Are new proposals on executive pay going far enough?

10/01/2017

Share Incentives analysis: What next for executive pay and remuneration? Catherine Gannon, chartered tax advisor and partner at Gannons solicitors, explains the limitations of the proposals set out in a government green paper.

Original news

Views sought on UK corporate governance framework update, LNB News 29/11/2016 81

The government has published a green paper on corporate governance reform, which seeks views on three areas where the government is considering updating the UK's corporate governance framework. The government is inviting responses to the green paper by 17 February 2017.

What are the issues that government is addressing and what are the key proposals?

Executive pay was one of the 2016 hot potatoes. The total pay for the CEOs of FTSE 100 companies has increased from 47 times to 128 times that of the average worker over the last 18 years. Executive pay is viewed by growing numbers as being disconnected from company performance. Shareholder discontent is rising. The list of complaints about executive pay goes on. In response, last month the government published a green paper--but, even the briefest review of the green paper indicates that the government is not that serious about cracking the issues.

The green paper attempts to deal with the rising perception of excessive executive pay. The focus of the paper is on aligning executive pay and shareholder interests. There is also a focus on shifting attention from short to long term business objectives. The key proposals are:

o to make all or some executive pay elements subject to a binding vote

o to introduce remuneration maximums for total annual pay

o to publish ratios comparing CEO pay to the pay earned by the wider workforce

The consultation also suggests an option of imposing tougher consequences for a company which loses its annual advisory vote on the remuneration report, such as requiring that the next pay policy must be backed by a 'supermajority' of shareholders in order to proceed, or requiring a binding vote on pay in the following year. Do you see these as the best approaches for addressing where a company has lost the annual advisory vote, or do feel different consequences should be imposed?

The wheels of progress are turning slowly. In 2013, the government introduced shareholder votes on executive pay packages. It did not work. In practice, 28% of shareholders do not exercise their vote and 93% of shareholders agree with board recommendations. Shareholder activism is still relatively dormant. There are a few notable exceptions where shareholders went against board recommendations on directors' pay which received great publicity. Such publicity clouds the reality of fairly passive shareholders generally.

Using shareholder votes as a means of curbing executive pay is problematic on many levels. Voting depends on shareholders actively understanding and evaluating boards' recommendations. Understanding includes knowledge of the financial metrics against which performance criteria will be measured. In reality, not all financial metrics are presented to shareholders. Reasons include the commercial sensitivity of financial forecasting, or uncertainty over exceptional accounting items which are not disclosed or explained properly. If shareholders cannot make an educated judgement on performance criteria, how are shareholder votes on executive pay useful?

Also, shareholders often do not know what a realistic financial target is. Shareholders are clueless about what is a stretch target for any executive to achieve. If CEOs are involved in setting the targets (which they often are against the guidelines) the stretch targets may be less ambitious than they could otherwise have been.

A further suggestion under the consultation is for quoted companies to be subject to a binding vote at the AGM where a pre-set upper threshold for total annual pay is exceeded. Do you have any views on this proposal, and do you anticipate any difficulties with operating it in practice?

Executive pay is high and will stay high despite the recommendations. In practice, quoted companies do not want to limit executive pay and the green paper proposals are unlikely to work. Here is why.

Most shareholders in UK quoted companies are institutions, such as pension funds and hedge funds. They owe duties to their beneficiaries, the investors and pensioners, and are desperate for dividend income to pass onto their clients. Executive directors in quoted companies provide a dividend stream to institutional investors in exchange for a reward via pay. It is this mutual dependence between institutional shareholders and the directors which perpetuates excessive pay. A binding vote on pay is not going to change that.

Reputational factors come into play as well--in order to outpace Frankfurt and Paris in the quest for best CEOs, quoted UK companies invest more and more into executive pay packages. What used to be seen as indulgent and excessive is now the norm, and many quoted companies pride themselves on paying multimillion pay packages. Lowering remuneration would mean a blow to internal self-esteem, a bitter pill no quoted company is willing to swallow.

During 2016, a spotlight was shone on the remuneration consultants advising remuneration committees. Consultancies have a vested interest in recommending high pay levels for directors to keep their retainer and hence very nice fees, thank you!

What are the trends in executive pay? Are there any different approaches to executive pay that you think the consultation should be considering?

Firstly, the co-dependency of institutional investors and directors should be opened up and brought to the public attention. The introduction of workers on boards could be helpful.

Secondly, setting standards regarding the quality of financial information for shareholders to base their judgement on is a way of making the current system more robust and which the government failed to address in a meaningful way.

Thirdly, another welcome idea would be the US born ‘pay for performance’. At the moment, directors are largely paid up front. There would be a shift by introducing arrangements where the onus of proof would be on the executive to justify pay annually.

Any changes to the UK Governance Code could go ignored. The code is just that--a code with no legally binding force. Given the gentle approach of control by a code is not working, maybe the time has arrived to rev up a gear.

Interviewed by Nicola Laver.

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