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REMUNERATION COMMITTEE EFFECTIVENESS
TO GOVERN IS TO CHOOSE

2024

STEVEN TOFT CONSULTANT AND BUSINESS WRITER

The demands placed on the RemCo, and any corresponding assessment of its effectiveness, have increased exponentially – and risk encroaching on areas of executive responsibility.

1.0

INTRODUCTION

It is some thirty years since the concept of a Remuneration Committee ('RemCo') was introduced to UK Corporate Governance and the 'effectiveness' of the Committee has been challenged for almost as long. The idea was first proposed by the Cadbury Report in 1992 in response to an increasing lack of investor confidence in the management of listed companies. The recommendation was then taken up by the Greenbury report on executive remuneration in 1995, which was commissioned in response to public concerns over the increased levels of reward paid to top executives in the recently privatised public utilities.

Right from the beginning there were different ideas about what a RemCo was supposed to achieve. Was it just there to protect shareholders by limiting the power of executives to set their own rewards? Was their brief to align executive reward more closely with performance, or to enable the company to attract and retain the best talent, or simply to rein in 'fat cat pay' and prevent rising inequality?

In the intervening three decades, these tensions have deepened, and new ones have been added. Weak economic growth and pay stagnation have led to a greater focus on inequality. Climate change and shifting social attitudes have driven the adoption of 'non-financial' performance measures. The acronym ESG (Environmental, Social and Governance) has become a contested feature of corporate target-setting.

The broadening of Directors' duties and the range of stakeholders defined by the Companies Act 2006 reflected a shift in the zeitgeist, which has continued apace ever since. Employees, the wider public, and the environment are now considered to be stakeholders and the RemCo must take these factors into account when designing plans, setting targets and deciding fair outcomes.

The question of defining 'organisational performance' and aligning it with reward outcomes is therefore a lot more complex than it was 30 years ago. A broader range of both financial and non-financial criteria must be taken into account. Consequently, the demands placed on the RemCo, and any corresponding assessment of its effectiveness, have increased exponentially – and risk encroaching on areas of executive responsibility.

As the public focus on corporate governance and reward quantum has shifted, so have the range of interests the RemCo is presumed to take into consideration by regulators, the media, and the general public. The need for the RemCo to demonstrate that it understands and can balance the interests of the company's various stakeholders has never been greater. Undoubtedly, the work of the RemCo has expanded while, at the same time, the sheer range of competing interests means that at least some of the impacted parties will be disappointed.

This creates the context for any assessment of RemCo Effectiveness. The RemCo cannot hope to balance these interests to the satisfaction of all. France's postwar Prime Minister Pierre Mendès France famously said that *"to govern is to choose"*. This applies as much to corporate governance as it does to the running of the state.

The purpose of this report is therefore to map out this changing context, define the implications and challenges for the RemCo, suggest some ways in which the Committee might respond, and highlight the questions that may need to be asked.

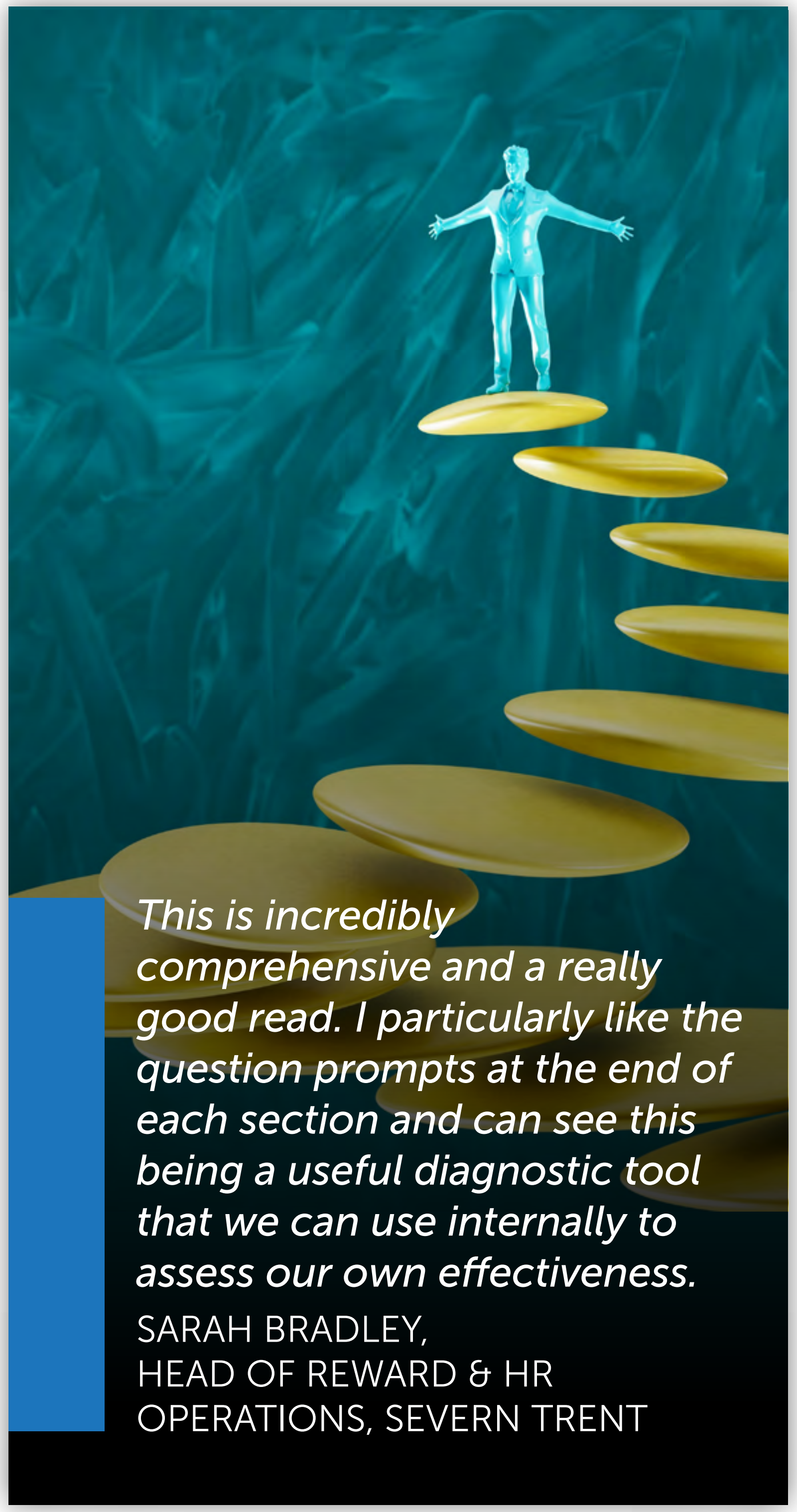
For the purposes of this report, we use the shorthand 'RemCo' for the Remuneration Committee that all UK listed companies are obliged to put in place. Similar board sub-committees for determining senior executive remuneration are used by large unlisted companies and by organisations in many other countries. Many of the findings in this report apply equally to those committees so, in this context, the term RemCo has a wider application than just UK PLCs.

Section 2 considers the **nature and extent of change to the commercial, social, and political context** in which the RemCo is now required to operate. What are the emerging trends of the past decade that have had the most dramatic impact on the role that the RemCo is now required to fulfil – including public scrutiny and government regulation.

In **Section 3** we examine in more detail **how these factors have impacted the 'work' of the RemCo** – including increased complexity, a wider range of stakeholders, and a heavier workload. To what extent is this 'more of the same' or has there been a 'sea change' in the role and expectations now placed upon the Committee.

Section 4 looks at the challenges facing the RemCo from the other end of the telescope. To what extent must the RemCo be mindful of the **impact on business performance and the overarching delivery of the business model** on which rests the sustainability of the organisation. This includes the need to secure senior executive talent in a competitive labour market and the threat of competition from less regulated and less visible sectors.

Section 5 looks at the detailed **implications of these challenges for the effectiveness** of the Remuneration Committee. The changing landscape has created a need for the RemCo to understand the challenges outlined in the context of their business, to make clear choices, and to explain them. The process for addressing this is outlined using a series of questions which RemCos might find useful to ask themselves and their key stakeholders.



This is incredibly comprehensive and a really good read. I particularly like the question prompts at the end of each section and can see this being a useful diagnostic tool that we can use internally to assess our own effectiveness.

SARAH BRADLEY,
HEAD OF REWARD & HR
OPERATIONS, SEVERN TRENT

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- **John Lee,** Managing Partner and Founder, FIT Remuneration Consultants
- **Drew Matthews,** Group Head of Reward, Benefits & Wellbeing, Centrica
- **Andrew Page,** Partner, People & Organisation Practice, PwC
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Public concern about inequality appears to track poor economic performance and low growth in incomes – rather than the actual level of inequality itself.

2.0 THE CHANGING CONTEXT

How has the commercial, social, and political context changed in which the RemCo now operates? As PARC noted in its seminal and wide-ranging 2015 Report on Remuneration Committee Effectiveness, the initial focus of the Cadbury Report in 1992 was to introduce a set of principles of good corporate governance. These principles were incorporated into the Listing Rules of the London Stock Exchange and introduced the principle of 'comply or explain'. 'Cadbury' was the first Corporate Governance Code in the world and its recommendations focused on the control and reporting functions of boards, and the role of auditors. However, by the time individual RemCos set about developing their role in the mid-1990s, the focus had already shifted to 'excessive' executive pay, partly in response to an outcry over executive rewards in the recently privatised utilities. The Greenbury Report in 1995 said that the RemCo should be sensitive to the 'wider scene' including pay and employment conditions elsewhere in the company.

In the decades since, the scene has widened to embrace concepts of 'fairness' in response to changing public attitudes and more challenging economic conditions post the 2008 financial crisis. Companies are now impacted by social, economic, political and environmental forces that were barely considered in the early 1990s. In more recent times, the invasion of Ukraine, the fallout from the Covid pandemic, and an alarming increase in serious climate events have combined with already known factors, such as economic stagnation and shrinking workforces to form what commentators have dubbed a 'polycrisis'. PARC has covered in depth the cumulative effect of these forces in previous publications, such as the *Building a Future Fit Workforce* and *Future Reward Leader* reports.

However, three of these trends may be considered to have had a more specific and focused impact on perceived RemCo Effectiveness. We expand briefly on these factors in this section.

2.1 ECONOMIC STAGNATION HAS INTENSIFIED THE FOCUS ON 'FAIRNESS AND EQUALITY'

Public and media concern about the level of senior executive pay has seen a significant increase since the 2008 financial crisis. High 'bankers' bonuses' were blamed for incentivising the behaviour in the financial sector that brought about the crash. The recession triggered by the crisis was followed by several years of cuts to public service spending and a public sector pay freeze. The UK experienced a particularly severe case of the synchronised stagnation that has afflicted most advanced economies. Pay and productivity growth never returned to anywhere near their pre-crisis levels.

The pattern has been aggravated by the inflation arising from the pandemic and the war in Ukraine, triggering what has been widely termed a 'cost-of-living crisis'. Real Household Disposable Income per person is still below its 2019 level, making the last parliament the worst for living standards growth since records began.

Paradoxically, by whatever measure used, there has been little change in the level of income inequality in the UK since 2008. Public concern about inequality appears to track poor economic performance and low growth in incomes – rather than the actual level of inequality itself. In fact, the steep rise in inequality occurred during the 1980s and 1990s, peaking just before the financial crisis. As the Institute for Fiscal Studies noted, the Top 1% and Top 0.1% now have a lower share of overall income than they did before 2008. But what matters more, as indicated by a recently published study, is that a majority of people in the UK believe that inequality is increasing. The issue also has a stronger salience among younger age groups, especially those educated to degree level.

Mercer's UK and European Practice Leader Peter Boreham supports the belief that the 2008 crash saw a major shift in the public and media focus on inequality and the attitudes to executive pay:

> *"Fewer people worried about executive pay when everybody's living standards were rising. In 2008 the music stopped! Bankers' bonuses and senior pay became a focus of outrage. This was a major reset for reward. It introduced a new concept of fairness. Fair pay for senior executives became seen as being relative to the rest of the workforce."*

With this shift in attitudes came a shift in the 'politics' of pay. PwC's People and Organisation Partner Andrew Page has noted that after the financial crisis the whole area of executive remuneration became more politically charged. The establishing of the High Pay Centre in 2009 marked the point at which executive pay was very firmly on the political agenda.

A study in 2023 reported that long-term weak economic growth leads to an increase in zero sum thinking – the belief that if one person gains another must lose. As John Burn-Murdoch pointed out in the FT, this is a rational response:

> *"When the pie was growing rapidly, the average person's material circumstances were indeed more liable to improve without the aid of luck or connections."*

However, in conditions of zero growth, a real-terms pay increase for someone must imply a real-terms cut for someone else.

If per capita GDP growth remains low, the focus on inequality will remain high, especially as the issue has particular relevance for the young well-educated, a cohort that will increase in influence over the course of the decade. While CEO pay is only a small part of the picture it is a very visible one. As RemCo Chair and former CEO Alan Giles noted:

> *"Growing concerns about societal inequality, and in particular the relativity of executive pay to the rest of the company's workforce, is a lens which the RemCo must now apply to most of its work."*

2.2

CHANGING SOCIAL ATTITUDES HAVE SHARPENED THE FOCUS ON CORPORATE BEHAVIOUR

Public attitudes to large corporations have undergone a significant shift during the past decade. Investor and media attention and the PR prowess of thinktanks and other commentators have increased public awareness. Anti-corporate rhetoric has risen, and at the same time there has been an increase in the standards of behaviour required of corporations by consumers, employees and the wider public. The social impact of companies has come under more intense scrutiny. Younger recruits, especially, are researching a company's social and environmental credentials before applying. The Edelman Trust Barometer found that a majority of people expect companies to have issued a statement on major concerns within a two-day period of their hitting the headlines. An increasing proportion expect CEOs and their Boards to take a public stand on issues such as the environment and inequality. This can even extend to issues on which a company might have hitherto assumed it had less of a direct interest. During the MeToo and Black Lives Matter protests, for example, companies came under pressure to state their policies. The growth of social media has amplified this trend. Companies deemed to have fallen short of the desired ethical standards will find themselves vilified on X and TikTok.

In this environment, damaging media coverage can blow up rapidly and executive pay often becomes the lightning rod for outrage. Any negative publicity is almost inevitably accompanied by questions about senior executive pay.

2.3

GREATER FOCUS ON CLIMATE CHANGE AND THE PUSH FOR NET ZERO

PARC examined this subject in our April 2024 report ***Getting to Net Zero: the Role of Reward***. We concluded that the speed of global warming, the intensity of climate events, rising public concern, and governmental consensus on the push for Net Zero would make it an increasingly important factor in executive reward. Governments, international bodies and investors are losing patience with vague aspirational statements from companies. They are calling for a clear Critical Path, broken down into five-year targets, to ensure that today's managers focus on tomorrow's problems. As climate change intensifies and the Net Zero targets get closer, the pressure on companies will only increase.

The Net Zero imperative has gathered momentum with a significantly more interventionist approach from governments. The UN's Integrity Matters report and the EU's Corporate Sustainability Reporting Directive (CSRD) are indications of the direction of travel. Described by the FT as *"**the most far-reaching climate data rules in the world**"*, the CSRD will extend beyond quoted companies to cover unlisted firms and foreign subsidiaries.

Overall, the past decade has seen an increase in the range of factors a company is expected to consider in designing reward policies, and in the level of scrutiny applied. The economic, social, political and environmental trends discussed in this section suggest that this is likely to intensify over the second half of this decade. The RemCo must therefore prepare for more intense scrutiny of executive pay from governments, investors and the wider public.

3.0

HOW THE 'WORK' OF THE REMCO HAS CHANGED

In this section, we will consider the extent to which factors such as those outlined in Section Two have had an impact on the actual work of the RemCo, and on perceptions of RemCo performance and effectiveness. To what extent do the various factors go beyond a mere extension of the Committee's role and duties – or should some be viewed as a 'sea-change' in the level of expectation. And what are the implications of the latter?

3.1

CORE TERMS OF REFERENCE

The changing perceptions of fairness and equality, and the social and environmental role of companies, have brought about a **broadening and deepening of the fundamental concept of corporate governance, which drive to the heart of a RemCo's core terms of reference.**

The 2006 Companies Act introduced the concept of 'Enlightened Shareholder Value' to UK company law. Section 172 of the Act modified the duty of directors and extended the company's stakeholders to include its employees, its suppliers, its customers, the wider community and the environment. However, the 2018 Corporate Governance Code placed wider obligations on the Board to explain in the annual report the level of engagement with the workforce, and how executive remuneration aligns with wider company reward policy.

This has had a significant impact on the work of the RemCo and has tipped the Committee in the direction of a more executive role, by extending its remit to wider employee engagement. Most of the RemCo Chairs and reward professionals to whom we spoke reported spending a lot more time reviewing executive reward principles in the context of relativities and alignment with the rest of the company – and in consultation with employee representatives.

John Lee, Managing Partner of FIT Remuneration Consultants, commented on this profound change:

> *"If you asked a remuneration committee 15 years ago what proportion of their workforce earned at least the national living wage, most chairs couldn't answer that question. Today, the overwhelming majority would know the answer. It's the same with gender pay statistics. RemCos now ask how the culture for setting all employee pay ties in with the culture of setting executive pay. This focus has grown significantly since 2018."*

One Reward Director we spoke to said that RemCos have embraced this challenge, and that since 2018 we have seen the emergence of the employee as a stakeholder. He remarked that RemCos are largely stepping up to the plate and engaging, and that there's a lot more attention being paid to the relativities. With the move to greater pay transparency, there is some real momentum behind this that is likely to continue.

During the lifetime of most RemCos, organisational performance models have become increasingly complex as companies attempted to balance competing interests

3.2

PERFORMANCE MODEL COMPLEXITY

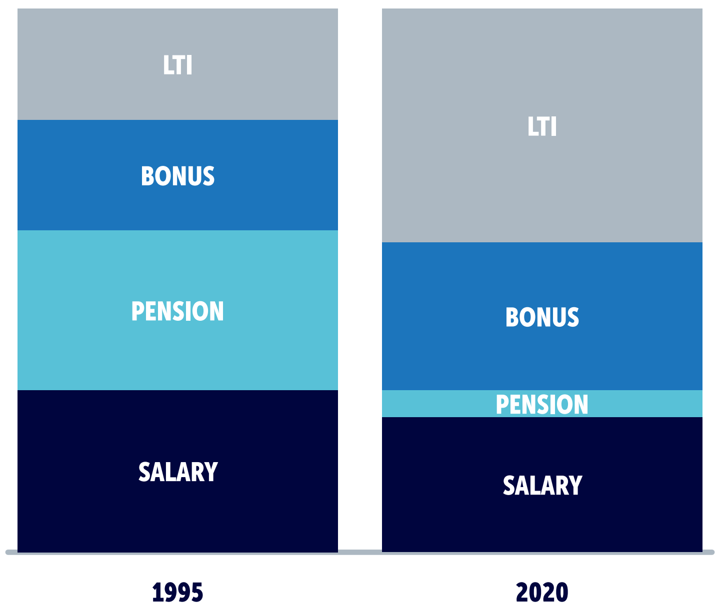
This extension of the RemCo's remit comes on top of a landscape that was already becoming more multifaceted. During the lifetime of most RemCos, organisational performance models have become increasingly complex as companies attempted to balance competing interests and to account for the diverse and changing nature of their markets and investors. Answering the question, 'What do we mean by organisational performance and how do we measure it?' has never been simple, but recent times have seen the range of criteria and variety of different metrics expand.

As we noted in PARC's *Performance Measurement Trilogy* in 2022-23, balancing the interests of investors and executives has seen the development of ever more complex metrics to address the age-old 'agency problem' of how to align the interests of those running the company with those who provide the investment. As London Business School's Alex Edmans' research found, shareholders want performance measures to be linked to 'shareholder returns', whilst executives tend to prefer measures over which they can exert a more direct influence. But as his LBS colleague Tom Gosling pointed out, many of the technical solutions which were supposed to have solved these dilemmas ended up being over-engineered to the point where they simply made the reward process less transparent on all sides.

At the same time, the variable (performance related) element in executive remuneration has accounted for an ever-expanding share of the total package, rising between 1995 & 2020 from one third to three quarters.

As the stakes have risen, RemCo judgement and discretion have become much more important.

INCREASE IN INCENTIVES AS A PROPORTION OF SENIOR EXECUTIVE REWARD



Source: London Business School

As the stakes have risen, RemCo judgement and discretion have become much more important. The complexity of the business environment in which most large businesses operate means that business judgement can be as important as financial data when making the final decision on the level and quality of performance achieved.

In a further revision of the Stewardship Code in January 2019, the FRC placed more emphasis on ESG criteria in the measurement of executive reward outcomes, recognising a trend that had been gathering pace during the latter half of the decade. This said:

> *"Signatories [to the Code] systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities."*

As John Lee pointed out, this has added a further dimension to the tension between executives and investors. Consumers and environmentalists are now also judging companies and their senior executives on their 'values'.

However, PARC's research in 2022 found a clear disconnect between investor enthusiasm for ESG and the difficulties companies were having in actually defining, measuring and implementing ESG targets. In some cases, the measures employed had unintended consequences and incentivised the wrong things. In the rush to be seen to be doing something, some companies were 'hitting the target but missing the point'. This is also reflected in increasing investor and public scepticism about 'green' incentives paying out without the company making any noticeable environmental progress.

As RemCo Chair Denise Collis remarked:

> *"A lot of executives find it difficult enough to set high quality objectives as it is. The more elements that are qualitative, the more difficult it is to do a proper assessment. We try to make sure that we have got hard metrics even on non-financial measures. As with all measures, they need to be directing attention to where we want the executives to spend their time."*

As we recognised in PARC's Net Zero report, there has been something of a backlash against ESG among some investors, especially in the US. Some of this may be driven by the political environment in the run up to the presidential election. Nevertheless, it appears that non-financial measures are here to stay – despite any imprecision in their definition, and the difficulty of their implementation. Companies will face increasing demands to report on progress towards Net Zero targets – both from monitoring organisations (such as Net Zero Tracker and Carbon 100+) and from governments. Political and social pressure on companies from an increasingly well-informed and vociferous population of stakeholders is unlikely to abate.

But as one CEO remarked, attempting to face external complexity with internal complexity is unwise. The textbooks and expert articles tell companies that the secret to doing 'performance measurement' well is to focus on those aspects which are material to your business and not to try to tick boxes in every area. However, achieving this is difficult. When more layers of complexity keep coming, reducing the task to tick-boxes has become a bone of contention between companies and investors. The next sections discuss the impact of this on relationships between companies and their various stakeholders.

3.3

MORE ACTIVE INVESTOR STEWARDSHIP

In response to public concern and exhortation by governments, investors are justifiably taking a more interventionist approach to executive reward. Since 2010, this has evolved into promotion of the concept of **shareholders as 'Stewards' of the organisations in which they own shares.**

Politicians also were keen to nudge investors to 'do something about excessive pay' in the hope of placating angry voters. The breakthrough was the requirement introduced by business secretary Vince Cable in 2013 for shareholders to approve at AGM a quoted company's remuneration policy. The legislation, known as the 'BIS Regs' for short, was the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013.

This was described by Anthony Hilton at the time as:

> *"Legislation designed to force companies to consider more clearly and explain publicly why they paid executives as much as they did, and to prompt shareholders formally to accept the policy and to intervene more readily in cases of obvious excess."*

Putting it more bluntly, one former head of reward commented at the time that:

> *"Undoubtedly the BIS Regs have served to focus the minds of RemCo NEDs. They now pay closer attention to papers and in meetings – and understand that they have personal liability."*

It cemented the RemCo's accountability (and blame) for any perceived 'incorrectness' in the design and execution of executive reward and has developed into a RemCo set of norms and conventions that go beyond the scope of the legislation. For example, the binding vote on remuneration policy (logically over 50%) has become at least 80% by convention. Any less and the company is required to consult with shareholders and issue a statement on their conclusions within six months. The company is also listed on the Investment Association's register – known colloquially as 'the Naughty Step'. It is also expected that any exercise of discretion by the RemCo will be to reduce senior executive pay rather than to increase it.

In addition to these conventions, investors often add their own specific requirements. As RemCo Chair and former CEO Angela Seymour-Jackson explained:

> *"Over the past 10 years we've seen the rise of single-issue policies from investor groups. A lot of the big investors who have their own research departments add additional conditions that the proxies don't cover. For example, Fidelity with their two-year holding period on the LTIP or BlackRock, who have an 'overboarding' requirement of no more than four board mandates, whereas for ISS and Glass Lewis it's five. Then there will be a shareholder who is anti-TSR, and says that if you introduce it, they'll be voting against no matter what.*
>
> *When you add all that up across the shareholder register you end up with multiple views which are not always aligned and are sometimes conflicting. The area where you feel you can operate safely gets smaller and smaller. For RemCos, just trying to work out what the landscape looks like has become much more restrictive."*

3.4

SHAREHOLDER DIVERSITY – WHO 'OWNS' THE COMPANY, AND FOR WHAT PURPOSE?

So, who are these 'Stewards' in practice? For starters, it must be recognised that the nature of share ownership in UK quoted companies has changed dramatically since the time of the Cadbury Report. The traditional image of the shareholder as a wealthy individual owner was already out-of-date by the early 1990s. Such investors owned over half of the total equity of UK shares in the early 1960s. By 1992 that was down to a fifth and it has continued to decline since. Just as significantly, the proportion owned by foreign investors increased from 13% at the time of the Cadbury Report to 58% in 2022. It is now critical that the Board and its Committees have a practical understanding of the diversity of their shareholder base.

Some of these 'stewards' may be holding a wide range of assets. Furthermore, shares may be held by nominee accounts and intermediaries. Many actual share owners have only the vaguest idea of the investment strategies adopted by their fund managers.

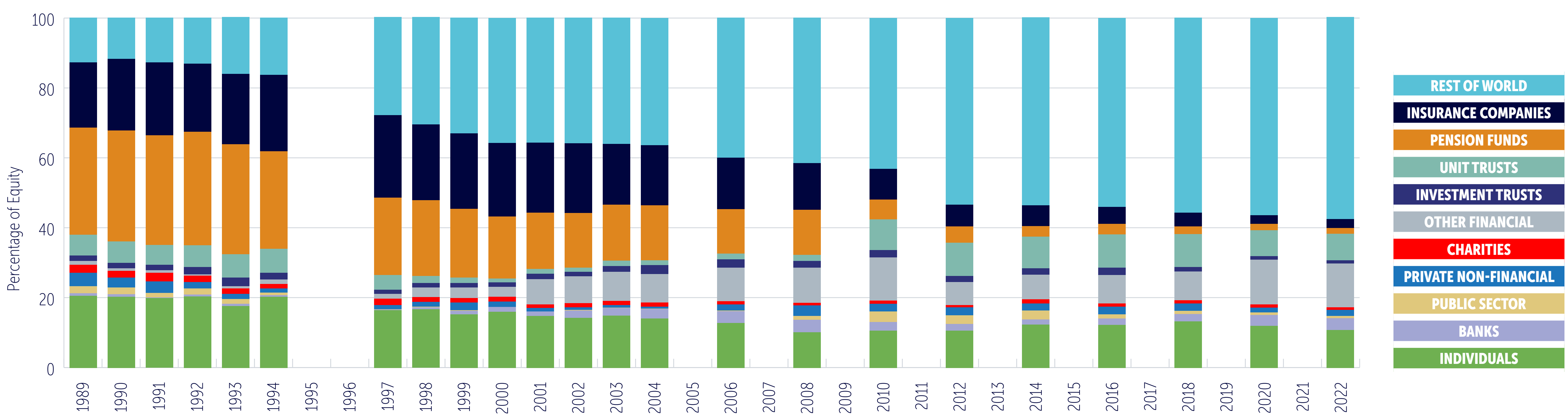
Among the Rest-of-the-World category in the diagram below, around 13% are classed by the ONS as foreign public sector. These are mostly the Sovereign Wealth Funds, – notably Norway, China and certain Middle East countries – that are becoming known for their increased activism. Norway alone holds 1% of global quoted equities.

Over a similar period, the percentage of equity owned by UK pension funds and insurance companies has diminished. Major players until the mid-2000s, the Association of British Insurers and the National Association of Pension Funds were high on the list of those to be consulted in discussions about corporate remuneration. Nowadays, between them, they account for less than 5% of the equity in UK quoted companies. Despite the exhortations of politicians for pension funds to invest in UK plc, even the MP's own pension scheme has a low level of investment in British companies. The FT reported in November 2023 that the parliamentary pension scheme invests just 1.7% of its fund in UK-listed companies.

This change in the balance of power in the ownership of quoted companies has changed the dynamic of shareholder interaction.

SHARE OWNERSHIP OF UK QUOTED COMPANIES

Source: [Office for National Statistics; Share Ownership time series dataset]



It is now critical that the Board and its Committees have a practical understanding of the diversity of their shareholder base.

3.5

THE ROLE AND GROWING INFLUENCE OF PROXY AGENCIES

The increasing demands of stewardship on the part of investors (and often their geographical remoteness) may well have led to the rise of 'proxy agencies' – bodies which analyse annual reports and make voting recommendations on individual resolutions. The increase in the proportion of US shareholders, on whom US proxy agencies tend to have greater influence, has contributed to this trend. Their role in shareholder advocacy is controversial and probably one of most significant areas of disagreement between companies and investors.

A recent FRC report found that almost all investors use proxy agencies, with most using one of the three major firms, ISS, Glass Lewis and IVIS. However, the research found that the influence of proxy agencies – as indicated by the correlation between voting recommendations and voting outcomes – is *"less extensive than sometimes asserted"*. In 2022, a vote of 20% or more against a resolution relating to director elections or remuneration occurred in only half of the cases where one or both of ISS or Glass Lewis had made such a recommendation. It also found that there was often a lack of consensus amongst the proxy advisors, with Glass Lewis and the ISS providing different recommendations in two-thirds of cases.

Even so, the main finding of the report was of a significant gulf in understanding between companies and investors. The FRC found a significant lack of consensus, reporting *"frustrations on all sides"* about the effectiveness of the process and the behaviour of the other parties. For example, there was no consensus between companies and investors on the quality of the research reports prepared by proxy advisors. Nearly half of companies that responded to the survey said that they were dissatisfied, compared to only 6% of investors. All the companies surveyed believed they should have sight of the voting recommendations in advisors' reports in advance.

A particular bone of contention was the level of engagement during the AGM season. The majority of proxy advisors surveyed did not usually engage face-to-face with companies during the AGM season, with most citing time and resource constraints as the main reason. Furthermore, the majority of investors do not notify companies of their basis or intention to vote against a resolution in advance of doing so. For the companies, this means that votes against a remuneration report can come as a surprise.

As the FRC report further noted, interviews with company and investor representatives suggest that there can often be a mismatch between a company's desire to engage with its major shareholders and those shareholders' willingness or ability to do so. Smaller organisations and those with very dispersed share registers found it particularly difficult to engage effectively. As Ellason remarked:

> *"We would strongly encourage proxy advisors to accelerate the review process and publication of their annual voting guidelines to allow remuneration committees more time to reflect this in their thinking. Too often we find that committees are left scrambling to consider new information from proxy advisors deep into their remuneration review processes."*

There are no easy answers, but what is clear from the study is that there is significant frustration around the general AGM process, and in particular the limited time during which advisors produce their reports and in which companies must respond. Short of significant increases in resource, it is not immediately clear how best this issue can be resolved.

There is even some sympathy for the proxy agencies among RemCo chairs. As Alan Giles remarked:

> *"Proxy advisers have a nigh on impossible job. The DRR has doubled in length and scope. The inevitable outcome is a rather formulaic approach to determining whether something does or doesn't fit with the guidelines."*

4.0

THE LABOUR MARKET FOR EXECUTIVE DIRECTOR TALENT

The developments we have outlined in the previous two sections have combined to create a highly complex and multifaceted regime for managing senior executive reward. So how does this impact on the overriding objective to secure high calibre executives to drive and focus organisational performance. Frequent comments from RemCo Chairs and reward professionals express frustration that this objective is being derailed by an infuriatingly arcane process.

4.1

CREATIVITY AND INNOVATION IN REWARD DESIGN AND EXECUTION

Terms like 'box-ticking', 'boilerplate solutions' and 'jumping through hoops' create the sense that the structure is stifling creativity and innovation in reward design and execution, rather than enabling it to become a source of strategic competitive advantage. This is reflected in the views of two of the RemCo Chairs we consulted.

Denise Collis commented that the current system makes it difficult to design something different:

> *"It is challenging to experiment. If you design something new and then, within a year, you realise it's a mistake, you can't just go back to shareholders and say, "Well, that didn't work. Can we try something else?" It's also much easier to test and retest in private equity reward, compared with LTIP's.*
>
> *If there was more flexibility to take account of what's going on in the market, I think we'd get more smoothing of reward. What tends to happen now is an LTIP pays out really well when the market's good and so on the back of this you set really stretch targets for the next three-year performance period. Then the market goes down, and the LTIP doesn't pay out, so you set more conservative targets. This means you are constantly creating spikes and troughs which can be unhelpful from a motivational perspective."*

RemCo Chair Carol Arrowsmith remarked on the reversion to the norm:

> *"Businesses spend most of their mental energy differentiating themselves. Only in Reward do they all crowd into the same corner.*
>
> *We've lost the days when we used to recruit a CEO, especially an internal appointment, and we'd typically put them in on say 20% below the market rate. Over the next three years, we'd get them up to market, and if they were performing well, we'd carry on and they could be upper quartile towards the end of their career, when they were at their most productive. You can't do that now. Most companies don't even think about paying under the market at the start, because it's too difficult to justify the subsequent pay rises."*

> ***Businesses spend most of their mental energy differentiating themselves. Only in Reward do they all crowd into the same corner.***
>
> CAROL ARROWSMITH,
> CHAIR OF THE REMUNERATION COMMITTEE, CENTRICA

4.2

ADDRESSING THE COMPETITIVE MARKET FOR TALENT

Equally, there is a rising level of concern about the lack of flexibility to recognise the competitiveness of the market for critical talent – particularly on the part of UK listed companies. Over the past two years, a number of companies have been seen to have broken ranks and increase their senior executives' pay in excess of what would normally have been deemed acceptable.

In May 2023 an article by Julia Hoggett, London Stock Exchange CEO, criticised formulaic opposition to pay increases outside of standard norms, even when the senior executive pay levels concerned were below recognised global peers – and she singled out proxy agencies for criticism.

> *"Attracting and retaining domestic and international talent to create value is something that UK listed company boards and their executive leadership teams strive to do every day.*
>
> *And yet, very often, this talent objective is hampered by the advice and analysis of the proxy agencies and some asset managers voting against executive pay policies even when those pay levels are significantly below global benchmarks. Often the same proxy agencies and asset managers that oppose compensation levels in the UK support much higher compensation packages in different jurisdictions, notably in the US. This lack of a level playing field for UK companies is often not discussed, or if it is, the downside risks to our companies, our economy and our competitiveness are not part of the conversation."*

She went on to warn that the UK is in danger of:

> *"Exporting skills, talent, tax revenue, and the companies that generate it".*

Early in 2024, Rupert Soames, Smith & Nephew Chair, took a similar position. He coined the term BRILO (British In Listing Only) to describe those UK-listed companies that conduct most of their business elsewhere in the world. For these organisations, he argued that:

> *"The current position on pay is not actually sustainable."*

Some high profile defections to a US listing by UK companies have underlined the point.

These include betting group Flutter, building supply firm CRH, packaging company Smurfit Kappa and plumbing equipment supplier Ferguson.

4.3

HAVE WE REACHED A TIPPING POINT?

Some commentators are, however, sensing a shift in the mood on executive pay on the part of the shareholders concerned. The Guardian's Nils Pratley remarked:

> *"We've now had three high-profile votes in which Footsie companies, against a backdrop of panic about defections from London, have played the US card as an ace and they have won every time. At the London Stock Exchange Group last month, 89% were in favour of a scheme to double the boss's max to £13m. At AstraZeneca, 64% approved a boost for Pascal Soriot to a potential £18.7m, with implied uplifts for US-based research chiefs."*

The FT sensed a similar trend:

> *"Frustrations among UK board directors about the constraints on offering internationally competitive pay packages to their top executives have been simmering for years. Falling behind on executive pay can hamper a company's ability to attract and retain the most talented senior management teams, which some say risks exacerbating the decline in the UK's capital markets.*
>
> *Now there are signs executive pay in Europe is at a tipping point, with greater efforts by boards and concessions from shareholders to bridge the divide with the US."*

Recent research by Deloitte supports the view that we are seeing an increase in large, global FTSE 100 companies moving forward with more radical pay proposals this year, both in terms of incentive levels and the structure of pay.

Ellason Partner Peter Smith thinks that we are seeing a step change now, where a number of companies at the top end of the FTSE take proposals to their shareholders and accept that they will only get a vote in the 50s or 60s. He adds that:

> *"There was a lot of nervousness about being on the IA naughty step. That nervousness is certainly reducing. I've heard more people in the last 12 months say they don't mind going below the 80% threshold than I had in the previous 10 years. I think we are going to see companies test the boundaries of investors' attitudes around pay structure and pay levels."*

It should be noted that the Investment Association was quick to acknowledge the concerns raised and responded with a consultation exercise with FTSE companies. In a statement in February 2024, it said:

> *"Given the views we have heard, we are conducting a more fundamental review of the Principles of Remuneration which will be published later in 2024, reflecting the evolving member expectations on remuneration and feedback from companies."*

Nevertheless, Tom Inchley of ISS sounded a word of caution:

> *"Summarising this review as representing an opening of the pay floodgates, as some commentators argued when the details were initially reported, does not necessarily capture the essence of the IA's letter.*
>
> *It will be interesting to see what the IA's planned simplification of its principles will entail, to ensure that they reflect 'evolving member expectations'."*

There is much talk of a change in the mood but it remains to be seen how much of an impact it has. While the newly elected government will probably avoid any direct intervention, the rhetoric from Labour politicians is likely to be negative about any significant rises in executive pay. It is reasonable to assume that political and media outrage and investor pushback against 'excessive' executive reward packages is likely to be a feature for some time yet.

However, Carol Arrowsmith does see a change coming, and she thinks that it's coming from all directions:

> *"You see it in the big tent conversation hosted by the stock exchange. You see it in the Investment Association's letter to RemCo chairs. You've got the simplification of things by the FCA. There is a recognition that they had pressured companies, in all sorts of ways, into overzealous compliance, which was actually starting to impinge on the competitiveness of UK business.*
>
> *I'm reassured to see that things are changing. Not because I think all executives need to be paid more. Quite a lot of them are paid perfectly adequately. But there are some businesses, in some circumstances, that need to do things differently."*

Denise Collis took a similar view that the impact of the regulations and guidelines has been to corral RemCos ever more tightly and take away a lot of their discretion and freedom in decision making.

> *"I think now we're starting to see a bit of a kickback. If you've got a significant number of companies sitting on the naughty step, it's more of a club than a naughty step. I wait with interest as to what the Investment Association guidelines look like when they come out in the Autumn."*

This reflects a more general concern among RemCo chairs about the constraints on a RemCo's freedom to act. As RemCo Chair Rakhi Goss-Custard put it.

> *"If we want the UK to be a competitive market, we need to trust Boards and RemCos to act in the best interests of a company and its various stakeholders. Boards don't want to pay execs excessively. They also will not keep someone who is failing. But they understand much more about the company and the relevant talent market, so should be trusted to do the right thing. I think shareholders and proxy agencies are starting to accept that."*

4.4

THE CAVEAT: DEFINING AND UNDERSTANDING THE REAL MARKET

A widening gulf between CEO pay in the UK and US has been cited as the driving force behind the pushback on the norms of recent years. But many are sceptical of the extent to which most UK CEOs are really part of the same market as their nominal US counterparts, and whether international comparisons are even possible.

As London Business School's Tom Gosling points out:

> *"Surprisingly, there's not a readily available database that enables consistent comparisons of CEO pay in different countries, taking full account of factors like company size, the level of risk in the pay package, and significant differences in local tax and pension regimes."*

Some of those we spoke to suggested that, while competition for talent from the US might be an issue for a few companies, the lack of a level playing field between the quoted and unquoted sectors in the UK presented just as much of a challenge for some other firms. John Lee remarked that over the past 10 years, he had witnessed a similar shift of good talent out of the listed arena and into PE backed companies. However, he noted that, while for those executives who are very successful, total pay could be exponentially higher, pay was less guaranteed and job security less. In his view, no less importantly, executives valued the greater simplicity of pay structures in PE, with bonuses invariably paid in cash at the year-end rather than subject to complex deferral and retention requirements.

RemCo Chair Rakhi Goss-Custard took a similar view that while the US is a real talent pool for specific sectors, such as digital technology or scientific areas, the main pressure point is from private companies:

> *"What I've seen from executives over time is that there is a level of frustration with the public market. There are more executives moving into private equity or private companies where they have more control. I think that's where you see more of the competition."*

Equally, Centrica's Group Head of Reward Drew Matthews was of the view that some people may tend to look to the US because it gives them an answer they like. But there are companies in Europe and the Far East competing with US companies and doing very well without paying their CEOs anywhere near the same. He questioned whether we are really competing with the US for executive talent? And he added:

> *"It's the same with private companies. There's a perception that people can go and earn loads of money, and sometimes they can. But there are a lot of examples where people aren't making anywhere near as much money. Executives should be under no illusion that going into private equity will be easier. There's often a much harder scrutiny of performance by the investors than in the PLC environment."*

Admittedly, there is some evidence that pay growth for CEOs in UK listed companies has been sluggish in recent years. A paper by consultancy Alvarez and Marsal in June 2023 argued that median FTSE 100 CEO remuneration has effectively stagnated for the last decade. However, none of this is likely to cut much ice with the critics of high pay in politics, the media and the wider public. Commenting on Julia Hoggett's call for a 'big tent' discussion on executive pay, the FT's Helen Thomas remarked:

> *"There isn't a big top big enough to convince the general person or policy-maker that an average pay packet of £4.3mn in the FTSE 100 is the root cause of what is holding the country back."*

4.5

THE SPECTRE OF DE-EQUITISATION

While there has been a shift of UK firms to list in the US there has also been a movement out of the listed sector and into private ownership. The pace of de-equitisation was described as 'relentless' earlier this year by broker Peel Hunt. However, while many explanations have been advanced to explain this trend, few seem to put the blame on senior executive pay. Duncan Lamont of Schroders, who has been tracking de-equitisation for many years, points out that, while the trend might have started in the UK, it is now a growing international phenomenon.

> *"In 1996 there were over 2,700 companies on the main market of the London Stock Exchange. At the end of 2022 this had collapsed to 1,100 – a 60% reduction.*
>
> *Individual countries like to beat themselves up about their failings on this front – self-flagellation is a popular British pastime – but the reality is that it has been a global trend.*
>
> *In the US, over 300 companies a year, on average, joined the stock market between 1980 and 1999. Since, there have been only 129 a year.*
>
> *In the UK, the number of new listings dropped after the financial crisis and has failed to pick up meaningfully since. Money raised in UK IPOs has also been on a steady downtrend. For UK-based companies this trend set in the early 1990s. For overseas companies, it has been in the past ten years."*

The net effect of all of this is that the stock market now provides exposure to a dwindling proportion of the corporate universe. He gives two main reasons for this:

1. More private finance is available and can now finance companies to a much later stage of their development.
2. At the same time, there has been an ever-greater administrative burden on listed companies. The cost and hassle of being a public company has increased. Recent research has found that the average UK company's annual report has increased in length by 46% in the past five years. For FTSE 100 companies it now stands at 147,000 words and 237 pages.

There is, of course, the counter-argument that UK rules on executive remuneration are part of the costs and hassle, but the fact that de-equitisation is continuing apace in many parts of the world suggests that it is, perhaps, not a major driver.

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5.0

THE IMPLICATIONS FOR GREATER REMCO EFFECTIVENESS

The previous sections have outlined the changing context for the RemCo, the shifting landscape in which they operate, and many of the challenges which need to be addressed.

An increasingly volatile political, social and economic landscape has changed the nature of the game. The RemCo now finds itself surrounded by a constellation of competing interests often reflecting conflicting values. Sometimes contradictory viewpoints will come from the same type of stakeholder. As many of those we have quoted have remarked, it is simply impossible to satisfy all of the different, and often conflicting perspectives, and trying to do so may well cause unintended consequences. We return to the quote from Pierre Mendès France, who famously said that *"to govern is to choose"*. Invariably there is no 'right' choice – merely one which appears 'most right' in the context of the specific business.

This has implications for the skills requirements and prior experience of RemCo chairs and members, the way in which the RemCo organises itself, its team dynamic, and the way it shares knowledge.

The following suggests the process by which the RemCo might address some of these challenges, by underlining the questions which the RemCo may need to address.

5.1

UNDERSTANDING THE CHANGING CONTEXT

In Section 2 we discussed the changing context in which the RemCo is now operating. It is essential that the RemCo takes some time to assess this changing landscape and the implications for their specific company, its shareholders and its workforce.

In particular, we focused on three areas:

1. **Fairness and equality** – Growing concerns about societal inequality, and in particular the relativity of executive pay to the rest of the company's workforce, is a lens which the RemCo must now apply to most of its work.
2. **Sharper focus on corporate behaviour** – Damaging media coverage can blow up rapidly and executive pay often becomes the lightning rod for outrage.
3. **Push for Net Zero** – As climate change intensifies and the Net Zero targets get closer, the pressure on companies will only increase.

These dynamics will continue to re-shape the RemCo's agenda. All have particular salience with younger and highly educated workers, who are more likely to research a company's track record before agreeing to join as employees and who, as one RemCo chair noted, are more ready to call the company out on social media. These employees will become an important resource for increasingly scarce talent in the latter half of this decade.

Developments over the past decade have taken Reward into a more politicised and more public arena. The RemCo needs to anticipate how these developments might shape the coming years. So far, the new Labour government has said little that suggests how it might seek to frame companies' duties in these areas, but its rhetoric suggests that the political focus will increase.

In keeping abreast of these issues, the professional backgrounds of RemCo members will become more critical. While they will invariably be well-informed about the wider political, social and economic context, sharing that knowledge in a team, synthesising it quickly and applying it to a business situation can still be a daunting task. Creating a shared 'team competence' and awareness will be essential.

← QUESTIONS FOR DISCUSSION

- To what extent does the changing landscape highlighted above feature in RemCo decision-making?
- What information sources are used, how, and with what frequency?
- What is the right balance between internal and external expertise and advice?
- Is the RemCo getting the right advice and is there sufficient challenge in the process of bringing that advice to the Committee?

→ QUESTIONS FOR DISCUSSION

Has the RemCo:

- Reviewed its core terms of reference to reflect its wider stakeholder remit
- Defined the level of engagement with the workforce, and how executive remuneration aligns with wider company reward policy?
- Reviewed executive reward principles in the context of relativities and alignment with the rest of the company – and in consultation with employee representatives?
- Assessed the extent to which the work of the RemCo may have tipped the Committee in the direction of a more executive role?
- Reviewed and considered the implications of greater pay transparency?

5.2

REFINING THE REMCO'S ROLE AND TERMS OF REFERENCE

As we noted in Section 3.1, the RemCo's remit and formal terms of reference have expanded to include the workforce as a whole. The RemCo is now obliged, under its core terms of reference, to engage with employees or their representatives, and this re-defines its role in managing pay relativities across the organisation.

This additional area of accountability involves establishing processes for understanding reward principles across the organisation and the implications for internal relativities, including such criteria as gender and ethnicity.

This represents a significant shift for the RemCo from having exclusive focus over an employee population barely into double figures to having a shared focus over one encompassing potentially many thousands. This has implications for the organisation and workload of the RemCo. Denise Collis, for example, has the role of employee engagement NED on one of her boards, and is tasked with bringing the voice of employees into the boardroom. Once a year she holds what she calls a 'fair pay RemCo', i.e. she takes a vertical slice of the organisation and asks whether they are treating people fairly and in line with the market at every organisational level.

These expanded terms of reference have potential implications for the composition of the RemCo. The profile of the Committee's membership may need in some way to reflect an appropriate diversity of background (age, race, nationality, etc.) to provide a broad market understanding, and professional skills and experience to provide a critical functional challenge. In some contexts, widening the attendance at a RemCo meeting to include representatives of affected stakeholders might help improve the rigour and objectivity of debate, and help to identify likely objections at an early stage.

5.3

CLARITY ON THE ORGANISATIONAL PERFORMANCE MODEL

With the increasing complexity described in Section 3.2, it is even more important to retain focus on how the organisation defines and measures performance, specifically:

- How the 'performance model' relates to the delivery of the business model
- How it links to the board's key strategic objectives
- How it relates to the delivery of sustainable, longer-term performance.

Angela Seymour Jackson has stressed that the purpose of the RemCo is to incentivise and reward management for achieving the strategy. If the RemCo becomes obsessed with the complexity of trying to keep everybody happy, they end up not doing their core job. In her view, good boards should be prepared to risk a below 80% vote if they have a real conviction that what they are proposing is essential for the delivery of the strategy. The onus is on the RemCo to do a better job of articulating why the remuneration policies being proposed are right for their business.

The RemCo needs to develop a shared understanding on what superior performance means in the context of their specific company and how that translates into the objectives set for its senior executives. As we noted in Section 3.2, responding to external complexity with internal complexity should be avoided. The key to doing 'performance measurement' well is to focus on those aspects which are material to your business and not to try to tick boxes to appease proxy advisers.

This clarity enables the RemCo to have confidence in its judgements on the balance between financial and non-financial objectives, the use of discretion, and the triggering of 'Malus and Clawback'. It is vital to be clear about what you mean by performance if you are taking money away from people.

The RemCo is the crucible in which these arguments must be developed before being deployed in the wider world. Being tough with each other helps to prepare for the tough questions that will come from outside.

← QUESTIONS FOR DISCUSSION

Has the RemCo:

- Reviewed what precisely is meant by organisational performance and how it is measured? How widely is this understood?
- Reviewed the balance between performance measures linked to 'shareholder returns', and those over which executives can exert a more direct influence?
- Reviewed the balance between fixed and variable reward?
- Reviewed the terms on which the RemCo should exercise judgement and discretion – i.e. beyond financial data – when making the final decision on the level and quality of performance achieved?
- Decided the weighting of ESG criteria in the measurement of executive reward outcomes?
- Established a process for balancing the disconnect between the enthusiasm of some investors for ESG and the difficulty of defining, measuring and implementing ESG targets?
- Reviewed the balance between quantitative (financial) measures and qualitative measures?
- Defined 'hard' metrics for non-financial measures or else clearly explained the judgement calls necessary to make the 'soft' metrics work?

5.4

UNDERSTANDING AND PRIORITISING THE NEEDS OF EXTERNAL PLAYERS

5.4.1

UNDERSTANDING THE 'STEWARDSHIP' ROLE OF INVESTORS

As we noted in Section 3.3, investors have embraced the idea of stewardship and are taking a more interventionist approach to the companies in which they invest. Their scrutiny of executive reward is more intense as is their willingness to oppose a company's remuneration policy.

While many of those interviewed for this report might hope for a relaxation of some of the conventions that have taken shape over the past decade as a result of this increased scrutiny, it is unlikely that they will disappear altogether. Even if investors are more open to creative reward policies, choosing to step outside the constraints of existing models will still require strong engagement with shareholders.

Companies need to decide who is best placed to represent the Board to the shareholders and explain the company's performance. Remuneration then becomes part of that wider conversation.

There is a view held by Alan Giles and others that it works well when the RemCo chair is also the Senior Independent Director (SID), which means that a main conduit between the shareholders and the Board also holds the remuneration brief. Combining these roles has a certain logic, given that many of the more contentious conversations with investors tend to be about executive reward in the context of company performance (or the lack of it). It also strengthens the ability to gain access to shareholders, particularly for smaller companies.

Being clear about the company's position while understanding the stewardship role of the investor is key to effective engagement. Our round table discussions came up with the following communication guidelines:

- Be clear about your business imperative.
- Build a narrative that shows you are being reasonable and balanced.

- Be transparent in the rationale for moving away from boilerplate solutions.
- Describe very clearly why proposals are in the interests of a wider set of stakeholders.
- Communicate with proxy agencies – but not as a substitute for consulting investors more directly.
- Put in the time and effort to convince people of the narrative.
- Own the media narrative.
- Prepare press releases in advance – rather than just reacting to 'stories.
- Don't expect journalists to read a 20-page remuneration report.

Publishing complex formulae might be of interest to technical experts but explaining how a RemCo weighs up the balance between 'formula driven' incentive payments and the exercise of business judgment requires considerable skill. Hence the need for a clear 'narrative' behind the process and the numbers.

And in the view of Angela Seymour-Jackson, RemCos need to be more courageous. A RemCo chair needs to be somebody with a bit of a thick skin. People with conviction and integrity and the courage to take on the arguments. That may sound very adversarial, but they will have to face up to some difficult discussions – and some unpopular votes.

QUESTIONS FOR DISCUSSION

- To what extent do you recognise the concept of shareholders as 'Stewards' of your organisation – and what do you consider that role entails?
- How do you respond to the convention of the 80% vote in favour of AGM resolutions?
- How far is it possible to adhere to this when faced with a 'single issue' demand from a particular investor group?
- How might you address any 'mismatch' between your company's desire to engage with its major shareholders and those shareholders' willingness or ability to do so.
- What could you do to create more meaningful engagement between all parties outside of the AGM season?

5.4.2

UNDERSTANDING THE DIVERSITY OF THE SHAREHOLDER BASE

Challenging the conventions around communication and consultation with shareholders also means understanding the composition of the shareholder base and prioritising those with whom it is most important to engage. This can be a time-consuming exercise and may run into pushback from shareholders who are simply not used to having conversations with RemCos and who may neither have the time or necessary expertise. The concept of 'shareholders' is now subject to far greater diversity – and runs across a continuum from passive investors who may care little about the remuneration policies of individual companies to activist investors who see it as their role to combat overly compliant boards.

QUESTIONS FOR DISCUSSION

- What knowledge and information does the RemCo have about the company's shareholder base, and how often is this updated?
- Is this understanding shared with the wider board?
- Does the RemCo understand investment and remuneration strategies adopted by individual fund managers – and does the actual shareholder?

5.4.3

UNDERSTANDING THE ROLE OF PROXY AGENCIES

As we discussed in Section 3.5, this is one of the most contentious areas for reward practitioners – and for the RemCo itself. There appears to be a wide gulf in understanding between companies and the proxy agencies that research and make voting recommendations on behalf of their investors.

This suggests that it is an area that will require significant dialogue if companies want proxy agencies to engage on the content and rationale for reward changes, and to support (or even simply not to oppose in principle) any innovative pay policy.

QUESTIONS FOR DISCUSSION

- Does the wider Board understand the level of influence that proxy agencies exert to affect voting outcomes?
- What can the RemCo do to ensure better understanding of the issues and improve the quality of the research reports prepared by proxy advisors?
- How might the RemCo engage with the proxy agencies to ensure longer lead times for the consideration and response to voting recommendations?

5.5

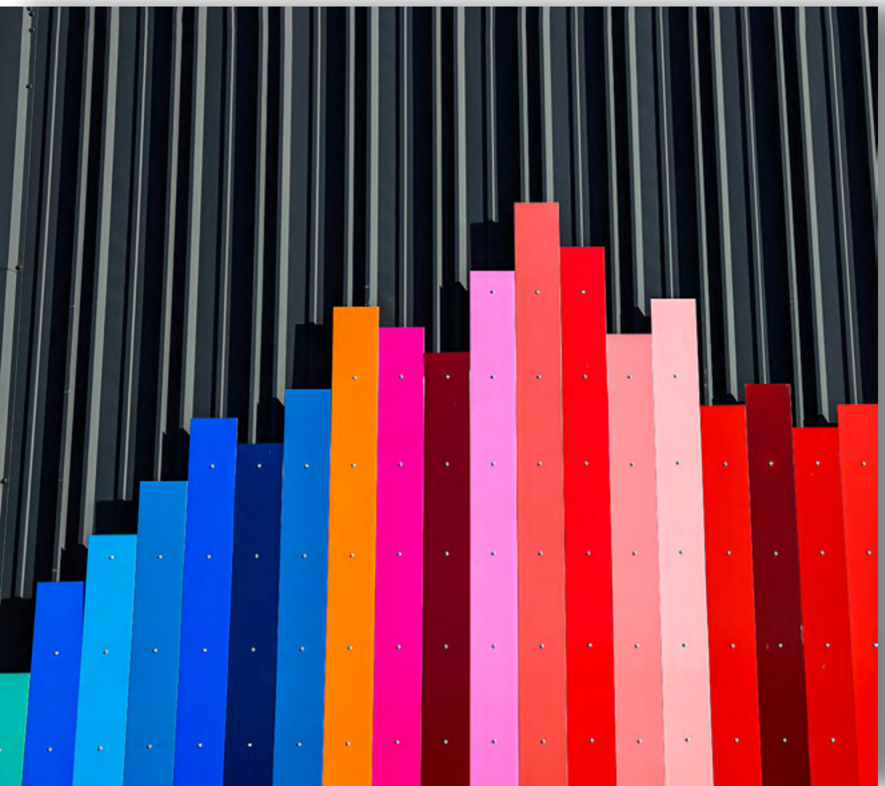
THE MARKET FOR KEY EXECUTIVE TALENT

5.5.1

UNDERSTANDING THE COMPETITIVE MARKET

The RemCo needs to be clear on its understanding of the dynamics of the labour market for its key executive roles and of the risk posed from other organisations and other markets – in different countries or in the non-listed sector.

For the RemCo to make convincing arguments for its remuneration policies, it must demonstrate a clear understanding of the real market, that enables it to present the business case in clear and compelling terms. Connecting the work of the various board committees can be a useful way of enhancing and sharing this knowledge.



← QUESTIONS FOR DISCUSSION

- Should the RemCo be defining the market for critical talent in a different way – and is this clearly differentiated for different skillsets?
- If there are assertions that rewards need to be more competitive versus international or private competitors, how does the RemCo ensure that it has robustly tested such hypotheses?
- Does your RemCo have the required flexibility to recognise the competitiveness of the market for critical talent – and does it exercise that flexibility?
- Do you agree that the UK is in danger of: 'exporting skills, talent, tax revenue, and the companies that generate it?'.
- Do you believe that the current trend of high-profile defections to a US listing by UK companies is set to continue?
- Do you agree that (for BRILOs in particular): 'the current position on pay is not actually sustainable?'
- Does your company face serious competition from the unlisted sector?
- Does de-equitisation have any implications for your organisation?
- Do you agree that we have reached a tipping point in discussions with shareholder representative bodies – as outlined in Section 4.3
- Does this open a greater window of opportunity for your company?

5.5.2

CREATIVITY, INNOVATION AND RISK IN REWARD DESIGN AND EXECUTION

The RemCo must then make a risk assessment as to whether the risk to the recruitment and retention of critical talent is greater than the reputational risks posed by challenging the orthodoxy on executive pay and significant shareholders voting against the company's remuneration policy.

↑ QUESTIONS FOR DISCUSSION

- Is it correct to say that your business spends most of its mental energy differentiating itself – and yet in Reward it crowds into the same corner?
- How differentiated is your reward design and does it reflect your business model differentiation?
- What is the RemCo's 'risk tolerance' for greater creativity and innovation in reward design and execution
- To what extent does the RemCo's external reward consultant understand and align with this level of risk tolerance?
- Is there scope for experimentation – in any real and practical sense?
  - » For example, if you design something new and then, within a year, you realise it's a mistake, can you go back and say, *"Well, that didn't work. Can we try this instead?"*

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5.6

SUMMARY AND NEXT STEPS

The concept of the Remuneration Committee exists in thousands of organisations and covers different forms and varying requirements for the purposes of corporate governance and regulatory compliance. The sheer diversity of size, business sectors, ownership, geography and public profile make it impossible to identify anything approaching 'best practice'. For this reason, PARC has adopted the approach of setting out the changing context, the implications this has for many of the various forms of Remuneration Committee, and therefore what questions it might be useful for them to ask themselves and, where appropriate, their key stakeholders.

What is not in dispute is the dramatic change in context and level of challenge experienced by most RemCos. In the decade-and-a-half since the financial crisis, the remit of RemCos has changed out of all recognition, in response to political, public and investor pressure. The discussions we had with RemCo chairs, Heads of Reward and others revealed some frustration at the increasing restrictions on RemCos and a corresponding decrease in their freedom to manoeuvre. Some worried that this would have a detrimental impact on their company's and the UK's competitiveness. For others it was a more general sense that they were prevented from 'getting on with the job'. There was also a feeling that the increased scope and visibility of the RemCo was gradually blurring the lines between executive and non-executive responsibility. For this reason, many were cautiously optimistic about the shift in mood that has taken place over the last 18 months.

That said, the social, economic and environmental pressures that brought about the current regime show no signs of abating. The social, economic, political and environmental pressures identified in Section 2 will ensure that there will be little let up during the rest of this decade in public scrutiny of companies and their executives' rewards.

For the RemCo, the implications of getting it wrong are profound and costly. In a world of rapid reaction and magnified outrage, reputational damage is no longer simply embarrassing. It's expensive too. And with the raised profile of the RemCo Chair, risk is individual as well as corporate. It is essential to understand this changing environment and the impact it is likely to have on the company, its investors, its employees and its other stakeholders. The RemCo must make the time to scan the horizon and anticipate these developments.

In this paper we have set out some of the ways in which the RemCo might respond to these pressures. Clarity of context, terms of reference, performance model and the labour market for senior executives are essential for confidence in communications and engagement with investors. The RemCo's shared understanding and purpose makes for greater effectiveness when dealing with any possible fallout from controversial decisions.

This paper is intended as a conversation starter for a discussion that we see evolving over the coming year. PARC will return to this subject and build on it in subsequent peer-to-peer sessions, PARC Learning events, and in our Strategic Reward Skills Masterclass.

APPENDIX

1.0

THE HISTORY OF CORPORATE GOVERNANCE

2024

UK CORPORATE GOVERNANCE CODE 2024

The revised UK Corporate Governance Code was published on 22 January 2024 and will apply to financial years beginning on or after 1 January 2025, other than provision 29 which will apply to financial years beginning on or after 1 January 2026.

Revised guidance to accompany the Code was published on 29 January 2024 in a new digital format.

2023

CORPORATE GOVERNANCE CONSULTATION

Following the consultation on Restoring Trust in Audit and Corporate Governance, in 2022, the government invited the FRC to strengthen the UK Corporate Governance Code in specific areas.

The key objectives were to improve the quality of companies' risk management and internal controls, and board's consideration of corporate governance activity to achieve their company's strategic objectives. We consulted on several other changes to the Code aimed at removing duplication and strengthening or streamlining reporting.

Corporate Governance Consultation.

2018

COMPREHENSIVE CODE REVIEW

The revision of the Code took account of work done by the FRC on corporate culture and succession planning, and the issues raised in the Government's Green Paper and the BEIS Select Committee inquiry.

Apart from giving centre stage to corporate culture and purpose, the 2018 Code Review broadened the definition of governance and emphasised the importance of positive relationships between Shareholders and Stakeholders. It also stressed the significance of independence and constructive challenge in the boardroom.

2016

AUDIT UPDATES

Following the introduction of the EU Audit Directive and the Regulation, the Code was amended to ensure that it worked alongside the new legislation.

2014

RISK & VIABILITY

The Guidance on Risk Management, Internal Control and Related Financial and Business Reporting was primarily directed at companies subject to the UK Corporate Governance Code.

The purpose of the guidance was to bring together elements of best practice for risk management; prompt boards to consider how to discharge their responsibilities in relation to the existing and emerging principal risks; and highlight related reporting responsibilities.

Risk & Viability (2014)

2010

THE UK CORPORATE GOVERNANCE CODE

The 2003 update to the Combined Code to include the recommendations of the Higgs Report and the Smith Report was followed by the 2010 review.

In the wake of financial crises that came to a head in 2008-09, the FRC decided to bring forward the review and the Code was renamed the UK Corporate Governance Code. The review concluded, among other things, that more attention needed to be paid to following the spirit of the Code as well as its letter.

2005

REVISED TURNBULL GUIDANCE

The Turnbull Review Group concluded that the original Turnbull Guidance contributed to an overall improvement to the standard of risk management and internal control, and therefore no significant edits were required.

A small number of amendments were proposed, among them requiring the inclusion in annual reports of information to allow shareholders to understand the principal features of a company's internal control procedures and risk management system.

Revised Turnbull Guidance (2005)

2003

SMITH REPORT

The FRC Group on Audit Committees, chaired by Sir Robert Smith, was tasked with developing the guidance on audit committees in the Combined Code. The group's report codified the role of audit committees. It was subsequently revised and is now known as the Guidance on Audit Committees.

HIGGS REVIEW

The Higgs review, conducted by Derek Higgs, was an independent review of the role and effectiveness of non-executive directors and the audit committee. It aimed to improve and strengthen the Combined Code.

While the review backed the existing non-prescriptive approach to corporate governance ('comply or explain') it also advocated for more provisions with set criteria for the board composition and evaluation of independent directors. This guidance has now been replaced by the Guidance on Board Effectiveness.

Higgs Review (2003)

1999

TURNBULL REPORT

The report, written by the committee chaired by Nigel Turnbull, set out obligations for directors under the Combined Code. The guidance on good practice for listed companies included keeping good internal controls, or having good audits and checks to ensure the quality of financial reporting and catch any fraud before it becomes a problem.

Turnbull Report (1999)

1998

HAMPEL REPORT

The Hampel Committee, chaired by Sir Ronnie Hampel, was set up to review the implementation of the Cadbury and Greenbury reports.

The Hampel Report aimed to harmonise, clarify and combine the two sets of recommendations into one Code. It relied on broad principles and a 'common sense' approach, which was necessary to apply to different situations, rather than Cadbury and Greenbury's perceived 'box-ticking' approach.

Hampel Report (1998)

1995

GREENBURY REPORT

The Greenbury Report was published in response to public and shareholder concerns about Directors' remuneration.

The Report was published by the Study Group on Directors' remuneration under the chairmanship of Sir Richard Greenbury. It included Principles of best practice, which encouraged greater visibility of remuneration structures and attached KPIs and the time horizons over which pay is released.

Greenbury Report (1995)

1992

CADBURY REPORT

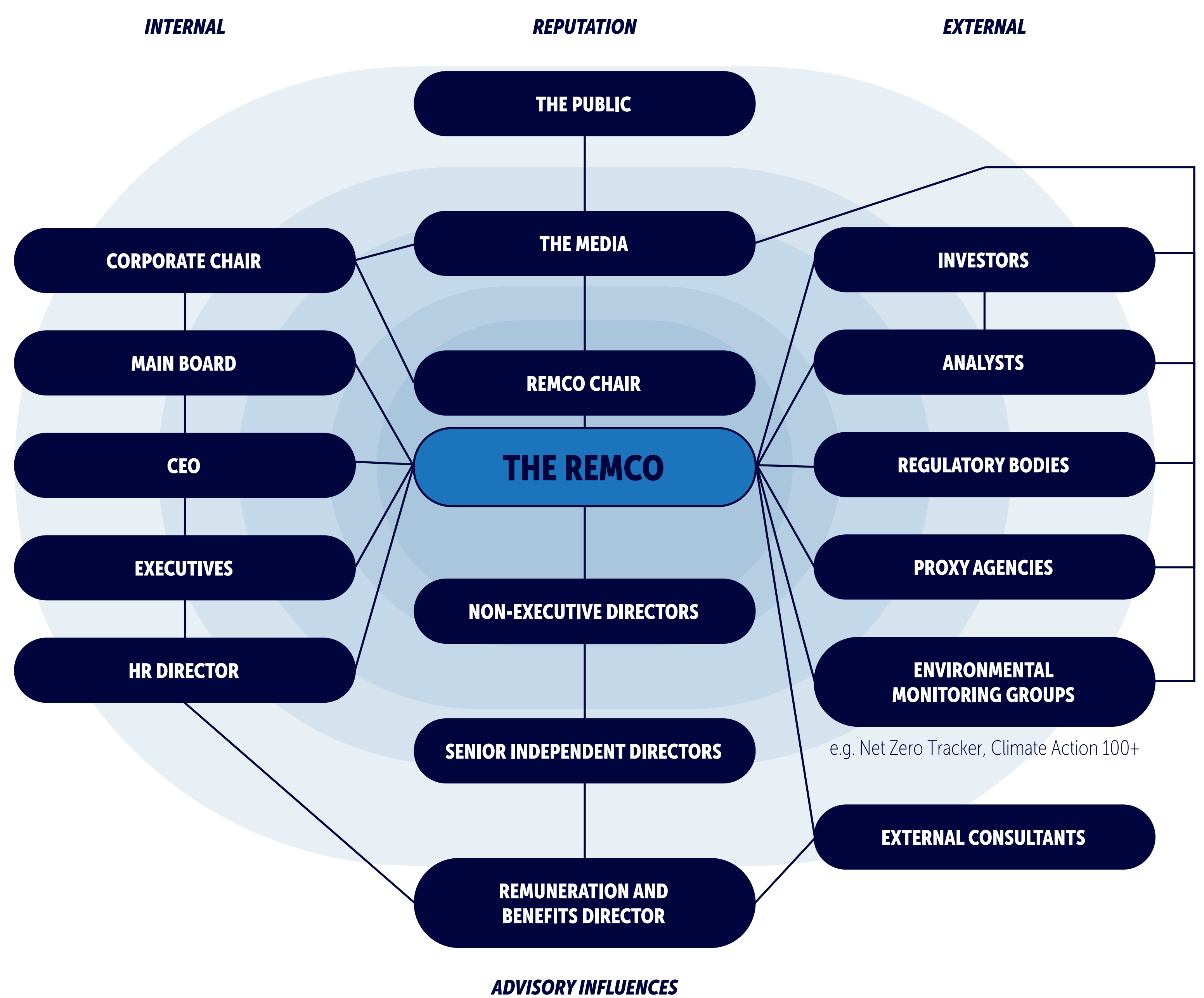
The Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury, developed a set of principles of good corporate governance. These principles were incorporated into the London Stock Exchange's Listing Rules and introduced the principle of 'comply or explain'.

The Cadbury Code was the first Corporate Governance Code in the world. The recommendations focused on the control and reporting functions of boards, and the role of auditors.

Cadbury Report (1992)

2.0

MAIN PLAYERS AND INFLUENCES



3.0

REMCO ORGANISATION AND PROCESS

Among those we spoke to, there was near unanimity that the relationship between the Board Chair, the RemCo Chair, and the CEO is fundamental. Some refer to it as the 'power triangle'.

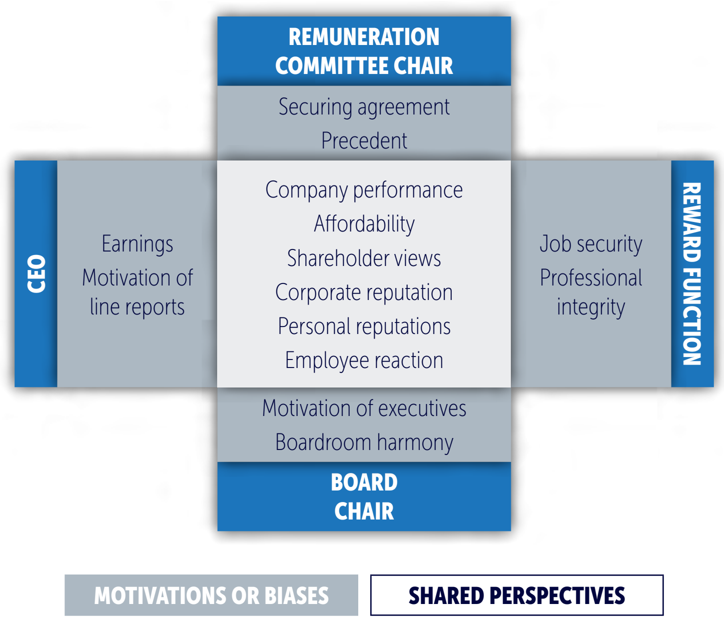
Alan Giles takes a similar view that what really matters for a well-functioning RemCo is the balance of power and influence between these key players. If one party becomes too powerful, or if there is any significant lack of trust or respect, this can lead to dysfunctional conversations and decisions. His diagram below illustrates the operational dynamic between these three roles and the Group HRD. In a well-functioning Remuneration Committee, there are a minimum of these four key players who interact to achieve a consensus middle ground – the middle box in the indicative model shown below. Factors considered will include: Will reward drive performance? Is it affordable? Will it be supported by shareholders? Is there a downside risk to our corporate reputation, or indeed our personal reputations? And how will our employees feel about it?

The frequency, timing, and duration of RemCo meetings must allow for adequate and informed discussion of critical contemporary and emerging issues. This need for thorough debate comes up against the time and resource constraints discussed in earlier sections. Most of those we spoke to felt that the RemCo needed to meet for longer, while acknowledging that the length of meetings and the overall workload has already increased significantly in recent years.

The quality and nature of information flows must allow for adequate understanding and interrogation by the Committee members. The timing of agenda and the prior circulation of papers must enable an informed debate of the core issues. It is therefore critically important for the information given to RemCo members to be clear and succinct. As Denise Collis explained:

> *"High-quality RemCo papers are hugely important as there isn't enough time in a RemCo for participants to be grappling with their understanding of the issues. Papers need to be simple, tell a story and contain clear information.*
>
> *Personally, I prefer to 'front end load' and attempt to build at least some alignment before the RemCo meetings, recognising that this is not always possible. Occasionally, it's useful for the Chair to write in advance to members to signpost the things they need to focus on and think about in advance of the meeting."*

OPERATIONAL DYNAMIC



Source: Alan Giles

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42 Berners Street, London W1T 3ND | +44 (0) 203 750 3502

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Contact **Karen Clark**, Managing Director