

CBI response to BIS discussion paper on executive remuneration

1. The CBI welcomes the opportunity to respond to the discussion paper on executive remuneration. We recognise the sensitivity and importance of the issues raised and the need for this area of corporate governance to be operated – and be demonstrably seen to be operated – to the highest standards. Whilst we believe the current approach to corporate governance, when operated correctly and with rigour, should achieve this, we equally recognise there are areas for improvement in process and transparency.
2. We believe that executive remuneration must be squarely linked to performance. High pay is only ever justified by outstanding performance. High rewards for mediocre performance are unacceptable. Failure should never be rewarded.
3. Our members are conscious of the wider debate in the UK and other advanced economies about the scale of differential levels of reward for employees across society. It is important that executive remuneration should be set through processes and at levels which are market-responsive but socially aware. It is vital to ensure that companies operating in the UK can continue to attract and retain top talent in globally competitive markets.
4. In this context, it is absolutely essential that there is a clear link between pay and performance at executive level that stands up to scrutiny. The CBI accepts that there are cases where this link is currently unclear and in some cases weak. The link needs to be strengthened and its operation clearly demonstrated in every public company.
5. The CBI's key principles for strengthening the link between executive pay and performance in UK quoted companies¹ are:
 - **High pay is only ever justified by outstanding performance. High rewards for mediocre performance are unacceptable. Failure should never be rewarded.**
 - **The metrics and evidence for performance should be made explicit in remuneration reports, and remuneration schemes should avoid complexity**
 - **The current basic framework of corporate governance relating to executive remuneration setting is robust when applied correctly and with rigour**
 - **But there are improvements that could further strengthen the system: these concern the make-up of remuneration committees, spreading good practice to encourage appropriate challenge, and greater scope to reduce or withhold reward where business performance is not sustained in the longer term**
 - **In taking decisions about executive reward, remuneration committees should have regard to the company's wider pay strategy, appropriate input considerations and consistency across senior management**
 - **Improved transparency would also help underpin our robust system. Changes should include disclosure of a single aggregate figure for directors' taxable remuneration, explanation of the nature of performance measures and additional disclosure relating to remuneration consultants.**

¹ The focus of this response is on UK public companies. Different considerations will apply, for example, to the UK subsidiaries of overseas-based parent companies.

1. To strengthen the link between pay and performance the CBI recommends:

- Remuneration schemes should avoid complexity
- The nature of the links between performance and reward, the measures used and – as far as practicable and subject to commercial sensitivity – the results on which reward has been calculated should be spelled out in remuneration reports
- A single aggregate figure for individual directors' pay should be included in annual reports in addition to other existing reporting
- Remuneration committees (RemCos) should consider executive remuneration in the context of company-wide pay strategy. Specifically, we propose that they should look at appropriate company-specific measures as part of this process. This might be in the form of a ratio between the median earnings of the highest-paid 10% of employees in the company and the median earnings of the lowest-paid 10%. However, any such data may not be an appropriate basis for comparison across a wide range of companies with different operating characteristics. It would therefore be for benchmark purposes only that, over time, would show trends in the company's internal pay strategy.

2. To build on the robust nature of the UK's existing system of corporate governance the CBI recommends:

- Business action to widen the pool of non-executive directors, including those taking part in RemCos
- RemCos should examine the practicalities of greater use of measures to reduce or withhold performance-linked reward where business performance is not sustained in the longer term. In addition, shareholder groups should encourage greater use of clawback provisions in companies, to apply in cases such as misstatement of results, while recognising the practical difficulties in implementing these provisions, particularly where remuneration has vested, or from former employees
- Better sharing of RemCo best practice, focusing in particular on encouraging appropriate challenge, with RemCo chairs committing sufficient time and developing their expertise
- Further disclosure on the process of appointing, use of and fees paid to remuneration consultants.

The CBI believes that the existing governance framework for remuneration, operated through remuneration committees, boards and shareholders is appropriate when implemented in a robust and rigorous manner.

High pay is only ever justified by outstanding performance

6. Outstanding performance can justify high pay. It is essential that we should never lose sight of the importance of attracting, retaining and motivating the most able executives to manage our public companies. Time and again, research has identified the quality of management as fundamental to the success of a business – and therefore essential to the shareholders of that business, its employees and customers, and to our wider society.²
7. The CBI is equally clear that high reward for mediocre performance, or any reward for failure is unacceptable.
8. All too often, debate on executive remuneration in the UK media focuses on headline numbers and misleading averages, overlooking the sheer variety and complexity of practice and outcomes. Nonetheless, we recognise that the existence of the essential link between executive performance and reward is not always readily apparent from remuneration reports. Nor do reports always show proportionality between performance and reward. This needs to change.
9. We have to recognise, however, that this is a complex area, made even more complex by the international nature of businesses and the difficulty of explaining the diversity of measures that need to be used to assess progress effectively.
10. Despite these difficulties, it is critically important that RemCos should set out their decisions in ways that leave no doubt about the strength of the links between the performance of executives and the reward they receive. This means avoiding complexity in remuneration schemes, explaining the processes of assessment and detailing the performance measures applied as clearly as possible in remuneration reports. The information included must not be at a level of detail that is commercially sensitive, but should give shareholders clarity about the basis on which decisions have been made.
11. Whilst changes to each element of reward should be recognised and reported as a separate decision by the RemCo, it is important that the impact of these separate decisions on the whole remuneration package is also reported. Currently, for example, many bonus and long-term incentive schemes have their parameters set in terms of multiples of basic salary, automatically triggering increases in these when salaries are reviewed. For example, a 2% increase in salary could automatically lead to a 10% increase in bonus potential, if the maximum bonus were set at five times salary. Depending on the nature of pension provision, a change in base salary can also trigger substantial additional pension costs.

The current basic framework of corporate governance is robust when applied correctly and with rigour

12. The CBI has long believed that the over-riding objective of a board's remuneration strategy should be to promote effective risk management and create a strong alignment of interests between directors and executives on the one hand and the long-term health of the organisation and its shareholders on the other. Our view is that the current framework, applied correctly and with rigour, is an appropriate and robust means to deliver that objective. It is well understood and establishes an appropriate balance of interests.
13. As the discussion paper rightly recognises, current systems for determining executive remuneration have evolved in response to guidance from, and discussions with, shareholder groups and other stakeholders in the investment and advisory community. The standard approach under current corporate governance practice is for RemCos to make recommendations on pay and other elements of remuneration for executive directors to the company board. The board as a whole holds final responsibility for sign off.

² R. Homkes, *Enhancing management quality: the potential for productivity growth after the recession*, CentrePiece, Winter 2010/11

14. The board, taken collectively, are independent of the company's executive management, as the majority are non-executive directors. They are usually elected annually by shareholders to act as their agents and represent their interests as owners of the business. Because of this system – and the fact that the chair of the RemCo is a non-executive director – the RemCo chair is effectively re-elected every year by the shareholders already.
15. There are, however, changes which should be made to help reinforce the rigour of the system. We outline our thinking below.

There are improvements that could further strengthen the system: these concern the make-up of remuneration committees, spreading good practice to encourage appropriate challenge, and greater scope to reduce or withhold reward where business performance is not sustained in the longer term

i) The make-up of remuneration committees

16. Strong boards and effective RemCos are central to good corporate governance and healthy businesses. As part of achieving these, the CBI has long advocated business action to widen the pool of non-executive directors, including those taking part in RemCos.³ This would help tackle the perception that the current system involves a “closed shop”⁴ of senior executives deciding who gets paid what at the top of companies. This perception is inaccurate, but deeply damaging to business reputation. An excessive emphasis on seeking as non-executives those who have filled executive, private-sector roles risks excluding candidates with much to offer, for example, from the professions or universities. Greater diversity among non-executives can bring many benefits, including different perspectives on executive rewards. Above all, non-executive directors have a key role to play on behalf of shareholders in providing independent scrutiny and challenge to the executive management.
17. In contrast to the contribution non-executive directors can make, the inclusion of additional independent members or employee representatives on RemCos would fundamentally change the UK's corporate governance framework. Independents or employee representatives would add little to the process by comparison with a non-exec who has the advantage of being an elected shareholder representative, has an understanding of the business thanks to being on the board and experience of the kind of challenge that is required. The same would be true of introducing a binding workforce vote. The costs and practical logistics of holding a vote across a global workforce and ensuring that all employees were provided with the information and understanding they would require to discharge their voting responsibilities is impractical. The proposal to introduce a binding vote for shareholders would fundamentally alter the UK's basic framework of corporate governance, which the CBI believes is robust when applied correctly and with rigour. The CBI strongly opposes these options.

ii) Spreading good practice to encourage appropriate challenge

18. Rules and guidelines can only be effective up to a point. In the end, the way decisions are reached on executive remuneration and the quality of those decisions depends upon the conduct of non-executive members of RemCos. We need to find ways to capture and spread good practice. A prime role for non-executives, for example, is to challenge executive directors and to weigh up the evidence on their performance, levels of reward and external labour market considerations in taking decisions as RemCo members. Some commentators have suggested that on occasion non-executives have been concerned not to rock the boat too hard, and may therefore have steered away from the tough decisions they should perhaps have taken.

³ *Room at the top*, CBI, 2010

⁴ *Cheques with balances: why tackling high pay is in the national interest*, The High Pay Commission, November 2011, p7

19. An essential step to ensure RemCos provide appropriate challenge is for their chairs to commit sufficient time and develop their expertise to a level that enables them to subject the evidence made available to the RemCo to critical scrutiny. Some RemCo chairs, for example, hold annual meetings with major shareholders, which can help ensure views are aligned. This is not an appropriate area for legislation, but shareholder bodies could consider revising their guidance to give emphasis to the vital part played by the chair and the demands of the role.

iii) Greater scope to reduce or withhold reward where business performance is not sustained

20. Alignment of the interests of directors with those of shareholders is essential for the long-term health of a company. As part of this process, the CBI has long supported the principle that a significant proportion of executive remuneration should be deferred to allow time for performance to be properly evaluated and for the sustainability of improvements to be tested. The focus should be on rewarding achievement of improvement in company results that is sustainable in the long term.

21. The government and shareholder organisations should encourage more widespread adoption of provisions as a standard practice to reduce or even entirely withhold deferred remuneration where improvements in company performance are not sustained in the longer term. This is best done through guidance, not prescription. The fact that remuneration linked to improved business performance is deferred until the improvement is proven should not in itself justify increased levels of reward.

22. The number of public companies with clawback provisions in their incentive schemes has been increasing⁵ and this is a welcome trend. In most cases current provisions are only invoked in circumstances such as misstatement of results or gross misconduct on the part of an individual. We would support shareholder groups encouraging more widespread adoption of clawback provisions in companies, while recognising the practical difficulties involved in clawing back remuneration that has already vested, or from former employees.

In taking decisions about executive reward, remuneration committees should have regard to the company's wider pay strategy

23. One of the points of reference recommended by the ABI⁶ in setting executive reward is the remuneration policy of the company as a whole. Its guidance suggests RemCos should assess the appropriateness of changes in the quantum of executive remuneration in the context of the company overall, including changes in employee remuneration more broadly.

24. The CBI believes there is a case for company-specific measures to act as an input consideration to help in this process. It should be for the RemCo to decide the measure that is most appropriate in each organisation. This might be in the form of a ratio between the median earnings of the highest-paid 10% of employees in the company and the median earnings of the lowest-paid 10%. However, ratios may not always be appropriate. For example, in global companies ratios that measure the median pay of the top and bottom across countries will be extremely hard to calculate and are unlikely to be meaningful or useful to the RemCo. Relevance and added value must be the key criteria in the selection of appropriate competitive measures.

⁵ *Executive directors' remuneration*, Deloitte, September 2011

⁶ *ABI Principles of remuneration*, Association of British Insurers, 2011

25. The key features of any company-specific measure would be that:

- The measure should relate to reasonably substantial groups of staff to make it meaningful over time, not particular individuals or posts so as not to personalise it
- It would need to be based on a definition of total reward that is workable but should include the value of long-term incentives as well as bonus
- Once adopted, it should be tracked consistently over time so the RemCo would be aware of changes in the broad distribution of the company's paybill, enabling it to explore the reasons for significant changes and to have the bigger picture in mind in setting executive remuneration.

26. The widespread difficulties in the US over application of Dodd-Frank Wall Street Reform and Consumer Protection Act in terms of calculating and publishing a ratio of CEO pay to that of typical employees has shown up the shortcomings of a prescriptive approach.⁷

27. Another consideration in the remuneration of senior executives is the fact that many public companies now have minimal numbers of senior executive staff on the main company board – most of the senior managers with major strategic responsibilities are often on executive committees and similar bodies below the level of the main board. As a result, the number of executive directors subject to the remuneration disclosure requirements can often make up only a relatively small proportion of key decision makers in the business. The attention given to their remuneration can also result in an unrealistic impression being created about levels of remuneration among the senior decision makers in the broader management team of a company.

28. RemCos need to consider the remuneration of senior executives who are not on the Board, and the consistency of both their packages and any increases with overall compensation policy. They should examine the merits of more transparency at the senior executive level, including, for example, looking at the range of salaries.

Improved transparency could also help underpin our robust system

29. We recognise that the link between pay and performance is sometimes not as clear as it should be, contributing to the tone of the current public debate. While executive remuneration is inevitably complex – and we have to be realistic that relatively high and volatile levels of pay are a necessity of senior leadership roles and so will always attract attention and risk adverse comment – there are steps we should take to improve transparency. We advocate three.

i) Disclosure of a single aggregate figure for directors' taxable remuneration

30. One side effect of the increasing amount of information on executive remuneration disclosed in recent years has been that it is much harder to see how all the elements fit together for any one executive director and the resulting overall reward package. The discussion paper rightly identifies this as an issue, pointing out that public companies are not required to disclose a single, aggregate figure for each executive director's total remuneration.

31. The CBI believes that disclosure of a single summary figure would be a sensible reform. It is important, however, that the basis for arriving at the figure should be clear and readily achievable without substantial extra work. This could best be achieved by reporting on the total of taxable remuneration. Such a figure would be volatile, however, and would need to be explained clearly. It should be noted that many companies already provide employees with a total reward statement which details the tangible and non-tangible benefits that make up their reward package. This could provide a useful starting point when assessing the range of financial and non-financial benefits that are included in the summary figure.

⁷ See for example *Pay law sparks "nightmare" on Wall St*, Financial Times, 31 August 2010

32. A simpler and less volatile measure would be to use basic pay and bonus, but this would risk neglecting the value of long-term incentives and would therefore paint a less accurate picture. Some balance between the two, perhaps reflecting the value of long-term incentives cashed in over the life of the following incentive period, might be an attractive option. Shaping this proposal will require work – we are ready to work with government and the FRC on what the best approach might be.

ii) Nature of the metrics used to drive reward

33. As mentioned above, some remuneration reports fail to provide sufficient detail about the nature of the metrics used to determine executive director rewards. Moreover, the metrics used are subject to periodic review as RemCos seek to create robust links between payouts and true long-term performance.⁸ Improved disclosure in remuneration reports would help to counter the mistaken impression that figures are 'plucked out of the air' by a RemCo. The amount of disclosure will need careful consideration to ensure it is not at a level of detail that is commercially or price sensitive.

iii) disclosure relating to remuneration consultants

34. Some commentators have suggested that some RemCos have in effect delegated their responsibilities to consulting firms. There have also been suggestions that seeking to position executive rewards at or above the median has had the consequence of producing a spiral in executive remuneration. The CBI has seen no evidence to this effect. It must be clear beyond doubt that responsibility lies with the RemCo, that it weighs up the full range of evidence through a systematic process, and that it explains its decisions to shareholders.

35. The discussion paper suggests there could be greater transparency over the use of remuneration consultants by RemCos to mitigate any risk of an inappropriate role. The CBI supports this. **Box A** sets out the main features of new legislation introduced in Australia earlier this year on this issue which government should consider when thinking about how this could be done. As a first step, we believe it would be worth requiring greater disclosure about the appointment, role and fees of consultants assisting the members of RemCos in the discharge of their duties.

Conclusion

36. The CBI welcomes publication of the discussion paper and we believe the debate it has initiated is timely. We would welcome the opportunity to work with the government to explore further the proposals we make in this response. Above all, it is important that any new measures are both workable and contribute towards the effectiveness and success of UK public companies in the tough competitive conditions we face in global markets in the years ahead.

CBI
November 2011

⁸ See for example *Relative total shareholder return: a relevant long-term incentive performance measure?*, Executive remuneration perspective, Mercer, July 2011

Box A**Increasing transparency over the use of remuneration consultants: the Australian approach**

Amendments to the *2001 Corporation Act* introduced in Australia earlier this year require:

- approval of the engagement of a remuneration consultant by the board or RemCo
- remuneration consultants to report to the non-executive directors or the RemCo rather than company executives

The remuneration report must also provide detailed disclosures about the consultant, including:

- name
- statement that the consultant made such a recommendation
- details of any other advice they have provided
- amount and nature of the consideration payable for the remuneration recommendation
- amount and nature of the consideration payable for any other kind of advice referred to above.

Both the remuneration consultant and the Board are required to make separate declarations that any recommendations on remuneration are free from undue influence by Key Management Personnel to whom the recommendations relate. The Board must also disclose its reasons for being satisfied that undue influence by Key Management Personnel has not occurred.