

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

| Price Base Year | PV Base Year | Time Period Years | Net Benefit (Present Value (PV)) (£m) | | |
|-----------------|--------------|-------------------|---------------------------------------|----------------|----------------|
| | | | Low: Optional | High: Optional | Best Estimate: |

| COSTS (£m) | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | Total Cost (Present Value) |
|---------------|---|--|----------------------------|
| Low | Optional | Optional | Optional |
| High | Optional | Optional | Optional |
| Best Estimate | | | |

Description and scale of key monetised costs by 'main affected groups'

- None.
- Based on consultations with stakeholders, we believe that most of the proposed disclosures are already captured by best practice and as such are based on readily available information that should come at no or limited additional cost to the company.

Other key non-monetised costs by 'main affected groups'

- There is likely to be a transitional cost associated with the adjustment to the new style of report which features a forward/backward-looking split. Changes to the format of remuneration reports are not likely to be very costly where companies already have the data available.
- The costs of additional disclosure on the link between pay and performance are going to be offset by a simplification of reporting requirements in other areas of pay.

| BENEFITS (£m) | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | Total Benefit (Present Value) |
|---------------|---|--|-------------------------------|
| Low | Optional | Optional | Optional |
| High | Optional | Optional | Optional |
| Best Estimate | | | |

Description and scale of key monetised benefits by 'main affected groups'

- None.
- Benefits to business and shareholders from improved incentives for corporate managers as a result of better aligned executive pay could be significant but are difficult to monetise as they very much depend on the behavioural response of individual companies and shareholders.

Other key non-monetised benefits by 'main affected groups'

- Better disclosure around executive pay will lower the cost of monitoring by shareholders, primarily institutional investors who have the incentive to engage on such issues. More efficient engagement represents a cost saving for both shareholders and companies.
- Informed engagement provides the setting for improved pay policy design, resulting in a better link to performance which should enhance company performance and boost shareholder returns.

Key assumptions/sensitivities/risks

Discount rate (%)

- The impacts of this policy intervention depend on the willingness of shareholders to act meaningfully when in possession of enhanced information.
- Effectiveness of the proposed policy will also depend on the complementary policy measures being implemented in relation to enhanced shareholder voting rights.

BUSINESS ASSESSMENT (Option 1)

| | | | | |
|---|-----------|------|-------------------|----------------------|
| Direct impact on business (Equivalent Annual) £m: | | | In scope of OIOO? | Measure qualifies as |
| Costs: | Benefits: | Net: | Yes | IN |

Evidence Base (for summary sheets)

This proposal fulfils a Coalition commitment to removing obstacles to growth whilst ensuring responsible corporate behaviour. The UK is widely seen as a leader on corporate governance and this is important for making the UK an attractive place to invest and do business.

I. Problem under consideration

Background

1. The case for regulation of directors' remuneration arises because of a well established market failure at the heart of the corporate governance regime. Classic agency theory suggests a relationship where the owners of companies (shareholders) delegate the management of the company (directors). This separation of ownership from control leads to information asymmetries and leaves room for directors to act in their own self-interest to the detriment of the owner. Within the classic principal-agent theory literature, directors' pay is a key mechanism for helping to minimise agency costs in order to align the incentives of managers with the interest of shareholders. It follows that where shareholders do not maintain control over directors' pay there is a strong theoretical likelihood that directors will exhibit rent-seeking behaviour or pursue a strategy which rewards them personally but does not contribute to the long term value of the company¹.

2. It is responding to this market failure that has driven the UK to regulate the processes of setting and reporting on directors' remuneration for over eighty years. During that time disquiet about directors' ability to reward themselves with excessive pay packages has surfaced periodically, leading to a number of legislative and non-legislative changes in the corporate governance framework (see Annex A for details). That disquiet has become more acute in recent years in the context of the economic downturn and the continued growth in directors' pay especially amongst FTSE 350 companies. Within the last 12 months alone there has emerged a consensus that the present system is in need of reform.

Current regulatory framework for directors' pay

3. The regulatory framework in the UK aims at addressing the potential information gap between directors and shareholders as well as giving shareholders the tools to maintain control over pay. The last major change to the regulatory framework surrounding directors' pay came into effect in 2003. In line with the traditional model of UK corporate governance, the regulatory framework is complemented by market rules², 'comply or explain' guidance in the UK Corporate Governance Code³ and good practice principles issued by investors.⁴

4. Specifically, all quoted companies (i.e. those incorporated in the UK and listed on a main stock exchange in the UK, US or an EEA state – currently around 1,100 companies) are required by the Companies Act 2006⁵ to produce a Directors' Remuneration Report (DRR) as part of the annual reporting cycle. The contents of the report are prescribed by regulations⁶ and it must contain details of:

¹ Rent-seeking behaviour is any action which leads to rewards or returns which are not justified or earned.

² UK Listing Rules www.fsa.gov.uk/pubs/other/listing_rules.pdf

³ UK Corporate Governance Code

www.frc.org.uk/documents/pagmanager/corporate_governance/uk%20corp%20gov%20code%20june%202010.pdf

⁴ For example, Association of British Insurers' Principles of Remuneration 2011 www.ivis.co.uk/ExecutiveRemuneration.aspx

⁵ Sections 420-422, 439 Companies Act 2006

⁶ Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 8.

- The company's policy on remuneration
- Salary, bonus and share-based compensation of each individual director
- Pension arrangements
- Performance conditions for any share-based schemes
- Policy on notice periods and termination payments

5. Companies must put this report to shareholders for a vote at the Annual General Meeting (AGM) by means of an ordinary resolution. This resolution invites shareholders to approve the directors' remuneration report (DRR). It does not ask shareholders to approve the payments made to individual directors. As section 439(5) of the Companies Act 2006 states, "no entitlement of a person to remuneration is made conditional on the resolution being passed". The effect of this is to make the vote 'advisory' in nature. It sends a signal to the company but the company is not bound by law to take any action in response to the vote.

6. The Companies Act 2006 also requires shareholder approval of payments for loss of office made over and above that which the company is legally obliged to pay. This vote does have legal effect and the company may not make any such payment without shareholder approval. However, the reality is that shareholder approval for payments for loss of office is never sought because payments made to departing directors are invariably pursuant to the terms of the individual's service contract and other legal agreements, or discretions created through those agreements.

7. In addition to the requirements in company law, market Listing Rules require all UK listed companies to comply with (or explain why they do not) the UK Corporate Governance Code. This includes provisions on the make-up and role of remuneration committees, the pay setting process and the structure of pay. The Listing Rules also require shareholders to approve any new share-based reward schemes, for all employees and not just directors. Companies typically seek approval every five to ten years for the broad structure of these schemes, but not the detail. This is done by means of a binding shareholder resolution at the AGM.

The growth in directors' pay

8. Well-structured directors' remuneration, which is clearly linked to the strategic objectives of a company, can promote business stability and growth. However, over the last decade, directors' pay in quoted companies has increased substantially whilst overall company performance has been poor and thus the link between remuneration and company performance has been hard to discern. Academic research has pointed out that, despite directors' pay typically being viewed as an instrument of corporate governance used for addressing agency problems, the design of directors' pay can itself be subject to substantial managerial influence, thereby becoming inherently part of the agency problem itself.⁷ Consequently, the intended relationship between pay and performance can break down if the design of pay packages is more reflective of managerial rent-seeking than the establishment of efficient incentives which lead management to maximise shareholder value.⁸

⁷ Bebchuk, Lucian Arye and Jesse M. Fried (2003), "Executive Compensation as an Agency Problem", *Journal of Economic Perspectives*, 17(3), pp. 71-92.

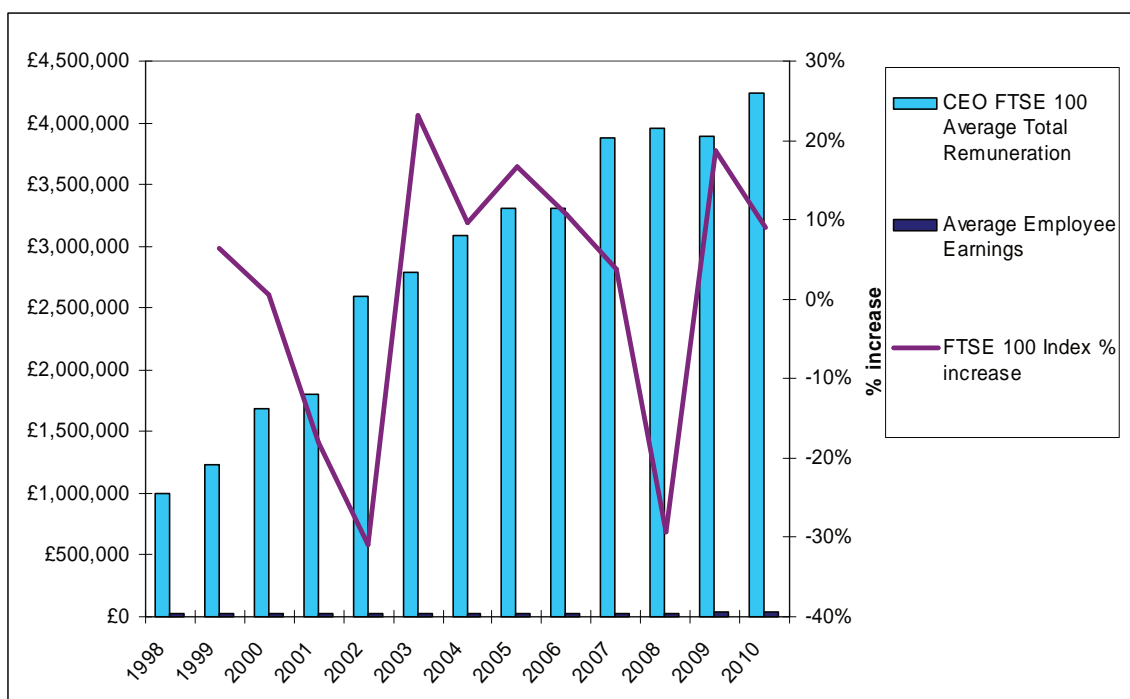
⁸ A number of authors have noted that certain aspects of pay design are more reflective of managerial rent-seeking than efficient incentive design:
 Blanchard, Olivier Jean, Florencio Lopez-de-Silanes and Andrei Shleifer (1994), "What do Firms do with Cash Windfalls?", *Journal of Financial Economics*, 36(3), pp. 337-60.
 Yermack, David (1997), "Good Timing: CEO Stock Option Awards and Company News Announcements", *Journal of Finance*, June, 52, pp. 449-76.
 Bertrand, Marianne and Sendhil Mullainathan (2001), "Are CEOs rewarded for luck? The Ones Without Principals Are", *Quarterly Journal of Economics*, August, 116(3), pp. 901-32.

9. Various academics have studied the link between directors' pay and long term company performance. Main and Smith (2011)⁹ found little evidence of a correlation between pay and performance in the UK, with executives presiding over a destruction of shareholder value receiving almost as much as value creators.¹⁰ Furthermore, the pay-performance elasticity is higher for value creators than for value destroyers. This is consistent with the findings of Gregg et al. (2010)¹¹ and van Reenan (2011)¹² who also document an asymmetric relationship between pay and performance in the UK. Over time, a relatively weak downward sensitivity of pay can lead to a "ratchet effect", with pay increasing during high performance periods but not falling when performance is low.

10. The average total remuneration of FTSE100 CEOs has risen from an average of £1m to £4.2m (13.6% a year) for the period 1998-2010. This represents over a four fold increase.¹³ This is faster than the increase in the FTSE100 index, retail prices or average remuneration levels across all employees which have risen 4.7% for the same period. By comparison to the growth in pay for executive directors, employees have seen much slower growth in earnings.¹⁴

11. Executive remuneration in FTSE250 companies has also risen fast, albeit at a slower rate, while growth in average CEO salaries in Small Cap and AIM companies has been more modest.¹⁵ (See figure 1 below)

Figure 1: Comparison of FTSE100 CEO average total remuneration, average employee earnings and FTSE100 performance 1998-2010¹⁶



⁹ University of Edinburgh Business School submission to the Kay Review.

¹⁰ The upper quartile of value destroyers in their sample received £2.4m versus the median value creating executive's total of £2.1m.

¹¹ Gregg, Paul, Sarah Jewell and Ian Tonks (2010), Executive Pay and Performance in the UK, LSE. Available at http://www2.lse.ac.uk/fmg/workingPapers/discussionPapers/DP657_2010_ExecutivePayandPerformanceintheUK.pdf.

¹² Brian Bell and John van Reenan (2011), Firm Performance and Wages: Evidence from Across the Corporate Hierarchy, LSE. Available at http://cep.lse.ac.uk/conference_papers/04_11_2011/BellVReenen_FirmPerformanceandWages.pdf.

¹³ This figure includes salary, bonus, deferred bonus, other benefits, long-term incentives, share options and pensions. Taken from: Manifest/MM&K, The Executive Director Total Remuneration Survey 2011, May 2011. Available at: <http://blog.manifest.co.uk>

¹⁴ We are well aware of the issues involved in looking at the average instead of the median when the distribution is skewed, but have chosen to use mean figures for data availability reasons. Furthermore, the picture does not materially change when the median is used. According to IDS data **INSERT REFERENCE**, median executive pay has tripled over a similar time horizon, which clearly represents a significant upward trend.

¹⁵ Hutton Review of Fair Pay in the public sector, Interim Report, December 2010. Available at: http://www.hm-treasury.gov.uk/d/hutton_interim_report.pdf

¹⁶ Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, May 2011. Available at: <http://blog.manifest.co.uk>

12. Research looking at the reasons for the growth in pay has reached different conclusions, with many studies pointing to the difficulty of identifying causal effects. As a result, no single, clear reason has emerged and the trend is most likely to be a combination of factors.¹⁷ In a BIS discussion paper issued in September last year, we explored these issues further.

13. **Company size and complexity** can explain some of the increase in directors' pay, with one study finding that the increase in CEO pay in the United States could be directly linked to the market capitalisation of large companies during the same period¹⁸. This may help to explain some of the faster growth in pay seen in the FTSE100 relative to smaller quoted companies but not the prolonged rise we have seen in the face of poor equity returns.

14. One of the most frequently cited reasons for high levels of pay is the impact of the **international market for CEOs** and the need to pay above average to attract the very best talent and mitigate against a flow of UK executives to other countries. However, the evidence to support this is limited and the proportion of non-UK directors in UK companies has remained relatively stable over time. Increasing globalisation should have increased the number of potential candidates for director level posts, which arguably should have helped depress pay - but we have seen limited evidence to support this. International comparisons of pay are difficult to make given the complexity of the packages in place and limited disclosure in some countries but studies tend to find that executive pay is highest in the US (reflecting a more significant reliance on equity based rewards¹⁹) with the UK some way behind and other European countries at a slightly lower level.

The structure of remuneration

15. The structure of remuneration has changed significantly over the past two decades as, in an attempt to address the principal-agent problem, most companies now pay a much larger proportion of remuneration in the form of variable and deferred pay based on more complex models that attempt to link pay to performance. Most senior executive pay packages contain the following elements:

- **Base Salary:** usually determined through benchmarking, based on general industry salary surveys supplemented by detailed analyses of selected industry or market peers.
- **Annual Bonus/Incentive Plans:** Typically bonuses pay out an award based on the performance of the company over no more than one year, usually the previous financial year. The payments may be made in cash or shares or a combination.
- **Long-Term Incentive Plans (LTIPs):** LTIPs typically involve the granting of shares to directors after a three year period upon the achievement of performance criteria, and must include some qualifying conditions with respect to service or performance that cannot be fulfilled within a single financial year.
- **Share Option Plans:** Share option plans are contracts giving directors the right to buy shares at a pre-specified price for a pre-specified period of time, which usually starts three years after the agreement of the plan and ends no later than ten years after it. Share option plans are non-tradable and are often forfeited if the executive leaves the firm before they become exercisable.

¹⁷ Frydman, C & Jenter, D., CEO Compensation, Rock Center for Corporate Governance at Stanford, November 2010. University Working Paper No. 77

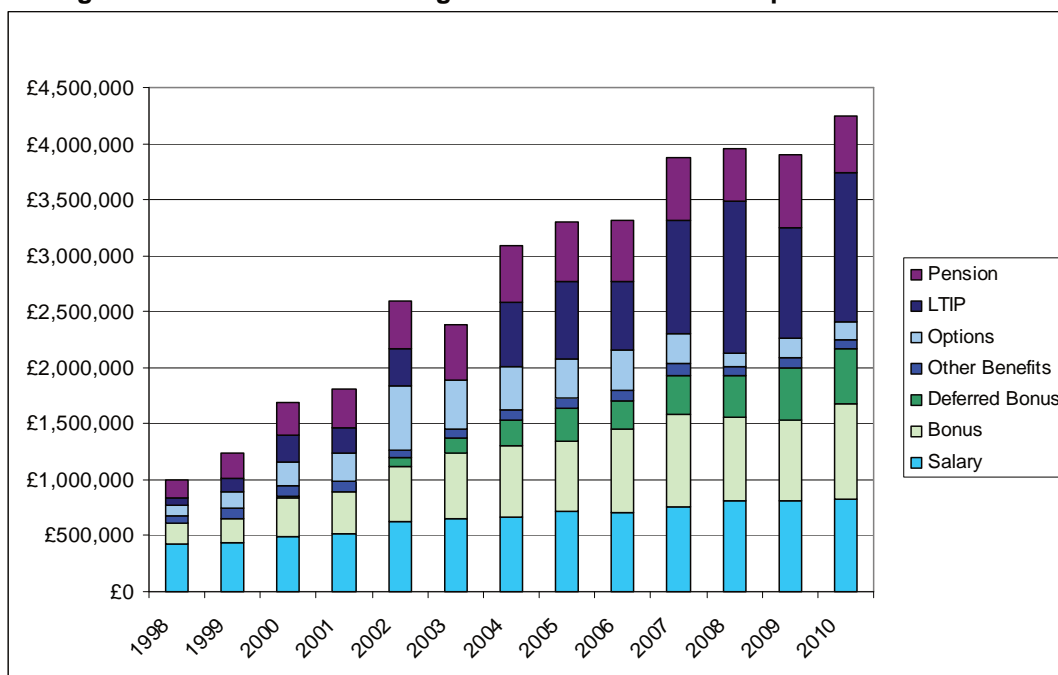
¹⁸ Gabaix, X. & Landier, A., Why has CEO pay increased so much? April 2007. Quarterly Journal of Economics

¹⁹ For evidence that adjusting for the equity component of pay is important in explaining the US pay premium, see the study by Fernandes et al. (2011), "Are US CEOs Paid More? New International Evidence", SSRN Working Paper.

- Deferred Bonus Plans: annual bonus plans which incorporate an element of deferral.
- Retirement Plans: Top executives routinely participate in supplementary retirement plans in addition to the company-wide pension plan.

16. Figure 2 shows how the composition of average CEO remuneration in FTSE100 companies has changed since 1998. In 1998, base salary made up over 40% of total remuneration for FTSE100 CEOs; by 2010 it accounted for less than 20%, with the remainder made up of a combination of bonus, long-term incentive plans (LTIPs), share options and pensions.²⁰

Figure 2: FTSE 100 CEO average total remuneration composition 1998-2010²¹



17. Many researchers have argued that the move towards more complex remuneration structures has actually driven increases in overall remuneration because executives expect higher pay in reward for higher risk - in other words, the value of deferred pay may be discounted because of the possibility it will not be paid.²² Our discussions with stakeholders also suggest that the complex structure of pay makes it harder to disentangle what executives are actually earning and for shareholders to judge whether this is appropriate. Furthermore, inadequate or obtuse linkage between pay and performance has the potential to provide incentives for directors which are badly aligned with those of shareholders and consequently affect the quality of the directors' relationship with wider stakeholders, including employees.

18. A PwC review of executive remuneration²³ summarises the problem:

The increase in pay has mainly been in the form of higher annual bonuses and long-term incentive (LTI) awards, which are nearly always performance-related. As our previous research has shown, the outcome has left almost everyone dissatisfied:

²⁰ The Manifest/MM&K Executive Director, Total Remuneration Survey, May 2011 Edition. Available at: <http://blog.manifest.co.uk>

²¹ Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, March 2011. Available at: <http://blog.manifest.co.uk>

²² PwC, If executive pay is broken, making it more complex is not the answer: The psychology of incentives, March 2011, Available at: <http://www.pwc.co.uk/eng/publications/if-executive-pay-is-broken-making-it-more-complex-is-not-the-answer.html>

²³ http://www.pwc.co.uk/en_UK/uk/assets/pdf/executive-compensation-review-of-the-year-2009-pwc.pdf

- *Generally management feel that incentives have become too complex and prescriptive, and are not aligned to the business strategy or within their control. As a result, they do not believe incentives drive performance or change behaviours and many perceive incentives simply to be a lottery.*
- *Many institutional shareholders believe there is a tenuous link between pay and performance.*
- *Few really believe that complex long-term incentives retain executives; they just make it more expensive for a new employer to buy-out the executive with golden hellos and guarantees.*
- *The public, particularly since the banking crisis, see executive pay as nothing other than a gravy train – pay regardless of performance rather than pay for performance.*

Quality and complexity of reporting on pay

19. In the light of these developments in executive pay structure, the reporting of pay policy has, if anything, become more important. There have been various private sector²⁴ and regulator reviews²⁵ of the quality of UK companies' narrative reporting/business reviews (covering mainly quoted companies) over the last ten years. In general these reviews have found that the quality of narrative reporting is improving but that there is still considerable variation and room for improvement between the best and worst performers. There are also concerns with the increasing length and complexity of company reports.²⁶ That is why BIS has recently consulted on changes to the regime for company narrative reporting, including pay reporting.²⁷ It has emerged from these consultations that the disclosure of information on executive pay, and in particular its relationship with performance, is a key concern for users of reports and is an area which can be significantly improved upon.

20. Given the nature of the principal-agent problem in relation to pay, there is a particular concern amongst stakeholders that a substantial lack of transparency surrounding executive pay results in asymmetry of information and moral hazard. Shareholders have told us that it can be difficult to identify the main facts and figures amidst a raft of other detailed information in the current Directors' Remuneration Report. This makes it time consuming to assess remuneration and to make comparisons across companies.

21. It is clear that regulations in this area have not kept up with developments in market practice. Despite companies already being required to give very full disclosure of remuneration under the Directors' Remuneration Regulations, companies do not give a clear figure for total remuneration for each individual director nor do they seem to provide a clear line of sight between levels and structure of remuneration and directors' performance in meeting the company's strategic objectives. Research has also highlighted that in some areas the Regulations themselves add to some of this complexity as it can be difficult to understand and that clarification of what is expected could improve compliance in these areas.²⁸

22. This view is supported by recent research looking at the remuneration reports of FTSE150 companies, which found that only around a third clearly disclosed how remuneration is dependent on performance²⁹ and by feedback to our earlier consultation on company reporting:

²⁴ For example, "Swimming in Words" Deloitte survey of narrative reporting in annual reports (October 2010) and "A Snapshot of FTSE 350 reporting" PWC (2009).

²⁵ Financial Reporting Council (FRC) reports "Louder than Words" (2009) "Cutting Clutter" (April 2011).

²⁶ The average length of reports increased from 44 pages in 1996 to over 100 pages by 2010. See BIS consultation available at <http://www.bis.gov.uk/assets/biscore/business-law/docs/s/10-1318-summary-of-responses-future-narrative-reporting-consultation.pdf>.

²⁷ <http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation> and <http://www.bis.gov.uk/Consultations/the-future-of-narrative-reporting-a-consultation>

²⁸ Deloitte, Report on the impact of the Directors' Remuneration Report Regulations, 2004.

²⁹ PwC, Insight or fatigue? FTSE350 reporting, 2010. Available at: http://www.pwcwebcast.co.uk/cr_ftse350.pdf

“We need more transparency. We need more coherent and pared down remuneration reports, which do not blind shareholders with the science. Good regulation should require companies to make remuneration reports less dense and less confusing. [...] We agree that it would be helpful to have disclosure of a single figure of the total non-pensionable remuneration for each director.” - Railpen Investments

“When directors’ rewards are significantly more generous than those given to other employees, there must [be] a clear and solid explanation about the link between pay and performance; and, furthermore, there should be no reward for failure. Complex bonus structures and the lack of transparency around boardroom pay are part of the problem. If we are to make progress on executive remuneration, it is critical that boardrooms explain clearly how rewards are linked to performance and how that impacts shareholder value.” - NAPF

“Improved transparency would also help underpin our robust system. Changes should include disclosure of a single aggregate figure for directors’ taxable remuneration, explanation of the nature of performance measures and additional disclosure relating to remuneration consultants.” - CBI

23. These comments suggest that without access to better and more concise information about pay, particularly on the link to performance, shareholders find it difficult to hold companies to account. Ensuring access to clearer information should encourage shareholders to play a more activist role

24. This is supported by academic evidence. For example, Ferrani and Moloney (2005)³⁰ find that “[d]isclosure requirements prompt the board to justify pay choices and the pay-setting process, and can also enhance the accountability and visibility of the remuneration committee” whilst also encouraging shareholders, particularly institutional shareholders, to play a more activist role. The authors also note that since “setting executive pay is a complex process, opaque disclosure will not generate effective shareholder oversight. In particular, aggregate disclosure concerning total firm executive pay which does not explain remuneration policy and the often highly complex performance conditions applicable [...] will not allow shareholders to assess pay policy effectively“.

II. Rationale for intervention

25. Pay policies which do not appropriately link executive pay to company strategy and performance have an economic cost through diminished shareholder returns, weakened corporate governance and reduced confidence in the corporate sector.

26. In response to a series of consultations on this and related issues, and in our discussions with them, business leaders, business representatives, investors and leading academics now agree that there is a problem of rising executive pay which is not linked to performance. For example, a survey³¹ of 20 UK-based investors in late 2011 found strong support amongst interviewees for the notion that executive remuneration is disproportionately high relative to performance. When asked whether executive pay has “become disproportionate to company profits and should [...] be reduced when the performance of the business does not meet expectations”, 16 out of 17 respondents said “yes” whilst 1 said that the issue required a case-by-case approach. Key stakeholders have also made their views known:

³⁰ Ferrarini, Guido and Niamh Moloney (2005), Executive Remuneration in the EU: The Context for Reform, Law Working Paper No. 32/2005, European Corporate Governance Institute. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=715862.

³¹ Corporate Governance Survey, The Share Centre, Nov 2011, prepared by Richard Davies Investor Relations Limited.

“What is unacceptable is soft targets delivering high returns.” **Roger Carr, President of the CBI, June 2011**

“One, we need business to show greater transparency – the public need to see [pay] figures that they understand. Two, companies need to demonstrate that rewards are for stellar performance, not for just doing the day job.” **John Cridland, Director General of the CBI, Nov 2011**

“The simple truth is that remuneration schemes have become too complex and, in some cases, too generous and out-of-line with the interests of investors.” **Dominic Rossi, chief investment officer of equities at Fidelity, Jan 2012**

27. While this is primarily an issue for companies and their shareholders, there is a consensus that - given the existence of a well-established market failure in this area³² - Government has a role to play in increasing transparency and improving leverage for shareholders on pay matters. As such, the Prime Minister and Business Secretary have committed to doing more to empower shareholders.

28. The Government has therefore proposed a package of measures to address the failings in pay reporting as well as wider failings in shareholder engagement. These include:

- (i) Greater transparency on pay reports to provide clearer information that is easier to understand. This will include splitting the report in two parts:
 - o proposed future pay policy, potential payouts, and factors taken into account when setting policy
 - o how policy has been implemented in the previous year, actual payouts relative to performance
- (ii) Empowering shareholders with stronger voting rights. We have consulted on the following possible options:
 - o a binding vote on future pay policy
 - o advisory vote on implementation of pay policy
 - o a binding vote on termination payments
 - o requiring a higher level of shareholder support on pay-related resolutions
- (iii) Changes to the Corporate Governance Code to increase the diversity and independence of Boards and Remuneration Committees
- (iv) Investor and business best practice on the setting and oversight of pay

29. This package has been widely supported including by business organisations such as the CBI and IoD, investor organisations such as the ABI, NAPF as well as individual investors like Fidelity and L&G. The proposed measures will give shareholders more leverage to challenge executive remuneration packages. Ultimately it is hoped that these measures, along with others to be introduced later this year will improve the link between corporate pay and performance to the benefit of the UK economy.

30. The evidence provided above shows that many of these problems are most acute in the very largest companies -particularly FTSE 100 - although practice in the FTSE250 tends to follow suit. However, we propose that these measures should apply to all quoted companies, as is the case for the current regime. The term ‘quoted company’ is a

³² See Jensen, Michael and Meckling, William, (1976) “Theory of the Firm: Managerial Behaviour, agency costs, and ownership structures”, *Journal of Financial Economics* vol 3, 305-360 and La Porta, R., Lopez-de-Silanes, F., Shleifer, A and Vishny, R., (2000) “Investor Protection and Corporate Governance” *Journal of Financial Economics* vol 58 pp 3-27.

recognised term in company law. Distinguishing between sub-sets of quoted companies according to their market listing or any arbitrary size threshold would be legally challenging as the FTSE classifications are updated several times a year. We intend to raise these issues in our forthcoming consultation and seek views on how widely these measures should apply.

Policy objectives

31. Together, we believe that these legislative and non-legislative proposals will give shareholders real leverage on executive pay. Shareholder empowerment lies at the heart of the UK's corporate governance framework and these reforms are consistent with that approach. Enhancing transparency on executive remuneration will give shareholders the information they need to hold companies to account. Companies will be encouraged to be proactive in designing pay policy which is acceptable to shareholders and to respond appropriately to shareholder challenges to executive pay.
32. The pay reporting proposals are designed to facilitate this greater engagement by giving shareholders better information. They need to be understood in the context of the Government's wider proposals for reform of the shareholder voting regime on pay. A successful outcome for the reform of executive pay reporting would be a greater level of engagement between companies and shareholders, improved clarity of pay reporting, increased satisfaction with pay packages and an improved link between pay and performance.
33. We will measure this through levels of shareholder voting on remuneration reports and by testing stakeholder views as well as by monitoring the quality of remuneration reports³³ and the relationship between pay and performance. There is no prior assumption that these measures will directly reduce the overall quantum of executive pay, although a result of a stronger link between pay and performance could be that average pay levels fall or cease to rise as quickly as they have in the last decade.

Coverage of this Impact Assessment

34. This impact assessment covers the first part of the package outlined above, **greater transparency on pay reports**.
35. Changes to shareholder voting rights were subject to a consultation stage IA: BIS 0341 (Shareholder votes on executive remuneration). We intend to submit a final stage IA in relation to this element shortly. Changes to the Corporate Governance Code are the responsibility of the Financial Reporting Council who will be consulting formally later this Spring. The other, crucial elements of the package are non-regulatory.
36. The proposals within this IA were previously considered as part of a wider package of proposals with respect to companies' narrative reporting (BIS 0284 published in September 2011).
37. A further consultation on the detail of the regulations will take place in Summer 2012.

³³ This will be for the most part be indirect monitoring through existing reviews of company reports by the Accounting Standards Board and consultancies such as Deloitte and Black Sun who provide annual reviews for the major FTSE companies.

III. Description of Options considered (including do nothing):

Option 1 (Preferred option): Revised regulations set minimum framework for reporting on pay, focused primarily on improving disclosure on the link between performance and pay. Balanced by use of best practice on wider pay reporting.

Full statement of future policy required when there is a binding vote; companies required to restate the key elements of the policy and report changes in intervening years.

38. Companies are currently required to submit a full remuneration report every year. Under this option, that report would be split into two parts: future pay policy and how the policy was implemented in year. Companies would only be required to set out the future policy when a binding vote is triggered – see separate IA [BIS 0341] for details. In the intervening years, companies would be required to restate the key elements of the policy (i.e. the structure of the pay package, how it supports strategy, and a summary of performance criteria) and any changes to that policy. Companies would still be required to report on how the policy was implemented on an annual basis. This represents a reduction in the current reporting burden on companies. It also allows companies a greater degree of certainty in the operation of their pay policy than an annual policy would.

39. The regulations would require companies to set out clear and transparent information on the link between pay and the performance of the company. Some of this goes beyond what is required by the current regulations. Companies would specifically be required to set out:

Future Policy

a) Key elements of pay for each director showing how these support achievement of the company's own long and short term strategic objectives, the target and maximum potential value to the director, associated performance metrics and whether clawback is possible.

b) Scenarios for how much directors will receive for on-target, maximum and below-target performance.

c) Whether a policy on exit payments has been agreed by shareholders and where it can be found.

d) Material factors that the Remuneration Committee has taken into account when considering the appropriate level of executive remuneration, including: whether or not employees have been consulted, comparison between CEO and wider workforce pay, report back on previous year's vote and action taken, comparison of total spend on executive pay and shareholder dividends.

Implementation of the policy

a) Single figure for total pay of each director linked as closely as possible to the period for which pay is reported.

b) Exit payments that have been made.

c) Comparison of overall company performance and pay.

d) Detail on the extent to which performance targets have been met for variable pay awards.

40. Under this option we would seek to balance these additions by simplifying some of the current disclosure requirements that do not directly relate to the link between pay and performance. This could include, for example, information on the benchmarks that companies take into account when assessing levels of pay, total shareholdings of directors and total pension entitlements. Given that the regulations represent a minimum standard, companies would have the flexibility to report on these issues if they felt it was relevant or if requested by their shareholders and we would expect best practice guidance to develop over time.
41. Although this option increases the types of disclosure required about the link between pay and performance beyond what is already mandated in the regulations, some companies are already exemplars in terms of presenting additional information to shareholders in an understandable and accessible format. Others are acting as 'early adopters' of elements of this package, including the single figure for total remuneration demonstrating that it is possible to report these elements without significant additional burden.

Option 2: Revised regulations set standard for pay reporting across a wider range of relevant issues and on an annual basis.

42. Companies are currently required to submit a full remuneration report every year. Under this option, that report would be split into two parts: future pay policy and how the policy was implemented in year. They would be required to report in full on both parts of the report on an annual basis.
43. In addition to the additional disclosures set out in option one, companies would continue to be required to disclose wider information such as details on the comparator companies and indices used to benchmark levels of pay; total shareholdings of directors under all long term incentive schemes, share options, and deferred bonus payments; and total pension entitlements setting out details of the pensions interests of individual directors.
44. In addition, they could be required to provide additional contextual information such as the proportion of income that is spent on staff, executives, dividends, re-investment, tax etc

Option 3: De minimis approach

45. Under this option, we would still need to split pay reporting into two parts (future pay policy and how the policy was implemented in year) in order to facilitate the changes to the voting regime. However, we would not change the current disclosure requirements so companies would continue to report as they currently do (i.e. no increased disclosure on the link between performance and pay and no change in other reporting requirements).

IV. Analysis of Options: costs and benefits

Option 1 (preferred option) Revised regulations set minimum framework for reporting on pay, focused primarily on improving disclosure on the link between performance and pay.

Benefits

46. Better disclosure around executive pay will lower the cost of monitoring by shareholders (primarily institutional investors who have the incentive to engage on such issues). This is particularly true in a world of increased information where there is value not only in improving the quality of information but also in ensuring that it is presented in a clear and comparable form.
47. Information around pay that is more in line with what shareholders find useful should also make engagement with companies over pay and related issues more effective reducing the costs of engagement for companies too. This more focussed approach would also enable investors to take a more targeted approach to holding companies to account by making unacceptable pay practices more transparent. In addition they will no longer need to provide information that shareholders do not find useful. For those companies that are already market leaders in providing pay information these changes will mean that regulations are brought into line with best practice.
48. Other potential benefits of better reporting on executive pay include raising the reputation of institutional investors by signalling or publicising the results of their activism and generating greater deterrence effects amongst those companies who might otherwise engage in rent-seeking activities.
49. In addition to these general benefits of more focused reporting, the nature of the specific proposals above suggest some additional benefits.

Restatement of future policy when there is a binding vote

50. Allowing companies to set out future pay policy fully every three years should enable companies to give themselves the certainty that they want in setting forward looking policy over a period longer than one year but not bind them to it if circumstances change in year. It might also act as a “nudge” to companies not to change policy so regularly.
51. Reducing the frequency with which full reporting is required will also provide savings to companies in preparing their remuneration reports for shareholders.

Greater disclosure particularly in relation to pay and performance

52. Stakeholders and external commentators have been very clear over a number of years that narrative reporting with regard to executive pay has had a number of flaws including a lack of transparency and a lack of detailed information on specific issues of concern, particularly on the link between pay and performance. Feedback from respondents to the question about whether quoted companies be required to explain how the performance criteria for remuneration policy for the year ahead relates to the company’s strategic objectives also suggest that they would welcome this approach:

In our view, the proposed Strategic Report should describe how the company's forward-looking remuneration policy and performance criteria for future awards are aligned with corporate strategic objectives. Vodafone

It is important that remuneration reports become more forward-looking than at present to enable shareholders and other stakeholders to comment on the proposals before they are a fait accompli. Trade Union Congress

Investors want companies' remuneration policies to be aligned with their interests and take account of the fact that effecting change to a company's strategy takes time, and mirror a company's development cycle. Investment Management Association

53. The additional information to clarify the link between pay and performance will provide greater certainty to shareholders on this issue and reduce their agency costs by limiting the time they need to spend reviewing pay policy statements
54. This approach focuses the additional disclosure requirements specifically on these points and gives shareholders the additional information they need to hold companies' management to account over executive remuneration. It will, for example, make it much clearer how the remuneration policy supports the achievement of the company's strategy by requiring companies to set this out in its forward looking policy. Further, the single figure for each executive will aim to make it much clearer how much is earned by each director by reference to the performance of the company. Currently this is hidden by a mountain of detail about specific performance pay elements.

The nature of the links between performance and reward, the measures used and – as far as practicable and subject to commercial sensitivity – the results on which the reward has been calculated should be spelled out in remuneration reports. CBI

Many companies already explain the linkage between performance-based payments made over the financial year and the performance delivered by the company. However, as this is important information for shareholders and the standard of disclosure varies, we agree that a specific requirement would be a helpful prompt to improve disclosure in this area. Towers Watson

55. Information on the factors that the remuneration committee has taken into account when developing the pay policy also helps shareholders to determine how robust the committee has been in setting executive pay, and therefore to hold them to account through both the annual vote on pay and the annual re-election of directors.
56. This approach also has the benefit of seeking to balance these additional requirements by simplifying some of the remuneration disclosures that are currently required. This represents a saving to the business by enabling them to focus their energies on key issues. Furthermore relying on best practice and industry-led guidance to develop rather than specifying directly how some of these elements are reported on - for example on the types of performance metric that should be referred to - should ensure that companies have sufficient flexibility to present the most relevant information in a way that they and their shareholders find most helpful.
57. Discussions with stakeholders (both companies and shareholders) have suggested that attempts to try and monetise likely benefits of these measures are unlikely to be meaningful. The time and effort spent on engagement on pay issues varies hugely by company and investor and from year to year. It would be difficult for stakeholders to estimate the likely

change to such effort as a result of these changes. In addition, the more significant economic benefits of the policy will be achieved, in conjunction with other measures, through more effective pay policies. These in turn will create a better link between pay and performance leading to a more supportive investment environment and a lower cost of capital than would otherwise be the case. Such benefits are likely to be extremely difficult to isolate and monetise.

58. **Costs** – Feedback to the narrative reporting consultation suggests that whilst the list of additional requirements set out in paragraphs 38-40 above looks quite extensive, in fact, it represents a best practice approach to the current reporting requirements. Much of the additional detailed information (on the various elements of pay awards for example) will be readily available at no or limited additional cost to the company and already forms part of the decision-making process within remuneration committees. It is arguable that any additional costs of reporting the information are transitional as companies get used to the new system. For those companies already providing this information as a matter of best practice the additional costs will be further limited.

We believe it is good practice for companies to outline how remuneration is linked to the performance of the company. Lloyds Banking Group

We ... would argue that most companies already disclose this information in their reports due to existing requirements. Rio Tinto

59. The benefit of requiring additional disclosures through the regulations would be that it ensures consistency and therefore comparability between companies. This could pose additional costs for companies that have to present information in a form that is perhaps less appropriate or convenient for their own circumstances. However, the fact that some companies are acting as ‘early adopters’ of elements of this package, including the single figure for total remuneration, demonstrates that it is possible to report these elements without significant additional burden.
60. The costs of the additional reporting requirements (net of any simplifications we are able to identify) are difficult for companies to specify in the context of the overall reporting requirements.

Option 2 Revised regulations set standard for pay reporting across a wider range of relevant issues and on an annual basis.

Benefits

61. The benefits of increased disclosure are the same as those for option 1 (preferred option), but greater in scope as they extend beyond the link between pay and performance to other remuneration disclosures to improve the quality of reporting. For example, disclosure of the total potential shareholdings of directors under long term incentive schemes would give shareholders greater information about the potential liability of the company to the directors (and potential dilution of share price).
62. **Costs** – As for option 1 this would represent some increase in the costs of disclosure required of companies, particularly if we introduced other new requirements such as distribution statement. In this option, these costs are not offset by a reduction in frequency of reporting.

Option 3 De minimis approach

63. This would represent a minimal change from the current position as companies would need only to slightly restructure their existing reports.

Transitional Costs

64. For all three options set out above there would be some transitional costs for companies in relation to splitting the current remuneration report in to two setting out separately the forward and backward looking elements of pay policy.

Summary of Costs and Benefits of Policy Options

65. As set out above Option 1 would provide the greatest net benefits with increased transparency for shareholders, allowing them to hold companies to account with respect to executive remuneration and improve the pay – performance link. Compared to the main alternative (option 2) it represents a more proportionate approach to the reported problem by focussing the required elements of disclosure on that link and simplifying other, existing, requirements. Aligning the frequency of reporting on pay policy with the voting cycle would provide additional benefits over option 2 by reducing costs and improving certainty for companies and shareholders.
66. Option 3 would mean that the current system of pay reporting would continue which, as set out clearly above, is not meeting the needs of shareholders and, in particular, limits their ability to improve the link between executive remuneration and company performance.

Rationale and evidence that justify the level of analysis used in the IA (proportionality approach)

67. This IA and the associated IAs covering the Shareholder Vote (BIS 0341) and Narrative Reporting (BIS 0284) draw on significant amount of evidence that has been provided to the department by a wide range of stakeholders including companies, shareholders, remuneration consultants and academics, either as part of a formal or informal written consultations (e.g. Long Term Focus for Corporate Britain³⁴ (September 2010), Narrative Reporting consultation³⁵ (September 2011), Executive Pay Discussion Paper³⁶ (July 2011) and the Kay Review³⁷ (September 2011) or through more informal stakeholder engagement that has taken place over the last six months. Much of this evidence has been focused on identifying the problems in the setting of executive remuneration and identifying possible measures to improve the current situation.
68. It has not been possible to monetise any of the costs and benefits set out above for the reasons set out in paragraphs x and y. In many ways the changes in disclosures set out above are relatively minor in comparison to the overall reporting regime. Many quoted companies already report a significant amount of information beyond that required by the regulations making it difficult to identify the impact of regulatory changes on their costs.

Risk and Assumptions

69. As set out in paragraph 28, the regulatory measures included within this IA represent only one element of the overall package of measures we believe is necessary to enable change in this area. As the Secretary of State for Business made clear to parliament on

³⁴ <http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain>

³⁵ <http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation>

³⁶ <http://www.bis.gov.uk/Consultations/executive-remuneration-discussion-paper>

³⁷ <http://www.bis.gov.uk/Consultations/kay-review-call-for-evidence-uk-equity-markets>

announcing this package, lasting reform also depends on active shareholders and responsible businesses accepting the need for change and pushing the agenda forward.

70. There is clearly therefore a risk that the measures included in this IA will not be as effective as anticipated if other elements of the package are not fully implemented or adopted by companies and shareholders in the way we expect. In particular, if shareholders do not make use of the additional information provided to put pressure on companies to improve the structure of executive remuneration and ensure a better link to company performance.

Direct Costs and Benefits to business calculations including OIOO considerations

71. Whilst we have not been able to monetise any of the costs and benefits of the preferred option we recognise that these measures represent a small regulatory tightening on business and therefore constitutes an “in” within the OIOO framework. The immediate benefits of better disclosure will be felt largely by institutional investors and their advisers who analyse companies’ remuneration reports. Many of these will be businesses too. However, the ultimate benefits will accrue to shareholders from improved company performance.

Wider Impacts

72. As the policy proposals apply to the largest public companies we do not believe that there will be any diversity, gender or human rights impacts of these proposals. The proposals apply only to quoted companies so no micro businesses are within scope.

Summary and Preferred option with description of implementation plan

73. For the reasons set out above option 1 represents our preferred option to tackle the identified failure in transparency around executive pay. The increased disclosures will give shareholders the information they need to have a real impact on executive remuneration policy and to bring it more in line with performance.

74. We believe this is a proportionate response to a well-recognised problem that shareholders and other stakeholders require Government to act upon. The proposed changes to reporting requirements should be seen in the context of a wide package of largely non-regulatory measures in this area and measures to improve corporate reporting more generally.

75. A further consultation on the detail of the regulations will take place in Summer 2012. Subject to parliamentary time we will bring forward secondary legislation later this year. This will have an impact on company reports from 2014. Prior to introducing secondary legislation, we will update this impact assessment to reflect the evidence received through the consultation period.

Enforcement

76. Enforcement will continue as now through a combination of shareholder oversight and more formal monitoring by the Financial Reporting Council (FRC) with respect to the UK corporate governance code.

Post Implementation Review

77. The measures put forward in this IA represent only one of part of a much larger package of proposals to tackle issues around executive remuneration, many of which are non-regulatory in nature and require shareholders and companies to change their behaviour. We will be working with stakeholders over the next few years to ensure a smooth implementation of the policy proposals and ensuring in particular that the regulatory elements, including the binding vote are working as intended.
78. As set out above in paragraph 32, we would expect the success of this policy to be reflected in higher levels of shareholder engagement, greater satisfaction with executive remuneration packages and a more discernible link between executive pay and company performance.
79. Satisfaction with executive remuneration reporting in particular will be monitored through existing consultants' reviews of company pay reports and the views of relevant stakeholders.



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