St PAUL'S INSTITUTE

Catherine Horton
Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

23rd February 2018

Dear Ms Horton,

Thank you for the opportunity to respond to the Financial Reporting Council's (FRC's) December 2017 *Proposed Revisions to the UK Corporate Governance Code*. St Paul's Institute is replying based on work on a project entitled *Fair Pay for Fair Work* being carried out at the Institute and funded by Friends Provident Foundation. This response is based on our research, our draft policy recommendations and the results of our two industry roundtables on the paper held in the course of February of this year. We are responding only to those questions and principles directly relevant to our research.

First, you have asked for views alongside the formal consultation on the revised Code. It is important to be clear that in keeping with Section 1 on Leadership and purpose, the importance of 'wider stakeholder interests to achieve long-term sustainability' is absolutely foremost in our thinking and consideration. We believe that companies have reciprocal obligations that accompany their limited liability and license to operate. Anything that can be done to discourage short-termism, and especially the focus on short-term share price, should be done. This has important implications for compensation policies discussed below. However, at this stage, the difficult and important issue to recognize is the emphasis on regular measuring and reporting can often have the unintended consequence of increasing management and investor focus on short-term, micros actions, rather than on long-term sustainability, purpose, strategy and stability of the company in question. In addition, the Institute would urge the Financial Reporting Council to be cognisant that we are regularly adding to reporting burden without taking anything away, and urge the FRC to maintain a sense of proportionality in reporting.

Already, FTSE 350 companies have annual reports in the hundreds of pages, increasingly limiting their readership to investment professionals. This further distances the individual investor, consumer and stakeholder from an ability to understand what is going on within listed companies. The loss of connection between the company and the person, whether that person is the customer, the investor or the end investor pensioner has much to do with current levels of distrust of finance and business. It also contributes to the runaway compensation culture as highly paid professional investors are opining on highly paid corporate executives. In every case we believe simplicity should be privileged in order to make reporting more accessible.

Second, we believe very strongly that all people and all companies have a responsibility as part of their own long-term sustainability and purpose to ensure that they leave the planet in a better position than they found it. This can be well-expressed through the UN Sustainable Development Goals but not only through them. However expressed, it should be incumbent on companies to be responsible citizens wherever they are located in terms of environmental protection, pay and treatment of employees and the use of circular economy principles wherever possible.

Q9 *Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?*

The requirement to publish data on gender balance is forcing quoted companies to consider, publish, address and monitor progress on steps they will take to reduce gender imbalances. This is the key value in the publication requirement. While disinclined in principle to be too prescriptive, comparable data and definitions across sectors, companies and time is most useful. However, it is vital to get a correct and accurate definition of executive compensation before publication is effective. Many of our participants believe current definitions do not work well.

It is for these self-same reasons that we favour requiring consistent publication of some kind of pay ratio or pay quartiles for all staff including senior executives. We believe (see below) that this data over time will force a discussion with the workforce and shareholders on workforce contribution to earnings and productivity.

Q14 *Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?*

Q15 *Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?*

Q16 *Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?*

Our working groups supported increasing responsibility of remuneration committees to look at pay policy as a whole, including executive compensation, but asked that the FRC be wary of shifting responsibility for execution from management to a Board committee.

On remuneration, as mentioned above, clear, consistent comparable data and definitions across sectors, companies and time will be most useful on executive compensation. This will encourage companies to explain why pay is distributed as it is and whether they feel they need to make any changes in remuneration policy. While it is tempting to reduce this to a single ratio, it will be important to consider how long-term incentive payments, optional bonuses, *malus*, and pension contributions will be considered in this calculation, as salary alone for senior executives would give only a small portion of the picture, and the current inclusion of exercised options makes figures move dramatically from year to year.

Our working group has considered whether the most effective measure might be the percentage change in total compensation by decile or quartile of the workforce each year, possibly separating out the very top executives. This would demonstrate to all stakeholders, investors and employees how the company's surplus is being distributed, and encourage the board and management to explain why they think these incremental increases represent each group of workers' contribution to the year's result.

Further, companies should think very seriously about long-term incentive plans (LTIPs) at least two levels:

- The complexity of these plans makes it very difficult for non-institutional investors to actually understand executive compensation or calculate the total quantum with any accuracy.

- Once long-term compensation, usually shares, are vested, members of these plans are entirely incentivised by short-term share price movements, as rights to share options cumulate annually. This means that they will begin to privilege share buybacks in order to ensure consistent share price increases. This suggests that a prime motivator driving corporate short-termism it is actually LTIPs. There is beginning to be evidence that this same LTIP/short-term share price incentive is what has made capital investment and research & development spend in the UK so much lower than elsewhere in Europe since the financial crisis. This creates an inverse link between the composition of executive compensation and the FRC's objective of 'wider stakeholder interests to achieve long-term sustainability.' It will be difficult to encourage executives to care most about the long-term when their financial incentivisation is based on short-term share price movements.

Please do not hesitate to contact us should you have any questions about this response. We will be running a series of public events on our policy conclusions later in the spring if these might be of interest to you.

Sincerely,

Barbara Ridpath
Director