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ROLE OF THE REMCO

How to achieve good governance of pay, people and culture

Report

July 2021

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The High Pay Centre is an independent, non-partisan think tank focused on the causes and consequences of economic inequality, with a particular interest in top pay. It runs a programme of research, events and policy analysis involving business, trade unions, investors and civil society focused on achieving an approach to pay practices that enjoys the confidence of all stakeholders.

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Report

Role of the RemCo: How to achieve good governance of pay, people and culture

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1 Foreword

I have been fortunate, throughout the vast majority of my HR career, to have worked with board directors who passionately understand the link between a great workplace culture and improved business performance. I have also been fortunate to have worked with remuneration committee chairs who had outstanding backgrounds in executive HR positions, something that ensures a natural disposition to scrutinise the overall health of the wider workforce. My teams and I have been given the scope to increase the breadth of people conversations at executive committee, remuneration committee, and ultimately, at board level. There is no doubt that the experience for employees in those businesses benefited from that focus. This has been demonstrated by increased employee engagement and ultimately increased business performance.

Sadly, I am all too aware that I have been fortunate. Despite the changes to the UK Corporate Governance Code, I still hear from those in HR where remuneration committees pay limited attention to the wider agenda and offer even less guidance on how to progress. Personally, I believe this is in part because remuneration matters are mechanistic in nature, with long established methods and processes that ensure context and benchmarking can be easily defined. It is, therefore, often safe ground for remuneration committees to find a historical comparison to support their position. Conversely, culture measurement is far less defined, with many variations of measurement, and a constant crossover with the concept of engagement.

I am therefore pleased to see that this report on the role of the RemCo not only highlights the benefits - and indeed, the necessity - of getting boards and remuneration committees more focused on wider people issues but, crucially, provides practical steps that can be taken. Sourced from a range of HR practitioners, these are not theoretical concepts but ideas that already work today. No doubt these are in place at companies where the board is as enlightened as many of those I have had the privilege to work with. I hope this report and the steps within it drive the debate forward so that many more companies may benefit from that enlightenment.

Dr Andrew Stephenson
Chief People Officer – Equiniti Plc

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2 Key findings

People and pay matters at board level

In 2018, changes to the UK Corporate Governance Code ('the Code') initiated reforms to broaden the remit of boards and remuneration committees (RemCos) to ensure that company boards paid more attention to people management issues such as culture, fair and proportionate workforce pay, and employee engagement. The COVID-19 pandemic and the attention that it has drawn to social and economic inequalities has also shone a spotlight on corporate pay and employment practices.

Following the principles outlined in our 2019 publication on RemCo reform,[1] this report offers recommendations to HR leaders and board members on how to deliver these principles in practice, specifically in the area of people and pay governance.

The report is intended to support businesses in fulfilling both the regulatory requirements outlined in the Code, and the societal expectations heightened by the pandemic. The recommendations are based on practical measures that some companies are already undertaking, drawn from interviews with leading HR and reward professionals. While every organisation is different, the fact that our recommendations have already been applied successfully by some businesses shows that they are practical and implementable measures that make economic and operational sense.

We argue that there is much boards can do to increase oversight of people and pay matters and deliver better outcomes, even if full-scale RemCo reform is not the end goal. To address people matters more effectively in the boardroom, we need to build strong relationships between HR leaders, boards and investors – supported by better workforce reporting and dialogue with the workforce. The value of treating people well, and the associated risks and opportunities, should be central to corporate governance and strategic leadership conversations for organisations of all sizes. For large organisations, board and remuneration committees should be discussing people and culture matters at every meeting. To achieve fairer pay practices with the confidence of the wider workforce and wider society, the workforce needs to be considered when we make decisions about executive pay.

Key recommendations

1. Formalise people and culture matters as a board-level issue. This should include expanding the remit of the RemCo to include review of workforce pay, people matters and culture, rather than solely focusing on executive pay.

   This can be done by:

   - covering people and culture matters across all committees, not just at the main board; the HR leader and board should work together to identify the relationship between people matters and strategy, risk, and value creation
   - ensuring that any people and culture committee regularly reports to the board, to make sure all workforce strategies are clearly understood
   - appointing at least one board member with experience in HR or another people profession; the RemCo chair should have expertise and interest in workforce/long-term sustainability
   - incorporating diversity of professional perspective onto the board by appointing directors with backgrounds in civil society or public service
   - the HR team providing metrics on people matters and wider workforce pay to the RemCo, alongside narrative to explain the strategic importance and highlight priorities.

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2 Company performance should be measured in terms of non-financial as well as financial metrics.

This can be done by:

- identifying workforce metrics with strategic relevance to the business and communicating the link to the board and investors
- making workforce metrics as robust as financial ones, drawing on academic support if necessary; this will give the board and investors confidence in the measures
- making sure that the performance-related element of executive pay includes non-financial performance, which should include some metric related to the workforce.

3 Workforce engagement should be more meaningful, and the workforce should be substantively involved in the pay-setting process.

This can be done by:

- creating a formal and permanent mechanism to provide the workforce with a collective voice at board level on the topic of pay, encompassing both executive pay and pay across the wider workforce
- establishing an employee forum where the agenda is set by trade unions (where applicable) and agreed with the executives, where executive remuneration is discussed regularly
- creating a workforce council which receives and feeds back on board matters, including executive pay
- aligning the CEO's performance-related metrics with those used to determine any employee bonuses so that the workforce understands how the CEO is paid
- appointing a worker director who is well supported by the board to represent and feed in the views of the workforce on pay-setting
- communicating the company pay practices to the workforce, such as the CEO pay ratio, to effectively engage employees on issues around pay.

3 Introduction

Build back better

The need to 'build back better' in the aftermath of the COVID-19 pandemic has become something of a cliché, but it reflects widespread recognition of the need to address issues including growing income inequality, pay stagnation and in-work poverty, and quality of working lives. These are issues that needed urgent attention before the pandemic but have become increasingly visible since.

These issues are intrinsically linked to the employment and pay practices of large businesses. How large employers pay and manage their workers helps to determine income levels, income differences and people's sense of job satisfaction across the economy. Workplace matters also impact productivity, the ability of the organisation to achieve its strategic aims, and its social impact. People, and pay, are core issues for organisations and for investors.

The campaign to 'build back better' thus has significant implications for businesses and other large employers, giving even more impetus to pre-existing debates about the purpose of business and its relationship with wider society. This should be viewed as an opportunity rather than a threat, as implicitly recognised by several industry initiatives.

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Fourteen of the UK's largest companies, co-ordinated by The Purposeful Company, have pledged to put issues such as the wellbeing of staff, local communities and broader society higher up on the boardroom agenda.[2] Over 400 companies and the Institute of Directors have joined the Better Business Act, a coalition calling for a revision of directors' legal duties to elevate the interests of stakeholders including workers, customers, communities and the environment alongside those of shareholders.[3]

The companies committing to The Purposeful Company's initiative stated their belief that a stakeholder-oriented approach would ultimately lead to greater long-term profitability. It can: indeed, a recent survey for UBS found that 90% of investors said the pandemic has made them want to align their investments with their values.[4] Perhaps most importantly, aligning business practices with the interests of other stakeholder groups can increase the stakeholder and public trust and confidence in business on which all companies ultimately depend.

Reforming the RemCo

These changes also have implications for corporate governance. In 2018, changes were made to the Code to include purpose, values and culture as priorities for the board.[5] The new Code also asks boards to broaden the remit of their remuneration committees (RemCos) beyond executive pay, and put in place a mechanism for the board to engage with employees, suggesting they use a workforce council, a dedicated non-executive, or a worker director. The Section 172 reporting[6] requirements also now ask large businesses to report on how the board is considering the interests of wider stakeholders. All these changes have the effect of requiring company boards to pay more attention to key people management issues such as culture, fair and proportionate pay across the workforce and employee voice and engagement.

Improving public and stakeholder trust in business through fairer pay practices was the objective of our report on RemCo reform.[7] The report included a template 'terms of reference', setting out potential principles for pay governance at large employers. Key provisions included the following:

- Organisations should consider converting their RemCo into people and culture committees, with a remit to oversee pay and conditions throughout the organisation (rather than just directors' pay) and to evaluate the impact that pay and working practices have on employee engagement and corporate culture.
- The RemCo should consider company performance holistically, from the perspective of all stakeholders, rather than basing pay awards solely on the basis of outcomes delivered for shareholders.
- Voices from the workforce should be incorporated into the pay-setting process, with workers consulted on the distribution of pay throughout the organisation and a specific mandate to ensure fairness in respect of pay differences.

The report was well received and a number of organisations have acted on our recommendations. But to achieve fairer pay practices with the confidence of the wider workforce and wider society, many employers need more detailed support and guidance on how to deliver these principles in practice. Many also felt that full-scale reform was too ambitious, but were looking for ways to achieve some of the same aims and take gradual steps towards full-scale change.

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This report aims to build on our previous work – as well as the principles set out by initiatives like The Purposeful Company and Better Business Act campaigns – by offering some practical ideas to this effect.

It details examples of best practice on governance around people and pay, based on a series of interviews with HR and reward leaders overseeing innovative practices in respect of the application of the principles set out in our previous report.

4 Research findings

Coverage of workforce matters at the RemCo

The Introduction made the case for companies to put the wellbeing of their workforce, both in terms of pay, and corporate culture and employment practices more broadly, at the heart of their governance structures.

To do this, there needs to be substantial time and focus dedicated to workforce matters at board level. While the RemCo is where executive remuneration policy is set, it is common for issues relating to remuneration across the wider workforce, such as how pay is distributed within the organisation, to be dealt with in other board committees. The same applies to wider people management issues. Over the course of our interviews and roundtable discussions with HR and reward leaders, we asked participants where workforce matters were being discussed at the board and what they thought had worked at their companies in terms of ensuring that workforce matters receive enough attention.

There were a range of responses from the HR leaders to the question of where workforce matters were being passed to on the board. Destinations included the nominations committee, the remuneration committee, the executive committee, the risk committee, the audit committee and the full board. Some, but not many, have a dedicated people and culture committee. Some used different committees depending on the aspect of people and culture being discussed. The topics discussed also varied, including: inclusion and diversity, employee engagement and/or pulse survey data, attrition or retention, succession, executive pay, pay fairness and organisational culture.

Views also varied on whether there is a 'natural home' for workforce matters: some thought that a dedicated people and culture committee was the right place, while others said that it didn't matter where they were discussed, as long as the discussion was had somewhere. There was also discussion of using strategic levers (such as risk or audit) to raise the profile of people matters:

> *'Being slightly mercenary, risk is a good place to put it because it's much easier to justify investment when you're closing a risk.'* **(HR director, Plc)**

One justification given for having a separate committee for workforce matters was that this creates a dedicated space for discussion and brings together interlinked topics. The view from an organisation that has a people committee was:

> *'Given the size of the board and the scope of what we are, I think it would get lost among the committees, even if we had a substantive chunk of the meeting dedicated to it, it would get lost. Whereas having a dedicated people committee allows us to have a substantive conversation about a range of topics that are interlinked.'*
> **(Chair of People and Remuneration Committee)**

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Despite the differing views, there was nonetheless a strong collective agreement that there does need to be an ongoing and meaningful discussion on people and culture at board level, wherever it happens.

Regardless of the technicalities of how this works, organisations in which workforce matters are being prioritised tended to cite the following as enabling factors:

1. A strong, effective relationship between the board and the HR leader, which supports good communication.
2. A designated committee for people matters, reporting regularly on the committee's activities to the full board and ensuring that all board members understand, and give time and consideration to, strategic matters relating to the workforce.
3. Excellent reporting of people matters into the board, which the board can have faith in.

Case study 1: Taking a scorecard of people metrics to the RemCo

At Kier Group, the HR leader gives the RemCo a comprehensive scorecard of people metrics relating to the broader workforce and attends all RemCo meetings. The scorecard includes metrics such as the CEO pay ratio, gender pay gap and engagement survey data, and a breakdown of employee benefits and *'what their ambitions are to close any gaps around the offering between our broader employee population and the more senior population'.* **(HR Director, Kier Group)** The scorecard is split roughly 50/50 between data and narrative: the commentary is around the organisation's aims and priority action areas.

4. Having RemCo members and wider board members with the right professional background and priorities. Having directors with an HR background, high levels of people expertise, and/or an interest in the long-term sustainability of the company rather than short-term financial returns, makes it much easier to prioritise workforce matters. Appointing the right person as RemCo chair and/or as chair of the full board was also raised as being especially important, as the chair can ensure that workforce matters receive space and time for discussion. It was also regarded as crucial to have a CEO who understands the value of workforce matters.

'One of the advantages of looking towards developing a dedicated people committee is that it mandates the board to ensure they have people with the right experience to challenge people matters. One organisation which has a people committee also therefore has trustees with experience of employee engagement, and a previous director of reward. And this mandate for people experience is baked into the terms of reference of the people committee.' **(HR director, Plc)**

'If you deliberately go and find board members who are interested in the sustainability of your company and not just its short-term performance and how it's seen by investors and analysts, then good things will happen.' **(HR director, Plc)**

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Case study 2: Appointing a director with a public sector background

SSE has appointed a non-executive director with extensive experience in the public sector, consisting of almost 40 years of roles in local government. This person holds the roles of non-executive director for employee engagement and RemCo chair. Having a balanced board with a wide-ranging skillset and set of experiences is seen as important and SSE has benefited from this wider perspective for many years.

In the public sector, financial sustainability is critically important, but delivering good outcomes for a range of stakeholders, and balancing the (sometimes conflicting) interests of these stakeholders, is a fundamental part of the job. Having a board member with a public sector background has helped the board to approach issues from the perspective of different stakeholders, including the workforce and local communities, as well as shareholders. In respect of pay, the mindset that comes from a career in public service rather than business has also supported the RemCo in its use of non-financial measures of performance used to determine top pay.

5 Having board members that represent stakeholder groups – the experiences of companies who have appointed worker directors will be discussed below. However, one HR leader emphasised the importance of bringing perspectives that reflect the interests of different stakeholder groups, without necessarily having to appoint a worker director:

> *'The thing that doesn't get debated, well it does get debated but it doesn't get connected up, is this issue about diversity of boards. So, if you're only hiring onto the board of a FTSE 100 anyone who's ever been on the board of a FTSE 100, then by definition you have about 900 people who can do it, and they do all of the roles. And this is important because it feels like shareholders' interests get prioritised over those of the wider workforce and customers. And that can be solved quite easily by just diversifying the board and having people with different perspectives coming onto the board. This is about overloading and it's about the incestuous nature of appointment of people onto Plc boards. It's almost as if we don't take a step back and look at the problem we're trying to solve... So, if I was to hire my next non-executive, they would be an ex-trade unionist – but no connection with the workforce. That would give me the diversity of view and opinion without it being that question around conflict of interest.'* **(HR director, Plc)**

Case study 3: Expanding the remit of the RemCo to include pay across the wider workforce

SSE has expanded the remit of their RemCo to include monitoring pay across the workforce, not just executive pay. This is with the aim of understanding and aligning pay practices across the whole organisation. They are unionised and use collective bargaining agreements to set the maximum percentage pay increases that are available to top staff: this ensures that top pay is set with reference to pay across the workforce. Members of the RemCo also meet with the unions to talk to them about executive pay to explain their remuneration policy.

'So, on consideration of pay, we've said to [the RemCo] that we want to report every year on how we're implementing our pay policy across the organisation. The RemCo has already got a policy that says that executive pay should be set both with reference to the market, but most importantly with reference to internal practice and internal relativities.

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So, we try and join up and give them a report year in, year out about what we're doing with pay across the wider organisation. And pretty consistently, when we've done pay awards for either our personal contract staff or we've negotiated pay for a collective agreement, that has set the maximum pay level of the maximum pay pot that's available to senior managers and executive teams. So, we have looked to really line that up, and make sure that there's a consistency from top to bottom of the organisation.' **(HR director, SSE)**

6 Being in a sector where people are the main 'selling point' can play a role, as this means that the importance of the workforce to the business is obvious to everyone on the board. For example, sales-based organisations discussed the ease with which they connect sales-based metrics to other kinds of people metrics, as opposed to workforce matters being an operational silo.

Challenges

Several of the HR leaders mentioned that one of the barriers to greater engagement with people and culture at board level is the sheer amount of time the RemCo spends on executive remuneration due to its complexity – an observation that was also raised several times during the course of interviews for our previous report on RemCo reform. One HR leader expressed the view that while the corporate governance requirements had been put in place with the right intentions, they had resulted in much more time being spent on executive remuneration.

Another reason for complexity is:

> *'Ironically perhaps, the changes in recent years to executive pay that have been designed to tie performance to longer-term horizons, such as the introduction of LTIPs, have had the unintended effect of making it so complicated, there is no longer space to consider wider factors.'* **(Remuneration consultant and ex-HR director)**

As argued in our 2019 report, it is difficult to see how this is the most productive use of the RemCo's time. The reiteration of these comments suggests that the overly complex executive pay-setting process continues to crowd out more important issues relating to the wider workforce. The pressure on the RemCo is also compounded by the public focus on executive pay, which has increased again since the pandemic. One HR leader told us that in the last 12 months, the remuneration committee had met 12 times.

Another barrier identified was that people matters can often come to the fore in a reactive way, when either individual businesses or entire industries are subject to scrutiny or criticism from the public and the media:

> *'Going forward, we need more strategic connectivity between different aspects of people matters. In terms of barriers to achieving this, one issue is external competition. For example, a lot of boards are now talking about inclusion and diversity due to #MeToo and Black Lives Matter. They suddenly say, "Oh, we need an I&D strategy," rather than saying, "How does this link to our pay, to our talent agenda, to our succession?" People "knee-jerk" in corporate Britain a bit around topics. The problem with people matters is that everyone has a view, so it can be very reactive. What is needed is to articulate a longer-term strategy and work out how everything fits together.'* **(HR director, Plc)**

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If a company is starting from a point of having relatively little focus on people matters, establishing a dedicated place for this may seem like a radical and risky step. One HR leader suggested a way of doing this gradually:

> *'What I'm trying to do is to get more and more of the people bits into the agenda through the existing committee structures that are there. … Part of my thinking is, once they are voluminous in all the meetings that we can easily have, there is a debate to say, "There's enough substance here to actually pull it into a dedicated place in its entirety." So since I've been here I've elevated it – and the board were very receptive to this; the HR reporting goes into the risk committee, the RemCo, the NomCo and we're starting to bring it to the audit committee too.'* **(HR director, Plc)**

Good practice

Having a designated committee for discussing workforce matters ensures that this area receives sufficient time and attention at board level. Furthermore, given that topics relating to the workforce are inevitably interconnected, it makes sense to discuss them together, rather than as separate agenda items across different committees. The RemCo may be the most obvious place to cover pay and other workforce matters, as the Code already states that the RemCo should consider wider workforce pay when deciding on the company's executive remuneration policy.

If the board does not consider the RemCo the right place for workforce pay and culture to be discussed, it should designate another formal place to discuss these matters. Some boards have this in a dedicated committee, others in the nomination committee, and others in the main board.

Examples of good practice in broadening the remit of the RemCo include:

- The RemCo should include directors with experience of working in the people profession, as well as directors who are representative of different stakeholder groups, such as the workforce. Appointing a RemCo chair with experience in HR, stakeholder relationship management or other relevant aspects of the people profession is particularly important.
- A strong relationship and regular communication should be in place between the RemCo and the HR leader within the business.
- The RemCo should receive a scorecard or selection of metrics from the HR director and team on wider workforce pay (such as the CEO pay ratio and gender pay gap) and a comprehensive range of other people metrics, accompanied by a narrative about priority action areas.
- To create space for more discussion of people and culture issues, long-term incentive plans should be replaced as the default model of pay with a simpler pay package based on basic salary, with an incentive to deliver sustainable long-term performance provided by a much smaller restricted share award.
- If there is limited interest in people matters at board level, HR leaders could consider raising people issues in strategic places, such as risk or audit committees, in order to highlight their importance as a potential risk to the company.
- If there is no designated committee for people matters, start by setting up an approach to governance that includes people matters in all committees. This creates a clear sense of the justification for creating a dedicated committee. This also helps to keep it a high priority for the board, and emphasises how it connects into a wider strategy.

Examples of good practice in getting workforce and other non-financial matters discussed at the full board include the following:

- If a people and culture committee is in place, report to the full board regularly on the committee's activities and ensure that all board members understand and give appropriate consideration to strategy relating to workforce matters.
- Appoint a board member with a public sector or civil society background, with experience of delivering good outcomes for a range of stakeholders, beyond generating returns for shareholders.
- Appoint a chair and/or CEO with a background or interest in workforce matters and/or long-term sustainability so that the board gives sufficient time and space to these issues, ensuring that they are not simply outsourced to a committee.

Measurement of people and culture

The steps outlined in the previous section should result in a greater recognition at the board that company performance needs to be understood and measured in holistic terms that recognise the many different stakeholders who, in varying ways, contribute to and depend on the success of the business. These stakeholders – particularly the company's workforce – see business objectives, performance and outcomes in terms that go beyond the financial returns delivered for shareholders. This should be reflected in the board and RemCo's conception of company performance, and the consequent decisions that it makes on pay.

The measurement of workforce matters, as well as their inclusion in performance-related pay, is a relatively new development, but is growing in prevalence.[8] As a result, there is much less consensus on how to measure workforce matters than there is for the more established financial metrics. We asked our participants to discuss their views on how best to measure workforce matters.

HR leaders feel that workforce-related metrics need to rely on a robust methodology, so that the board and investors can have faith in them. This then enables the metrics to be incorporated into performance-related pay, where appropriate.

> *'What you put in as your metrics in your incentive plans [sends a] message to the leadership [about] what you value at the company.'* **(HR director, Plc, on including an employee engagement metric in an LTIP)**

Case study 4: Developing a robust customer metric to inform performance-related pay

DFS worked on a customer metric over several years to get it to the point that it was as robust as the company's financial metrics. To do this, they had academic support and independent verification via a peer review process.

The company's aim was to move from being driven by crude but easily measurable sales metrics, which could potentially be driven by high-pressure sales tactics, to genuinely good customer service, measured by metrics as robust as the financial data. The initial focus was on removing ways that customer satisfaction levels could be manipulated. One example was by looking at the Net Promoter Score (NPS) at the point of sale and then again in six months' time. As NPS scores decrease at a very predictable rate, any outliers made it easier to narrow in on specific instances

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that might be impacting it - something as small as a particular sewing machine! - or identify instances where the initial score may have been massaged. They also worked on increasing response rates to statistically valid levels.

Overall, this meant getting to a point where NPS was statistically robust. This meant that when they wanted to connect reward to customer service, they had statistically valid, externally recognised measures which had the confidence of all employees. Almost everyone in the company had their pay attached to the NPS score. At the CEO level, 20% of bonus was based on NPS, with a weighting equal to profit; in sales it would be 50%; at delivery driver level it was 10%. This reflected the different extent to which different roles affect customer satisfaction, but ensured that all employees were invested in the same business objective.

The fact that the customer metric was robust gave the board, the remuneration committee and the investors confidence in it, and enabled the customer metric to be integrated into performance-related pay across most of the workforce. The same process could be carried out with workforce metrics.[9]

While robust metrics were seen as essential, HR leaders also emphasised the need to have a blend of data and narrative when reporting on people matters to the board. Most said that they used roughly a 50/50 balance of data and narrative.

From the investors' perspective, there was widespread agreement among those with whom we engaged that companies tend to use too many metrics, and investors don't have the time to take into account this level of complexity. Both investors and remuneration consultants felt that the best approach was for companies to use a small number of metrics that have strategic relevance.

> *'There is a risk we end up with a narrow vanilla list of metrics, which misses the point. … [We should ask]: "Where is the strategic alignment to the business needs?" … One example was a hotel group, who had employee engagement as a metric against pay but also had the evidence base to demonstrate that engagement was related to hotel occupancy. So, there was a bottom-line reason why it mattered, and a link to the company's purpose, values.'* **(Remuneration consultant)**

There was also a recognition that using workforce metrics doesn't guarantee that the company is incorporating these issues into their strategy.

> *'We all know that sometimes you can tick the box on a metric, but actually the underlying work or bigger picture isn't right.'* **(Institutional investor)**

Challenges

Areas such as culture are, by their nature, complex, but several HR leaders told us that the literacy on people matters at boards is not always particularly high:

> *'I think most people know that people matters are really important, and they kind of know what they want to hear, but in many cases, without core expertise, people would take comfort in the numbers without really getting to the bottom of them. My general experience is that there's far less literacy with people and metrics, than there*

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> *is with the finances, even non-CFOs, non-audit people, when you get that senior, it's drilled into people that they need to know about finance. People have a decent understanding, but if you try to explain why good employee engagement is not always representative of the culture of the business, trying to explain that it's just a factor, not the whole picture, people's eyes glaze over!'* **(HR director, Plc)**

Another HR leader made a similar point, saying that she might need to explain, for example, why attrition rates are likely to be much higher in their sector than in others that the board members had worked in. The kind of knowledge and experience that the board members have will shape the extent to which they challenge the workforce metrics provided.

Good practice

Examples of good practice in developing workforce-related measures include the following:

- Identify workforce metrics with strategic relevance to the business and communicate the link to the board and investors – for example, how employee engagement relates to customer service (leading to repeat business) or reduced staff turnover (resulting in lower recruitment, training and administration costs).
- Make these links as robust as the direct financial metrics, drawing on academic support if necessary to increase quality of workforce-related metrics. This gives the board, as well as investors and other stakeholders, confidence in the metric. This also enables the metric to be connected to reward.
- Where executive pay includes a performance-related element, part of this should be connected to relevant workforce metrics.
- As an HR leader, bring a mixture of metrics and narrative to the board. This is particularly useful in the cases where there aren't any board members with HR expertise. Narrative helps to contextualise the numbers.
- Consider whether a risk or value lens on people issues will resonate most in board engagements. This will help to frame conversations on workforce matters in a way that will have the greatest impact.

Workforce engagement (on pay)

The Code recognises that, as a major stakeholder, workforces should be involved in corporate decision-making processes. To encourage this, it suggests mechanisms by which companies can give workers a voice at board level:

- an advisory panel or workforce council
- a dedicated non-executive director
- a worker director.

Pay levels, and how pay is distributed across the organisation, are undoubtedly issues that affect workers. If a company wants to recognise the interests of the workforce as a key stakeholder, it is imperative that it engages its workforce in the pay-setting process. Participants in our research were asked to discuss what mechanisms they had in place for workforce engagement, and whether engaging with the workforce on pay was part of this broader engagement.

We found a range of different approaches to workforce engagement. This echoes the findings from the recent report by Royal Holloway, University of London and the Involvement and Participation Association (IPA), which analyses the use of these workforce engagement mechanisms in the FTSE 350.[10]

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One important distinction to draw out is the difference between approaches that provide an opportunity for the board to listen to any issues that the workforce wants to raise (a 'listening' mechanism), compared with approaches which actively seek feedback from the workforce on specific topics of interest to the board. Our interviews highlighted the difference between the two: while most organisations have something in place on the 'listening' side of things, many do not have formal mechanisms in place for two-way engagement.

In terms of the mechanisms recommended by the Code, the examples we heard of showed that organisations using workforce councils tended to have a two-way engagement function as they select topics on which to get the workforce's feedback. However, for several of the organisations that had opted to appoint a non-executive director with responsibility for stakeholder engagement, activities were predominantly or solely 'listening' ones (such as town halls or site visits), rather than two-way engagement.

The range of approaches companies are taking to the FRC requirements demonstrates a need for more clarity over what the engagement activity is designed to do, and what would make it most effective. There is also some confusion and a great range in the role that should be played by the HR leader in this engagement, and their relationship with the nominated non-executive director. This can lead to a difficult relationship between the board and the HR function, and a lack of meaningful engagement.

> *'What are the board's responsibilities in terms of meaningfully ensuring there is engagement with the staff? One of the problems that seems to have happened with that piece of work [board engagement with employees] is that boards are confused about where their responsibilities stop. … A board's got responsibilities for finances, but they don't do the finances! They just make sure the measures are in place to make sure things are happening properly. And somehow the boards have taken this employee involvement thinking to mean "I've got to personally do something on the board; we need to send a board member to do two board sites a year and pretend to talk to people." Whereas what they should be doing is ensuring the management have the necessary things in place to be listening to employees, taking action accordingly, measuring that sort of feedback and doing something about it. But it seems to really lack teeth, and lack teeth from the investors' perspective as well, which is preventing any meaningful change.'* **(HR director, Plc)**

Our findings therefore chime with those of the Royal Holloway and IPA, that organisations need to:

> *'properly reflect on the purpose they want that engagement to serve. Are they looking for a sounding board for proposals, a greater diversity of viewpoints, a channel to raise workforce concerns, or to shift the purpose and values of the company in a new direction?'*[11]

One HR leader stressed the importance of knowing when to ask for employee feedback, pointing out that you shouldn't ask for feedback if you aren't going to be able to act on what people might say:

> *'It's disengaging, and can be very patronising, to ask workers for their feedback if the board then ignores it.'* **(HR director, Plc)**

Despite the Code recommending that RemCos report on what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy, our interviews found little evidence of engagement with the

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workforce on pay (either across the workforce or in specific relation to CEO pay and pay differences). This could result in reputational ramifications and might represent a concern for existing and prospective investors, if non-compliance with the Code is brought to light.

It is notable that the Royal Holloway/IPA report lists the 15 issues most frequently discussed at board level as a result of employee engagement, and none of these are pay-related.[12] We found that the best examples of workforce involvement in the pay-setting process were at the companies that had established a partnership agreement with a trade union, and/or had set up a workforce advisory panel or similar. Sometimes these two were interconnected, as where an organisation has partnership agreements with unions, the unions tend to be involved in the workforce advisory panel; for example, one of the organisations we interviewed had a workforce council made up of 20 senior shop stewards.

Case study 5: Pay alignment across the workforce and union involvement in pay-setting

Severn Trent Plc has long-standing partnership agreements with Unite, GMB and Unison. There is an employee forum, a 'traditional trade union forum' made up of employee representatives elected by the workforce. The agenda is set by trade unions and agreed with the executives. The RemCo chair attends once a year to talk about remuneration matters, including the CEO single figure, and takes questions. This is a chance for employees to express concerns or support. This was in place prior to the 2018 UK Corporate Governance Code.

Severn Trent Plc also aligns the CEO's performance-related metrics with those used to determine the all-employee bonus. This way, the workforce is being rewarded in the same way as the CEO and, as a result, workers understand how the CEO is being paid. The RemCo does a regular piece on workforce alignment, to ensure that the executives are treated the same as the workforce.

The majority of HR leaders justified the lack of workforce engagement on pay by saying that there was very little 'noise' from the workforce on CEO pay or the pay ratio disclosures. Some of our interviewees weren't clear why there was a lack of interest – whether it was because workers don't know about it and/or aren't being engaged on it, or because they are genuinely uninterested. It could also be a question of influence – if employees do not feel they have any influence over CEO pay, it is unlikely to come up in engagement. Several thought that workers are more interested in how their own pay relates to the pay of their peers than to the pay of executives. However, if this is the case, we would expect to see workers be interested in the pay ratio disclosures, as they include information on pay levels across the whole workforce (pay at 25th, median and 75th percentile points). It was also suggested that the CEO pay ratios are considered more abstract than, for example, a decision about a pay increase.

The apparent lack of interest from workers may be due to the fact that we found less evidence of boards communicating pay ratio disclosures or the pay thresholds for the different quartiles to their workforce. This may be partly because the requirement to disclose CEO pay ratios was introduced relatively recently. One HR leader gave the example of their gender pay report being posted on the company intranet and being widely downloaded by staff, which demonstrates employee interest in issues of pay and pay (in)equality. This suggests that companies should proactively disseminate information on pay, including the pay ratio report. If pay is fair and distributed in a sensible and proportionate manner, this could support employee engagement and prevent any misunderstandings of pay practices taking hold.

Case study 6: Discussing board matters at a workforce council

This Plc chose two of the FRC guidelines for workforce engagement - a workforce council as well as a NED with responsibility for employee engagement.

The workforce council meets quarterly. The members are selected by management and are made up of a mix of people from across different departments and levels; they have made it a diverse group.

Along with the workforce members of the council, it is attended by executives, a secretariat and a NED, though which NED attends changes on a rolling basis. It may also include other attendees relevant to the topic being discussed; for example, when the session covered the recruitment process, they included some employees who had recently been recruited, to ask them for their perspectives.

Sessions consist of a presentation followed by discussion and feedback. The topics are suggested by the HR leader to the board and then finalised by the board's choice. Some are driven by governance requirements and some are driven by strategic priorities. Topics have included new people practices, appraisals, changing hours, pay policies and remuneration, Corporate Social Responsibility (CSR), company purpose, and productivity. The board then receives the minutes of the meeting, and any actions are communicated out to the wider workforce in monthly meetings.

The HR leader highlighted that the culture of the organisation helps to drive successful workforce engagement:

'We have a very open culture. We aren't very formal or hierarchical, so people are happy to pass feedback upwards.'

Another perceived barrier to workforce engagement on pay is that it can be difficult to gather feedback about pay in an objective way; workers have their own interests at heart and cannot remain objective. One of the HR leaders told us that, while they have a formal engagement process in place (a workforce council) and that this covers many people aspects, including executive pay, it can be difficult to engage with the workforce about their own pay. This is because feedback informs rather than determines decisions.

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The HR leader described this as being *'a voice, rather than a vote'.* We also heard from business leaders who raised examples of their staff voting to take a pay cut so as to avoid redundancies within the organisation. These moments of engagement – where the workforce is asked to input in difficult decision-making about pay and people matters – were perhaps more common in the throes of the pandemic than had previously been the case.

Case study 7: Taking board papers to the workforce advisory panel

In response to the changes to the Code, this Plc has established a workforce council. It operates on a revolving 12-month programme and involves around 15 people from across the organisation.

The innovative and unusual aspect of this council is that the board shares a number of its papers with the council before each board meeting so that the council can give its input. Not all papers are shared with the council – the board decides which papers are to be shared. Some of the papers are managed directly by the chair or other board members, and when there are papers about people and culture, the HR director goes in and talks to them about it.

'It is a great way to hear from them about what they think in a pragmatic way. Some of the ideas they come up with… it's very easy to say, "Oh we [already] thought of that," but generally we get some benefit, and it's definitely a two-way deal: they get insight into what the organisation is doing and can give us input, but also we expect them to go back and be ambassadors for the topics we discuss and to be story-tellers and influencers and explain why we do some of the things we do when they see them rolled out by the organisation. It works pretty well.' **(HR director, Plc)**

To select workforce representatives, the board asks for nominations from within the business, but they don't officially advertise it. They intentionally look for a diverse group, which the HR leader said helps them to look more widely.

The HR leader said that they might take papers to the council on aspects of pay, but this appears to be limited and does not extend to any meaningful contribution to executive pay policy from the workforce.

'We don't have executive compensation discussions with [the workforce] before we've told people [executives] their [pay] outcomes. If I was taking a paper to the board or the RemCo on an approach or a change on something to do with pension or pension contributions, that sort of paper we might take. The chair generally selects the papers that he thinks would be relevant to get their input on.' **(HR director, Plc)**

Worker directors

Appointing a worker director or directors to the board guarantees that at least one worker is involved in the pay-setting process. However, research participants argued that it does not necessarily provide a mechanism for collective workforce engagement in the pay-setting process.

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HR leaders expressed a range of views on worker directors. As only a tiny fraction of Plcs have taken up the worker director option,[13] most HR leaders expressed reasons why they had not – or had not yet – done so. However, more companies may consider moving in this direction in future.

> *'Each year we get closer and closer to it. Ideologically, we believe it's exactly the right thing to do, in the same way we believe that our NEDs make a brilliant contribution to our organisation, our trade unions are really important stakeholders and partners, why would you not have an employee? It feels anomalous, if you believe that they're an important stakeholder group, not to include them.'*
> **(HR director, Plc)**

In the two instances we came across where organisations had appointed worker directors onto the board, this was seen as adding significant value. There was one organisation, a subsidiary of a Plc, in which worker directors had been elected by the workforce:

> *'It works, and actually it's stellar for employee engagement, because they go back and they are part of the decision-making process; there's absolutely no question about it. I think we underestimate the ability of the workforce to elect the right people. … They genuinely add value – they add value in the debate, but they also add value in the clarity you put on papers when you know the workforce are going to read it.'* **(HR director, Plc)**

We recommend that any employee representatives, be they worker directors or members of a workforce council, should be selected with input from the workforce.[14] Selecting employee representatives without workforce input somewhat defeats the purpose of involving the workforce in the company's decision-making process. Input could be sought through outreach with the workforce, explaining what board membership might entail, as well as through existing communication channels such as recognised trade unions and works councils, or through direct elections. As our research findings demonstrate, in all cases where a workforce engagement mechanism involved worker representatives elected by the workforce, our interviewees perceived this mechanism to be effective.

Case study 8: Worker directors (or 'employee directors') appointed by management

At Capita Plc, the employee directors were selected by management, without any input from the workforce. There was an application process in place for the two employee director positions, which was open to anyone who had been at the organisation for at least two years. There are rigorous and ongoing support structures in place to ensure that the employee directors are able to carry out their roles, including long inductions with members of the executive committee and board, and an external firm commissioned to assist them with their roles.

The HR leader at this company emphasised that the employee directors were not responsible for workforce engagement; rather, their job on the board was to act as a NED, but from the perspective of an employee rather than *all* employees. The employee directors therefore add value by improving diversity of thought on the board.

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In this instance, employee directors do not provide a mechanism for collectively engaging the workforce in the pay-setting process. The HR leader pointed out that employee directors alone, while adding immense value to the board, cannot act as a panacea for the company's workforce engagement. In this sense, following the Corporate Governance Code isn't necessarily sufficient for effective workforce engagement:

'The Corporate Governance Code had the right intent, but it's a bit simplistic. You could follow the Code and have a completely disengaged workforce.'
(Chief People Officer, Capita Plc)

Good practice

We found several good examples of workforce engagement mechanisms, but examples of workforce engagement in the pay-setting process were less common. These appeared to be most effective at companies that had established a partnership agreement with a trade union, and/or had set up a council of workforce representatives. In the best cases, engagement was a two-way process of sharing information with the workforce and feeding their views back to the board. It also tends to be better developed in companies that have had the mechanism in place for longer (before the requirement came in) or a pre-existing culture of engagement.

There is no single solution to creating meaningful employee voice, but companies should establish a formalised, permanent mechanism or mechanisms that will provide the workforce with a collective voice at board level. This should include the topic of pay, encompassing both executive pay and pay across the wider workforce.

Examples of good practice are as follows:

- Understand that engagement and employee voice is a two-way mechanism, not one way. It should be seen as a way for employees to influence decisions, rather than just to be engaged with the management agenda.[15]
- Establish an employee forum or council (if one does not already exist) where the agenda is set collaboratively, with input from executives, trade unions, the board and employees.
- Share board papers with a workforce council in advance of the board meeting and take feedback on these papers to the board.
- Proactively communicate pay ratio disclosures and information on the distribution of spend on pay and internal pay differences across the workforce to all workers, to enable better discussion of fair pay across the organisation contextualised by accurate data.
- In addition to consultations with shareholders, a relevant non-executive director could give a presentation explaining executive pay to a workforce council ahead of the AGM and gather feedback from the council.
- Align the CEO's performance-related metrics with those used to determine any all-employee bonus or performance-related pay. This way, the workforce is being rewarded in the same way as the CEO and therefore understands how the CEO is being paid.
- Appoint worker directors to the board. The worker directors should not be seen as the voice of the workforce as a whole (a heterogenous body with a broad range of views), but as individuals bringing a different background and perspective to high-level decision-making processes, including on pay and people-related issues, that are largely

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dominated by business leaders with 'white-collar' backgrounds in careers traditionally driven by financial performance measures.
- Election or selection of employee representatives (whether worker directors or members of a workforce advisory panel) should be done with input from the workforce, and should be supported by induction processes and access to external advice and support.

5 Summary of good practice

In this section, we summarise the examples of good practice that we have included in the report.

We propose three core aims for companies looking to improve their pay governance and ensure that workforce matters are prioritised at board level:

1. People and culture should be a formal part of the board mandate and agenda. The RemCo should address pay and culture throughout the whole organisation, rather than solely focusing on executive pay.
2. Company performance should be measured not only in terms of financial metrics, but also in terms of workforce metrics and other non-financial metrics, such as environmental and social impact.
3. Companies should ensure the workforce is substantively involved in the pay-setting process, as required under the UK Corporate Governance Code.

1 People and culture should be a formal part of the board mandate and agenda

Examples of good practice in getting workforce and other non-financial matters discussed at the full board include the following:

- Establish people and culture matters as a standing item across committees, not just at the main board. Include a balance of narrative and metrics, and connectivity to strategic goals.
- If a people and culture committee is already in place, it should report regularly to the full board about the committee's activities and ensure that all board members understand and give appropriate consideration to strategy relating to workforce matters.
- Consider the experience of board members. Those with HR leadership backgrounds are likely to be more aware of people issues and pay across the workforce. In the public sector and civil society, delivering good outcomes for a range of stakeholders, and balancing the (sometimes conflicting) interests of these stakeholders, is the purpose of the role, with financial sustainability a means of achieving this, rather than the other way around.
- Appoint a chair and/or a CEO with a background or interest in workforce matters and/or long-term sustainability.

Examples of good practice in broadening the remit of the RemCo include the following:

- Appoint directors with people management experience to the RemCo, as well as directors representative of different stakeholder groups, such as the workforce. Appointing a RemCo chair with experience in HR or other relevant aspects of the people profession is particularly important.
- Develop a strong relationship and regular communication between the RemCo and the HR leader.
- Provide a scorecard to the RemCo with metrics on wider workforce pay (such as the CEO pay ratio and gender pay gap) and a comprehensive range of other people metrics, accompanied by a narrative about priority action areas.

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- To create space for more discussion of people and culture issues, long-term incentive plans should be replaced as the default model of pay, with a simpler pay package based on basic salary and with an incentive to deliver sustainable long-term performance provided by a much smaller restricted share award.
- If there is limited interest in people matters at board level, raise people issues in strategic places – such as at risk or audit – to highlight their importance as a potential risk to the company.
- If there is no designated committee for people matters, start by setting up an approach to governance that includes people matters in all committees. This ensures it remains a high priority for the board. This then creates a clear sense of the justification for creating a dedicated committee.

2 Company performance should be measured in terms of non-financial as well as financial metrics

Examples of good practice in introducing non-financial metrics include the following:

- Identify workforce metrics with strategic relevance to the business and communicate the link to the board and investors.
- Develop workforce metrics as robust as the financial metrics, drawing on academic support to improve quality if necessary. This gives the board, as well as investors and other stakeholders, confidence in the metric. This also enables the metric to be connected to reward.
- Where executive pay includes a performance-related element, part of this should consist of workforce metrics.
- As an HR leader, bring a mixture of metrics and narrative to the board. This is particularly helpful in the cases where there aren't any board members with HR expertise.

3 The workforce should be substantively involved in the pay-setting process

Examples of good practice in involving the workforce in the pay-setting process include the following:

- Establish a formalised, permanent, two-way mechanism that will provide the workforce with a collective voice at board level on the topic of pay, encompassing both executive pay and pay across the wider workforce.
- Establish an employee forum where the agenda is set collaboratively, with input from trade unions, executives and board employees, and where executive remuneration is discussed on at least a yearly basis.
- Proactively communicate pay ratio disclosures and information on the distribution of spend on pay and internal pay differences across the workforce to all workers, to enable better discussion of fair pay across the organisation contextualised by accurate data.
- Share board papers with a workforce council before the board meeting and take feedback on these papers to the board.
- Ask a relevant NED to give a presentation explaining executive pay to a workforce council and gather feedback from the council.
- Align the CEO's performance-related metrics with those used to determine any all-employee bonus. This way, the workforce is being rewarded in the same way as the CEO and therefore understands how the CEO is being paid.
- Appoint a worker director or directors to the board. The worker directors should not be seen as the voice of the workforce as a whole (a heterogenous body with a broad range of views), but as individuals bringing different backgrounds and perspectives to high-level decision-making processes.

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- Elect or select all employee representatives (whether worker directors or members of a workforce advisory panel) with input from the workforce and support them with induction processes and access to advice and support.
- Communicate pay practices to the workforce. One company shared their gender pay report with employees on the company's intranet. The report was widely downloaded by employees, which suggests that proactively disseminating other information on the company's pay practices, such as the CEO pay ratio, would be an effective way to engage employees on issues around pay.

6 Conclusion

This project set out to identify innovative pay governance practices that could be more widely applied by HR leaders and board members looking to strengthen their company's pay and employment practices.

The measures we identify may not be applicable to every major employer. However, the fact that they are already in use at some large employers emphasises that they are practical and implementable measures that make economic and operational sense for these organisations.

The examples cited are heartening instances of progressive and innovative practices. However, it is important to emphasise that they should not be taken as being typical of corporate Britain more widely. If we are to genuinely 'build back better' following the COVID-19 pandemic, it is essential that UK companies deliver fairer pay and better working lives.

Before the onset of the pandemic in 2020, over one in six working households were in poverty.[16] This demonstrates that for many UK workers, being in work is not enough to guarantee a decent standard of living.

The stark gap between high and low earners is reflected in the fact that, internationally, the UK has the ninth greatest income inequality of the 40 OECD countries, a group of high-income economies. Other than the United States, it is only lower-income OECD economies such as South Africa, Turkey and Bulgaria that have a worse record on income inequality than the UK. To add to this, analysis by the European Trade Union Institute in 2019 found that the UK has lower worker participation in business governance than every EU country, other than Latvia and Estonia.

There are, of course, many causes of these issues beyond business practices – but businesses are key to resolving them. They stand to be among the biggest beneficiaries through better long-term performance, greater public trust, and the creation of a better world to live in – because businesses ultimately comprise the people that work for them. This makes the people profession a key strategic partner in achieving these goals.

In our introductory section we highlighted the important thinking being done around the principles of good business. We hope that this report can be of value in respect of putting these principles into practice, in the specific area of governance of pay and people.

7 Methodology

The report was based on two roundtable discussions and individual interviews with over 30 HR leaders, business leaders and reward experts, as well as investment industry representatives, carried out between January and June 2021. Participants were selected on the basis of CIPD surveys of member organisations' pay governance practices. Company characteristics were considered when selecting participants, to ensure a range of characteristics in terms of sector, workforce size, workforce composition, extent of global operations and trade union representation.

8 Endnotes

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