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HIGH PAY CENTRE

UK Corporate Governance Code Consultation: response from the High Pay Centre

Background

The High Pay Centre is an independent, non-partisan think tank focused on the causes and consequences of economic inequality. We focus in particular on pay, worker voice and responsible business practice.

Recent examples of HPC work include:

- Research for the CIPD examining the skills and professional backgrounds of board members of UK companies https://highpaycentre.org/the-value-of-people-expertise-on-corporate-boards/
- 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 he 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, play an important role in how major employers distribute their expenditure on pay. They determine 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?

> 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 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 fairly empty reporting.

It would be possible to comply with this provision by stating that environmental and social matters are not taken into account. While it is unlikely that many companies would take this approach, they will probably offer little more than fairly general statements saying that environmental and social matters are taken into account without any meaningful reporting of, for example:

- the environmental and social impact of their business model and operational practices;
- the challenges with measuring this;
- and the extent to which better environmental and social outcomes might conflict with the objective of delivering returns for shareholders

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.

The Code already requires 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. 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.

> 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 companies’ 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 workers, 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 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/gztlyqki/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/)

In particular worker directors, despite being widespread in other parts of Europe, enjoying strong public support and only sit on the board of five UK-listed company boards.

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, and 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 transition 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 fufils 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 - as succession planning and senior appointments are important both intrinsically and instrumentally, therefore a more transparent and fairer system is favourable.

However, whilst potentially implicit in Provision 24 "development of a diverse pipeline for succession", we believe greater emphasis should be placed on the 'grassroots' succession planning. 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 many companies have substantial budgets for training and development, and they frequently hire numerous young professionals each year. Therefore, they ought to have a vast pool of talent that could potentially feed into senior management roles. The fact that boards and investors sometimes complain about the impact of scrutiny over top pay and the limits this places on their ability to attract and retain the small number of plausible potential executives indicates that they are not maximising the potential of their own workforce.

A reference in the code to succession planning from entry level up would help address the root causes of leadership shortages and ensure a more sustainable and diverse talent pipeline. Relatedly, it would result in greater competition at the top and therefore result in better quality senior 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 productivity. 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. We much prefer the term 'environmental and social impact' because it encourages the most comprehensive, transparent and reflective reporting to stakeholders in a way that terms like 'sustainability matters' or 'environmental and social objectives' do not.

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.

As noted above, the current reference to reporting on 'sustainability matters' is again a vague term, unlikely to encourage fully honest and self-critical reporting. The environmental connotations of 'sustainability' also make it likely that the important social impact of business practices will largely be ignored.

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 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 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?

> 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. It would be useful to add a provision that explicitly states that alternative compensation structures, such as fixed base salaries for executives, would simplify remuneration and avoid some of the complexities associated with performance-related incentives. Most workers across the economy, including leadership roles in the public sector or voluntary sector operate on the expectation that the post-holder will be paid a salary for the role and they will do a good job in return for this salary. Large businesses might also function this way - and it 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.

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 pay should be aligned with the company's environmental and social impact, on the other hand, sets a requirement for the company to conceive of its performance in respect of the its environmental and social impact, as well as the financial returns it generates, and to incentivise good environmental and social impacts if it uses performance-related pay at all.

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> 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 of importance interest 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 pg 36-38 https://highpaycentre.org/wp-content/uploads/2020/12/0.1_MUL1564-FOUNDATION-Pay-ratios-report.pdf)

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 into account. 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.

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 contributes 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.

As a final point that relates to this issue specifically but also our entire response and the FRC's work reviewing the Code more generally. We have recommended some (small) additions to the Code which may go against the grain of many comments. There has been a very active campaign to reduce the corporate governance 'burden' on companies, backed by a highly contentious belief that this will benefit the economy and wider society.

It should be noted that this belief does not at all accord with public opinion. When the High Pay Centre issued polling on attitudes to business, 49% agreed with the proposition that large businesses generally did not behave in a way that is beneficial to society compared to 38% who said they do behave in a way that is general beneficial to society. 58% of respondents said they believed that businesses should be subject to more regulations so they are accountable and the wealth they create is shared fairly, compared to 31% who said that businesses should be subject to less regulation so that businesses are free to innovate and take the decisions they need to grow and create jobs.

(For more information see https://highpaycentre.org/wp-content/uploads/2022/11/STA0922916658-001_aFFT-Pay-Ratios-Report_1022_v5.pdf)

The Corporate Governance Code is not supposed to be set according to public opinion. However it is supposed to reflect the public interest and to encourage behaviour from businesses that is aligned with the interest of wider society. The public can be expected to have a reasonable grasp of what is in their interest and all polling suggests they do not favour a roll-back of supposedly burdensome regulations that actually very often ensure much better and more responsible business practice.

We think this is an important point worth highlighting, given the increasingly vocal arguments being made regarding the supposed corporate governance burden