Speech: Stewardship and governance

Introduction

I am very grateful to the Investment Association for inviting me to speak to you today, to give a government perspective on stewardship and governance.

This issue is vital to promoting trust in how our major businesses are run, and in how capital is invested on behalf of society.

You will be aware of the corporate governance reforms that the government is implementing following our green paper consultation last year.

I welcome the positive engagement of business and investors with that reform programme. I will come on to the specifics of the policy package in a little while.

But first, I would like to speak about the broader policy context within which this reform sits.

Wider policy context

As set out in the Industrial Strategy, our ambition is to make the UK the best place to start and grow a business, and to remain strongly attractive to investors.

All over the world, standards of governance are advancing, employment practice is changing, and investors are becoming more discerning.

Our objective is not just to sustain our advantages in these fields, but to extend them to ensure we are world beating.

In this way, we will further enhance the UK’s global business reputation, whatever the future holds.

Success will be seen in the reputation companies enjoy with their workforce, with consumers, and with communities.

We should not take this reputation for granted.

As Greg Clark said when he first launched the Industrial Strategy:

> We have a worldwide reputation for fair dealing, but also examples of behaviour that tarnish the good name of business. This is no time to lower our sights or our standards. This country will never win a race to the bottom.

I know that the majority of UK companies and their investors share this view.

Yet, according to [Edelman's latest Global Trust Barometer](), trust in UK business declined from 45% to 43% last year, putting us even further below the current global average of 52%.

So how can we rebuild that trust?

For government, it is about recognising that its approach to the regulation of business, the labour market, competition and other areas is not a zero sum game.

Business success should not depend on a lowering of consumer, employment, competition or governance standards. High regulatory standards should instead be an enabler of business success.

High standards are essential to maintain confidence in capitalism and free markets as a system which serves society, and not the other way round.

And the government's role in this is twofold: it is not just to set and enforce minimum standards of behaviour, but also to encourage and extend best practice.

Our measure of success is not merely the avoidance of failure: it is to have a regime which attracts investment because of the confidence investors can have; which attracts employment because of the rewarding work we provide; and which creates public confidence because of the wider good that our businesses deliver.

We have unfortunately seen several instances of major corporate failure in recent times, both by large quoted and large private companies.

But where there has been culpable incompetence or wrong-doing, it has not gone unpunished. And obligations have been upheld.

In the wake of BHS, regulators fined the audit firm £10 million and the relevant audit partner was banned from any audit work for 15 years.

And £363 million was eventually secured from the former owner of the company to help BHS pensioners.

Setting baseline standards and taking effective enforcement action is vitally important. But, it is not enough.

Government also has an important role to play in signalling what business behaviours it admires as progressive and likely to enhance public confidence and our international reputation.

We strongly embrace the principle that there is not a choice to be made between good governance and competitiveness.

Well governed businesses in the modern era are more sustainable, attract more investment, and in the long term are more competitive.

Government is clear – and there is plenty of research to support this view –

that the best performing companies in the long term have a clear purpose and a strong set of values and beliefs.

Raw pursuit of the bottom line alone is not a sufficient basis for long term success and will not engender public support.

Nor will it win the support of today's employees.

Good work

We need today to adapt our employment practice to a confident younger generation who are more digital, more knowledgeable, more global.

They are looking for workplaces that have values and do good in the world.

Employers who want to attract and retain the best talent available need to offer more.

And the framework of law, regulation and practice which guides interactions between employers and employees needs to move with the times.

So government is taking forward the vast majority of the recommendations in Matthew Taylor's ground-breaking review of modern working practices.

This includes steps to improve transparency for both employees and employers, and introducing a new right for workers to request a more predictable and stable contract.

The success of these and other changes will clearly depend not only on the response of workers but also of the companies that create jobs, and the shareholders who provide the capital to invest in high quality and productive employment.

Most businesses and investors get this and are engaging very positively with the actions that government is taking in response to Taylor.

They recognise that today in Britain we have relatively full employment – one of the great achievements of modern times – and with that choices for employees.

Gone are the days when people turn up for work just to earn a daily crust.

As the UK moves towards an increasingly knowledge-based economy, competitiveness will depend on having engaged and motivated workforces.

Today's employees are looking increasingly for some involvement in their workplace. Not only a sense of purpose, but also that they can play a role in improving the business.

Better information, better communications and opportunity to have a say.

Good leadership

Let me turn now to boards.

In a successful modern economy, great business leadership needs to be valued and respected.

Part of that is ensuring that it is representative of society and reflective of the opportunities a modern Britain can create.

This means diversity.

UK institutional investors are making board representation an increasingly important part of their stewardship activities.

I am grateful in particular to Chris Cummings, the CEO of the Investment Association, for the joint letter he and Sir Philip Hampton sent to a number of FTSE350 companies on this issue earlier in the year.

Although there is room for improvement, encouraging progress has been made:

Women now account for 27% of FTSE350 boards, up from just 9.5% in 2011. We now have just 5 all-male boards across the FTSE350 compared to 152 in 2011. And one third of our top companies – which are mostly very international in their reach – are are run by non-UK nationals.

However, the proportion of female executives on boards is still low – just 8% of the FTSE350 total.

Moreover, as noted by the Parker Review, the lack of representation of ethnic minorities in the boardroom remains a concern: 54% of FTSE100 companies still not do not have any ethnic minorities on their boards.

So overall in corporate leadership we have made encouraging progress, but we are not yet fully representative of wider society; we are not yet world leading.

Markets and competition

Turning to the wider market context, we need to recognise how rapidly consumer markets are changing with the advent of the digital economy.

In many areas, such as retail, we have arguably the most advanced digital economy in the world.

We want to extend that lead.

But with that we need to sustain public confidence and protect vulnerable consumers.

That means we need to adapt competition policy to a new fast-moving, more complex and more demanding era.

We will therefore publish a review of existing competition legislation by April 2019, while looking more broadly at how the UK's competition and consumer regime is working to support consumers and businesses, including in digital markets.

On mergers and acquisitions specifically, earlier this year the Takeover Panel amended its rules to require bidders to make earlier and fuller disclosures of their plans, and give bid targets more time to prepare their response.

This will further enhance the integrity and transparency of our regime, keeping the UK open to foreign direct investment which generated almost 76,000 new jobs last year.

Kingman review of the FRC and CMA market study of audit

New investment also depends on the confidence investors have in what businesses tell them, and the quality of corporate reporting is absolutely integral to a high investment economy.

The UK has historically had a strong reputation for the rigour of our audit profession and very high standards in financial reporting.

However, recent events have raised questions about whether we need to sharpen our standards further.

Creating the best place to invest means having a place where shareholders prefer to invest because they know they get the best information.

This concern for high standards and public and investor confidence is why Greg Clark invited Sir John Kingman in April this year to carry out a root and branch review of the Financial Reporting Council.

It central aim is to ensure that the FRC can stand as "a beacon for the best in governance, transparency and independence."

And the CMA, again following a request from Greg Clark, is separately undertaking a market study of the audit market to ensure that regulation and competition are working hand in hand to deliver high quality audit.

Sir John's review is expected to be complete by the end of the year, and the CMA expects to publish provisional findings on a similar timetable.

Corporate governance reform

This leads me on to corporate governance and stewardship, the themes of today's conference.

You will be aware that the FRC recently revised its UK Corporate Governance Code and will shortly be launching a review of its Stewardship Code.

The updated Governance Code includes several changes requested by Greg Clark in light of the government's consultation on the Corporate Governance Reform green paper.

Perhaps the most significant of these is the new requirement on companies to enable greater board engagement with the workforce to understand their views.

All good businesses already know that this makes sense, and many already do it in practice, and very effectively. Arguably, we are ahead of many other countries.

But the modern workforce is looking for more explicit recognition, and for an opportunity to help shape their company's success.

And it is this workforce which engages daily with the company's customers, suppliers and other stakeholders.

So their attitude, their satisfaction in their work and pride in the business must be vital.

The new Code provision for enhanced engagement complements an important new reporting obligation covering the existing duty on a company's directors – under Section 172 of the Companies Act.

This key section of company law requires directors to pursue the success of the company for the benefit of its shareholders, while also having regard to the interests of employees and other stakeholder interests.

The government has accepted concerns from investors and wider civil society, as well as from the business community, that there is currently no systematic and consistent way of assessing how companies are meeting their Section 172 duty.

So the new regulations we are introducing require companies to report annually how they are engaging with employees and other stakeholders under Section 172, and to set out the impact of this on directors' decision-making.

So that you, the shareholder stewards, will have a clear account of how boardrooms are approaching the issue.

As recognised in the rich range of responses to the green paper from UK investors, this is not about increasing stakeholder rights at the expense of shareholder rights.

Their interests are not diametrically opposed, as we have discussed, but inter-linked.

A company which engages effectively with its employees, its customers, suppliers and other stakeholders will be more competitive, more sustainable and better able to create value in the long-term.

I welcome, in this context, the new GC100 guidance, produced at Greg Clark's request and published recently, which provides practical help to directors on their performance of the section 172 duty.

And also the earlier joint guidance published by the Investment Association and ICSA on ‘The Stakeholder Voice in Board Decision-Making’.

The effect is cumulative. We have the Code changes. We have the new section 172 reporting requirement. We have business and investor led guidance.

And shortly, we will have a set of governance principles for large private companies through the work and leadership of James Wates and his team.

The effect is, for the first time, to lock the importance of real boardroom engagement with stakeholders into the UK’s formal corporate governance architecture.

To bring our business leaders into frequent, productive exchange with their employees, customers, and suppliers, as well as shareholders.

Executive pay reform

Alongside the section 172 measures, our corporate governance reform package introduces new reporting obligations on executive pay.

The headline measure here is the requirement – from next year – for quoted companies to disclose and explain each year the ratio of their CEO’s pay to the median and quartiles of the company’s UK employees.

Ministers have made clear that the intention here is not to prescribe what a ‘good’ or ‘bad’ pay ratio looks like.

But ministers do want pay ratio reporting to drive companies to reflect on, and then explain, how they believe their approach to pay in the board-room aligns with pay and reward across the rest of the company.

And we must acknowledge that executive pay remains an issue of public concern.

It is actually the biggest barrier to UK public trust in business according to Edelman’s latest Trust Barometer, with 58% citing it as a problem.

And with the median FTSE100 CEO earning £4 million last year, compared to £28,000 for the median UK worker, that is perhaps not hard to understand.

I should nonetheless acknowledge the growing role of investors in challenging unjustified pay outcomes.

As part of this, the government was pleased to accept the Investment Association’s proposal to establish a public register of those companies that experience significant shareholder dissent on executive pay or other issues.

The register is now almost a year old and is serving not just as a list of companies that encounter shareholder dissent, but as a platform to highlight any action that a company chooses to take to address shareholder concerns.

I also welcome the publication today of the Investment Association's updated executive remuneration guidance for companies.

This provides more stringent guidance on post-employment holding periods for shares and share options, better clawback provisions for performance pay where there has been dereliction of duty and closer alignment between pension benefits for directors and the wider workforce.

All in all, the government's corporate governance reforms, supported by business- and investor-led action, are intended to help reinforce the UK's world leading approach to governance.

And this in turn provides crucial underpinning for the Industrial Strategy to make this the best country in which to invest and do business.

I set out at the beginning of this speech how public support for a free market economy depends upon ensuring the system is seen to serve society, and not the other way around.

All the policy areas I have referenced today are intended to support this goal.

It means no race to the bottom on employment standards, no dilution of the rigour of our competition regime and no letting up in the UK being a world leader in corporate governance and stewardship, in audit and financial reporting.

The UK must remain a high standards economy. And we must move with the times and reflect the attitudes and aspirations of a changing society in a changing world.

This depends on the vital role that UK investors can and increasingly do play to help maintain those standards.

Good stewards are active stewards. They recognise that a company's long-term success depends on how it articulates its purpose and invests in its culture and values.

On how it engages with and treats its employees, customers, suppliers and local communities.

Where they see that pay ratios are out of line and unjustified, they apply pressure to put things right.

Where they see that employee or stakeholder engagement is inadequate and inconsistent with running a sustainable, long term business, they insist that it is improved.

We see many encouraging signs that this is happening. But we are ambitious for more.

Because we want to be the best.

Thank you very much.