TUC response to the FRC review of the Combined Code

Financial Reporting Council Review of the Combined Code of Corporate Governance - TUC response

Introduction

1.1 The TUC represents 6.5 million working people in 59 trade unions. Many of our members are employed by companies, and are directly affected by the quality of decision making in the boardrooms of the companies in which they work. Corporate governance has a direct impact on the workings, culture and priorities of UK boards and thus on the lives of our members. We welcome this opportunity to contribute to the Financial Reporting Council’s review of the Combined Code of Corporate Governance.

1.2 The UK corporate governance system puts considerable emphasis on the role of shareholders in terms of monitoring companies and thus on the relationship between companies and their shareholders. While the TUC has never supported a system of corporate governance that prioritises the interests of shareholders over those of other key stakeholders such as employees, we are nonetheless concerned that whatever corporate framework is in place should operate effectively to ensure that company directors make decisions that support the long-term success of the companies they lead and thus the interests of our members.

1.3 Successive reviews of governance have put increasing emphasis on shareholder monitoring and engagement as a discipline on companies and as a substitute for regulation. The recommendations of the Cadbury, Greenbury, Hampel and Higgs reviews, on which the Combined Code of Corporate Governance (henceforth Combined Code) is based, all focus on ensuring that the interests of shareholders and directors are aligned, on the assumption that this is the key to ensuring good corporate governance.

1.4 The TUC’s response to Sir David Walker’s review of corporate governance in UK banks and other financial industry entities (henceforth the Walker Review) sets out our view of the flaws of this approach. To summarise, the TUC believes that shareholder engagement with companies is too weak and uneven to perform the important role placed upon it by the UK’s corporate governance system. As the Walker Review itself points out, a decreasing proportion of UK company shares are actually owned by long-term UK investors. Shareholders whose strategies are based primarily on short-term share trading rather than long-term shareholding will have neither the motivation nor in all likelihood the capability of undertaking effective engagement with companies. Indeed, when share traders take a ‘short’ position on a company’s shares, it is in their interests for the company's shares to perform poorly, making it entirely inappropriate for such shareholders to play any role in that company's governance.

1.5 As a major focus of the Combined Code is on the relationship between company directors and shareholders, our concern about the quantity and quality of shareholder engagement is highly relevant to our view of the effectiveness of the Combined Code. However, rather than repeat the arguments in full, the TUC's response to the Walker Review is attached as an appendix.

Overview of the Combined Code's effectiveness

2.1 The TUC does not believe that the Combined Code in its current form is fit for purpose. The strength of the Combined Code is that many of its principles have, over time, gained wide, although not universal, acceptance, and have improved standards of corporate governance; an example of this would be the separation of the positions of Chief Executive and Chair of the Board, which has become widely adopted. However, there are other areas where the principles of the Code are either routinely ignored or interpreted in a way that contravenes at least the spirit of the principles. These points will be returned to in the discussion on remuneration below. The danger with uneven application is that is fosters a 'pick and choose' approach, where companies feel free to comply with those parts of the Code which they are minded to adopt and to ignore the rest, thus rendering corporate governance subject to directors' self-interest, rather than the long-term interest of the company, its shareholders and other stakeholders.

2.2 The TUC believes that the lack of an enforcement regime for the Combined Code is a major weakness that has allowed uneven adoption of the principles both between and within companies. If a company ignores a Combined Code principle, no consequence for the company arises from its non-compliance, other than on the occasions where shareholders raise the issue, which are rare.

2.3 The TUC proposes that the Financial Reporting Council (FRC), through the Financial Reporting Review Panel, should take on the role of monitoring company reports on the Combined Code, possibly on a rotating basis (though with some element of randomness built in), and should issue an annual report on its assessment of companies’ compliance with the requirement to comply with or explain its approach to the Combined Code provisions. Companies that flout the Code’s provisions should be given a chance to improve but, if they fail to do so, should be de-listed from the UK stock exchange. Without this ultimate sanction, the idea that compliance with the Combined Code is a listing requirement is meaningless.

2.4 An alternative would be for the Combined Code to be adopted as a set of regulatory requirements.

Remuneration

3.1 One of the areas of greatest failure of corporate governance is the area of directors’ remuneration. From the Greenbury Committee through to the Directors’ Remuneration Report Regulations 2002, the approach that has been taken by regulators and market participants to directors’ pay is that providing information to shareholders will enable the latter to monitor directors’ pay and act to ensure that it is appropriate. The TUC believes that this approach has simply failed.

3.2 Survey after survey[1] has set out the inexorable rise of directors’ pay and the growing gap between pay levels of directors and those of other staff both within the same company and throughout the rest of the economy. For this growing gap to be explained in terms of market forces, it would be necessary to show that there are far fewer potential directors available to do these jobs than was the case ten or fifteen years ago and that without these levels of pay it would not be possible to fill posts. This is patently not the case. The spiralling increases in directors’ pay have stemmed from a number of reasons, none of which are to do with a declining pool of talent from which to recruit.

3.3 The main principle on remuneration says that levels of remuneration should be sufficient to attract, retain and motivate directors ‘but a company should avoid paying more than is necessary for this purpose’. The TUC believes that this principle has been universally contravened by companies; the increases that directors receive year on year are far higher than is necessary to attract, retain and motivate appropriate staff. In many instances, the same directors are doing jobs similar to those they were

[1] See, for example, the Guardian 14.9.2009

doing ten years ago, but for levels of pay that have risen exponentially. There is no 'objective' reason for this, and it stems directly from the weaknesses of the executive pay setting and monitoring system in the UK. There is no evidence to support the case for such high levels of pay in terms of recruitment and retention. UK companies have got away with it because they are all doing the same thing, thus creating a mythical 'market rate' based not on competition but on the comparisons made by pay consultants, and because the institutional shareholders who should be holding them to account are frequently themselves paid very large sums of money and are culturally desensitised to the scale of the remuneration packages on offer.

3.4 The first part of the supporting principle B.1.1 says that while the remuneration committee should judge where to position their company relative to other companies, they 'should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance'. Again, this principle is comprehensively flouted by remuneration committees. The vast majority of remuneration committees use remuneration consultants to advise them on pay in other companies. Combined with the stated desire of many companies to pay in the upper median or upper quartile, this creates an upward spiral that has nothing to do with the recruitment of individual directors but reflects the absurdity of remuneration committees all referring to each other in a circuitous and self-referential process based on mutual self-interest.

3.5 The second part of the supporting principle says that '[remuneration committees] should be sensitive to pay and employment conditions elsewhere in the group, especially when setting annual salary increases'. This principle is completely ignored by companies. There is no evidence that any remuneration committees have ever considered the pay of other staff in the company when setting directors' pay. This principle is rarely mentioned in remuneration reports and when it is it is usually a bland, one-line assertion with no supporting evidence.

3.6 There is no justification for ever-widening pay differentials; why should a director be 'worth' five times, then ten times, then thirty times as much as one of his or her staff just because a number of years have passed? Ever-widening pay differentials risk creating resentment and low morale among the workforce and can make it harder to achieve pay settlements with staff. They are redolent of a 'one rule for us and one rule for them' approach that should have no place in the modern workplace; and say to staff that their relative contribution to the company has declined over time.

3.7 In order to achieve the intention behind supporting principle B.1.1, the TUC believes that the Combined Code should be strengthened and should recommend that pay increases offered to executives should be in line with those offered to other staff in the company. In addition, wider disclosure, including the distribution of pay across the company as a whole and the ratio between top and bottom, should be included in remuneration reports. This will be set out in more detail in the recommendations below.

3.8 While the TUC supports the intention behind the three principles discussed above, we believe they have had very little, if any, impact on the decisions of remuneration committees. They have not led remuneration committees to try to keep pay levels in check, to guard against pay ratcheting and to take into account pay increases of other company staff. We therefore conclude that in their current form they are of little value.

3.9 Provision B.1.1 states that the performance elements of remuneration should form a significant proportion of the total remuneration package. The TUC strongly disagrees with this provision. It is the recommendation, proposed by the Greenbury Committee and reinforced in every review exercise since, that a high proportion of pay should be performance-related, that largely accounts for the extraordinary rate of increases of total remuneration since that time. As has again been comprehensively documented, performance targets are very rarely sufficiently stretching, and the majority of incentive schemes pay out for mediocre and even poor performance. The attitude shown by Shell’s remuneration committee earlier this year when it proposed paying out bonuses on the grounds that although the targets had been missed, it was only by a small margin, is typical of most remuneration committees, who treat incentive related pay not as an award for exceptional performance but as part of what any director who does an acceptable job will receive. There is no reason why people whose salaries are already extremely high compared to many other people with responsible and demanding jobs (such as top civil servants, local government leaders, the Prime Minister) need additional incentives just to get out of bed in the morning and do a reasonable job?

3.10 The emphasis on incentive related pay is based on a key assumption of corporate governance, namely the belief that the 'agency problem' can be solved through remuneration policy. The TUC believes that this assumption is flawed. Remuneration is a very blunt tool to use to ensure alignment of interests, and assumes that money is the main motivation of company directors. The TUC does not believe that this is in fact the case, nor that it should be: the interests of UK plc will not best be served by those for whom financial reward is the main motivation. Companies need people whose commitment is to their job and the company they lead, not to their pay check. It is insulting to the many company leaders who would do their best for their company regardless of what bonus package is in place to assume that money is their main motivation and that they need fancy incentive plans in order to do their job well. The banking crisis has illustrated all too graphically what happens when people are motivated by personal financial gain rather than by commitment to their company, their job and appropriate values.

3.11 The TUC believes that a rethink of the provision that a high proportion of remuneration should be performance-related is long overdue. The TUC believes that incentive related pay should comprise a lower proportion of total pay: we would suggest that ten percent would be an appropriate proportion.

3.12 Provision B.1.6 recommends that notice periods should be set at one year or less. This is an area where compliance is much higher than on the principles discussed above. However, the TUC believes that there is no justification for those who lead companies and therefore have the most influence on company strategy having more protection from company failure than other company employees. Notice periods for directors should be the same length and on the same terms as those offered to other staff. These are generally between one and three months.

3.13 Looking at B.2 on procedure, the TUC believes that employees should be represented on remuneration committees through their trade unions. This would facilitate remuneration committees taking into account pay and conditions elsewhere in the company and would bring a breath of reality into the discussions. A formal procedure for consulting staff on the remuneration packages for directors should be developed, and a summary of staff views included in the remuneration report.

3.14 The Code is silent on pay consultants. The TUC believes that the wide use of pay consultants and the latter's approach to pay has contributed to the unjustified rise of executive pay and believes that remuneration committees should use pay consultants with caution and only for provision of information, not for advice on the design of pay packages. In addition, the TUC believes that there is a risk of conflicts of interests if companies use pay consultants who are being used by the company for other consultancy services, as this creates an incentive for the consultants to promote the interests of the directors who have appointed them; this should therefore be avoided. The TUC believes that further guidance on the use of pay consultants would be beneficial.

TUC recommendations on remuneration

3.15 The TUC proposes that the following should be included in the Combined Code:

i) Pay increases offered to executive should be in line with those offered to other staff in the company in order to prevent the ever-widening of differentials.

ii) Incentives schemes should be open to all staff.

iii) Bonus and incentive payments should not dominate the remuneration package and should comprise a lower proportion of total pay; the TUC suggests that ten percent would be an appropriate proportion.

iv) Incentive pay should be linked to long-term indicators that reflect stability, risk management and wider corporate goals and values (such as good employment relationships, which are known to correlate with future profitability) and not just to bald profit numbers.

v) Long-term incentive schemes should genuinely be long-term, with a vesting period of at least five and preferably ten years. Annual bonuses should be ended.

vi) Notice or contract periods for directors should be the same length and on the same terms as for other staff.

vii) Remuneration reports should be required to include information on:

(1) the ratio of highest director total pay to lowest employee pay in the company;

(2) the distribution of pay throughout the company as a whole by grade;

(3) each director's increase in basic salary for each of the last three years;

(4) the average pay increase for staff elsewhere in the company for each of the last three years.

viii) Where the average rise in basic pay for directors is significantly higher (say more than 1%) than the average rise for employees, an explanation for this differential from the remuneration committee should be included in their report.

ix) Employees should be represented on remuneration committees through their trade unions. There should be a formal process for consulting staff about the remuneration packages proposed for directors and a summary of staff views should be included in the remuneration report.

x) Remuneration reports should be forward looking and should be subject to a binding vote at company AGMs (while this would best be achieved through an amendment to the Directors' Remuneration Report Regulations 2002, it could also be set out as a Combined Code provision).

The role of non-executive directors

4.1 There is a lot of emphasis in the Combined Code on the independence of non-executive directors (NEDs). The Walker Review has raised the issue of the need for relevant skills and experience on the boards of banks and other financial institutions. The TUC agrees both with the need for independent non-executive directors on boards and that all boards need a range of relevant skills and experience among their members.

4.2 However, the TUC also believes that boards would benefit from NEDs drawn from a much wider range of backgrounds and experience than at present. Currently, the majority of NEDs are current or retired executive directors of other boards, thus representing a very narrow constituency of experience and interests. Inclusion of people from different backgrounds and sectors would bring to boards fresh thinking and give them the kind of reality check that would have been invaluable to bank boards in recent years.

4.3 The TUC set out detailed arguments in favour of broadening the range of NEDs on boards in its submission to the review of the role and effectiveness of non-executive directors carried out by Derek Higgs in 2002. The review recommended that proposals to bring this about should be investigated by a further committee. Unfortunately this has not led to any changes in recruitment practice or board composition.

4.4 The TUC's detailed proposals for broadening the range of NEDs were also set out in our submission to the Higgs review, which is attached as an appendix. One key recommendation for broadening board membership is that all NED positions should be publicly advertised, with job descriptions and person specifications used for recruitment, as should anyway be the case under equal opportunities good practice. Failure to advertise NED posts publicly perpetuates the current practice of filling posts mainly from retired or other executive directors and fuels use of the 'old boys network' as a means for filling boards. The TUC believes that the Combined Code should stipulate that all NEDs positions should be publicly advertised.

4.5 In addition, the TUC believes that training and induction for NEDs should include information on the management of employment relationships, including both best practice in this area and the evidence of the link between positive employment relationships and company performance.

Director elections and boardroom evaluation

5.1 The TUC believes that corporate governance and shareholder engagement with companies would be enhanced if directors stood for election on an annual basis, and believes that this should be included in the Combined Code.

5.2 The TUC agrees with the Walker Review that board evaluation using an external facilitator would be a useful periodic exercise. However, we believe that an external facilitator that has any other relationship with the company should not be used. Disclosure of a relationship does not enable shareholders and stakeholders to assess whether or not the relationship has compromised the facilitator's judgement, and the TUC believes that it is preferable to prevent such a conflict of interest arising in the first place.

5.3 There are three other areas where the TUC believes that the Walker Review's recommendations on board evaluation should be strengthened. Recommendation 13 says that the statement should include an indication of the extent and nature of communication with major shareholders. The TUC believes that in addition it should include an indication of the extent and nature of the board's engagement with key stakeholders. As argued above, key stakeholders have a strong interest in the long-term success of the company, and the extent and nature of engagement with them will provide a valuable insight into the extent to which the board is acting effectively in its management of stakeholder relationships.

5.4 The Walker Review rejects the option of requiring the external facilitator to state whether the evaluation report reflects the discussions that have taken place on the grounds that the evaluation statement is a sufficient development at this time. The TUC believes that such an attestation would be of benefit, and is hardly an arduous addition to the requirement to carry out the evaluation in the first place.

5.5 The Walker Review raises the possibility of requiring an advisory vote on the evaluation report to take place at company AGMs but argues that this should be left to the discretion of individual boards. The TUC believes that putting the evaluation report to the vote would be a valuable addition to the ways in which investors can express their views to the board, and would be a useful way for investors to signal either concern with or approval of the general way in which a board is conducting itself. At present, it is not particularly easy for investors to signal concern through their votes; voting against the report and accounts as a whole is seen as an extreme step that few investors wish to take, even when they do have concerns about company direction. An alternative can be to vote against individual board members, and in particular, if the concern is a general one, the Chair; but this can seem inappropriate in a situation where it is not the Chair who is seen as the problem. Most resolutions are very specific and do not provide a good way to signal general concern; laying one requires considerable resources of organisation and time which investors will generally only consider in an extreme situation. For these reasons, the TUC believes that voting on the board's evaluation report would provide a useful additional mechanism through which investors can express their view in a transparent and quantifiable way and should be made mandatory.

5.6 The TUC believes that this kind of evaluation would be valuable for all company boards, and would suggest that the proposals outlined above should be included in the Combined Code.

Shareholder engagement

6.1 For our views and proposals on this area, please see section five of our response to the Walker Review, which is attached as an appendix.