ICAEW

REPRESENTATION 47/18

BEIS SELECT COMMITTEE: MARCH 2018 CALL FOR EVIDENCE ON EXECUTIVE PAY

Issued 9 May 2018

ICAEW fully participated in the Committee's Third Report of 2016-2017. We submitted written evidence, and we actively supported the Committee by analysing the written evidence made to that inquiry. We are grateful for this opportunity to provide our refreshed thoughts on the subject of executive pay . We have provided an Action Plan for boards as our answer to the Committee's fourth question, and we trust it will be of significant interest to the Committee. In summary, this calls for boards to:

1. Treat everything as though it is public
2. Recognise all the reasons why pay is important
3. Look at the entire pay structure
4. Talk about fairness
5. Use simple language
6. Lift the lid on what executives do
7. Have real conversations
8. Admit mistakes
9. Set out pay principles
10. Persist and be patient

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 150,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

This ICAEW response of 9 May 2018 reflects consultation with the Corporate Governance Committee whose members are drawn from business, investment and wider stakeholders. The Committee informs our thought leadership and policy work on corporate governance issues and related submissions to regulators and other external bodies.

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Q1. What progress has been made on implementing the recommendations on executive pay by the previous Committee in its 2017 report on Corporate Governance?

It is a mixed picture as the *Government's response to the BEIS Green Paper on Corporate Reform* picked up on some of the Committee's recommendations but not others. We hope that our update is of assistance, but the Committee should also seek updates directly from BEIS and the Financial Reporting Council.

- As far as we are aware the FRC are not pursuing a traffic light rating system for the remuneration aspects of the Corporate Governance Code ('the Code') or for any other aspects of the Code. Measuring culture and the effectiveness of corporate governance processes is challenging. ICAEW will be looking at this issue in detail in due course, as part of our *Connect and Reflect* series of thought leadership papers, eg, we will be considering the IOD's Good Governance Index and the ASEAN Corporate Governance Index created by the ASEAN Capital Markets Forum.

- Long-term incentive plans are not being phased out and shareholders are not being given more binding votes. However, the revised Code is likely to lengthen the minimum vesting and post-vesting periods for shares from 3 years to 5 years, and new legislation will require quoted companies to provide a clearer explanation of the range of potential outcomes from complex, share-based incentive schemes.

- The matter of stretching targets and clear objectives is covered in the existing Code, and this is very likely to be repeated in the revised Code. The FRC's revised Board Effectiveness Guidance will also develop this area. Of course targets may be financial or non-financial.

- We do not expect compliance with the revised Code to allow employee directors (or workforce directors) to sit on remuneration committees as they will not be independent NEDs. However, the revised Code will place greater emphasis on stakeholder engagement, and a new provision concerning workforce engagement suggests three options: director appointed from the workforce; a formal workforce advisory panel; or a designated non-executive director. Both new types of director will have the same role and responsibilities as all other directors, plus the additional responsibility of presenting the workforces' perspective, but not of representing employees or the wider workforce. Code provisions operate on a 'comply or explain' basis.

- The new Code will say that any Chair of a remuneration committee should normally have previously sat on a remuneration committee (not necessary the remuneration committee they will chair) for at least one year. Chairs of remuneration committees will not be expected to resign if their proposals do not receive the backing of 75% of voting shareholders, but greater prominence has been given to opposition votes of 20% or more through the Investment Association's register and through changes to the Code. The current Code says that when, in the opinion of the board, there has been a significant vote against a resolution, the board should explain what action it intends to take to understand the reason behind the vote result when it is announced. The revised Code will be stronger as it will include a new provision will explicitly refers to 20% or more votes being cast against a resolution. Companies will still have to explain, when announcing voting results, what actions they intend to take to consult shareholders in order to understand the reasons behind the result, but in addition, updates should be published no later than six months after the vote. The board should then provide a final summary in the annual report, or in the explanatory notes to resolutions at the next meeting, on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed.

- The pay ratios being introduced will compare CEO pay to the median pay of UK employees across the group, and this will be a legal requirement rather than a Code matter. CEO pay will not be compared with the pay of senior executives. We are not aware of similar ratio requirements being developed for public or third sector bodies.
- There is likely to be a provision in the revised Code which says that annual reports should include an explanation of the company's approach to investing in, developing and rewarding the workforce and what engagement with the workforce has taken place to explain to how executive remuneration aligns with wider pay policy.
- The Government has appointed PwC's economics team, supported by Professor Alex Edmans of London Business School, to undertake research into share repurchases. This is making progress by way of a survey and interviews, and we understand that findings will be shared with BEIS in mid-June.
- The Committee's recommendation for a code for large private companies is being progressed. Some private companies will be legally required to report on their compliance.
- We are surprised by the public announcement that these new principles will not deal with executive pay.
- We believe that clawback and malus deserve closer attention, and we would like to encourage the Committee to consider this area as part of the current inquiry.

Q2. What improvements have been made to reporting on executive pay in the last 12 months?

ICAEW does not monitor reporting on executive pay.

Q3. What steps have been taken by Remuneration Committees and institutional investors to combat excessive executive pay in the last 12 months.

ICAEW does not monitor reporting on executive pay.

Q4. What further measures should be considered?

The Committee's Third Report said that it is now up to businesses to respond positively, in their own interests, to adjust to raised expectations in relation to executive pay. We wholeheartedly agree. Our response to this question reflects the contents of a forthcoming ICAEW publication 'How to end excessive pay' which forms part of our Connect and Reflect through leadership programme.

Business plays a vital role in building a world of strong economies, but perceptions of excessive pay are undermining its ability to do this. When executive pay is seen as excessive it attracts overwhelming attention as a blatant symbol of unfairness, and the anger which follows overshadows all other business problems and achievements. ICAEW believes that this corrosion can be reversed. We see excessive pay as a business issue which needs to be tackled in a business-like way.

Inspirational leadership requires courage. It also requires the vision to look beyond legal requirements to see the bigger goal, which is public trust and confidence. Board directors have the power to do things differently, and ICAEW's framework of Connect and Reflect and this Action Plan are intended to inspire them to change. It is critical that directors accept personal responsibility for altering the impression that they are unwilling to listen, and are resigned to negative media coverage and relentless public hostility about executive pay. Layers of governance in large companies are intended to support directors rather than shield them from personal accountability. Remuneration committees, specialist advisers and reporting requirements have valuable contributions to make, but ultimately, all company directors need to justify decisions on executive pay.

Connecting with the public on pay, Reflecting on what is said and taking action if it is required, will require directors to develop and trial new ways of working. We do not underestimate the bravery this will take as the challenge is huge. Even directors who are uncomfortable with the current situation may fear making things worse. However, it is futile to hope that, in the absence of change, criticism of executive pay will reduce or disappear, and therefore directors must resist the temptation to focus their attention elsewhere. The need for prioritisation is highlighted by the fact that if pay is seen as excessive it detracts from commercial success and the contribution business makes to economic growth, the provision of jobs and tax revenue.

CONNECT AND REFLECT

'Connect and Reflect' is ICAEW's suggested framework for modern corporate governance. Its central objective is to bridge the divide between those who run companies and society. Connecting and Reflecting requires directors to think broadly. We have provided a ten point Action Plan for boards to follow. A board that ducks any of these ten steps has no grounds for complaint if people outside of the board think that their executives' pay is excessive.

Changes in the amount or structure of executive pay may be the consequence of following the Action Plan if a board concludes that their justifications for the current levels of executive pay are weak. However, better understanding could also result in no change or in an increase in executive pay.

By approaching the pay debate calmly and systematically, boards will avoid the temptation to jump to quick-fix solutions or to dismiss interest in executive pay as voyeuristic and uninformed interference. However, boards cannot achieve Connect and Reflect in isolation. All participants in the debate must be encouraged to think about pay in new ways, listen carefully to counter arguments, set aside personal interests and long-held prejudices, and be open to changing their opinions. Arguments in support of current levels of executive pay tend to centre on the importance of wealth creation. In the current environment, these arguments rarely get a fair hearing. We want that to change. All viewpoints deserve a fair hearing.

There is no doubt that our Action Plan is ambitious, but we sense a willingness to change. Directors know that whatever they decide to pay, company executives will be subject to scrutiny by employees, the public, journalists and politicians. Criticism of payments for failure is just the tip of the iceberg. Perceptions of excessive pay are pervasive, and no longer limited to a small group of executives or companies. The problem is systemic and endemic. Too often, boards maintain the status quo in order to avoid attention, and because failure to meet an executive's expectations is viewed as a personal slight towards that individual. Succumbing to external pressure is not necessarily a sign of weakness. Boards following this Action Plan will be in the best position to stand up to any criticism or to make changes if that is the right thing to do.

Turning tides

When the treatment of minority groups inflames public opinion, it makes change inevitable, and it does not matter whether the minority is being disadvantaged in ways that are unfair to them or advantaged in ways which are unfair to others.

In many countries, same sex relationships have gone from being criminalised and scorned, to being tolerated, to full legal and social recognition. Similarly, slavery went from being perceived as a colonial right, to being an economic necessity, to a national shame consigned to the history books. The end of apartheid in South Africa is an example of a minority being advantaged over a majority in a way that ultimately became unsustainable for both sides.

In retrospect, it can be hard to justify why these changes took so long. With the benefit of hindsight, the arguments made in favour of the previous system seem feeble, the objections to change seem trivial, the barriers to change seem small and the answers appear obvious.

ACTION PLAN FOR BOARDS

1. Treat everything as though it is public

Boards need to put themselves in a position where they can be confident, open and fearless in publicly explaining who gets paid what and why. Individual board directors must feel able to deliver a public explanation regardless of whether or not an explanation is actually requested or required, or whether they are the chosen spokesperson.

Show me the money

There is increasing transparency about the monetary value which is attached to roles. The speed of this change is determined as much by culture and practice as it is by legislation. In the public sector it is common for salary disclosure to be compulsory and for negotiation to be prohibited.

The traditional source of information about pay is job advertisements. Adverts for basic roles almost always include the hourly rate although this may be the legal minimum. On the other hand, not all adverts include a specific salary or salary band, and advertised salaries can be misleading, eg, if a salary band is very broad, or if individual candidates negotiate more than the advertised maximum or accept less than the advertised minimum. Sales staff often expect to negotiate their salaries on an individual basis as this allows them to demonstrate the skills that are needed for the role.

Online tools are generating greater transparency as to what different companies pay for comparable roles. Websites provide average salaries for specialist roles as well as reviews of employers. Some websites allow individuals to provide their personal details, and potential earning capacity is compared with actual earnings. These websites depend upon actual and advertised salary data.

Some national tax authorities publish individuals' incomes and salaries. Companies which list in the UK are required to publicly disclose what they pay individual directors. Other companies, organisations and executives voluntarily disclose what they pay or receive. For example, some companies have taken the decision to allow their employees to know exactly what their superiors and peers earn.

Increased transparency is breaking down the cultural norm of individuals being reluctant to disclose what they get paid to their colleagues, or even to their partners or other family members. There appears to be a greater willingness to talk about pay, earnings and wealth. For some, it is no longer embarrassing or rude to cover these topics in day-to-day conversations. However, attitudes seem to vary between generations, sectors and income brackets. What is clear is that attitudes vary, and privacy is not guaranteed.

2. Recognise all of the reasons why pay is important

Articulating the reasons which lie behind perceptions of excessive pay will help boards to empathise with the public's anxiety and confusion. The starting place is to acknowledge that pay is not just a commercial issue but a social issue as well. The changing nature of work means that awareness is growing and sensitivity is intensifying.

A tough gig

The rate of business change is reflected in changes to working life. Some countries are experiencing a rise in self-employment in a range of sectors and at a variety of levels. For example, self-employment is common among IT consultants, and among domestic workers and taxi drivers, some of whom offer their services though agencies or companies. Self-employment and zero hours contracts offer flexibility; workers may have more than one job or they may choose to work more at times when they have fewer commitments to their family or studies. However, the trade-off for this flexibility can be fewer employment rights and no pension.

Shifts in earnings, the economy and patterns of employment have caused generational issues which threaten long-held value systems. The old pattern was a long career with one company, and this almost certainly came with guaranteed promotion as seniors retired. For most people this stability and predictable rise in pay has been replaced with the opportunities and risks presented by greater professional and geographical mobility. Changes to pensions have eroded the security and certainty afforded to previous generations of workers. This impacts how employees view what they and their leaders earn, and the extent of their loyalty to their current employer. The weakening of trade unions has altered the relationship between executives and the people they lead. Memories of collective bargaining may be fading fast, but the underlying problems and power imbalance which led to that system endure.

Pay has national and international importance because it underpins economies and public services. Income is of critical importance to family life, educational attainment, physical and mental health, social mobility and economic migration. Pay is also critical to home ownership which can be the biggest determinant of immediate and future wealth.

For some, the level of pay which an individual generates through their own efforts is the best indicator of positive personality traits such as ambition, commitment and tenacity. This may be why pay can be as closely linked to self-esteem as it is to life chances and lifestyle. However, there is a difficult to define tipping point when the reaction to high pay changes from admiration to disapproval. In these circumstances, referring to technicalities in executives' contracts misses the point that the promises made in contracts should have been scrutinised before being agreed, and beneficiaries do not have to enforce contracts which result in excessive rewards.

A motivated workforce is a productive workforce, but excessive pay for a small minority compounds cynicism that social background and personal connections will always pay better than talent or hard work. Comparing the increase in the amount and complexity of executive pay with the spread of pay stagnation suggests that the current system only benefits a small privileged group rather than the majority. Exit packages which coincide with executive failures are perceived as corrupt, and the gender pay gap also signals failure. On this basis it is not surprising that phrases such as 'it's not what you know, it's who you know' and 'if your face fits' have not gone away

3. Look at the entire pay structure

Seen in the context of the company's entire pay structure, boards need to consider whether executive pay will be seen as excessive. This will require an exploration of the history of their company's current pay structure, especially the structure and amount of executive pay. If there has been a significant rise in executive pay over a relatively short time period then the reasons for this will need to be understood.

Studying universities

The pay of vice-chancellors of UK universities has been attacked by the media, politicians and by the University and College Union. The social and political context is that the rise in tuition fees and the burden of student debt is preventing education from reaching its full potential in social mobility.

The widening gap between university vice-chancellors' pay and that of other academics working at the same university seems to indicate that university remuneration committees are putting vice-chancellors into a separate category where only peer-to-peer comparisons matter, and that they are not looking at their university's entire pay structure.

Individual vice-chancellors have responded by referring to the global market place and high pay packages offered at academic institutions overseas. They link the rise in tuition fees with shrinking government subsidy as opposed to their pay, and they have expressed fears that attacks on academia may damage a thriving element of the UK economy.

An appropriate pay structure is critical to a company's success as recruitment and retention depend upon a fair system of reward, and good pay architecture encourages talented staff to seek promotion. Pay can boost an individual employee's performance, but unless this is monitored, inflated pay can also result in slow staff turnover, complacency and inertia. A pay rise marks the success of the recipient, but it may motivate or demotivate their colleagues. On the other hand, pay reductions or freezes convey a lack of confidence and can result in employees and investors going elsewhere.

Pay can cause a multitude of dilemmas which may not be immediately apparent. Employees who threaten to move to a different employer may be persuaded to stay if their current employer decides to be generous, but this can undermine the company's overall pay architecture. Similarly, long-serving staff may receive salary and pensions which are anomalous when compared to their colleagues'. Companies may feel forced to create new anomalies if they need to attract specialised staff who expect higher pay than existing employees, although specialists may also be prepared to accept less security of employment.

An obvious way for companies to enhance their brand and attract their preferred executives is to pay above the market rate, although this attitude rarely applies to employees lower down the company. It is natural for executives to compare their pay with that of their peer group. As the pool of executives diversifies this consideration may naturally decrease, but in the meantime, peer comparisons should be augmented by wider considerations, or, in some instances, peer comparisons should be discouraged altogether because they are irrelevant or dangerous.

Some companies have two methods of recruitment and pay negotiations. The two are interrelated, and the method used depends on the seniority of the role.

Head-hunters are more likely to be instructed by companies when there is a small pool of potential candidates, eg, senior executives, or when specialist knowledge or experience is very hard to come by. The limited number of candidates usually results in a personalised recruitment experience, and, as a result, individual candidates are able to influence how much they get paid, how their pay is structured, as well as their other terms and conditions.

The experience of the majority of employees is very different. It is more usual to secure employment by responding to an advertisement rather than being contacted on an individual basis about a job opportunity. The bulk of the workforce probably cannot or do not negotiate their own pay when they are first recruited by a new employer or at any stage of their working life, so they are much more likely to be paid what their employer judges to be the right amount for the role, rather than what they think their individual skills, knowledge and commitment to the company are worth. Most employees have limited opportunity for significant financial advancement within their current role. On the other hand, executive pay packages often include variable financial rewards in the form of complex incentive schemes which are set or agreed by external stakeholders, ie, by non-executive directors who sit on remuneration committees and by shareholders. The pay for the majority of workers is not subject to the same external oversight, although all those who make the decisions on pay must always be mindful of what competitor organisations pay for equivalent roles.

Some companies may find that Connecting and Reflecting leads them to adopt a single process for recruitment, and/or for pay negotiations with new employees, or for internal promotions. Other companies may prefer to harmonise in some areas but not in others. Retaining two or more systems does not prevent a company from developing holistic pay principles.

4. Talk about fairness

Boards must not dismiss fairness or morality as unsophisticated arguments which are not worthy of consideration. Subjective and objective considerations should be allowed equal prominence in board discussions on pay as both have merit. Companies who do not treat their own people fairly may find it hard to persuade customers and suppliers that they can expect a better experience.

The least we can do

Damaging competitiveness is a counterargument to government interventions to influence pay, including through taxation. However, despite this once powerful objection, the UK has introduced the National Minimum Wage and the National Living Wage, and it is not alone. Hong Kong's statutory minimum wage was preceded by a minimum allowable wage for foreign domestic workers.

Arguments which centre on any pay being better than no pay (unemployment) have largely been overshadowed by stronger concerns about reducing the gap between rich and poor, that work should always pay better than state benefits, and a determination to stamp out poverty amongst working people.

Debates around minimum pay and excessive pay are underpinned by the same basic concerns about fairness and decency. The difference is that protecting the poorest in society instinctively attracts sympathy, while the natural reaction to high pay is shock or envy. This may be because the pay debate is coloured by personal experience. Only a minority experience either very high or very low pay during their adult working lives, and an even smaller minority experience both. However, financial distress is common, and the fact that this experience is rarely forgotten explains why there is widespread sympathy towards low paid workers.

Boards should also recognise that low pay and high pay are commonly conflated in a practical way. Solving the problem of excessive pay becomes a solution to low pay. The hypothesis is that if executive pay is reduced, then low and average pay will automatically increase. An extension of this hypothesis is reallocation of the saving to roles which are highly valued by society but undervalued in terms of pay, eg, to employees working in health and social care. These hypotheses depend upon a view that there is a single salary pot and an automatic reallocation of savings to others. Dependent on your point of view, this assumption is either overly simplistic or entirely logical.

5. Use simple language

Connecting and Reflecting on executive pay requires companies to provide simple explanations, and, in theory, it should be relatively straightforward to peel back the layers of complexity to reveal them.

That makes sense

To achieve the best results, medical professionals must partner with their patients, and this requires a solution to the information asymmetry which exists in the relationship. Although the imbalance between the professional and their patient is the most blatant example of this, in fact clear communications between medical colleagues is recognised as being of equal importance. One of the more challenging aspects of medical communications is how to convey uncertainty of treatment outcomes.

The terminology of the civil courts was radically altered in order to improve the comprehension and navigation of the court system by non-lawyers, reduce inefficiencies and improve access to justice. References to plaintiffs, pleadings, further and better particulars and interrogatories were replaced with plain references to claimants, statements of case, requests for further information and disclosure.

Benchmarking, formulas, percentages and statistics tend to support compliance obligations. Unfortunately these complex processes and interpretations are a breeding ground for specialist words and acronyms which few understand. An even smaller group are prepared to admit that they do not understand, especially if they think that asking the question risks personal embarrassment, and if they predict that the answer they will receive will be, at best, unhelpful, or at worst, will plunge them into deeper confusion.

The majority of employees' pay comprises only a few elements, usually basic salary, bonus and overtime. Executive pay includes elements which rarely apply to other employees, eg, immediate or future share awards which are linked to complex targets and holding periods. This difference explains why the host of technical language and acronyms which are used to describe and calculate executive pay are impenetrable to most people, eg, remuneration instead of pay, long-term incentive plans (LTIPs), vesting and post-vesting, etc. Although the intention may be to encourage executives to think long-term, or to think about non-financial performance as well as financial performance, the design and description of complex schemes can give the impression that the intention is to obscure rather than to explain.

For companies to ‘connect’ they must make the specific information which has been requested available in a suitable format, ie, the information provided must be capable of being understood without specialist knowledge. The information must also be directly relevant to the original request so that the recipient does not have to sift through voluminous irrelevant material or disclaimers before they reach the answer to the question they originally asked.

Using simple language lends itself to clear presentation. The best presentation will reflect how employees think about their own pay which is as a monetary amount, ie, bonuses are more often viewed as monetary amounts rather than as a percentage. Employees compare what they get paid with: what their superior is paid; what their colleagues are paid; and what their peers who work in other companies are paid. Even if the employee does not know the accurate or up-to-date pay for these individuals or groups, they may feel able to make an informed guess. This explains the attraction of simple ratios which can be easily understood at-a-glance. This ease of comprehension is partly attributable to the use of single figures which cover all elements of a pay package.

6. Lift the lid on what executives do

Letting others glimpse the day-to-day working lives of senior executives could transform them into real people in the eyes of the public.

A day in the life

A head-hunter pairs 24 top CEOs with a UK undergraduate in a global millennial talent initiative. Each CEO shares a working day one-to-one with a UK undergraduate. The scheme aims to create a personal connection between today’s top leaders and talented young people about to enter the workforce, giving CEOs a more direct connection with young talent. Students gain insight into what it takes to lead a major organisation and changing opportunities in a dynamic workplace.

‘We openly shared information about what he was looking for from a career and I explained the highs and lows of what I do and how my career has developed. Gaining an insight into his aspirations and how they might be fulfilled in our profession was well worth a day of my time.’
Michael Izza, CEO ICAEW

This type of work experience has a number of objectives. Prioritising talented individuals from groups which are currently under-represented at board level may help to improve the diversity of future boards, as well as allow future board directors insights which will help them to balance their financial ambitions with a deeper understanding of the expectations they will need to meet. The advantage of choosing participants who have not yet entered the workforce is that they are less likely to have entrenched preconceptions about senior executives, including views on the pressures executives face or on executive pay. Realistically there can only ever be a limited number of direct participants in these schemes. However, placements could be conditional on communications which include participants’ subjective opinions on what they have seen and heard which are not restricted to a list of meetings attended.

This is a good starting place, but it is just the first step in the long journey executives need to tread to make themselves accessible and human. A wider programme of outreach and visibility is needed in order to reach this destination. Spending time with talented young people who are the leaders of the future has value and can be enjoyable, but the workforce and the community are far more diverse in terms of their abilities and interests. Many of them have entrenched views which they may be reluctant to talk about, and this will be difficult to change.

High pay for celebrities and sports stars is often raised in discussions about excessive executive pay. This may be because the public find it easier to relate to celebrities and sports stars than to business leaders, and that is partly because the public can watch them perform and gain enjoyment from this. A career in show business or sports is understood to be high-risk, to require specialist performance skills which few possess, and to also require the resilience to tolerate intrusive and sustained media attention. Sports and show business are also recognised as offering unique opportunities for financial advancement based entirely on skill and application rather than social or educational background.

‘Lifting the lid’ will promote a stronger understanding of what executives do, including the depth of their psychological contract (as well as a legal contract) with the companies they lead. At the moment there is a lack of clarity and therefore cynicism around how CEOs and other executives are recruited, eg, why external appointments can be preferred over internal promotions, making it impossible for employees to reach the top in their own company. ‘Lifting the lid’ is an opportunity to talk about these frustrations, to see if they are accurate, and if they are, to explore what can be done to make things fairer.

Executives should welcome this opportunity to be open about the risks they took early on in their careers, and the successes and failures they encountered. Employees are generally encouraged to think of their pay as one element of a wider package of reward which also includes working environment, flexible working, development opportunities, security of employment, etc. It would be interesting to know whether executives share these considerations, what characteristics they admire in their colleagues and peers, the pressures they face, how and when they decide to change companies (and whether they intend to stay in touch), whether they would do it again if they had their time over, and, if things go wrong, whether they are really committed to being ‘last on the bridge’.

7. Have real conversations

Real conversations need to replace the stand-offs which surround executive pay. Directors must find new ways to talk so that everybody’s views can be explored rather than shouted down.

Time for a change

There are signs that conversations are already taking place and resulting in changes.

Woodford Investment Management Ltd has scrapped staff bonuses, arguing that they did little to boost performance and did not influence the right behaviours. Salaries were increased so that employees were not left worse off.

Financial exchange group Deutsche Börse has introduced a cap on the total pay package of its executive board members. The company said the decision to introduce the cap was taken by its supervisory board as part of the continuing development of its executive board remuneration system.

Despite the remuneration policy being approved by shareholders, BP encountered a non-binding negative shareholder vote to the CEO’s pay package. Safety and operational targets had been met but the company had suffered financial and job losses. The CEO of BP did not receive his full award that year or the subsequent year (although since then, his pay has risen).

At the moment announcements about executive pay can prompt harsh criticism which usually results in a dead end that fails to satisfy either side. This predictable cycle is counterproductive as it hardens the defensive positions of companies and angers their critics. An ongoing candid conversation, or at least an ability for such conversations to take place, should help reduce these crisis points. Informed and calm conversations are the best way to break the cycle of accusation, fear, finger-pointing, vitriol and silence. Routine company reporting has little relevance here as it is primarily designed for a business audience, and therefore it is indecipherable to non-specialists. Reporting is also rigid as it takes place at routine times of the year, in a set format, and the content is prescribed rather than tailored to the information ordinary people want to know, or when or how they want to receive it.

New proactive and reactive communication methods need to be found for two-way conversations which allow boards and the public to truly ‘connect’. Two-way conversations require all participants to put aside convenient but lazy stereotypes; critics of excessive pay can no longer always be described as envious activists who are incapable of understanding how business really works; not all executives are bombastic and uncaring; and those with the power to effect change are no longer timid sycophants who are continually constrained by conflicts of interest and self-interest.

One of the major challenges is that a conversation between a private individual and a company has an inherent power imbalance. Boards need to find a way to overcome this so that both sides can ‘make eye contact’. Communicating in a digital format should not prevent this. Efforts should be made to make conversations feel and sound as personal as possible. Referring to the questioner by name and thanking them for their question may help, in the same way that it can be helpful to thank a customer for their feedback regardless of whether it is positive or negative.

We are confident that companies can and will rise to this challenge. Companies have found ways to have proactive conversations about other difficult topics. For some issues the conversation is internal, eg, staff satisfaction and retention measured through surveys. For others they are external, eg, market research for customer satisfaction, focus groups for new products, or press releases designed for investors and others. Companies know that in order to land their messages with all of their audiences, they need to present the same information in different ways and at different times. The same imagination needs to be applied to internal and external conversations about executive pay.

Boards may find it helpful to make an analogy with their pricing policy which must fit with the ethos and history of the company, as well as being acceptable or attractive to customers. Luxury goods and premium services have a high price tag, but before companies risk pricing themselves out of a market, they need to convince themselves and others that their approach is justified.

8. Admit mistakes

Mistakes need to be admitted, any remedial action explained, and a commitment made to not repeat the mistakes of the past.

Sorry is not the hardest word

Parents teach their children to say sorry as a quick and convenient way to solve disputes and to underline what behaviour is unacceptable. The ability to say sorry is intended to be a life skill, although the skill does not necessarily translate into adult life. This may be because saying sorry has been seen as a sign of weakness. This is changing. Organisations and individuals in the public eye are increasingly recognising the power of the s-word. Harnessing this power requires sincerity as getting it wrong often makes matters worse. Timing is also key. Waiting until a revolver is being pointed at your head is a mistake. Saying sorry and meaning it is not the same as being sorry you got caught, regretting the consequences of actions, or feeling ashamed or guilty. It is about personal responsibility, but that does not mean that the person themselves did a bad thing. Politicians know that they may be called upon to make national apologies for historic events such as colonialism, slavery and the Holocaust. Truth Commissions help to heal nations scarred by past atrocities. Cynics may gloat, but ultimately saying sorry can resonate and it may be the best that can be done.

When mistakes have been made they are only compounded by over-reliance on the collective responsibility of boards. On the other hand, individual board members who were involved in deciding an executive's pay may not know what they can or should say to the aggrieved party, whether that party is the executive themselves, other company employees, journalists or the public. Even directors who are initially willing to stand by decisions may be put off from speaking out by internal barriers or by the hostility of the audience.

Executives rarely attempt to justify their own pay, at least not publicly. This may be because they are scared of showing their vulnerability, concerned about setting a precedent for other executives in their peer group, or they may be fearful that anything they say will be interpreted as self-serving. Even the return or refusal of a bonus can be interpreted in a negative way. If executives become more willing to talk about their pay then this will be a marker of success for Connect and Reflect.

9. Set out pay principles

Boards that have followed the Action Plan will be ready to articulate their company's approach in principles. We have provided one example of executive pay principles below, but principles need to cover all employees or the whole workforce.

Executive pay principles

Produced by Daniel Godfrey for the Responsible 100 Roundtable on Executive Pay 2017.

1. Company has clear expression of purpose and has clear long term, measurable objectives for executive pay
2. Company has clear shorter-term financial and non-financial milestones and targets that would indicate being on track
3. Board explains why they have set salary at the level they have in the context of it being:

   a) Appropriate to the value expected to be delivered over the long term
   b) Appropriate in the context of the scarcity of skills, knowledge, experience and character required
   c) Appropriate in the context of a competitive environment for the individuals' services
   d) Not more than is needed to attract, retain and motivate the individual

4. Board consults with shareholders and employees to explain their proposals, listens to feedback and makes principled responses
5. Company pays a significant part of salary in shares that must be held for long term, even after executive leaves the company
6. Company pays no performance related pay above the basic salary including shares
7. Board takes responsibility for hiring, leadership and performance management (including support, training or replacement of executive directors)

Principles should capture the spirit of boards' broad discussions around pay and demonstrate the depth of their knowledge of this subject. When designing pay principles, boards should keep in mind that the goal is clarity for all audiences. The narrative which sits alongside principles may need to explain the differences between executive and non-executive directors, and the role of remuneration committees and their advisers, in simple language.

10. Persist and be patient

When the arguments are strong and gain momentum, widely-held attitudes can change in ways that might have seemed unimaginable.

Gone up in smoke

Changing the attitudes of smokers and the tobacco industry took several decades. Arguments about personal liberty and private property gradually subsided in the face of growing medical evidence about secondary smoking. Governments decided to introduce smoking bans once a critical mass of public opinion had already changed through a mixture of debate, evidence and personal experience.

Transformation in the tobacco industry went through various stages. Although the industry started by denying that there was a problem, followed by campaigning on the basis of tolerance and accommodation of smokers, tobacco companies then worked with governments to ensure fair operation of an advertising ban. By the time the ban was introduced, the industry had reached a point of acceptance.

There remains a debate about the negative outcomes arising from smoking bans, in particular the impact on the hospitality industry and sports sponsorship. However, this debate is quieter than it used to be. Complaints by smokers have also largely faded away.

We hope that boards will be inspired by this, and that they do not give up on trying to persuade the public that what they decide to pay their executives represents value for money if they are convinced of this argument. At the same time, boards need to recognise that changing opinions takes time, and the more controversial the issue the more time it will take.

Conclusion

Committed executives should welcome Connect and Reflect if they are tired of personal insults, and if they want their achievements to be regarded as more important than what they get paid. The best executives know the value of empathy, and they recognise how their company fits into the social and political landscape. They also know that their success depends on blending with society. However, this is impossible unless they leave the comfort of an isolated and elite group.

Boards need to be stoical in their determination to follow and revisit this Action Plan, and they also need to be determined to adhere to their principles whatever internal or external pressures they face. Perseverance could lead to things which seem impossible today. For example, the focus could shift to companies who pay their executives less than their competitors; companies and executives could campaign for pay restraint; employees could feel sufficiently informed to publicly justify what their executives receive; companies could move away from having a small number of highly empowered and highly paid executives and replace them with a flatter structure and more democratic decision-making; or, a company could pay its executives the same high pay that they pay today but without attracting outrage.

