BIS | Department for Business Innovation & Skills

Directors' pay: guide to Government reforms

Directors' remuneration which is well structured, clearly linked to the strategic objectives of a company, and which rewards contributions to the long-term success of that company, is important in promoting business stability and growth. However, pay policies which do not appropriately link directors' remuneration to company strategy and performance can diminish shareholder returns, weaken corporate governance and reduce public confidence in business.

Over the last decade, directors' pay in the UK's largest listed companies has quadrupled with no clear link to company performance.[1] Business leaders and investors now agree that this is a problem. Key stakeholders have spoken out in favour of action:

> *"In the way we pay ourselves…now is the time to be more transparent, more responsible and more accountable. High pay must be for exceptional performance, not mere attendance."* **Sir Roger Carr, President of the CBI, May 2012**
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> *"The level of executive pay at the UK's largest companies has become unjustifiable over the last decade and it's right that the Government recognises that it is shareholders who have the power to control it."* **Simon Walker, Director General of the IoD, March 2012**
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> *"[T]he days of gold-plated payouts for failed leaders are coming to an end. We have the chance to agree a new set of rules focused on greater simplicity, greater transparency and genuine reward for performance. It is an opportunity we must take."* **Otto Thoresen, Director General of the ABI, April 2012**
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> *"The simple truth is that remuneration schemes have become too complex and, in some cases, too generous and out-of-line with the interests of investors."* **Dominic Rossi, Chief Investment Officer of Equities at Fidelity, January 2012**

Today the Government is announcing a far reaching package of reform to strengthen the hand of shareholders to challenge excessive pay. These are the most comprehensive reforms of directors' pay in a decade. By creating a more robust framework within which directors' pay is set, agreed and implemented, these proposals:

- restore a stronger, clearer link between pay and performance;
- reduce rewards for failure;
- promote better engagement between companies and shareholders;
- and, overall, empower shareholders to hold companies to account through binding votes.

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[1] The average total remuneration of FTSE100 CEOs has risen from an average of £1m to £4.2m for the period 1998-2010. Data from Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, May 2011, available at: http://blog.manifest.co.uk.

Binding vote on pay policy

The current advisory shareholder vote on the directors' remuneration report was designed to give shareholders an effective and more focused way in which to influence directors' pay. However feedback from shareholders is that many companies are not responding adequately to their concerns.

These shortcomings need to be addressed. The Government will introduce a new binding vote on a company's pay policy in order to empower shareholders and encourage improved dialogue with the companies they own. This vote will require the support of a majority of shareholders voting to pass.

Companies will set out their proposed pay policy as shown in Table A, including potential payments and the performance measures that will be used. They will also have to set out their policy on how exit payments will be calculated. Once approved by shareholders, companies will be required to act within the pay policy and will not be able to make payments outside the scope of that policy. For the first time there will be a real and binding control on pay.

Table A: Contents of the policy report

- A table setting out the key elements of pay and supporting information, including how each supports the achievement of the company's strategy, the maximum potential value and performance metrics.
- Information on employment contracts.
- Scenarios for what directors will get paid for performance that is above, on and below target.
- Information on the percentage change in profit, dividends and the overall spend on pay.
- The principles on which exit payments will be made, including how they will be calculated; whether the company will distinguish between types of leaver or the circumstances of exit and how performance will be taken into account.
- Material factors that have been taken into account when setting the pay policy, specifically employee pay and shareholder views.

The vote will take place annually unless companies choose to leave their pay policy unchanged, in which case the vote will happen at a minimum every three years. This will encourage companies to devise a policy for the long term, clearly linked to their strategy and will put downward pressure on pay ratcheting. If directors wish to change the company's policy, they will need shareholder approval.

Where a company fails the binding vote it will have to continue to use the existing policy until a revised policy is agreed. Companies will have the choice to either convene an Extraordinary General Meeting to put forward a revised policy, or wait until the next Annual General Meeting to do so.

The Financial Reporting Council (FRC) has announced it will consult on potential changes to the Corporate Governance Code, including that where a substantial minority of shareholders vote against the policy, a company should publish a statement saying what they will do to address shareholder concerns. This would publicly hold directors to account. The Government welcomes the business and investor support for this idea, and trusts it will be established practice by the time the primary legislation comes into effect.

Advisory vote on implementation

Shareholders will continue to have a say on payments made to directors through an annual advisory vote on the implementation of pay policy, including actual sums paid in the previous year. The Government proposes that companies report on the information shown in Table B. This vote will require the support of a majority of shareholders voting to pass. In this way, shareholders can signal whether they are content with how the approved policy has been implemented.

Table B: Contents of the implementation report

- Single total figure of remuneration for each director
- Detail of performance against metrics for long term incentives
- Total pension entitlements (for defined benefit schemes)
- Exit payments made in year
- Detail on variable pay awarded in year
- Total shareholdings of directors
- Chart comparing company performance and CEO pay
- Information about who has advised the remuneration committee
- Shareholder context

The proposed single figure will be comprehensive. It will cover all types of reward received by directors in the previous year including fixed and variable elements as well as pension provision. The Government is grateful to the FRC's Financial Reporting Lab, and those companies and investors who worked with the Lab, for its help in developing a methodology for how the single figure should be calculated.

The Government recognises that, while there are a number of ways of calculating a single figure, it is important to have consistency between companies as to what is included in the figure and how it is calculated. For variable elements of pay, the single figure will reflect actual pay earned rather than potential pay awarded. This includes:

- full bonuses awarded for the reporting period; and
- long term incentives where the reporting year is the last financial year of the performance cycle.

If a company fails the advisory vote they will be required to put their overall pay policy back to shareholders for re-approval in a binding vote the following year. The Financial Reporting Council (FRC) has announced it will consult on potential changes to the Corporate Governance Code, including that where a substantial minority of shareholders vote against the advisory vote, a company should publish a statement saying what they will do to address shareholder concerns. This would publicly hold directors to account. The Government welcomes the business and investor support for this idea, and trusts it will be established practice by the time the primary legislation comes into effect.

Exit payments

Individual cases of directors who have left companies with substantial exit packages have attracted widespread criticism from shareholders and the public who see this as 'reward for failure'. Both shareholders and business leaders have called for the existing framework to be updated to provide for greater scrutiny and increased transparency around exactly how much directors could receive in the event of the early termination of their contract.

The Government considers that shareholder voting powers in this area need updating. To empower shareholders, the Government will require companies to set out their approach to exit payments as part of their pay policy. This will be put to the binding vote. Once shareholders have approved a company's approach to exit payments, the company will be bound by that policy and therefore limited in what it can pay departing directors.

Whenever a director leaves, a company will have to publish a statement promptly, setting out exactly what the director has received. Unlike now, shareholders will not have to wait months to find out how much a departing director has been paid. Exit payments will also be reported in the implementation report and subject to an advisory vote. In this way shareholders will be able to signal whether they are content with exit payments that have been made.

Role of business and investors

It is not Government's role to micromanage companies but instead to create a robust framework to ensure that active shareholder engagement is sustained over the long term. The Government is encouraged by recent activism by shareholders in engaging with the companies they own to ensure that pay reflects performance and does not reward failure. Importantly, we have also seen companies engaging constructively in the face of shareholder opposition.

Lasting reform is dependent on both business and investors maintaining this activism and developing and adopting good practice on pay. The best companies and investors are already leading the way and acting as early adopters of these reforms.

There is a balance to be struck between investors' need for clear and specific information to hold companies to account and companies' requirement for flexibility so they can design and implement pay policies that suit their organisation. This is recognised by both business and shareholders. In the coming months, the Government will continue to work closely with business and investor groups to develop clear guidance on the level of detail and type of information that should be reported.

Next steps

The Government will bring forward amendments to the Enterprise and Regulatory Reform Bill shortly to introduce these reforms. In tandem, we will publish for comment revised, simplified regulations setting out what companies must report on directors' pay.

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