

Title: Improved Transparency of Executive Remuneration Reporting IA No: BIS0355 Lead department or agency: BIS Other departments or agencies: FSA	Impact Assessment (IA)		
	Date: 29/05/2013		
	Stage: Final stage.		
	Source of intervention: Domestic		
	Type of measure: Secondary legislation		
Contact for enquiries: Nicole Roberts x6431			

Summary: Intervention and Options	RPC Opinion: RPC Opinion Status
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Cost of Preferred (or more likely) Option			
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Measure qualifies as One-Out?
-51.2m	-51.2m	5.2m	Yes IN

What is the problem under consideration? Why is government intervention necessary?

Over the last decade, director remuneration in the UK's largest listed companies has increased rapidly with little evidence that this is a result of improved performance. Pay policies which fail to align the incentives of directors with shareholders due to information asymmetries are economically costly through diminished shareholder returns, weakened corporate governance and constitute a market failure. The problem being considered is how to improve the informative content of company reporting on directors' remuneration in order to enable shareholders, as the owners of companies, to engage effectively in the pay-setting process, save time and engage more effectively on other aspects of the business. The current regulatory regime has failed to secure adequate reporting standards and not kept pace with developments in remuneration policy, justifying a refresh of the regulations.

What are the policy objectives and the intended effects?

The policy objective is to address failures in the governance of directors' pay through targeted reforms of remuneration reporting requirements which will provide shareholders with the clear, high quality and consistent information they need to make effective investment decisions and will lead to better aligned incentives. Shareholder empowerment lies at the heart of the UK's corporate governance framework and the proposed reforms are consistent with that approach. Access to clearer remuneration reports places shareholders in a stronger position to challenge unjustified pay policies, which should encourage greater engagement with companies and ultimately steer corporate pay setting behaviour towards an approach that links rewards more closely to performance.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

(1) Revised regulations which set out the key requirements for the pay policy and annual reporting on pay. Focused primarily on improving disclosure on the link between performance and pay, and balanced by use of best practice on wider pay reporting. (*preferred option*)

(2) Slight restructuring of existing reports to align to changes to voting rights made in the Enterprise and Regulatory Reform Act (de minimis approach). This is essentially the do nothing option as some minimal changes are required to facilitate the reforms to shareholder voting.

Option 1 is preferred because it sets out the minimum requirements of the pay policy, and improves disclosure on the relationship between pay and performance by balancing regulation with flexibility and best practice. The proposed approach to pay disclosures ensures a level of consistency between companies and creates room for best practice guidance to develop.

Will the policy be reviewed? It will be reviewed. If applicable, set review date: 2017

Does implementation go beyond minimum EU requirements?	Yes				
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	Micro No	< 20 No	Small No	Medium Yes	Large Yes
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)			Traded:	Non-traded:	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible SELECT SIGNATORY: Jo Swinson Date: 19 June 2013

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2012	PV Base Year 2012	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -101.1	High: -16.2	Best Estimate: -51.2

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	30	0	30
High	105	0	105
Best Estimate	59.5	0	59.5

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

There will be transitional costs during the first year of policy implementation associated with the adjustment to the new style of report. Such costs include both increased internal resource devoted to compliance with the new framework and external professional fees and will vary according to company size and complexity. The policy will apply to approximately 900 UK quoted companies. However, investment companies (which account for 300 of the 900 quoted companies) will face minimal costs as they tend not to have executive directors with complex performance related pay.

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

Ongoing costs would only arise if it were more burdensome for companies to produce the information necessary to comply with the new framework than that required by the current reporting framework. However, based on consultations with stakeholders, we believe that most of the proposed disclosures are based on readily available information. Therefore, ongoing costs are assumed to be negligible, and have not been monetised.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	NA	0.5	3.9
High	NA	1.6	13.8
Best Estimate	NA	1.0	8.3 (quantifiable)

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

Better and clearer disclosure around executive pay will lower the cost of monitoring by shareholders, primarily institutional investors who have the incentive to engage on such issues. Quantified benefits expressed above include time saving to shareholders and NEDs who use the information.

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

Benefits to business and shareholders from more efficient allocation of resources and improved incentives for corporate managers as a result of better aligned executive pay could be significant but are difficult to monetise as they very much depend on the behavioural response of individual companies and shareholders and the benefits of improved engagement. More efficient engagement represents a cost saving for both shareholders and companies and give shareholders more time to focus on issues that have the greatest material impact on shareholder value, such as corporate strategy. Informed engagement provides the setting for improved pay policy design, resulting in a better link to performance which should enhance company performance and boost shareholder returns, and a more efficient allocation of resources. Overall a more engaged and empowered shareholder base could lead to better corporate governance in UK companies which is associated with lower costs of capital.

Key assumptions/sensitivities/risks

Discount rate (%) 3.5

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

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:	In scope of OIOO?	Measure qualifies as
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Costs: 6.0	Benefits: 0.8	Net: -5.2	Yes	IN
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Evidence Base (for summary sheets)

This proposal fulfils a Coalition commitment to removing obstacles to growth whilst ensuring responsible corporate behaviour. The UK is widely seen as a leader on corporate governance¹ and this is important for making the UK an attractive place to invest and do business.

Executive Summary

This IA sets out the argument and evidence to support the government's preferred option for improving the UK remuneration reporting regime with respect to executive remuneration in quoted companies. This follows further formal and informal consultation with stakeholders after the consultation stage IA.

Following feedback from the RPC and others the IA now includes a more detailed discussion of the likely behavioural impacts following the implementation of the preferred policy option and a further explanation of the issues around measuring such likely benefits in advance of policy implementation. It also however includes some estimates of cost savings by shareholders and companies from the simplification.

The IA concludes that the transition costs for the 900 UK quoted companies within scope are likely to be significantly outweighed by the potential improvements in company performance that can result from better aligned executive remuneration due to better information, based on the fact that, for the FTSE100 alone, the market capitalisation would need to increase annually by only 0.0003%, or operating profit by only 0.003% to exceed the costs. Quantified benefits are in terms of the cost savings to shareholders and directors from the better information. Unquantified benefits include more effective use of Board time, increasing shareholder return, remuneration decisions that better link pay to performance, reputation and deterrence, and deterring frequent changes to the pay policy. However, based just upon the quantifiable cost and benefit information, for OITO purposes we present the policy as a net cost 'IN'.

Quantified Impact Summary Table

	One-off impacts	Annual impacts	Present Value over 10 years	Total Present Value	Impacts on business (pa) (EANCB)
Benefits - Quantified					
<ul style="list-style-type: none"> Shareholder cost saving Director cost saving 	£0 £0	£760k £213k	£6.5m £1.8m	£8.3m	£0.8m
Costs					
<ul style="list-style-type: none"> One-off transitional costs 	-£59.5m	£0	-£59.5m	-£59.5m	-£6.0m
Net Impacts				-£51.2m	-£5.2m

¹ See for example Governance Metrics International country ratings www.gmiratings.com

I. Problem under consideration

Background

1. The case for regulation of directors' remuneration arises because of a well established market failure at the heart of the corporate governance regime. Classic agency theory suggests a relationship where the owners of companies (shareholders) delegate management of the company to their agents (directors). This separation of ownership from control leads to information asymmetries² and leaves room for directors to act in their own self-interest to the detriment of the owner. Within the classic principal-agent theory³ literature, directors' pay is a key mechanism for helping to minimise agency costs in order to align the incentives of managers with the interest of shareholders. It follows that where shareholders do not maintain control over directors' pay there is a strong theoretical likelihood that directors will exhibit rent-seeking behaviour or pursue a strategy which rewards them personally but does not contribute to the long term value of the company⁴.

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

Current regulatory framework for directors' pay

3. The regulatory framework in the UK aims at addressing the potential information gap between directors and shareholders as well as giving shareholders the tools to maintain control over pay. The last major change to the regulatory framework surrounding directors' pay came into effect in 2003. In line with the traditional model of UK corporate governance, the regulatory framework is complemented by market rules⁵, 'comply or explain' guidance in the UK Corporate Governance Code⁶ and good practice principles issued by investors.⁷

4. Specifically, all quoted companies (i.e. those incorporated in the UK and listed on a main stock exchange in the UK, US or an EEA state – currently around 900 companies) are required by the Companies Act 2006⁸ to produce a Directors' Remuneration Report (DRR) as part of the annual reporting cycle. The contents of the report are prescribed by regulations⁹ and it must contain details of:

- The company's policy on remuneration
- Salary, bonus and share-based compensation of each individual director
- Pension arrangements

² Where managers are better informed about their levels of effort and its impact on company performance than shareholders.

³ Theory explaining how principals and agents interact and in particular how principals ensure that agents (in this case corporate managers) act in the interests of shareholders in a situation where managers always have more and better information.

⁴ Rent-seeking behaviour is any action which leads to rewards or returns which are not justified or earned.

⁵ UK Listing Rules www.fsa.gov.uk/pubs/other/listing_rules.pdf

⁶ UK Corporate Governance Code

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

⁷ For example, Association of British Insurers' Principles of Remuneration 2011 www.ivis.co.uk/ExecutiveRemuneration.aspx

⁸ Sections 420-422, 439 Companies Act 2006

⁹ Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 8.

- Performance conditions for any share-based schemes
- Policy on notice periods and termination payments

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

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

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

The growth in directors' pay

8. Well-structured directors' remuneration, which is clearly linked to the strategic objectives of a company, can promote business stability and growth. However, over the last decade, directors' pay in quoted companies has increased substantially whilst overall company performance has been poor and thus the link between remuneration and company performance has been hard to discern. Academic research has pointed out that the design of directors' pay can itself be subject to substantial managerial influence.¹⁰ Consequently, the intended relationship between pay and performance can break down if the design of pay packages is more reflective of managerial rent-seeking than the establishment of efficient incentives which lead management to maximise shareholder value.¹¹

9. Various academics have studied the link between directors' pay and long term company performance. Main and Smith (2011)¹² found little evidence of a correlation between pay and performance in the UK, with executives presiding over a destruction of shareholder value receiving almost as much as value creators.¹³ Furthermore, the sensitivity of pay to performance is higher for value creators than for value destroyers. This is consistent with the findings of

¹⁰ Bebchuk, Lucian Arye and Jesse M. Fried (2003), "Executive Compensation as an Agency Problem", *Journal of Economic Perspectives*, 17(3), pp. 71-92.

¹¹ A number of authors have noted that certain aspects of pay design are more reflective of managerial rent-seeking than efficient incentive design:

Blanchard, Olivier Jean, Florencio Lopez-de-Silanes and Andrei Shleifer (1994), "What do Firms do with Cash Windfalls?", *Journal of Financial Economics*, 36(3), pp. 337-60.

Yermack, David (1997), "Good Timing: CEO Stock Option Awards and Company News Announcements", *Journal of Finance*, June, 52, pp. 449-76.

Bertrand, Marianne and Sendhil Mullainathan (2001), "Are CEOs rewarded for luck? The Ones Without Principals Are", *Quarterly Journal of Economics*, August, 116(3), pp. 901-32.

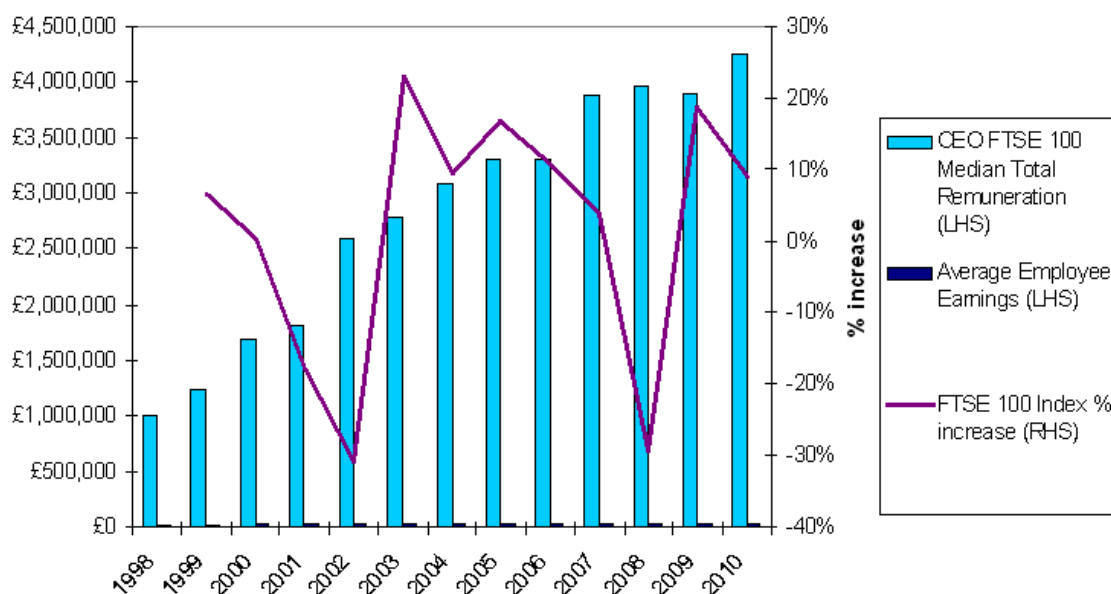
¹² University of Edinburgh Business School submission to the Kay Review.

¹³ The upper quartile of value destroyers in their sample received £2.4m versus the median value creating executive's total of £2.1m.

Gregg et al. (2010)¹⁴ and van Reenan (2011)¹⁵ who also document an asymmetric relationship between pay and performance in the UK. Over time, a relatively weak downward sensitivity of pay can lead to a “ratchet effect”, with pay increasing during high performance periods but not falling when performance is low.

10. The average total remuneration of FTSE100 CEOs has risen from an average of £1m to £4.2m (13.6% a year) for the period 1998-2010. This represents over a four fold increase.¹⁶ This is faster than the increase in the FTSE100 index, retail prices or average remuneration levels across all employees which have risen 4.7% p.a. for the same period. By comparison to the growth in pay for executive directors, employees have seen much slower growth in earnings.¹⁷ (See figure 1 below)

Figure 1: Comparison of FTSE100 CEO average total remuneration, average employee earnings and FTSE100 performance 1998-2010¹⁸



11. Executive remuneration in FTSE250 companies has also risen fast, albeit at a slower rate, while growth in average CEO salaries in Small Cap and AIM companies has been more modest.¹⁹

12. Research looking at the reasons for the growth in pay has reached different conclusions, with many studies pointing to the difficulty of identifying causal effects. As a result, no single, clear reason has emerged and the trend is most likely to be a combination of factors.²⁰ In a BIS discussion paper²¹ issued in September last year, we explored these issues further.

¹⁴ Gregg, Paul, Sarah Jewell and Ian Tonks (2010), Executive Pay and Performance in the UK, LSE. Available at http://www2.lse.ac.uk/fmg/workingPapers/discussionPapers/DP657_2010_ExecutivePayandPerformanceintheUK.pdf.

¹⁵ Brian Bell and John van Reenan (2011), Firm Performance and Wages: Evidence from Across the Corporate Hierarchy, LSE. Available at http://cep.lse.ac.uk/conference_papers/04_11_2011/BellVReenan_FirmPerformanceandWages.pdf.

¹⁶ This figure includes salary, bonus, deferred bonus, other benefits, long-term incentives, share options and pensions. Taken from: Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, May 2011. Available at: <http://blog.manifest.co.uk>

¹⁷ We are well aware of the issues involved in looking at the average instead of the median when the distribution is skewed, but have chosen to use mean figures for data availability reasons. Furthermore, the picture does not materially change when the median is used. According to IDS data, median executive pay has tripled over a similar time horizon, which clearly represents a significant upward trend.

¹⁸ Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, May 2011. Available at: <http://blog.manifest.co.uk>

¹⁹ Hutton Review of Fair Pay in the public sector, Interim Report, December 2010. Available at: http://www.hm-treasury.gov.uk/d/hutton_interim_report.pdf

²⁰ Frydman, C & Jenter, D., CEO Compensation, Rock Center for Corporate Governance at Stanford, November 2010. University Working Paper No. 77

²¹ <http://www.bis.gov.uk/assets/biscore/business-law/docs/e/11-1287-executive-remuneration-discussion-paper.pdf>

The structure of remuneration

13. The structure of remuneration has changed significantly over the past two decades as, in an attempt to address the principal–agent problem, most companies now pay a much larger proportion of remuneration in the form of variable and deferred pay based on more complex models that attempt to link pay to performance.²² Most senior executive pay packages contain the following elements:

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

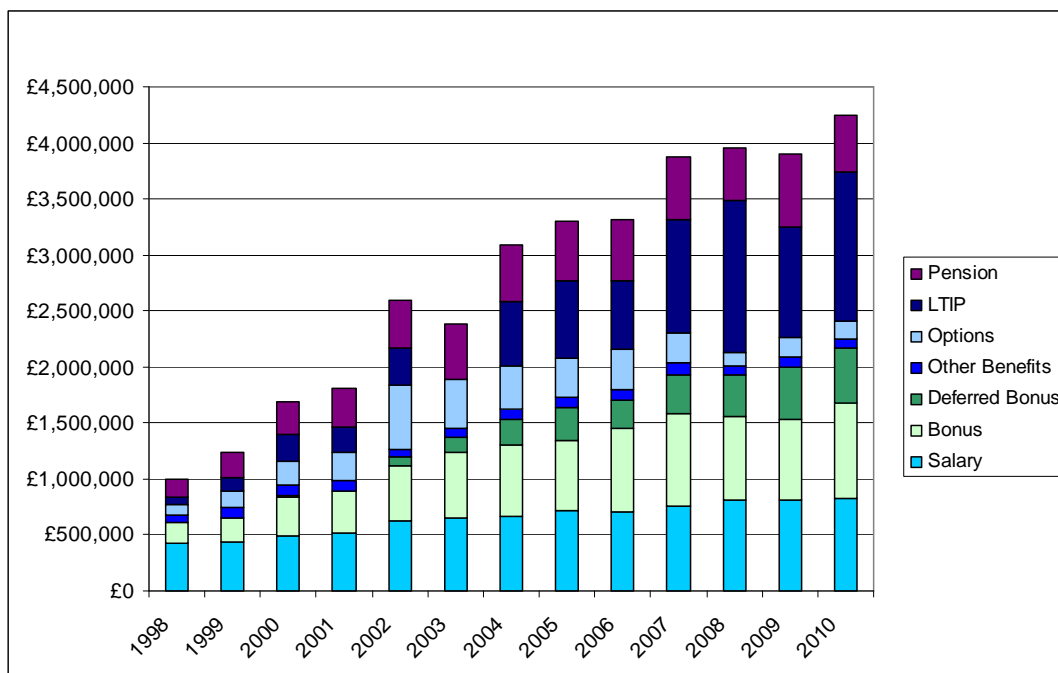
14. Figure 2 shows how the composition of average CEO remuneration in FTSE100 companies has changed since 1998. In 1998, base salary made up over 40% of total remuneration for FTSE100 CEOs; by 2010 it accounted for less than 20%, with the remainder made up of a combination of bonus, long-term incentive plans (LTIPs), share options and pensions.²³

Figure 2: FTSE 100 CEO average total remuneration composition 1998-2010²⁴

²² See, for example, the following PwC review which stresses the importance of performance-related pay in accounting for the overall increase in remuneration; http://www.pwc.co.uk/en_UK/uk/assets/pdf/executive-compensation-review-of-the-year-2009-pwc.pdf.

²³ The Manifest/MM&K Executive Director, Total Remuneration Survey, May 2011 Edition. Available at: <http://blog.manifest.co.uk>

²⁴ Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, March 2011. Available at: <http://blog.manifest.co.uk>



15. Many researchers have argued that the move towards more complex remuneration structures has actually driven increases in overall remuneration because executives expect higher pay in reward for higher risk - in other words, the value of deferred pay may be discounted because of the possibility it will not be paid.²⁵ Our discussions with stakeholders also suggest that the complex structure of pay makes it harder to disentangle what executives are actually earning and for shareholders to judge whether this is appropriate.

Quality and complexity of reporting on pay

16. In the light of these developments in executive pay structure, the reporting of pay policy has, if anything, become more important. There have been various private sector²⁶ and regulator reviews²⁷ of the quality of UK companies' narrative reporting/business reviews (covering mainly quoted companies) over the last ten years. In general these reviews have found that the quality of narrative reporting is improving but that there is still considerable variation and room for improvement between the best and worst performers. There are also concerns with the increasing length and complexity of company reports.²⁸ That is why BIS has recently consulted on changes to the regime for company narrative reporting, including pay reporting.²⁹ It has emerged from these consultations that the disclosure of information on executive pay, and in particular its relationship with performance, is a key concern for users of reports and is an area which can be significantly improved upon.

17. Given the nature of the principal-agent problem in relation to pay, there is a particular concern amongst stakeholders that a substantial lack of transparency surrounding executive

²⁵ PwC, If executive pay is broken, making it more complex is not the answer: The psychology of incentives, March 2011, Available at: <http://www.pwc.co.uk/eng/publications/if-executive-pay-is-broken-making-it-more-complex-is-not-the-answer.html>

²⁶ For example, "Swimming in Words" Deloitte survey of narrative reporting in annual reports (October 2010) and "A Snapshot of FTSE 350 reporting" PWC (2009).

²⁷ Financial Reporting Council (FRC) reports "Louder than Words" (2009) "Cutting Clutter" (April 2011).

²⁸ The average length of reports increased from 44 pages in 1996 to over 100 pages by 2010. See BIS consultation available at <http://www.bis.gov.uk/assets/biscore/business-law/docs/s/10-1318-summary-of-responses-future-narrative-reporting-consultation.pdf>.

²⁹ <http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation> and <http://www.bis.gov.uk/Consultations/the-future-of-narrative-reporting-a-consultation>

pay results in asymmetry of information and moral hazard³⁰. Shareholders have told us that it can be difficult to identify the main facts and figures amidst a raft of other detailed information in the current Directors' Remuneration Report. This makes it time consuming to assess remuneration and to make comparisons across companies.

18. It is clear that regulations in this area have not kept up with developments in market practice. Despite companies already being required to give very full disclosure of remuneration under the Directors' Remuneration Regulations, companies do not give a clear figure for total remuneration for each individual director nor do they seem to provide a clear line of sight between levels and structure of remuneration and directors' performance in meeting the company's strategic objectives. Research has also highlighted that in some areas the Regulations themselves add to some of this complexity as it can be difficult to understand and that clarification of what is expected could improve compliance in these areas.³¹

19. This view is supported by recent research looking at the remuneration reports of FTSE150 companies, which found that only around a third clearly disclosed how remuneration is dependent on performance³² and by feedback to our earlier consultation on company reporting:

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

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

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

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

21. This is supported by academic evidence. For example, Ferrani and Moloney (2005)³³ find that "[d]isclosure requirements prompt the board to justify pay choices and the pay-setting process, and can also enhance the accountability and visibility of the remuneration committee" whilst also encouraging shareholders, particularly institutional shareholders, to play a more activist role. The authors also note that since "setting executive pay is a complex process, opaque disclosure will not generate effective shareholder oversight. In particular, aggregate

³⁰ Moral **hazard** is a situation where there is a tendency for managers to take undue risks because the performance costs are borne by shareholders. This situation often arises because information asymmetries mean it is difficult for shareholders to judge the performance of their managers and the decisions they make.

³¹ Deloitte, Report on the impact of the Directors' Remuneration Report Regulations, 2004.

³² PwC, Insight or fatigue? FTSE350 reporting, 2010. Available at: http://www.pwcwebcast.co.uk/cr_ftse350.pdf

³³ Ferrarini, Guido and Niamh Moloney (2005), Executive Remuneration in the EU: The Context for Reform, Law Working Paper No. 32/2005, European Corporate Governance Institute. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=715862.

disclosure concerning total firm executive pay which does not explain remuneration policy and the often highly complex performance conditions applicable [...] will not allow shareholders to assess pay policy effectively“.

II. Rationale for intervention

22. In response to a series of consultations on this and related issues, and in our discussions with them, business leaders, business representatives, investors and leading academics now agree that there is a problem of rising executive pay which is not linked to performance. For example, a survey³⁴ of 20 UK-based institutional investors in late 2011 found strong support amongst interviewees for the notion that executive remuneration is disproportionately high relative to performance. When asked whether executive pay has "become disproportionate to company profits and should [...] be reduced when the performance of the business does not meet expectations", 16 out of 17 respondents said "yes" whilst 1 said that the issue required a case-by-case approach. Key stakeholders have also made their views known:

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

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

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

23. While this is primarily an issue for companies and their shareholders, there is a consensus that - given the existence of a well-established market failure in this area³⁵ - Government has a role to play in increasing transparency and improving leverage for shareholders on pay matters. As such, the Prime Minister and Business Secretary have committed to doing more to empower shareholders.

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

- (i) Greater transparency on pay reports to provide clearer information that is easier to understand. This will include splitting the report in two parts:
 - proposed future pay policy, potential payouts, and factors taken into account when setting policy
 - how policy has been implemented in the previous year, actual payouts relative to performance
- (ii) Empowering shareholders with stronger voting rights. Reforms to implement a binding vote on future pay policy; an advisory vote on implementation of pay policy; and a binding vote

³⁴ [Corporate Governance Survey, The Share Centre, Nov 2011, prepared by Richard Davies Investor Relations Limited.](#)

³⁵ See Jensen, Michael and Meckling, William, (1976) "Theory of the Firm: Managerial Behaviour, agency costs, and ownership structures", *Journal of Financial Economics* vol 3, 305-360 and La Porta, R., Lopez-de-Silanes, F., Shleifer, A and Vishny, R., (2000) "Investor Protection and Corporate Governance" *Journal of Financial Economics* vol 58 pp 3-27.

on termination payments are currently being taken forward through the Enterprise and Regulatory Reform Bill.

- (iii) Changes to the Corporate Governance Code to increase the diversity and independence of Boards and Remuneration Committees
- (iv) Investor and business best practice on the setting and oversight of pay

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

26. The evidence provided above shows that many of these problems are most acute in the very largest companies -particularly FTSE 100 - although practice in the FTSE250 tends to follow suit. However, we propose that these measures should apply to all quoted companies, as is the case for the current regime. The term 'quoted company' is a recognised term in company law. Distinguishing between sub-sets of quoted companies according to their market listing or any arbitrary size threshold would be legally challenging as the FTSE classifications are updated several times a year.

Policy objectives

27. Together, we believe that these legislative and non-legislative proposals will give shareholders real leverage on executive pay. Shareholder empowerment lies at the heart of the UK's corporate governance framework and these reforms are consistent with that approach. Enhancing transparency on executive remuneration will give shareholders the information they need to hold companies to account. Companies will be encouraged to be proactive in designing pay policy which is acceptable to shareholders and to respond appropriately to shareholder challenges to executive pay.

28. The pay reporting proposals are designed to facilitate this greater engagement by giving shareholders better information. They need to be understood in the context of the Government's wider proposals for reform of the shareholder voting regime on pay. A successful outcome for the reform of executive pay reporting would be a greater level of engagement between companies and shareholders, improved clarity of pay reporting, increased satisfaction with pay packages and an improved link between pay and performance.

29. We will measure this through levels of shareholder voting on remuneration reports and by testing stakeholder views as well as by monitoring the quality of remuneration reports³⁶ and the relationship between pay and performance. There is no prior assumption that these measures will directly reduce the overall quantum of executive pay, although a result of a stronger link between pay and performance could be that average pay levels fall or cease to rise as quickly as they have in the last decade.

Coverage of this Impact Assessment

30. This impact assessment covers the first part of the package outlined above, **greater transparency on pay reports.**

³⁶ This will be for the most part be indirect monitoring through existing reviews of company reports by the Accounting Standards Board and consultancies such as Deloittes and Black Sun who provide annual reviews for the major FTSE companies.

31. Changes to shareholder voting rights were subject to a final stage IA: BIS 0341 (Shareholder votes on directors remuneration). Changes to the Corporate Governance Code are the responsibility of the Financial Reporting Council who will be consulting formally later this year. The other crucial elements of the package are non-regulatory, including industry led guidance that is currently being developed.

32. The proposals within this IA were previously considered as part of a wider package of proposals with respect to companies' narrative reporting (BIS 0284 published in September 2011).

33. A further consultation on the detail of the regulations took place in Summer 2012, which was published alongside a consultation stage IA (BIS0355).

Scope of the policy

34. This policy applies to all quoted companies (i.e. those incorporated in the UK and listed on a main stock exchange in the UK, US or an EEA state). It does not apply to small and micro businesses and the Small and Micro Business Assessment is not applicable.

III. Description of Options considered (including de minimis):

Option 1 (Preferred option): Revised regulations set the key requirements for reporting on pay, focused primarily on improving disclosure on the link between performance and pay. This will be balanced by use of best practice on wider pay reporting which allows companies flexibility to report in the most relevant form for them, and investors to influence the level of detail.

Full statement of future policy only required when there is a binding vote (at minimum every 3 years);

35. Companies are currently required to submit a full remuneration report every year. Under this option, that report would be split into two parts: future pay policy and how the policy was implemented in year. Companies would only be required to report on the future policy in years when shareholders are required to vote on that policy – see separate IA [BIS 0341] for details. In other years there would be no mandatory requirement to report on pay policy. Companies would still be required to report on how the policy was implemented on an annual basis.

36. The regulations would require companies to set out clear and transparent information on the link between pay and the performance of the company, and present key information on actual pay in a single figure to improve clarity. Companies would specifically be required to set out:

Future Policy (at minimum every 3 years)

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

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

c) Policy on exit payments and recruitment.

d) Material factors that the Remuneration Committee has taken into account when considering the appropriate level of executive remuneration, including: whether or not employees have been consulted, comparison between directors and wider workforce pay and shareholder views.

Implementation of the policy (annual)

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

b) Detail on the level of variable pay and the extent to which performance targets have been met

c) Exit payments that have been made.

d) Comparison of overall company performance and pay, relative spend on pay in relation to key performance indicators and increase in directors pay in comparison to the wider workforce.

e) Implementation of the pay policy in the current financial year

37. Under this option we have sought to balance these additions by simplifying some of the current disclosure requirements that do not directly relate to the link between pay and performance.

38. The regulations also represent a minimum standard, so companies would have the flexibility to report on these issues if they felt it was relevant or if requested by their shareholders and we would expect best practice guidance to develop over time.

39. Although this option increases the types of disclosure required about the link between pay and performance beyond what is already mandated in the current regulations, some companies are already exemplars in terms of presenting additional information to shareholders in an understandable and accessible format. A number of others are acting as 'early adopters' one or two elements of this package (which is possible within the requirements of existing legislation), including the single figure for total remuneration, arguably demonstrating that it is possible to report some of these elements without significant additional burden.

Option 2: De minimis approach

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

41. The de minimus approach was not taken forward on the basis that it would not meet the intended policy aim. Without regulations setting out the content of the pay policy and improvements to the clarity of information in the annual implementation report, there would have been legal uncertainty for companies and investors over what constituted a legally binding pay policy, and the extent to which actual payments were consistent with it. Shareholders would

also have continued to have had limited clarity on actual pay and the link between pay and performance.

IV. Analysis of Options: costs and benefits

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

Scope of the policy

42. These regulations will only apply to those UK companies that choose to list on a public market and qualify as “quoted” under the company law regime. There are currently approximately 900 such companies (600 excluding investment companies). In particular, these measures are likely to impact most on the very largest UK quoted companies where issues relating to remuneration reporting are currently causing most concern. These companies generally already devote significant resources to corporate governance activities (including reporting) and we do not expect these measures to add significantly to that cost on an ongoing basis.

43. The extent to which benefits occur will depend largely on the behaviour of individual shareholders and companies and rely to some extent on a cultural shift taking place. This cannot be achieved through legislation alone, and the Government is working with investors and business on promoting guidance, best practice and other non-legislative measures alongside legislative reform. In the discussion of the costs and benefits which follows, and in the later analysis of the risks and assumptions, we have offered a description of the intended behavioural shift.

Benefits

44. The analysis of benefits presented below is based on extensive discussion with stakeholders and the responses to the Department’s consultations, but it is impossible to predict with certainty how behaviour will actually change. External factors such as the volatile economic climate, changing nature of activism (“shareholder spring”), changing shareholder base, domestic and international regulatory developments and landmark case studies³⁷ will all shape how behaviour in this area evolves and thus it is difficult to determine the direct contribution of the proposed policy to engagement and hence company performance.

Benefits of more effective use of board time

45. We believe that one of the central benefits of this policy will be more time spent by corporate boards on business critical issues rather than discussion of the finer points of executive remuneration. However the quantification of these more macroeconomic benefits of the policy (associated with reduced opportunity costs of board time) is extremely difficult and we therefore present below a simple comparison of the scale of company performance against the costs of the policy. This is presented as a hypothetical indication of scale but is not considered as part of the calculation for OITO.

46. Taking, just the FTSE 100, which are a subset of the 900 quoted companies in scope of the policy proposals, we consider to what extent total company value would need to rise (all

³⁷ For example, the 51% vote against the directors’ remuneration report at GSK in 2003 was a landmark case in demonstrating the potential impact shareholders could have by using their voting powers.

other things being equal) in order to identify the “tipping point” between costs and benefits. The total market capitalisation (current total value of all shares tradable) of the FTSE 100 is £1.7 trillion. In order for the benefits associated with increased company performance through the better allocation of management time to match the estimated costs of £6m in equivalent annual terms (see cost section below), the market capitalisation of the FTSE 100 alone would need to increase annually by only 0.0003%, or operating profit by only 0.003%³⁸

Increasing shareholder return

47. A key benefit sought from these proposals is greater shareholder engagement, which combined with the reforms to voting, set out in IA 0341, will put pressure on companies to be more open and transparent with shareholders with respect to setting directors pay and its link to the longer term value of the company. Shareholders have told us that remuneration reports are often complex and opaque, so providing information that is more in line with what shareholders find useful, and is presented in a clearer and more consistent manner, should enable them to take a more targeted approach to holding companies to account. It is therefore expected that these policy measures should allow shareholders to restrain excessive increases in pay more effectively, leading to the potential benefits of a closer link and hence aligned incentives between pay and long term sustainable company performance, and not incentivising behaviour that leads to short term personal gain.

48. By tackling problems of transparency it is safe to assume that there are benefits associated with the policy in question. Divided amongst shareholders this direct benefit is likely to be small but it is the link to performance that will have the greatest impact on shareholder returns through increases in growth.

Remuneration decisions

49. The requirement to disclose total remuneration levels more clearly, as well as the relative performance levels, will give remuneration committees greater power to challenge unacceptable pay levels or weak performance criteria as there will be a greater need to justify their decision making. Information on the factors that the remuneration committee has taken into account when developing the pay policy, will both ensure that the committee takes these factors into account as well as helping shareholders to determine how robust the committee has been in setting executive pay, and therefore to hold them to account through both the annual vote on pay and the annual re-election of directors.

Reputation and deterrence

50. Other potential benefits of better reporting on executive pay include raising the reputation of institutional investors by signalling or publicising the results of their activism and generating greater deterrence effects amongst those companies who might otherwise engage in rent-seeking activities. Also, shareholders may better consider appropriate levels of pay given the performance of the company in which they invest. This could place more pressure upon executives to improve their performance. The benefits described above are intangible and thus difficult to estimate. In addition such intangible benefits are extremely difficult to separate from other exogenous factors that will affect institutional investor reputation and executive performance.

Deterring frequent changes

51. Requiring companies to report on their pay policy only in years when shareholders are required to vote on it will provide savings to companies in preparing their remuneration reports for shareholders. It is intended to act as a “nudge” to companies not to change policy so regularly and take a longer term view to pay. In addition to the wider benefits of a longer term

³⁸ BIS estimates based upon data from the FAME database

approach to pay, anecdotal evidence suggests that investors currently spend a large amount of their time discussing proposed changes to pay.

Shareholder cost savings

52. Better disclosure around directors’ pay will lower the search costs associated with monitoring by shareholders, by providing for better, simpler and more consistent reporting. This is particularly true in a world of increased information where there is value not only in improving the quality of information but also in ensuring that it is presented in a clear and comparable form. Again, this benefit is difficult to quantify given the varied nature of shareholder investment styles and thus the extent to which they look at executive pay in detail. However, based on available data and consultation responses it is possible to give a flavour of the potential savings.

53. There are a large number of shareholders across the 600 companies in question (900 less 300 investment companies) and the FAME database makes it possible to identify some 36,000 shareholders, the majority of which are institutional investors and nominees acting on the behalf of others. It is therefore safe to assume that this is the minimum population of shareholders that are likely to benefit from time savings associated with improved/simplified transparency of executive pay. We also assume that at an average hourly wage rate for ‘financial institution managers and directors’ of £31.55 per hour (taken from the Annual Survey of Hours and Earnings). If each of these institutional shareholders had two corporate governance employees look at remuneration reports (an assumption informed by our engagement with stakeholders) and they saved 10, 20 or 30 minutes then benefits of £370k - 1.1m per annum would be accrued. This sensitivity analysis is summarised in Table 1 below:

Table 1 - Shareholder Time Savings – Sensitivity Analysis:

Time Saving	Total Cost Saving (£)
10 min	380,000
20 min	760,000
30 min	1,130,000

Calculations:

$$\text{Population} \times \text{Hourly Wage} \times \text{Number of Corporate Governance Employees} \times \text{Time Saving (hrs)}$$

$$(36,000) \times (£31.55) \times (2) \times (0.166, 0.33 \text{ or } 0.5 \text{ hrs})$$

Investee cost savings

54. Remuneration Committees may also benefit from a time saving through reduced time spent explaining pay and finding and reviewing items in the report for discussion. Due to the committees familiarity with pay we assume that no more than 10% of time will be saved.

55. Non-Executive Directors (NEDs) are typically paid £70-105k per year for holding board positions and normally meet 4-5 times per year and the committee is typically made up of 4-5 . Assuming that each of these meetings lasts half a day (3.5hrs) then we estimate that benefits of time savings will be within the range of £370k - £550k in total across all 600 companies. We have also conducted sensitivity analysis around the assumption of 10% time saving by NEDs. See table 2 and its calculations below.

Table 2 – Non Executive Director Time Savings – Sensitivity Analysis:

Time Saving	Total Cost Saving (£)
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Low	67,000
Med	213,000
High	473,000

Calculations:

£70-105k / 250 working days = daily rate of £280-420

Assuming a 7hr working day then half day meeting would last 3.5hrs, costing £140-210

Number of meetings x number of NEDs x Half Day Rate x percentage of time saved x number of companies (600).

Low $4 \times 4 \times £140 \times 5\% \times 600 = £67,000$

Med $4.5 \times 4.5 \times ((£140 + £210)/2) \times 10\% \times 600 = £213,000$

High $5 \times 5 \times £210 \times 15\% \times 600 = £473,000$

Issues around estimating the benefits

56. Discussions with stakeholders (both companies and shareholders) have suggested that attempts to try and monetise likely key benefits of more optimal pay by linking it to performance, increased shareholder return through better aligned incentives and the reputation/deterrent effect from these measures are unlikely to be meaningful. The time and effort spent on quality effective engagement on pay issues varies hugely by company and investor and from year to year. It would be difficult for stakeholders to estimate the likely change to such effort as a result of these changes.

57. These more significant economic benefits of the policy will be achieved, in conjunction with other measures, through more effective pay policies. These in turn will create a better link between directors' pay and directors' and company performance leading to a more supportive investment environment, a lower cost of capital than would otherwise be the case, directors incentivised to act in the long-term interests of shareholders (instead of pursuing short term gain), and better relationships between companies and shareholders freeing up time to spend on material issues like strategy, performance and risk.

58. Such benefits are likely to be extremely difficult to isolate and monetise. Furthermore, they will depend to a large extent on the behavioural responses of companies and shareholders to the new reporting framework. In particular, the potential benefits of the policy depend on the willingness of shareholders to act on the higher quality information that will become available to them. Furthermore, the more receptive companies are to engaging with shareholders, the greater the impact of the policy is expected to be. Despite the difficulties in quantifying benefits as outlined above we nevertheless believe the benefits of the policy will exceed the costs as a result of unquantified benefits, including more effective use of Board time, increasing shareholder return, remuneration decisions on linking pay to performance, reputation and deterrence, and deterring frequent changes to the pay policy.

59. On the one hand, enhanced clarity of remuneration reporting provides a basis for greater engagement between companies and shareholders. However, shareholders may be reluctant to engage more actively with companies if they view that it would be disruptive to company management, damaging to external reputation or perhaps if the incentive to engage is mitigated by classic free rider problems which arise in the context of dispersed ownership. Despite these uncertainties regarding the behavioural response of stakeholders, on the basis of the feedback to our consultation, and anecdotal evidence from pre-compliance, it is the Government's belief

that the proposed measures would enhance engagement between shareholders and companies.

Experience of other countries.

60. Other countries have made similar changes to requirements around increasing transparency of executive pay, these include the US, Australia, Switzerland and Japan. Other countries are also likely to make similar changes, including Germany, Spain and France. However, no evidence exists as to the benefits accrued or likely to be accrued at this early stage.

Table 3 - Summary of Quantifiable Benefits (Ongoing):

Estimate	Total Cost Saving (£)
Low	450,000
Best	970,000
High	1,600,000

It is important to note that the majority of benefits will accrue from the potential affects upon corporate growth of investee companies and thus increased returns to shareholders. These benefits can not be quantified. The department will take measures to ensure that these impacts can be qualitatively evaluated during the post implementation review.

Costs

Option 1 (preferred option)

61. The additional reporting costs associated with the proposed changes to reporting of executive remuneration (net of any simplifications we are able to identify) are difficult for companies to estimate in the context of existing reporting requirements. Nevertheless, an attempt was made as part of the June 2012 BIS consultation on revised remuneration reporting regulations to gather the necessary information to make an informed judgement on the likely impact of the policy. The cost estimates presented below are based upon responses received from companies that participated in the consultation exercise. The responses to the initial consultation produced only qualitative information. Most respondents observed that the majority of the costs faced by companies would be during the transitional phase, both in seeking external advice to ensure compliance and in the extra time needed to produce the new report. Whilst some respondents described the potential costs as significant, an equal number stated that costs would not be significant or even cost neutral. In addition, a number of companies are already pre-complying to varying extents, with many providing as much information as possible in the style of the new format. We expect this number to increase as additional companies, who are yet to publish this years annual reports, choose to pre-comply.

62. Due to the lack of available evidence on costs, BIS returned to consultation respondents that provided some form of quantitative estimate in order to obtain more detailed estimates of the likely cost impact of the policy proposals. This information has been used as a basis for the analysis presented below, however it should be noted that this may not be a representative sample of all companies affected by the policy but presents the best possible assessment of likely costs given the shortage of available evidence.

Transition costs

63. Overall, we received several responses which provided quantitative estimates of the cost impact of the policy. We recognise that this is a small number of companies on which to base total cost estimates. However, given that all companies within scope currently have to produce a report to the same prescribed standard and format, all companies will face the same changes, and that the types of activities for which we have been provided with quantitative information reflect the (unquantified) activities reported by other respondents during the consultation phase, we judge that the responses received provide a reasonable basis on which to determine the aggregate impact of the policy³⁹. Therefore, it is our view that the methodology followed for calculating costs, while not representative in a strictly statistical sense, is consistent with the Standard Cost Model and results in a reasonably accurate indication of the cost burden on companies for the purpose of this IA.

64. These responses emphasised the transitional costs associated with adjusting to the new legislation to be incurred during the first year of implementation. Transition costs will include internal resource time spent adjusting to the new format for company reports as well as additional external professional fees in order to ensure that the new reports are fully compliant with the revised reporting framework. It is assumed that such transitional costs are incurred in the first year of the policy.

65. The average value of transition costs submitted to us by companies was approximately £100,000, with a range of point estimates between £50,000 and £175,000. Responses were received from both large FTSE100 companies (four out of seven) as well as privately owned consultancies whose clients include quoted companies (note that this sample is not statistically representative, and we provide a sensitivity analysis below). After reviewing the break down of costs that were provided these significant one-off costs did not seem unreasonable, given the need to provide some disclosures in a prescribed format, and the likely use of consultancy and legal advice.

66. The extent to which adjustment costs are incurred is likely to depend on the size and complexity of preparing the company's current reporting framework. It will also be influenced by the complexity of the actual pay structures and the extent to which companies have already been exceeding current requirements and meeting best practice, and the level to which they have chosen to pre-comply. Although a number of companies have chosen to pre-comply with one or two of the new disclosures in the last few months (in particular by reporting pay in a single figure) companies are still required to comply with the existing legislation and it has not been possible to get any robust data on the costs/benefits of full pre-compliance.

67. It is reasonable to assume that, on average, larger companies will face higher adjustment costs. The large quoted companies which responded to our request for quantitative evidence – four in total, all members of the FTSE 100 – on average estimated that annual transition costs would amount to £145,000, ranging between £130,000 and £175,000.

68. A significant fraction (approximately one third) of the population of 900 UK quoted companies are investment trusts. The boards of such companies - as described by their representative body - are typically comprised solely of non-executive directors who are not issued complicated pay packages consisting of significant amounts of equity based or performance related compensation but are instead paid a flat non-performance related fee. A response to our consultation from an investment companies' representative body explained that, based on a sample of 205 investment companies, non executive directors of investment

³⁹ Note that the cost calculation does not take into account any flexibility within the company around staff absorbing all or part of the extra transitional cost into their existing work pattern

companies receive between £5,000 and £75,000 per year for qualifying services. This is in stark contrast to the complicated remuneration arrangements that are typically associated with large quoted commercial companies. Consequently, the remuneration reports of investment trusts tend to be very simple and brief (internal BIS analysis suggested that these reports are typically 1-2 pages compared to around 20), and these companies will not be required to complete the disclosures in the new reports that are explicitly focussed on variable and performance related pay. Given that the costs associated with adjusting to the new reporting framework are proportional to the complexity of remuneration practices, it is reasonable to assume that investment companies will not experience significant adjustment costs.

69. Given that adjustment costs for investment companies are assumed to be minimal for the reasons mentioned above, such costs have not been monetised for the purposes of this impact assessment.

70. Excluding investment companies, there are approximately 600 quoted UK companies. However, these companies range in size from large FTSE 100 constituents to much smaller quoted companies. As mentioned previously, it is anticipated that adjustment costs are positively related to company size. As a best estimate, it is therefore assumed that the higher end of the range of transition costs described in paragraph 60 applies to the largest 100 UK quoted companies, whereas the remaining 500 quoted companies (excluding investment companies) face lower adjustment costs.⁴⁰

71. In particular, in order not to underestimate total adjustment costs, it is assumed that £50,000 represents the transition cost faced by the smallest firm in the sample. On the other hand, it is likely that the largest firm of the remaining 500 faces a transition cost that is very close to that incurred by the smallest company of the population of larger firms. In the absence of any data on the extent of the relationship between transition costs and company size, it is assumed that transition costs among the 500 smaller quoted companies range between £50,000 and £130,000, distributed in a linear fashion. The average transition cost for the 500 smaller companies is therefore £90,000.

72. It therefore follows that total transition costs are given by

$$\begin{aligned} \text{Total transition costs} &= \text{No. of large companies} \times \text{transition cost per large company} \\ &\quad + \text{No. of smaller companies} \times \text{transition cost per small company} \\ &= (100 \times £145,000) + (500 \times £90,000) = \mathbf{£59.5m} \end{aligned}$$

Sensitivity analysis

73. In order to capture the uncertainty around cost estimates given the small number of consultation responses, a range of estimates is provided based on the variation in the responses that we received. To establish a higher end on transition costs, we assume that costs are independent of firm size and are equal to the upper bound of the estimates that we received (see paragraph 60). It follows that total transition costs equal

$$600 \times £175,000 = \mathbf{£105m}$$

74. In order to obtain a lower bound on transition costs, it is assumed that all companies face the lower bound of the range of transition costs as indicated by the consultation responses (see paragraph 60):

⁴⁰ Whilst it is possible that many of the UK incorporated companies which are listed abroad are large, analysis of the FAME database indicates that there are only 9 large UK quoted companies listed abroad.

$$600 \times £50,000 = \text{£30m}$$

75. The foregoing analysis is summarised in the table below.

Table 4: Summary of cost estimates:

	Transitional Cost (£m)	Description
Best estimate	59.5	Baseline estimate which accounts for company size differentials.
High estimate	105	Assumes all firms face high adjustment costs.
Low estimate	30	Assumes all firms face low adjustment costs.

Ongoing costs

76. Companies already produce remuneration reports and the new regulations are intended to catch up with best practice. Therefore, the ongoing/ recurring costs of the policy will be negligible. This is because much of the additional detailed information (on the various elements of pay awards for example) will be readily available at no or limited additional cost to the company and already forms part of the decision-making process within remuneration committees and is used in putting together the current reports. This proposal is about how that information is presented rather than being about collecting additional information. This view was supported by consultation respondents who either explicitly claimed that ongoing costs would be negligible or the majority of costs would fall in the transition period.

77. The benefit of requiring additional disclosures through the regulations would be that it ensures consistency and therefore comparability between companies. The fact that some companies are acting as ‘early adopters’ of one or two elements of this package, including the single figure for total remuneration, arguably demonstrates that it is possible to report these elements without significant additional burden or preparation time.

78. The emphasis in the responses we received to the revised remuneration reporting consultation was on the transitional costs as companies get used to the new system. For those companies already providing this information as a matter of best practice the additional costs will be further limited. Given that much of the information required under the new reporting regime is already currently available, it is not anticipated that there are likely to be material ongoing costs associated with the policy. The consultation provided very limited quantitative information regarding ongoing costs with a number of respondents suggesting that the policy would minimal cost following adjustment.

79. Taking into consideration the information received during consultation and the fact that significant burdens are not being placed on business to gather additional detailed information, it is assumed that there are no ongoing costs associated with the policy such that the cost impact is transitory and occurs in the first year of implementation.

Option 2 De minimis approach

80. This would represent a **minimal change** from the current position as companies would need only to restructure slightly their existing reports, setting out separately the forward and

backward looking elements of pay policy. This would slightly reduce the transitional costs, as there would be less prescription over the form of reporting beyond the requirement for a separate policy and implementation report. However, it would significantly reduce the benefits relative to the other policy options as it would not lead to increased transparency of either the future pay policy or its implementation, and investors would still find it difficult to compare companies and to get a complete picture.

Summary of Costs and Benefits of Policy Options

81. As set out above, Option 1 would provide the greatest net benefits with increased transparency for shareholders, allowing them to hold companies to account with respect to executive remuneration and improve the pay – performance link. It represents a proportionate and effective approach to the reported problem by focussing the required elements of disclosure on the link between pay and performance.

82. Option 2 would mean that, with the exception of a minor restructuring of the report, the current system of pay reporting would continue which, as set out clearly above, is not meeting the needs of shareholders and, in particular, limits their ability to improve the link between executive remuneration and company performance.

83. We believe that the benefits of this proposal are at least equal to the costs as a result of unquantified benefits, including more effective use of Board time, increasing shareholder return, remuneration decisions on linking pay to performance, reputation and deterrence, and deterring frequent changes to the pay policy. However, based upon quantifiable cost and benefit information, for OITO purposes we present the policy as a net cost 'IN'.

Table 3: Summary of quantifiable costs and benefits across the appraisal period

	One-off impacts	Annual impacts	Present Value over 10 years	Total Present Value	Impacts on business (pa) (EANCB)
Benefits - Quantified					
• Shareholder cost saving	£0	£760k	£6.5m		
• Director cost saving	£0	£213k	£1.8m		
				£8.3m	£0.8m
Costs					
• One-off transitional costs	£59.5m	£0	£59.5m	£59.5m	£6.0m
Net Impacts				£51.2m	£5.2m

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

84. This IA and the associated IAs covering the Shareholder Vote (BIS 0341) and Narrative Reporting (BIS 0284) draw on a significant amount of evidence that has been provided to the department by a wide range of stakeholders including companies, shareholders, remuneration consultants and academics, either as part of a formal or informal written consultations (e.g.

Long Term Focus for Corporate Britain⁴¹ (September 2010), Narrative Reporting consultation⁴² (September 2011), Executive Pay Discussion Paper⁴³ (July 2011), the Kay Review⁴⁴ (September 2011) and the revised remuneration reporting regulations (June 2012), or through more informal stakeholder engagement that has taken place over the last six months. Much of this evidence has been focused on identifying the problems in the setting of executive remuneration and identifying possible measures to improve the current situation.

85. The policy proposals do not introduce requirements for companies to gather significant amounts of new information such that the main costs imposed on business relate to familiarisation issues and are expected to be incurred during the first year of policy implementation. Many quoted companies already report a significant amount of information beyond that required by the regulations making it difficult to identify the impact of regulatory changes on their costs. Bearing this in mind, we have constructed an interval representing the likely cost impact of the policy based upon information received from stakeholders during the consultation process.

86. The main benefits of the policy stem from more efficient allocation of resources and improved incentives for corporate managers as a result of better aligned pay policies. This impact could be significant but is very difficult to monetise because: (i) it depends on the behavioural responses of stakeholders; and (ii) it would be difficult to isolate the impact on company performance that is specifically attributable to improved managerial incentives. For these reasons, it is deemed to be disproportionate to quantify explicitly the full benefits associated with the policy, however efforts have been made to quantify time savings for shareholders and remuneration committees.

Risk and Assumptions

87. Costs in this IA have been estimated on the basis of limited information gathered from a small number of consultation respondents. The resulting calculations are therefore not statistically representative but instead provide a reasonable best estimate of the likely impact of the policy for the reasons discussed earlier.

88. As set out in paragraph 24, the regulatory measures included within this IA represent only one element of the overall package of measures we believe is necessary to enable change in this area. As the Secretary of State for Business made clear to parliament on announcing this package, lasting reform also depends on active shareholders and responsible businesses accepting the need for change and pushing the agenda forward.

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

Direct Costs and Benefits to business calculations including OI2O considerations

90. The preferred option represents a small regulatory tightening on business and therefore constitutes an “in” within the OI2O framework. For the purposes of this IA, it is expected that

⁴¹ <http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain>

⁴² <http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation>

⁴³ <http://www.bis.gov.uk/Consultations/executive-remuneration-discussion-paper>

⁴⁴ <http://www.bis.gov.uk/Consultations/kay-review-call-for-evidence-uk-equity-markets>

costs are transitional and occur in the first year of policy implementation.

91. The immediate benefits of better disclosure will be felt largely by investors and their advisers who analyse companies' remuneration reports. Ultimately, the policy should result in a clearer relationship between directors' pay and directors' and company performance. These benefits are indirect as they are predicated on behaviour change (eg shareholders increased scrutiny and engagement), extremely difficult to quantify, and have not been monetised for the purposes of this impact assessment.

92. However, some cost savings within investee companies and shareholders have been estimated. These small direct cost savings have a best estimate present value of £8.3m over a ten year period. This equates to an equivalent annual benefit of £0.8m for OITO purposes (using the updated BRE calculator).

93. Weighing against these benefits are the direct upfront costs (£59.5m is the best estimate of these). Again annualising this cost via the BRE calculator yields a OITO equivalent annual cost of £6.0m. We thus have an overall net IN of £5.2m for OITO (in 2009 prices).

Wider Impacts

94. We do not believe that there will be any diversity, gender or human rights impacts of these proposals. The proposals apply only to quoted companies so no micro businesses are within scope.

Summary and Preferred option with description of implementation plan

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

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

97. We are bringing forward secondary legislation to come into force in October 2013, and which will have an impact on company reports from late 2013.

Enforcement

98. Enforcement will continue as now through a combination of shareholder oversight and more formal monitoring by the Financial Reporting Council (FRC).

Post Implementation Review

99. The measures put forward in this IA represent only one of part of a much larger package of proposals to tackle issues around executive remuneration, many of which are non-regulatory in nature and require shareholders and companies to change their behaviour. We will be working with stakeholders over the next few years to ensure a smooth implementation of the policy proposals and ensuring in particular that the regulatory elements, including the binding vote are working as intended.

100. As set out above in paragraph 28, we would expect the success of this policy to be reflected in higher levels of shareholder engagement, greater satisfaction with executive remuneration packages and a more discernible link between executive pay and company performance.

101. Satisfaction with executive remuneration reporting in particular will be monitored through investor feedback, results from AGMs, various annual reviews of company pay policy and reporting (which a number of consultancy firms and interest groups routinely provide) and the views of relevant stakeholders.

102. We will review the policy formally in 2017 but will monitor its impact through stakeholder discussions, monitoring of investor voting on executive pay and evidence of an improved link between pay and performance. Investor satisfaction with remuneration packages is likely to be the key indicator of success in the short-term.