PENSIONS AND LIFETIME SAVINGS ASSOCIATION

BUSINESS INNOVATION AND SKILLS SELECT COMMITTEE CORPORATE GOVERNANCE INQUIRY: CONSULTATION RESPONSE

"AS INVESTORS, PENSION FUNDS HAVE A KEY ROLE IN RESOLVING CORPORATE GOVERNANCE CHALLENGES"

October 2016

INTRODUCTION

The Pensions and Lifetime Savings Association is the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes with over 20 million members and £1tn in assets, and over 400 supporting businesses. They make us the leading voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.

EXECUTIVE SUMMARY

The Pensions and Lifetime Savings Association believes that companies with good corporate governance, an engaged workforce and a diverse breadth of experience and perspective at board level perform better and deliver higher returns for our pension fund members. As long-term investors representing 16 million savers, our members have a key interest in better corporate governance leading to more successful companies. We welcome the BIS Select Committee's interest on this vital subject. Our position on the three key areas of interest to the Committee is as follows:

- **Directors' duties** – We are supportive of the current iteration of Directors Duties but believe that these are poorly understood, enforced and reported against. More needs to be done to raise awareness of Directors' long-term responsibilities. Regulators should monitor reporting of how these responsibilities have been fulfilled.
- **Executive remuneration** - Our members are concerned by rising levels of executive pay in relation to the wider workforce and believe the justification for this increase is weak. We support measures to empower engaged shareholders and require disclosure of intra-company pay ratios.
- **Boardroom diversity** - We believe that in a global economy, a broad range of experience and perspectives is helpful to understanding diverse markets and guarding against 'group think'.

As a broader issue, covering all three themes, we would like to see better discussion of companies' working practices, stakeholder relationships and corporate culture - and how these relate to the wider purpose and strategy of the business – in the strategic report section of annual reports.

The PLSA provides resources and analysis for pension funds in order to support their stewardship activities and deliver better corporate governance, including:

- Our corporate governance policy and voting guidelines for key resolutions at company AGMs, which are reviewed and updated annually;[1]
- An annual review of AGM voting at FTSE 350 companies, assessing stewardship levels and identifying emerging corporate governance issues;[2]
- and our 'Understanding the worth of the Workforce' toolkit, helping our members to engage with investee companies on issues relating to working practices and corporate culture. [3]

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[1] Corporate governance policy and voting guidelines, PLSA, 2015
[2] AGM season report, PLSA, 2015
[3] Understanding the worth of the workforce: A stewardship toolkit for pension funds, PLSA, 2016

We would be very happy to work with the Select Committee to ensure that our insights from this extensive programme of work can usefully inform the conclusions of the inquiry.

INTRODUCTION

As the membership body for UK pension schemes with nearly £1 trillion of assets under management, the Pensions and Lifetime Association has a keen interest in ensuring the highest standards of corporate governance in the UK. According to our most recent annual survey, approximately 70 per cent of our members invest in UK equities, meaning that the performance of these companies is vital to pension funds' ability to deliver secure incomes in retirement to their beneficiaries. Research has consistently shown the benefits of good governance to long-term financial performance. [4]

We are therefore keen to promote transparent, accountable governance structures that synchronise the long-term interests of all a company's stakeholders and we welcome the BIS Select Committee's interest in this objective. Our position on each of the three discussion topics identified by the Committee in the terms of reference for this inquiry is set out below.

DIRECTORS DUTIES

We are supportive of the existing iteration of Directors' duties outlined in section 172 of the 2006 Companies Act, mandating directors to act in a way that promotes the long-term success of the company in the interest of its members (ie shareholders), but to have due regard for the impact of the company on workers, suppliers and customers, as well as the wider community and environment.

This requirement is well-intentioned and strikes an appropriate balance between the interests of different stakeholders to whom Directors must be accountable. We believe the intention of the requirement is sufficiently clear – Directors can and should eschew ostensibly profitable activities that have significant negative consequences for their stakeholders.

We are, however, concerned about levels of understanding, compliance and enforcement of Directors' duties. A perception that Directors must pursue (often short-term) profits no matter the costs to other stakeholder endures. Recent controversies regarding complex arrangements designed to minimise corporation tax

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[4] See for example, Gunnar Friede, Timo Busch and Alexander Bassen, *ESG and financial performance: aggregated evidence from more than 2000 empirical studies* in *Journal of Sustainable Finance & Investment*, Volume 5 issue 4, p210-233, 2015; or Anita Anand, *The Value of Governance* in Rotman International Journal of Pension Management, Volume 6 Issue 2, 2013 p38-31

payments are illustrative in this respect. Though the Companies Act's specific reference to having consideration for "the impact of the company's operations on the community" ought to make it clear that Directors are not legally required to aggressively minimise tax, this mis-conception continues to frequently appear in the media whenever a particular controversy appears.[5]

Annual reports rarely detail how Directors have upheld these responsibilities or how they have sought to understand the perspectives of different stakeholders. We believe that, given the importance of a company's stakeholder relationships to its long-term success, the 'strategic report' section of the annual report should be used to discuss the nature of these relationships, key risks and opportunities that derive from them, and how they relate to the wider business strategy.

Our stewardship toolkit 'Understanding the worth of the Workforce' recommends our members actively encourage the companies that they invest in to disclose this information.[6] However, it should be noted that the proportion of UK-listed companies owned by pension funds is declining.[7] Other investors may be less engaged with the long-term success of these companies and thus less likely to hold their Directors to account. As such, we think that regulatory bodies such as the Financial Reporting Council (FRC) should more actively scrutinise Directors' disclosure of how they have carried out their duties.

The key performance indicators outlined in annual reports frequently do include various stakeholder-oriented metrics around factors such as workplace safety, customer satisfaction and environmental footprint. But yardsticks specifically designed to align executive interests with shareholders, such as earnings-per-share and total shareholder return, dominate the measures used to determine performance-related executive pay packages. It would be no surprise if executives were to prioritise those performance indicators that are linked to their pay package over those that are not. This is not to say that we necessarily endorse more complex pay packages involving a wider range of performance metrics, but that the most commonplace measures in current use are reflective of Directors priorities as set by boards and remuneration committees.

Balanced against these concerns is the risk that extensive refinements or additional guidelines relating to the existing duties would be confusing and burdensome. Policymakers and regulators should focus on ensuring better enforcement of existing rules, but raising awareness will also be important.

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[5] See for example the *We all want Apple to pay tax,* Daily Telegraph, 24 January 2016 via http://www.telegraph.co.uk/news/worldnews/europe/eu/12118898/We-all-want-Apple-to-pay-more-tax.html

[6] *Understanding the worth of the Workforce: A Stewardship toolkit for pension funds*, Pensions and Lifetime Savings Association, 2016

[7] *Ownership of UK quoted shares 2014,* Office of National Statistics, 2015

As investors, pension funds recognise that a positive working relationship with all stakeholders is vital to all investee companies. The PLSA produces a number of resources to support our members' stewardship activities, and ensure responsible conduct on part of the companies they invest in. Materials include questions to ask asset managers regarding their approach to stewardship, both when putting mandates out to tender and on an on-going basis in relation to topical issues as well as voting guidelines for key resolutions at company AGMs and an annual survey assessing pension fund stewardship activities and identifying best practice. We will also shortly be writing to leading UK companies to share our toolkit on corporate reporting of employment practices and corporate cultures, encouraging them to work with our members to achieve the standards for reporting set out in the toolkit. We would welcome the BIS Select Committee's support in promoting this initiative.

Recommendations:

- Existing Directors' duties are sensible and well-balanced and should be retained, with a closer focus on the variable quality of their application.
- Stronger enforcement and more effective awareness- raising regarding directors' duties should be a priority for policy-makers.
- The FRC should scrutinise companies' disclosure of how directors' have fulfilled their duties more closely.

EXECUTIVE PAY

The average FTSE 100 Chief Executive was paid around 60 times the average UK worker in the late 1990s, compared to around 180 times today.[8] Conventional explanations for this increase relate to a wide range of trends, including financialisation; globalisation and technological change; and the decline of trade union membership.

The bargaining power of low and middle-income workers in countries such as the UK has diminished in the face of competition from automation and emerging economies. Meanwhile, as the size and global scale of businesses - and particularly the financial services sector that supports them - has grown over the past 30 years, the financial impact of good or bad decisions made by the individuals in key strategic decisions at companies has also increased. As such, the highly-skilled, mobile workers capable of filling these positions have experienced a much greater demand for their services than was the case at smaller organisations limited to national markets. Lower levels

[8] *Executive pay '180 times average' report finds*, BBC News, 14 July 2014

of trade union coverage have weakened a potential counterbalancing force to these trends.[9]

In addition to these economic factors, it is also important to note the role of corporate governance in facilitating the growth of executive pay. Whether the upward trajectory in top pay been subject to sufficient challenge is subject to considerable debate.

It is questionable, for example, whether the individual impact of an executive on a company can be isolated from contextual factors such as the economic climate, consumer trends or the support of the wider workforce. The management writer David Bolchover has uncovered considerable scepticism of the impact that individuals in place for periods of a few years have on long-standing businesses with hundreds of thousands of workers and operations across the globe. As one leading entrepreneur put it:

"It is a myth that one man (and normally, it is a man) is responsible for a large proportion of the outperformance of a large, long-established, institutionally owned plc…Very often, the results owe more, for example, to an improving economy, or to a specific market in which the company operates which is doing particularly well, or to the strength of its existing brand, or to the fact that competitors are suffering for whatever reason, or to the research and development division which has come up with a new invention, and so on"[10]

Similarly a current FTSE 350 Chairman argues:

"The role of the CEO is often overstated. Many CEOs are in charge of operations that would run quite smoothly without their daily input… The bigger the system, the more the system counts rather than the person on top of it."[11]

Despite the logic of these arguments and the lack of overwhelming evidence to the contrary, it is rare to see a FTSE remuneration committee discuss them in remuneration reports.

There is also limited evidence of a global market for executive 'talent'. A 2013 study found that fewer than 1 per cent of the world's biggest companies had recruited a CEO from a foreign rival and over 80 per cent had appointed their CEO internally.[12] Recent research from MSCI found that large pay gaps between executives and ordinary workers within organisations correlated with inferior performance.[13]

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[9] For examples of some of the many papers discussing these trends see *Bankers pay and extreme wage inequality in the UK*, Brian Bell and John Van Reenen, 2010 (financialisation); Seven reasons not to care about high pay, Adam Smith Institute, 2016 (globalisation); and IMF Staff discussion note: inequality and labor market institutions, International Monetary Fund, 2015 (decline of trade union coverage)
[10] *Made to Measure: How opinion about executive performance becomes fact*, High Pay Centre, 2015
[11] Ibid
[12] *Global CEO Appointments: A very domestic issue*, High Pay Centre, 2013

Another MSCI analysis found that the studied companies with the highest-paid CEOs in absolute terms had under-performed those with the lowest-paid.[14] Between 2000 and 2013, the market value of FTSE 350 companies analysed by Incomes Data Services increased by 64 per cent, while annual bonus payments to executives rose by over 300 per cent and so-called 'long-term incentive payments' increased by 268 per cent.[15]

If these arguments are not sufficiently acknowledged during the executive pay-setting process, the high pay of the remuneration committee members and the asset management firms that then approve them at company AGMs maybe a factor. Research for the Trades Union Congress found that two thirds of remuneration committee members were themselves directors of other companies, and were paid on average £441,383, sixteen times the UK national average.[16] A Financial Times analysis found that the chief executives of the world's largest asset managers were on average paid bonuses worth fifteen times their annual salary.[17] This arguably renders these constituencies conflicted when scrutinising corporate remuneration practices.

We await details of the Prime Minister's proposed new powers to hold companies to account over executive pay with interest. The tri-annual binding vote on pay policy introduced in 2013 was a welcome development, however we believe that companies are still doing too little to recognise shareholder concerns over executive pay.

Perhaps as a result of the increasingly fractured and international nature of shareholding, too many shareholders are insufficiently engaged with the companies they invest in to make a majority shareholder vote against pay practices a realistic or commonplace occurrence. There is still insufficient leverage to compel companies to take action over executive pay when a significant minority of shareholders (ie over 20 per cent) voice their dissent over a pay-related resolution at their AGM, even though these shareholders are often the most engaged with the business.

The Prime Minister's proposal of making the existing advisory annual retrospective vote on pay awarded binding, to go with the forward-looking tri-annual binding vote on pay policy is interesting, but might not necessarily overcome this challenge. Alternative solutions could include a requirement for companies to achieve a super-majority in their AGM votes on remuneration reports, with a failure to achieve 75 per cent support triggering a further binding vote on the pay policy. Avoiding the public embarrassment of a second vote and potential revisions to remuneration strategy

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[13] *Looking more closely at intra-corporate pay gaps*, MSCI, 2016
[14] Are CEOs paid for performance: Examining the effects of equity incentives, MSCI, 2016
[15] *Executive remuneration in the FTSE 350 – a focus on performance-related pay*, Incomes Data Services, 2015
[16] Trades Union Congress, *A culture of excess*, 2015
[17] *Bonus culture in asset management 'out of control'*, Financial Times, 4 September 2016

would provide a strong incentive for companies to take shareholder concerns over pay practices more seriously.

We are also supportive of proposals to require companies to publish the pay ratio between their Chief Executive and the media pay level within the organisation. It is important that this figure is not presented in isolation, but included as part of the narrative discussion in the strategic report around the company's culture and working practices. In this light, other ratios between the Chief Executive and the next highest-paid employee, as well as the thresholds for each quartile of the organisation are also useful to investors.[18]

Our forthcoming annual report on FTSE 350 AGM voting trends will discuss executive pay issues in more detail. The report will outline recent patterns in pay votes at AGMs, as well as covering our members' views on executive pay – a large majority of our members expressed concern at current pay levels, even at successful companies, and also agreed that pay in the asset management sector has an effect on the sector's capacity to scrutinise the pay practices of investee companies.

We also review our corporate governance policy and voting guidelines on an annual basis. This year's updated version of the guidelines will be published shortly, and will incorporate amendments on executive pay in light of some of the developments discussed in this submission.

Recommendations:

- More needs to be done by companies and shareholders to hold companies to account over unjustifiable pay increases.
- Policy makers should consider 'super majority' thresholds for votes on executive pay, in order to empower engaged shareholders.
- Disclosure of pay ratios should be required, to support narrative reporting around companies' working practices and corporate culture.

COMPOSITION OF BOARDS

From a societal fairness angle, there is an obvious interest in ensuring fair access to the most powerful, influential and well-paid business positions. However, there is a strong business case for ensuring that boards reflect the diversity of the population –

[18] Companies are already required to publish the 'single figure' for total CEO pay while forthcoming gender pay gap reporting will require companies to calculate the thresholds for each pay quartile in order to record intra-quartile gender pay differences. Therefore recording the pay ratio between the CEO and each quartile would not represent a significant new burden.

and the company's stakeholders – as a whole. Companies are increasingly global operations and require experience and understanding of a diverse range of markets.

There is also a strong risk that 'group think' can develop amongst individuals with similar backgrounds and professional histories, resulting in a boardroom culture that is insufficiently rigorous and challenging in its decision-making process.

Similarly, given that the historically over-represented groups at board level are no more likely to be more innately talented than under-represented groups, a homogenous board may be at risk of failing to fulfil the potential available to it.

The Davies Report on Women on Boards highlights research showing that strong stock market growth among European companies is most likely to occur where there is a higher proportion of women in senior management teams.[19] Similarly, McKinsey have found that 'companies in the top quartile for gender or racial and ethnic diversity are more likely to have financial returns above their national industry medians. Companies in the bottom quartile are statistically less likely to achieve above-average returns.'[20]

As such, diversity and representation on company boards is a key concern for investors – as an organisation, we have been vocal proponents of past efforts to encourage greater diversity and our corporate governance policy and voting guidelines encourage our members to ensure investee companies have a proper strategy in place to ensure diverse boards. In the pension funds sector, responses to our annual survey suggest that over 80 per cent of pension fund trustees are male.[21] Our submission to The Pensions Regulator consultation on 21st century trusteeship and governance highlighted the need to achieve a much better gender balance.[22]

We believe that a lack of diversity is also a major problem for the wider investment industry and are playing a leading role in addressing this challenge. 'Diverse investments, diverse perspectives' will be the theme of our annual investment conference, one of the largest industry gatherings in the UK, in 2017, which we hope will provide an opportunity for the industry to think seriously about how it can be more representative of the customers it serves.

Of course, many of the causes of under-representation result from structural disadvantages that particular demographic groups face earlier in life, over which companies have little control. However, the later stages of personal development that companies can influence are also important, so 'pipeline' diversity in relation to

[19] *Women on Boards*, Lord Davies of Abersoch, 2011
[20] *Why diversity matters*, Mckinsey, 2016
[21] *Annual Survey 2015*, Pensions and Lifetime Savings Association, 2015
[22] *21st Century Governance and Trusteeship Consultation response*, Pensions and Lifetime Savings Association, 2016

graduate scheme placements or management training schemes, for example, should also be monitored, assessed and discussed. In this context, gender pay gap reporting regulations mandating companies to disclose the gender balance and pay gap at each quartile of the organisation are helpful. Our Understanding the worth of the workforce' toolkit encourages our members to engage with companies over the diversity (including, but not limited to, gender diversity) of their workforce throughout different levels of the organisation, as well as at board level.

The Prime Minister has repeatedly stated her intention to make boardrooms more diverse by introducing workers and consumers on company boards. We strongly believe that business leaders should understand what is going on at the 'shop floor' of their company and our toolkit also recommends our members ask what communications channels and fora are in place to ensure that this is the case.

If worker representation on boards is to be introduced, the value of the initiative will depend on factors such as which workers are chosen and on what basis are they elected or appointed; precisely what rights and responsibilities they have at board level; and what support is available to ensure that they can fully participate and add value in relation to the wide range of complex subjects that are discussed at board meetings. We are currently undertaking a more detailed examination of these issues and will outline our ideas on how worker representation could work most effectively in the near future.

Recommendations:

- Regulations requiring companies to disclose gender balance and pay gaps should be welcomed.
- Companies should record diversity levels, in terms of gender and other aspects of diversity and representiveness, throughout their organisation.
- The introduction of worker representation on company boards should entail deeper consideration of a wide number of practical matters such as the appointments process; rights and responsibilities; and training and support.

CONCLUSION

The BIS Select Committee's interest in corporate governance issues is understandable and welcome.

Corporate tax affairs, controversies over executive pay and environmental scandals have brought the issue of how companies are run and to whom are they accountable to the forefront of policy debate in the UK in recent years.

The Government is now due to announce a series of proposals for policy reform this Autumn. It is vital that these potential policy changes are informed by a thorough and vigorous analysis – we hope that this submission will contribute to that process and would welcome the opportunity to continue working with the Select Committee to support the successful identification and implementation of the right policies.

Luke Hildyard
Policy Lead, Stewardship and Corporate Governance
Pensions and Lifetime Savings Association
luke.hildyard@plsa.co.uk