transparency and control of excess. One participant observed that, in order to achieve this, the Government is relying on "shame" to control company behaviour – in particular it uses its Behavioural Insights Centre to devise ways of getting change to happen cheaply. The danger here is that the perception of what is "right" may be lost in headlines or the wider mood of the country. Interestingly, for example, MM&K research shows that from 2002 to 2010, shareholder returns were as high as or higher than increases in executive pay.

One diner felt strongly that executive pay, and the Government's approach to it, were being used for political means, which was not helpful to the future of the economy. Instead, it would be better to have a reasonable conversation between a company and government. Politicians do not understand the real issues about pay differentials – they have too much at stake.

The example of gender pay reporting was next. Whilst all participants supported people being paid equally and that the gender pay gap needed to be addressed, the general opinion was that the way in which the pay gap was being reported was likely to lead to deliberate misreporting as it gave good copy to newspapers and commentators. One guest considered that the problem with doing this was that it would disguise the real issue, which is the relative movement of the sexes through the ranks.

In order to prevent further rules and regulations in this area, it was suggested that the role of the remuneration committee needs to be widened – for example this is already happening in "Financial Services", where the committee needs to consider individual pay awards below executive director level and therefore opens up more comparable pay awards to review.

When asked what else businesses could do to help themselves in this area, one guest asked the meeting if enhanced reporting transparency had helped. Another answered that it was making a difference. Interestingly, one fellow diner criticised a fear that providing more information is somehow bad for companies. They did not understand why this should be the case and felt that companies should not be ashamed of what they have done and should be prepared to defend it. By doing this, they could manage the public perception of their business better.

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