

Traidcraft's Response to BIS Discussion Paper on Executive Remuneration

INTRODUCTION: RATIONALE BEHIND TRAIDCRAFT'S RESPONSE

Traidcraft

Traidcraft is one of the UK's leading fair trade organisations. Our mission is to fight poverty through trade, practising and promoting approaches to trade that help poor people in developing countries transform their lives. Traidcraft was established in 1979 and comprises two operational organisations: the trading company Traidcraft plc and Traidcraft Exchange, an international development charity.

Traidcraft plc sells more than 700 food, household, soft furnishings and clothing products from nearly 100 producer groups based in 30 countries in Africa, Asia and Latin America. It had a turnover of £18.5 million in 2010/11. Traidcraft Exchange is an international development charity, with total expenditure of £3.2 million in 2010/11.

Fairness of remuneration internationally

Traidcraft would be interested in seeing not only greater fairness of incomes within the UK, but also globally. Supply chains stretch from developing country producers to UK retailers and consumers. We are acutely aware that many of the workers and farmers in developing countries are not paid a 'living wage'¹ for the work that they do. By contrast, the CEO of a major supermarket selling their goods can be paid £5 million per year - far in excess of anything that might be regarded as a need².

There is currently a considerable debate about how to define a living wage – however the Ethical Trading Initiative is urging its member companies not to “allow the challenge of how to calculate a living wage to distract them from getting on with raising wages. In many countries the minimum wage falls so far below any living wage estimations that even significant increases in pay are unlikely to exceed a living wage.¹”

Fairness of remuneration within the UK

Traidcraft wishes for greater overall fairness in remuneration from the following two perspectives:

- Less differentiation in the amount people are paid for a similar number of hours of work, and;
- Desiring greater equality than promoted by the anti discrimination approach which advocates equal pay for the same job.

¹ What is a 'living wage'? The ETI Base Code says that 'wages should always be enough to meet basic needs and to provide some discretionary income'. www.ethicaltrade.org/in-action/issues/living%20wage

² In 2009/2010 year Sir Terry Leahy, chief executive of Tesco, earned more than £5.2m in salary and bonuses. Guardian Wednesday 2 June 2010; Telegraph 3 Jun 2010

Traidcraft UK has a policy that the highest paid member of staff should not be paid more than six times the full time equivalent of the lowest paid member of staff. By contrast, the *median* remuneration of FTSE100 chief executives³ is in the order of 700 times more than the annual salary of somebody on the UK living wage of £7.20/hour⁴. This differential has widened dramatically in the last two decades, with no corresponding widening of productivity. There does not seem to be a link between pay and performance.

We also have wider concerns about high levels of executive pay. That it:

- diverts money away from core business activities;
- undermines feeling of cohesion and solidarity within a company of people working together in a similar context;
- undermines social cohesion within a country when there is significant disparity in pay;⁵
- can be a factor in stimulating demonstrations of discontent.

Traidcraft would therefore welcome the UK government setting an expectation that Executives' maximum pay should not be more than a certain ratio above the lowest paid worker within that company's UK operations, and that consideration should also be given to the ratio between Executives' pay and the median pay of other employees.

Remuneration to be linked to Directors' fulfilling their Companies Act 2006 duties

The Companies Act 2006 recognised companies' wider role in society. The government has a role to promote public good, and so should not make recommendations which purely benefit shareholders or individual directors, but rather guide directors to deliver their wider duties.

The 2006 Companies Act sets out that, in addition to acting in 'members' [shareholders] interests, Directors need to have regard to:

- a) the likely consequences of any decision in the long term,
- b) the interests of the company's employees,
- c) the need to foster the company's business relationships with suppliers,
- d) customers and others,
- e) the impact of the company's operations on the community and the environment,
- f) the desirability of the company maintaining a reputation for high standards of business conduct.

³ Analysing the FTSE 100 over five years: Total CEO Pay vs. Company Performance 2006-2011?
www.pattersonassociates.co.uk/wp-content/uploads/2011/09/20110919-5-Year-CEO-Final_published.pdf

⁴ Following on from London Living Wage Campaign the Living Wage Foundation has been set the UK living wage at £7.20 for those outside London. See www.livingwage.org.uk

⁵ "The Spirit Level" (2009) by Richard Wilkinson and Kate Pickett studied ~23 countries and found that health and social indicators were worse in the most income-unequal countries.

We would like to see directors' pay based on a balanced scorecard of performance measures against these directors duties (a) – (f) above, as well as other relevant metrics.

ANSWERS TO CONSULTATION QUESTIONS

Role of shareholders

1. *Would a binding vote on remuneration improve shareholders' ability to hold companies to account on pay and performance? If so, how could this work in practice?*

Traidcraft in principle is in support of an advisory vote. However the company has employment contracts with its directors. We are concerned about the risk that could occur in practice if the shareholders voted 'no.' It is possible that the company might then find itself in breach of contract with one of its directors.

Instead the shareholders could vote on which non-executive director chairs the remuneration committee.

2. *Are there any further measures that could be taken to prevent payments for failure?*

If there is an internal culture which passes significant pay increases which do not relate to director's performance against their duties, then

- a) external pressure needs to be applied to the process of how remuneration decisions are made;
- b) changes need to be made internally both in terms of the people making remuneration decisions, and the processes. In particular remuneration committees could be directed to consider new information, as suggested below.

The Government could produce an annual publication which analyses data from Companies' annual reports to compare individual FTSE 100 director's salaries in the following way:

- 1) ratio of top to median individual company staff remuneration packages. (This would show the spread of remuneration packages).
- 2) ratio of top to bottom individual company staff remuneration packages. (This would show the outright top to bottom distribution of pay.)
- 3) proxy indicators for the implementation of director's duties as follows:
 - i. legal judgements against the companies e.g. county and high court judgements against the company (cf contractual relations, reputation of business conduct);
 - ii. environment agency fines (cf environment);
 - iii. Health and Safety executive judgements/fines (cf impact on staff or community);
 - iv. Successful employment tribunal claims (cf staff);
 - v. outcomes of National Contact Point (for the OECD Guidelines for Multi National Enterprises) decisions and outcomes of any court cases in any of the countries where the company operates which went against the company (cf reputation of business conduct and long term).

Putting this analysis into the public domain would generate media interest and hopefully create a context where those involved in setting executive pay were mindful of how their pay decisions would be perceived.

3. What would be the advantages and disadvantages of requiring companies to include shareholder representatives on nominations committees?

We think more emphasis should be placed on a company board having a balanced set of expertise so that it is able to fulfil the full set of directors' duties. So, rather than shareholders being represented, we believe the nominations committee would do well to include suitably qualified individuals to help recruit the skills it currently lacks. For example a company which has extensive overseas operations in countries with high levels of human rights abuses might want to recruit a director with human rights expertise. To do this a suitably qualified expert in human rights might be seconded onto the nominations committee just for that recruitment, in recognition that the current board lacked those skills.

Role of remuneration committees

4. Would there be benefits of having independent remuneration committee members with a more diverse range of professional backgrounds and what would be the risks and practical implications of any such measures?

There is a need to change the culture of non-executives approving disproportionate pay increases for the executives. In some circumstances non-executives are peers in other companies, of the executives whose pay they are approving. Their decisions may then indirectly influence the pay they may receive in their executive roles. So a breadth of people on the remuneration committee would be desirable.

The more fundamental priority, however, should be to have a full board with diverse set of backgrounds. A diverse board, with wide variety of skills, backgrounds and experience, would then be more critical in their assessment of how much should be spent on executive remuneration as part of a discussion of the most appropriate use of the company's resources. Non-executives could give a steer on suitable maximum levels of pay, and weightings to be given to performance assessments.

5. Is there a need for stronger guidance on membership of remuneration committees, to prevent conflict of interest issues from arising?

Yes, particularly to avoid a network of directors in different companies being involved in influencing each other's pay.

6. Would there be benefits of requiring companies to include employee representatives on remuneration committees and what would be the risks and practical implications of any such measures?

Traidcraft is in support of employee involvement within the governance of companies, and we have a staff director who is elected every two years. We have this role in recognition that staff are an important stakeholder of the organisation. However we are not in support of a staff member being on the remuneration committee since we see that this could lead to a conflict of interest.

The support function of secretary to Traidcraft's Remuneration Committee is provided by the Head of our Human Resources department (who is not an executive). This allows provision of impartial guidance on how to structure executive pay, so that it is consistent with how the



majority of staff are remunerated. For example the reward policy for executives and staff are structured in a similar manner.

Please see our suggestion in our response to Question 2 that the government publish the:

- ratio of top to bottom of staff remuneration packages
- ratio of top to median of staff remuneration packages

7. What would be the costs and benefits of an employee vote on remuneration proposals?

Traidcraft is in support of transparency. Directors' pay is disclosed in annual reports and all staff are able to see the base pay levels of every post. However a yes/no vote is a blunt instrument. Rather, the remuneration committee should consult with staff representatives (who are aware of their executives remuneration), and consider how the directors have fulfilled the 2006 Company Act set of director's duties, when deciding on appropriate remuneration.

8. Will an increase in transparency over the use of remuneration consultants help to prevent conflict of interest or is there a need for stronger guidance or regulation in this area?

Transparency over how remuneration consultants were selected (including terms of reference for the consultant), which consultants were used and how long they have been employed as consultants is welcomed.

Structure of remuneration

9. Could the link between pay and performance be strengthened by companies choosing more appropriate measures of performance?

Yes. First a maximum envelope needs to be set that limits overall remuneration. This maximum envelope of remuneration needs to be set with the consideration of fair pay for a day's work, with the emphasis being on fairness across a company, and where possible including considerations of fairness along the supply chains it is part of. Within that envelope it would be appropriate for directors to be set a balanced scorecard framework of performance objectives, which include a reflection as to whether they have exercised their director's duties. We would expect all directors to have the same generic set of headings for performance reflecting the different elements of director's duties, but that the specific objectives would be different according to sectors and the particular company.

A key element would be transparency about how the remuneration package has been set, and the principles of how a director's performance will be evaluated. We recognise that there may be a need for confidentiality in relation to how a director is assessed on specific elements of their performance. For example at a year end a director may be part way through sensitive activities or process which can't be disclosed until completed. It is for this reason that we would welcome disclosure on the principles and weightings of how a director's remuneration will be assessed.

10. Should companies be encouraged to defer a larger proportion of pay over more than three years?

The government needs to balance different factors.

- There is a need for companies to make decisions that factor in longer term outcomes, particularly in relation to the environment, and in relation to a stable trading system.



- Companies making short term gains from volatility in currency and commodity markets undermine the ability for trade to be undertaken in a manner that benefits all contributors to a supply chain. We would welcome the directors of these companies to more visibly fulfil the director's duty to consider the long term impacts of their decisions.
- Pension funds, as significant investors in companies also want to see companies perform well in the long term.
- However the longer the pay is deferred the higher the possibility for conditional and future remuneration to be unclear. We welcome the BIS' narrative reporting consultation seeking to find a way to compare actual as well as conditional and future pay. Once a meaningful comparable way of comparing pay has been developed our concern about deferred pay reduces.
- Remuneration packages for deferred pay will need to walk a careful line in relation to allowances made for external circumstances. On the one hand a company is subject to external factors, such as a recession, which will change the nature of what a company is able to achieve. On the other hand when exceptions and "get-out" clauses are incorporated in performance assessment, these will water down the effectiveness of the performance process as a whole.

On balance we consider three years to be an appropriate time horizon.

11. Should companies be encouraged to reduce the frequency with which long-term incentive plans and other elements of remuneration are reviewed? What would be the benefits and challenges of doing this?

It will be difficult to prescribe the frequency of how often remuneration packages are reviewed.

Whilst it would be simpler if they were not changed so frequently, companies may feel the need to update them to keep a current director from moving to a more lucrative job.

This question raises the issue of how to influence the culture that exists amongst some directors around the pursuit of and validity of very high remuneration packages.

12. Would radically simpler models of remuneration which rely on a directors' level of share ownership to incentivise them to boost share value, more effectively align directors with the interests of shareholders?

Possibly, but that is not the only objective: shareholders are only one stakeholder of a company.

The government should anyway be cautious. Lessons from the collapse of Enron indicate that the method needs to be carefully thought through to ensure that directors are not incentivised to stimulate unstable share price rises. The price at which share options can be exercised needs to include a criterion for assessing the stability of a particular valuation.

13. Are there other ways in which remuneration - including bonuses, LTIPs, share options and pensions – could be simplified?

The simplest way would be for the basic salary to provide the bulk of a person's remuneration, with only a small percentage being paid on top only for *exceptional* performance. This is the system that Traidcraft itself operates.