Executive Remuneration Working Group

Final Report

July 2016

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Executive Remuneration Working Group Recommendations

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Non-Executive Directors should serve on the remuneration committee for at least a year before taking over the chairmanship of the committee. The Financial Reporting Council (FRC) should consider reflecting this best practice in the UK Corporate Governance Code.

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Boards should ensure the company chairman and whole board are appropriately engaged in the remuneration setting process. This will ensure that the decisions of the remuneration committee are agreed by the board as a whole.

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Remuneration committees need to exercise independent judgement and not be over reliant on their remuneration consultants particularly during engagements with shareholders. To ensure independent advice is maintained, the remuneration committee should regularly put their remuneration advice out to tender.

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Shareholder engagement should focus on the strategic rationale for remuneration structures and involve both investment and governance perspectives. Shareholders should be clear with companies on their views on and level of support for the proposals.

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Companies should focus their engagement on the material issues for consultation. The consultation process should be aimed at understanding investors' views. Undertaking a process of consultation should not lead to the expectation of investor support.

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Remuneration committees should disclose the process for setting bonus targets and retrospectively disclose the performance range.

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The use of discretion should be clearly disclosed to investors with the remuneration committee articulating the impact the discretion has had on remuneration outcomes. Shareholders will expect committees to take a balanced view on the use of discretion.

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The board should explain why the chosen maximum remuneration level as required under the remuneration policy is appropriate for the company using both external and internal (such as a ratio between the pay of the CEO and median employee) relativities.

RECOMMENDATION 10:
Remuneration committees and consultants should guard against the potential inflationary impact of market data on their remuneration decisions.

Executive Summary

Introduction

The Executive Remuneration Working Group was established by the Investment Association in the Autumn of 2015 as an independent panel to address the concern that executive remuneration has become too complex and is not fulfilling its purpose. The Working Group published its Interim Report in April 2016, and consulted widely throughout May and June 2016 with a wide range of stakeholders before forming its final recommendations which are set out in this Report.

Since the Working Group has been formed, there has been significant focus on executive remuneration, highlighted by the events of the 2016 AGM season. This year, two FTSE 100 companies had their remuneration reports voted down. Other companies received very significant negative votes for a range of issues, including the link between pay and performance and substantial increases to remuneration potential.

In launching her leadership campaign, the new Prime Minister focused on inequality, executive pay, and trust between businesses and society as a whole as key issues to address during her tenure. The Prime Minister raised three particular issues in relation to helping to rebuild trust on executive pay, including: giving shareholders binding rather than advisory votes; improving transparency of bonus targets and pay multiples; and simplification of bonus pay and longer term alignment between the company and shareholders.

Over the last 9 months, the Working Group has focused on providing a market based solution on these last two issues. The Working Group brings together company and shareholder representatives to provide recommendations on how the current structure of remuneration can be simplified to provide better alignment between companies and shareholders. The Working Group has also made a number of recommendations on improving transparency of remuneration. In the Interim Report and during the consultation phase, the Working Group did not consider legislative solutions such as binding votes on remuneration. The Working Group has not had sufficient time to consider all the options for the implementation of a binding vote and the impact such a policy change would have on market practice and the ability of UK companies to attract talent.

Identifying the problem with executive pay

There is growing concern from both companies and investors with the current levels of executive pay and its complexity. Executive pay is opaque to the outsider and difficult even for some participants, remuneration committees and shareholders to understand. Growing complexity has contributed to poor alignment between executives, shareholders and the company, sometimes leading to levels of remuneration which are very difficult to justify.

A central cause of this complexity is that companies feel they are forced to adopt a one-size-fits-all LTIP model. This model sees companies using the same form of long-term performance measurement (performance targets set over three years). This single system, while intended to link long-term performance with shareholder experience, does not always reflect how a business works, or allow for the fact that it may not be possible to set meaningful long-term targets in all businesses. In addition, in order to provide greater alignment with shareholders, further conditionality has been added to executive remuneration structures, such as clawback, malus and holding periods. This has led to participants significantly discounting the remuneration they are awarded and has often led to increases in levels of remuneration.

Increasing flexibility

The Working Group therefore believes that the solution is greater flexibility for companies to choose the most appropriate remuneration structures for their business needs and company strategy. Remuneration structures need to be appropriate to the executives, company context and the business strategy. It is the Working Group's hope that for those companies where the remuneration committee consider that the current LTIP model does not work, there will be alternative options open to them.

The Working Group has set out of a framework in order to illustrate what this flexibility might mean in practice. This was outlined in the Interim Report and has been refined following feedback during the consultation process.

The framework of structures set out by the Working Group should not be seen as an exhaustive or approved list of alternatives, but as examples designed to explore the practicalities of a more flexible system. For any structure to be accepted, it must be well-suited to the company and well-justified by the remuneration committee which has established a relationship of trust with its investors.

Rebuilding trust

Participants in the consultation process raised further suggestions on how increased flexibility could be embedded into the system. Having reflected on this feedback, the Working Group has also set out recommendations which consider how a more flexible system can be implemented. These recommendations encompass a range of behavioural and structural changes that are needed to improve the system and allow more flexibility. In particular, the Working Group hopes to address the breakdown of trust between shareholders and companies where this has occurred, so that companies are able to use this flexibility.

The five areas that the Group has made recommendations on are:

- **Strengthening remuneration committees and their accountability**

  Investors need to be confident that remuneration committees have the ability to make the right long-term decisions for the company. To do this the chairman and members of the remuneration committees need to have the appropriate knowledge of the business.

- **Improving shareholder engagement**

  The Working Group has identified a mismatch in expectations between companies and investors in the engagement process. Companies too often treat the consultation process as a validation exercise rather than understanding the need to respond to shareholder concerns. There is also a perception that investors are sometimes not being clear about their views to companies, or are not representing the views of the institution both from a governance and investment perspective.

- **Increasing transparency around target setting and use of discretion**

  Currently there is cynicism about high bonus pay-outs and the use of discretion which has eroded trust between companies and investors. The Working Group therefore recommends that transparency around setting of targets, particularly for the bonus, and the use of discretion is improved to rebuild trust in the system.

- **Addressing the levels of executive pay**

  A significant part of the breakdown in trust between shareholders and companies has been the ratcheting of pay over recent years. The rising levels of pay have been partly driven by the growing complexity of the current system of pay, and the Working Group believes that simplification of pay structures will go some way to addressing this. However, remuneration committees and consultants' desire to 'chase the median' has also had an impact on remuneration levels.

- **Setting parameters on how alternative structures might operate to gain market trust**

  The Working Group is clear that the current problems in executive pay will only be solved with practical solutions, and that without appropriate parameters for structures that differ from the current LTIP model, it is unlikely that alternatives will gain market traction. The Working Group has set out parameters in the following four areas: discount rate for restricted share awards, length of holding periods, shareholding guidelines and payment for failure.

Binding votes on executive remuneration

In the latter stages of preparing this Report, we have had a change of Prime Minister. Early statements from the Government outline the potential to change the current advisory vote on remuneration reports to a binding vote. This provoked discussions in the Working Group on the binding vote and executive pay.

The UK has a leading approach to the approval of executive pay. Under the stewardship of Vince Cable as Business Secretary, the requirement to have a binding vote on the company's remuneration policy every three years was introduced. These requirements mean that directors can only be paid in accordance with the approved remuneration policy. This binding vote on remuneration policies, whilst only introduced in 2013, has strengthened the ability of investors to hold companies to account, and has helped remuneration committees to align the long term remuneration strategy with the company's strategy. This approach has significant advantages over other voting systems for listed companies elsewhere in the world, and it certainly appears not to have interfered with choices of the place of listing. This new policy vote has for most companies only had one cycle, with the majority of companies having had only a single policy vote. We are yet to see how investors and companies will approach the second policy vote in 2017.

A binding vote on the remuneration report or remuneration actually received was considered under Vince Cable, and at that time was rejected due to concerns over the legal and operational issues with its implementation. In particular, there were questions as to how such a vote would relate to an individual director's contract and the impact such uncertainty would have on the ability of UK listed companies to attract talent.

There are a range of views in the Working Group about the role and effectiveness of extending a binding vote to payments actually made to executives. The Working Group was established to deliver market based solutions which would not require any further regulation. It has sought, within this context, to provide recommendations on how the current system could be improved to provide more flexibility to companies, to choose a remuneration structure which is most appropriate for the company's business strategy and needs. The Working Group is seeking to rebuild trust between remuneration committees and investors to allow this flexibility to work in practice.

There are a number of approaches which the Government could consider if it chooses to pursue additional binding votes on remuneration. Some of these approaches are more nuanced than a binding vote for all companies every year, for example, focusing binding votes on those companies that have failed to receive support from 75% of shareholders on the remuneration report in the previous year.

The Working Group has not had sufficient time to consider all the options and the impact such a policy change would have on market practice and the ability of UK companies to attract talent. However, it recognises that trust between companies, investors and wider society needs to be rebuilt and that additional binding votes might be a means to aiding this process. Individual members of the Working Group would be happy to contribute to this debate given their experience and the views that they have heard from a wide range of stakeholders in the last year.

Introduction to the Executive Remuneration Working Group

In the Autumn of 2015, the Investment Association established an independent Executive Remuneration Working Group (the "Working Group") to assess whether the current structure of executive remuneration, and in particular its complexity, was inhibiting company management from acting in the best long-term interests of companies and their investors.

The five members of the Working Group comprise representatives from companies, investors and asset owners to ensure views from across the investment chain were represented.

The Working Group members are:

- **Nigel Wilson,** Group Chief Executive, Legal & General Group PLC (Chairman)
- **Russell King,** Remuneration Committee Chairman, Aggreko PLC and Spectris PLC
- **Helena Morrissey,** Chief Executive, Newton Investment Management and Chair, The Investment Association
- **Edmund Truell,** Chairman of the Strategic Investment Advisory Board
- **David Tyler,** Chairman, J Sainsbury PLC and Hammerson Plc

The Working Group is independent of the Investment Association. However, the Investment Association has acted as secretariat to the Working Group.

The Investment Association has informed the Working Group of its intention to review, promptly after the publication of the Working Group's Final Report, its Principles of Remuneration to consider the recommendations of the Working Group.

Background to the Final Report

In April 2016, the Working Group published an Interim Report to lay out its core recommendations and seek stakeholder feedback. The secretariat to the Working Group attended over 32 roundtables involving over 360 individuals from 21 April to 7 July 2016. These individuals represented stakeholders from across the investment chain including company chairmen, remuneration committee chairs, executives, HR and reward directors, company secretaries, asset managers, asset owners, representatives from government departments, think tanks, trade associations, regulators, lawyers and remuneration consultants.

The Working Group would like to thank all of the individuals who participated in the roundtables or individual meetings and those who provided written input.

During these roundtables, the Working Group received wide-ranging, considered and thorough feedback on its proposals, which has now been developed into this Final Report.

Executive Pay: Time for a new approach

The Working Group believes that the current approach to executive remuneration, while intended to link pay to performance, has developed into a complicated system with many examples of poor correlation between company performance and remuneration outcomes. Rising levels of executive pay over the last 15 years have not been in line with the performance of the FTSE over the same period, feeding the increasingly negative perception of listed companies by the public.

Not only is executive pay failing to act as the tool to incentivise performance, the complexity of the system is creating a growing reputational risk for all market participants: companies and investors alike.

A common concern voiced throughout the feedback was that there was a single 'one-size-fits-all' model for executive remuneration in the UK. The vast majority of companies structure their executive remuneration with a basic salary, benefits including pension provision, annual bonus (dependent on one-year performance targets) and long term incentive (dependent on three to five-year performance targets). The dominance of the three-year Long Term Incentive Plan (LTIP) has come to exclude the adoption of other remuneration structures which may be more appropriate to the company's business model or strategy.

The LTIP Model

LTIPs are intended to motivate executives to achieve certain goals over the long term. They are designed to provide long-term alignment between executives and shareholders. Setting long-term (usually three year) performance targets, is intended to incentivise management to ensure they are implementing the chosen business strategy and taking the right long-term decisions. The payment of LTIPs in shares also aligns the executive's interests with shareholders and requires them to think like owners.

However, the Working Group heard that companies can find it difficult to set appropriate performance targets under the LTIP, which is undermining its effectiveness.

The first challenge is to choose the right performance metrics. These metrics should be linked to the implementation of the long-term strategy. Condensing a complicated strategy into a small number of metrics is challenging enough; choosing metrics which reflect the executive's role and contribution to that strategy and company performance can be even more challenging.

Once these metrics have been chosen, the remuneration committee have to set the actual targets considering internal budgets, market consensus or external relativities. These targets need to be both challenging and achievable over the three year performance period. The Working Group heard that LTIP performance targets that seemed sensible when they were set could soon be too stretching or unachievable, or alternatively too easy and unchallenging, due to external factors. Hence, the LTIP often fails to do its job.

Finally, it is generally expected that these targets will be disclosed prospectively. This may affect the company's choice of measures as some metrics (particularly strategic milestones) may be commercially sensitive. The problems that companies face in setting long-term performance conditions can have significant effects on the behaviour and motivation of the participants in these plans. The choice of performance conditions based on relative TSR or other relative market based measures can make participants treat LTIPs as a lottery as they feel unable directly to influence the result. Performance targets that are not considered achievable during the performance period due to external factors such as exchange rate, commodity prices, or inflationary influences can impact on the perceived value of LTIPs.

Remuneration committees want to attract and retain talent in their company. However, they face competition from private equity firms, non-listed and foreign companies, which operate without the same public disclosures, scrutiny and shareholder approval processes on pay and usually without long-term performance conditions. This competition for talent has been a major factor in the rise in quantum.

The spikes in LTIP pay-outs and the uncertainty of outcomes, caused by problems with long-term target setting, is compounded by the growing complexity of remuneration structures. The introduction of additional restrictions such as malus, clawback and holding periods, while intended to increase the long-term alignment with shareholders, have reduced the perceived value of LTIPs.

As the number of additional restrictions placed on an element of executive pay increase, the perceived likelihood of an executive receiving that element of remuneration reduces. Executives therefore tend significantly to discount the value they ascribe to these elements of remuneration. The reason for this is the same for executives as it is for many other individuals, in that pay to be received in the near future is worth much more psychologically than pay that will be received in five years' time or that will be subject to additional release conditions. This 'discounting' by executives has caused increases in overall remuneration, as remuneration committees have increased fixed pay or LTIP award sizes to compensate for the uncertainty and complexity of LTIPs.

Investors are also concerned with the consequences of this one-size-fits-all approach. Companies with inappropriately structured remuneration packages are often the same companies which will apply discretion to allow higher pay-outs as they have failed to design a structure which aligns with their intended objectives for the executive or with their business cycle. Complicated performance measurement has meant that there is now a growing and disproportionate amount of shareholder engagement spent on executive remuneration, to the detriment of other governance issues.

The issues with the LTIP model prompt the question as to whether LTIPs are doing what they are intended to do. Should companies be forced to adopt a model which can be so complex that executives and investors do not understand and value it? It cannot be an efficient system if a component of remuneration, which investors and remuneration committees are spending a significant amount of time and effort on, is not valued appropriately by the recipients.

The Working Group believes that there is a need to recognise that the current LTIP system does not accommodate the variety of needs of the broad range of companies which operate within it. There needs to be more acknowledgement that all companies are different and will need different remuneration structures to recognise their particular business context.

The Working Group believes that a fresh approach is needed to consider how executive pay could better align the interests of executives, shareholders, and the company.

Moving to a more flexible executive remuneration structure

The Working Group's core recommendation is that the market needs to move away from a one-size-fits-all approach to a system where companies have more flexibility to choose the remuneration structure which is most appropriate for their business. Remuneration structures need to be appropriate to the executives, company context and the business strategy. It is the Working Group's hope that for those companies where the remuneration committee consider that the current LTIP model does not work, there will be alternative options open to them.

A company's remuneration structure should be considered on the basis of suitability for that business. The company will then have to explain and justify why a different approach is appropriate to shareholders. Flexibility means that boards are expected to use their knowledge of the company to choose a structure which will act in the long-term interests of the company. The Working Group expects that a number of companies will still find the LTIP model to be the most suitable for them.

The idea of greater flexibility was positively received at roundtables. The vast majority of participants agreed that the current system is not appropriate for all companies, and that increased flexibility in the system would be beneficial, as the consequences of companies using inappropriate remuneration structures have been the growing complexity of performance targets and rising quantum.

However, the Working Group also recognises the concerns about the practical obstacles to bringing in a more flexible system. Companies expressed their concern during roundtables as to whether such flexibility will be accepted by investors and whether remuneration committees would be willing to be the first mover for change. At the roundtables, the majority of investors were also in favour of flexibility. However, their main challenge to companies was that they felt that there is already adequate flexibility in the current system for companies. Investors cited a number of companies that have moved away from the LTIP structure with an unconventional remuneration structure and have received shareholder approval.

While the Working Group recognises that flexibility may lead to a diversification of structures operating in the market, the Group notes that there is a concern that this will make the overall system more complex. This is an issue particularly for shareholders and proxy advisers who are concerned that a wider set of remuneration approaches will lead to more consultation on executive remuneration rather than less. Both investors and companies want to see engagement focus on a broader range of governance issues; this will be difficult to realise if the volume of engagement on remuneration increases further. The Working Group believes that flexibility will lead to less complexity on an individual company level as companies will be able to choose a structure which has a simple link to their business strategy, rather than attempting to mould a standard structure to fit their needs. It is also expected that engagements on remuneration issues will be more focused on the company strategy as remuneration committees will have to justify why a particular structure is appropriate for their company and strategy.

The Working Group recognises that remuneration committees of UK Listed Companies are not working in a vacuum. If they are to recruit, motivate and retain the best executives in the interests of investors in UK Listed Companies, they have to ensure that remuneration is competitive with that of other companies: those listed in other countries (and their subsidiaries); family companies; and privately owned companies (including those owned by private equity businesses). Pay in all of these companies is not publicly available and therefore not often reviewed by the media or by investors in UK listed companies. Talented executives are often attracted to work in these businesses because remuneration schemes there are simpler and long term, based around share ownership without performance conditions. They are aligned to the interests of shareholders, and little time and energy is spent by either executives or investors in debating long term remuneration. The Working Group believe that a move in this direction would be advantageous to UK listed companies and would not add to total remuneration levels.

Given the underlying support for the premise of flexibility, the Working Group seeks to explore how this can be achieved in practice, using some of the structures discussed in the Interim Report, as well as addressing some of the concerns that were raised during the roundtables. The question that this Report seeks to answer is, given that flexibility has clear support as the right approach to executive remuneration in the future, what behavioural and systemic change is needed in order to make this possible?

RECOMMENDATION 1:
There should be more flexibility afforded to remuneration committees to choose a remuneration structure which is most appropriate for the company's strategy and business needs.

Exploring possible alternatives – What does flexibility look like?

In its Interim Report, the Working Group drew together a framework to consider how flexibility might work in practice. Following the consultation process, the Working Group has refined the framework, which is outlined below.

Framework for choosing a remuneration structure

The agreement on the need for greater flexibility means that two fundamental questions about remuneration structures will need to be considered by remuneration committees to decide on what is appropriate for their particular business. The first question is what the committee requires remuneration to do for them, and what role it needs to serve in their business. The second issue is to assess what role long-term performance measurement will have in the remuneration structure.

The Working Group therefore, has sought to build a framework to help committees to consider the options that are right for their business.

What is the purpose of remuneration?

Companies have different priorities depending on their industry, business cycle, and strategy, and therefore may need a different approach to remuneration. The Working Group believes that the following set of underlying components for an effective remuneration structure should act as a guide for remuneration committees when considering what their priorities are and how remuneration should align with their particular situation.

1 Structures should be aligned with:

- **The interests of shareholders** – reward for creating shareholder value which should be linked to the shareholder outcome
- **The performance of the company** – reward for contribution to good company performance and penalty for failure
- **The implementation of the company's long-term strategy** – reward for successfully implementing the strategy
- **The interests of other employees in the organisation** – remuneration structures for executive directors should be able to be applied to other employees in the organisation
- **Wider corporate and social responsibility goals**

2 **Structures should be simple and transparent** – meaning that they should be easily understandable for the participant, remuneration committee, investors and other stakeholders

What alternatives are available?

The second issue for remuneration committees is considering the alternative structures that they may wish to adopt. In the Interim Report, the Working Group outlined a series of alternative structures. The Working Group believes that it is necessary to set out such a series of alternatives to promote confidence among investors and ensure expectations are clear for all parties by seeing what flexibility might look like in practice.

The alternatives presented for discussion in the Interim Report were focused on variations of how long-term performance features in the remuneration structure, as in the Working Group's initial discussions there was seen to be a general acceptance of some elements of pay, such as salary, annual incentives (bonus) and pension/benefit arrangements. The feedback received during the roundtables was also directed at these other elements of the pay package, and the Working Group has taken this into consideration.

The four structures that were considered in the Interim Report were:

- **LTIP Model** – consisting of a grant of shares that vest based on performance measured over a three to five-year period against a series of pre-agreed targets. Most awards are then subject to a further two-year holding period.

- **Deferral of bonus into shares** – the bonus is paid partly in cash, with a significant proportion paid in shares that vest over a significant time period. There is no additional long-term incentive award.
- **Performance on grant** – participants receive a grant of shares awarded based on performance achieved over the previous three years. The grant of shares then vests three to five years after the grant. This option was not popular and has been removed from the framework.
- **Restricted Share Awards** – an annual grant of restricted shares, which will vest after a period of time based on continued employment.

The framework of structures set out by the Working Group should not be seen as an exhaustive or approved list of alternatives, but as examples used by the Working Group to explore the practical reality of a more flexible system. It remains imperative that companies consider the right structure for their business and engage with shareholders to understand their perspective on the choice of structure.

Feedback on the alternative structures

During the roundtables, companies welcomed all the possible options outlined above, with the exception of the performance on grant model, which was seen as being difficult to operate. It would not solve the issue of setting three year performance conditions in advance, as remuneration committees would still have to set performance conditions prospectively. There are also significant operational issues with new joiners and concern that the total length of the scheme (six-eight years in total) would be demotivating to participants. Therefore the performance on grant structure has been removed from the Working Group's framework, leaving the other three structures as working examples of flexibility.

Market-priced share options were also consistently raised during our consultation as an alternative model. Share options were seen as an alternative to restricted share awards. This is because the exercise price means that options have an inbuilt share price underpin which could help to prevent payment for failure. However, the Working Group are concerned that share options do not have a symmetrical impact in terms of the loss and gain experienced by participants. Compared with shareholders, share options give participants a disproportionate upside when good performance is achieved, and no downside for poor performance. The Working Group is cautious about recommending a return to a structure which has, in recent years, fallen out of favour for good reason.

Different companies were able to see qualities in other alternative structures which fit their business models, with the bonus deferral option being seen as suitable for companies with shorter business cycles such as those in the retail sector. The restricted share alternative was seen as a helpful option by companies who, due to the nature of their business, find it difficult to set meaningful long-term targets under an LTIP structure.
There were also those companies that felt the LTIP model was most appropriate, as they believe that it provides suitable leverage and companies have found it a useful way of linking the shareholder and executive experience, as well as signalling the important elements of their long-term strategy.

Investors acknowledged the role of some of these alternatives. However, not all were supportive of restricted share awards due to the perceived loss of some element of the long term performance link.

The Working Group would also like to emphasise that in-principle support for structures such as restricted shares from some investors does not mean that such structures are guaranteed to be accepted by shareholders for all companies. For any structure to be accepted, it must be well-suited to the company and well-justified by the remuneration committee which has established a relationship of trust with its investors.

Barriers to flexibility and how to overcome them

The Working Group has considered the obstacles to flexibility that were raised during the roundtables and believes that the following areas need to be addressed by market participants in order for more flexibility to be adopted.

Rebuilding trust

During the roundtables and through their own experiences, the Working Group is highly aware that one of the biggest obstacles to change in executive remuneration lies in the breakdown in trust between shareholders and remuneration committees. The current system of remuneration has evolved reactively as a small number of companies have gone against best practice and compromised shareholder trust. New investor policies and guidelines have been introduced to prevent the poor practice reoccurring. Naturally, investors are keen to prevent instances of inappropriate pay or payment for failure. Companies, though, can often view this caution as an inflexible stance.

In order for flexibility to be introduced in the system, trust needs to be regained where it has been lost so that investors will feel comfortable supporting companies who choose a different approach. Remuneration committees also need to feel that investors are engaged and willing to listen to their rationale for proposing an alternative remuneration structure. Without this trust, the Working Group believe that it is unlikely that shareholders would accept, and remuneration committees would propose, some of the alternative approaches suggested.

The Working Group believes that there are five areas to help restore trust in the system, namely:

- Strengthening remuneration committees and their accountability
- Improving shareholder engagement
- Increasing transparency in target setting and use of discretion
- Addressing the level of executive pay
- Setting parameters to illustrate how different structures may operate to gain market trust

Accountability – Strengthening remuneration committees

Both investors and company representatives felt that more needs to be done to make remuneration committees more accountable for their decisions in order for flexibility to succeed. Remuneration committees need to establish a rapport with shareholders so that they can trust that they are choosing the right structures. Whilst this trust is evident in some remuneration committees, particularly where alternative structures have been approved by shareholders, it is by no means universal.

Board effectiveness has been much written about in recent years. For investors, poor remuneration decisions are often indicative of governance issues or an ineffective board. It is therefore presupposed that companies must endeavour to have the best non-executive talent, with a wide diversity of perspectives, and the right information provided to them to make the best long-term remuneration decisions.

Investors are not wholly confident that non-executive directors are currently upholding their duty to take long-term decisions on behalf of shareholders. Many of the dissenting votes during the most recent AGM season have been triggered by investors feeling that companies are taking short-term decision on pay without a broader perspective on the shareholder experience or long-term view. For example, investors are concerned about cases where companies have not used their discretion to address pay-outs which, although awarded within an approved remuneration policy, do not reflect the wider company performance or shareholder experience. Given investor scepticism about the robustness of remuneration committees' long-term decision making, more needs to be done to strengthen the committees' decision making process and accountability to help restore trust.

Remuneration committees need to ensure that they are evaluating the likely outcomes of proposed schemes, both in "business as usual" scenarios as well as other more or less favourable circumstances at the point of establishing schemes. These different scenarios should be clearly set out in consultations for new schemes. As well as assessing structures at their inception, remuneration committees should use their discretion to assess all decisions and pay-outs to ensure that they are a fair reflection of company performance.

For trust to be rebuilt in the system, it is also important that the role of the remuneration committee is developed so that they have the necessary skills and experience to approach what is a challenging role. Remuneration committees need to have extensive knowledge of the company, the personalities of the executives, and the shareholder base in order to be truly effective.

It was regularly commented in the roundtables that the workload of the remuneration committee is underestimated. Unlike the audit committee, which has a "recent and relevant experience" criteria for the audit committee chairman, the position of remuneration committee chairman is often given to a new or inexperienced non-executive on appointment to the Board. There is no prerequisite to have experience in managing either remuneration issues or the significantly complex personal dimensions which are involved when setting pay and judging performance outcomes.

The Working Group therefore recommends that remuneration committee chairs should have at least one year's experience on the remuneration committee before becoming chair of the committee. This would allow the new non-executive to build the appropriate knowledge of the business, the personalities on the board and understand the views of the company's major shareholders. The Working Group also recommends that the Financial Reporting Council (FRC) look to update the UK Corporate Governance Code to reflect this need for a more experienced remuneration committee chairman.

The Working Group also recognises that the remuneration committee chair must ensure that they have a strong working relationship with the chairman of the board. There have been a number of cases where the remuneration committee has taken a decision which is not supported by the chairman, and therefore the committee's decision has been undermined or overruled by the chairman, who normally would have the closest relationship with the chief executive.

There needs to be an appropriate and open dialogue between the board chairman and the remuneration committee chairman to ensure that there is no conflict on decisions made by the remuneration committee. It is also important that companies respect the provision of the Corporate Governance Code which requires these two roles to be separated and not held by the same person. Companies will manage this relationship in different ways. However, the Working Group recommends that companies consider the benefits of the chairman being a member of the remuneration committee or at least attending its meetings. This would make sure that the chairman is involved and aware of the decisions and can support their implementation.

The Working Group recognises that there is a role for consultants in supporting the work of remuneration committees, although ultimate decision-making is the responsibility of the remuneration committee. There is still a view in the market that some remuneration committees are over-reliant on their consultants. This can usually be evidenced by companies adopting the consultant's standard remuneration structure or off-the-shelf advice. It is also notable in engagement meetings in which some remuneration committees rely on their consultants to explain the proposals or approach. Therefore, the Working Group considers there is a need for remuneration committees to ensure that they are taking the appropriate advice but do not become over reliant on the advice given by their consultant.

RECOMMENDATION 2:
Non-Executive Directors should serve on the remuneration committee for at least a year before taking over the chairmanship of the committee. The Financial Reporting Council (FRC) should consider reflecting this best practice in the UK Corporate Governance Code.

RECOMMENDATION 3:
Boards should ensure the company chairman and whole board are appropriately engaged in the remuneration setting process. This will ensure that the decisions of the remuneration committee are agreed by the board as a whole.

RECOMMENDATION 4:
Remuneration committees need to exercise independent judgement and not be over reliant on their remuneration consultants particularly during engagements with shareholders. To ensure independent advice is maintained, the remuneration committee should regularly put their remuneration advice out to tender.

Shareholder engagement – Improving the process

The Working Group is acutely aware of the central role of the shareholder-company dynamic in determining executive remuneration structures. The system of shareholder engagement on the issue of remuneration has clearly become under strain. This was confirmed by participants at the roundtables. Improving the environment for shareholder engagement is central to moving to a more flexible system of remuneration. Moving away from the current LTIP model will require close relationships between companies and investors in order to decide on the appropriate remuneration structure for the company in question.

A particular concern raised by companies is the perception that shareholders and proxy advisers are not willing to listen to their arguments when considering a new remuneration structure, and will not accept divergence from the norm. There is a perception that investors are overly reliant on proxy advisers rather than making their own decision whether to support the company. Companies also complain that they receive different views from the investment managers and governance teams within the same investment house.

On the investor side, institutions are faced with an increasing volume of consultation on the minutiae of executive pay, leaving little time or resources for engagement on other governance issues. Investors are often frustrated that companies treat consultation as a validation of their decision, approaching investors only a short time before the AGM and expecting automatic approval from shareholders of their proposals because they have "consulted" investors.

On the issue of integration of fund management and governance teams, investors emphasised to the Working Group that governance teams within investment houses are usually the aggregator of numerous fund managers' views, and will provide a single view to the company. It is not uncommon that a fund manager will not want to provide negative feedback so their relationship with the company and executive is not impacted. This leads to the governance teams being the conveyor of the house view.

Given these views on the process, there needs to be significant improvement on both sides.

The Working Group believes that shareholders must analyse remuneration structures and payments in a joined-up manner, considering both the governance and investment perspective. It is the Working Group's hope that the remuneration structures are more closely aligned with the company's business strategy, so this integrated engagement with governance and fund management expertise will be critical. The Working Group recognises that the perception of investors from companies is often a result of internal structures within investors, where the governance team work as a coordinator for various views of fund managers and manage the voting process. However, the market needs to encourage and promote more obvious linkage between fund managers and governance teams so that companies understand this link. The Working Group recognises that there are many good examples of this approach, but believes that integration needs to be further championed, with poor practices being called out and discouraged by companies and the market.

Companies also need to treat the consultation process as a two-way dialogue to obtain feedback from their shareholders. Companies need to consider when to consult with shareholders and concentrate their consultation on the major strategic remuneration issues rather than the minor details of pay. Companies need to listen and respond to feedback from their shareholders, and anticipate that they may not always receive support for their proposals. Consultation does not mean that companies will gain automatic acceptance of their proposals. The role of consultation should be to understand the views of shareholders, and having conducted a consultation will allow remuneration committees to decide the best way to reflect or enhance their proposals.

In order to maximise the effectiveness of the consultation process, the Working Group believes that clarity in communication between all parties is essential. Companies must exercise their judgement so that dialogue with shareholders focuses on material issues and link to strategy. Shareholders should provide clear feedback and views on the proposals wherever possible so that companies are clear of their position and likely level of support for a particular proposal. The Stewardship Code recommends that institutional investors disclose their voting records publicly. The Working Group supports this practice and encourages investors to make sure their voting records are accessible.

Companies remain concerned about the role of proxy advisors in determining voting outcomes. During the consultation, we heard that most investors will use proxy advisers as one of multiple inputs into their voting decisions. Proxy advisers therefore should not be held to be the ultimate determining factor of voting outcomes. Shareholders said that proxy advisors highlight the issues which shareholders ask them to. This means that if there is a change in the underlying view of the shareholders, and they change their house voting policies, it is likely that the proxy advisor will change the policies which they use to analyse companies. Proxy advisors want to ensure that they are taking the approach and highlighting the issues which their clients wish them to. The Working Group is mindful of the influence that proxy advisors have with some overseas investors. Some international investors consider voting as an obligation rather than a right, which is part of the investment process.

RECOMMENDATION 5:
Shareholder engagement should focus on the strategic rationale for remuneration structures and involve both investment and governance perspectives. Shareholders should be clear with companies on their views on and level of support for the proposals.

RECOMMENDATION 6:
Companies should focus their engagement on the material issues for consultation. The consultation process should be aimed at understanding investors' views. Undertaking a process of consultation should not lead to the expectation of investor support.

Increasing transparency in the target setting process

The Working Group believes that transparency is crucial to tackling complexity in remuneration structures as well as for building up the trust necessary for a more flexible system. The two particular areas where transparency needs to improve for trust to be rebuilt centre on the setting of bonus targets and the use of discretion.

Annual Bonuses

There is often a suspicion regarding bonus payments which, in the past 10 years for FTSE 100 companies, have regularly paid out between 70%-80% of the maximum opportunity. There is concern that at least a proportion of annual bonuses are used to "top up" salary payments and are seeing as part of fixed pay, with a portion of annual bonus which pays out if performance is only satisfactory. Annual bonus targets are often set against budget or consensus levels which can lead to certainty in bonus outcomes. There is often a lack of clarity in annual report disclosures on how remuneration committees set bonus targets, making it difficult for investors to assess the methodology of bonus payments and their appropriateness.

Retrospective disclosure of bonus targets is essential in order to explain these pay-outs, and allow investors to understand the link between pay and performance. Whilst there has been significant improvement in the number of companies providing details of bonus targets on a retrospective basis as a result of significant investor pressure, there is still more to be done. The Working Group would like companies to go further in explaining how their targets are set, whether against budget levels or against consensus estimates. This will allow companies to show the robustness of their target setting approach and how challenging the bonus targets are.

Discretion

Discretion has been a source of increasing tension in recent years. Remuneration committees increasingly feel that they cannot use discretion, as it will not be supported by shareholders. Companies often feel that they are unable to use upward discretion, and that investors will only approve the use of downward discretion.

However, investors need to be able to see that there is a track record of responsible use of discretion in order to approve upward discretion. By clearly justifying all remuneration committee decisions and specifically the application of discretion, remuneration committees can improve their credibility with investors. Additionally, if a company has applied negative discretion in situations where external circumstances have improved the executives position outside of their control (for example where there have been favourable impacts on earnings from a strengthening exchange rate), investors are more likely to be comfortable in supporting upward discretion if adverse circumstances negatively affect the executive (e.g. earnings being impacted by a weakening of exchange rates). The Working Group believes that by being clear and transparent about the committee's decision-making on discretion, companies will be able to build up trust with their investors and stakeholders.

RECOMMENDATION 7:
Remuneration committees should disclose the process for setting bonus targets and retrospectively disclose the performance range.

RECOMMENDATION 8:
The use of discretion should be clearly disclosed to investors with the remuneration committee articulating the impact the discretion has had on remuneration outcomes. Shareholders will expect committees to take a balanced view on the use of discretion.

Addressing the level of executive pay

The Working Group is mindful of the dangers of ignoring the issue of absolute amounts of executive remuneration. Indeed, concerns over quantum were consistently raised at the roundtables. This has also been evidenced through the 2016 AGM season with a number of companies receiving significant votes against their remuneration reports. In a number of cases, the votes against were attributable to significant increases in overall quantum, or companies paying a significant level of remuneration where investors had judged it had not been warranted by performance.

The level of remuneration has also been cited as an issue contributing to the lack of the public trust of business. There is growing public disapproval of the absolute levels of remuneration paid to business leaders, as well as growing divergence between remuneration paid to those business leaders and remuneration paid to other employees in the company. The issue of quantum is often the underlying issue behind shareholder and public disapproval of executive remuneration. There is also a degree of cynicism within the market that pay structures are reverse-engineered to provide a certain level of pay.

When the Working Group was established by the Investment Association, the Group were asked to look at the structures of executive remuneration and how they could be simplified. The issue of overall quantum was not an issue which the Working Group were asked to consider. It is the Working Group's view that quantum is ultimately a matter for boards, who must consider how they justify the level of pay for their executive, relative to internal and external reference points. The internal reference point should preferably be the ratio between the remuneration of the CEO and median employee pay, which should then be publically disclosed. Boards must take account of CEO pay relative to market levels, but they must also make sure that their decisions are not dictated by benchmarking alone, as this has significantly contributed to the "remuneration creep" in the FTSE.

It is the view of the Working Group that there are two drivers of the recent increases in quantum. Firstly, following the financial crisis and the uncertainty which resulted, some companies did not set appropriately challenging performance conditions. Secondly, the increasing complexity of remuneration structures has driven increases to overall remuneration. Structural requirements to improve long term alignment between shareholders and executives such as holding periods, clawback and malus have led to demand from executives to be compensated for this greater complexity with higher base salaries or bonus/LTIP opportunities.

There has been increasing incidences of large LTIP awards vesting which, coupled with share price appreciation, has led to significant levels of remuneration being disclosed in the company's single figure table. This is as a result of the increasing size of LTIP grants due to the discounting of executives and weak performance conditions for some companies in recent years. The highly geared remuneration structure based on performance over three years, means that year-on-year remuneration outcomes can be volatile with either no remuneration vesting or significant levels of remuneration being paid. This leads time and again to headlines in the media which concentrate on the executives with high pay-outs but not those who receive no pay out – thereby exacerbating the lack of public and investor trust in listed companies.

The Working Group does not feel it is their role to recommend absolute levels of remuneration; this is a matter for individual boards. However, in considering their proposals, they believe that more flexibility should lead to simpler remuneration structures and more certain outcomes for executives and therefore less discounting of the remuneration received. This should then lead to a reduction in overall remuneration levels.

The Working Group believes that the provision in the Remuneration Consultants Group Code of Conduct[1] which requires remuneration consultants to "be sensitive to the potentially inflationary impact of market data" has never been more relevant. The Working Group calls for poor practices to be called out by committees and investors. A small number of consultees highlighted recent cases of remuneration consultants providing information to executive directors, to show that the directors were paid "behind the median". This leads to significant pressure on remuneration committees to increase levels of pay and appears to be against the Remuneration Consultants Group Code of Conduct and such behaviour must be addressed by remuneration committees, consultants and the Remuneration Consultants Group.

1 Remuneration Consultants Group Code of Conduct (December 2015)

RECOMMENDATION 9:
The board should explain why the chosen maximum remuneration level as required under the remuneration policy is appropriate for the company using both external and internal (such as a ratio between the pay of the CEO and median employee) relativities.

RECOMMENDATION 10:
Remuneration committees and consultants should guard against the potential inflationary impact of market data on their remuneration decisions.

Parameters for alternative structures

The Working Group restates its view from the Interim Report that in order for a new approach to remuneration to be realised, practical considerations must be at the forefront of discussions. In its Interim Report, the Working Group consulted on a range of parameters which would need to be in place to move to alternative structures. Following these discussions, the Working Group thinks that the following parameters are suitable:

Discount Rate

Some alternative structures to LTIPs, such as restricted shares, have more certain outcomes. The current value of LTIPs would therefore not be appropriate to be transferred one-for-one and a discount rate will need to be applied. While the Working Group recognises that there are multiple factors that will influence the choice of discount rate, it believes that it is useful that the market is provided with a guideline rate. After considering the views expressed at the roundtables, the Working Group believes that discussions on the discount rate for moving from the LTIP to restricted share award should begin at a guide rate of 50%, although this level may depend on the other parameters which the company chooses to adopt. However, investors would not want to see this to be the start of a protracted negotiation, their broad expectation is that 50% is an appropriate approach, and were keen to see that the level of restricted share awards were held in future and do not gradually increase over time.

Length of Holding Periods

The Working Group noted the problem of further extending holding periods past five years due to the discounting of value of the awards once they are extended out into the future. Additionally, short average tenure of executives means that longer holding periods may be meaningless. The Working Group therefore thinks that the three year performance period followed by two year holding period under the current LTIP model is sensible as it promotes longer-term alignment with shareholders without tipping into such a length where discounting starts to take effect and remuneration committees feel the need to grant larger awards to compensate. For restricted shares, the Working Group heard a consistent view that staggered vesting of awards over years three to five would be a possible method of vesting.

Shareholding Guidelines

In the Interim Report the Working Group considered the issue of shareholding guidelines and what role these should play in remuneration structures. The Working Group also sought views on what level shareholding guidelines should be set at. There was some feeling among respondents at the roundtables that the suggested level of 500% of salary was too high to be a guideline for all companies, as for smaller companies this could be very difficult to achieve and may force award levels up. This level is the current median level of shareholdings for chief executives in the FTSE 100. Alternatives were discussed, such as referring to the guideline in terms of a number of shares rather than as a percentage of salary. The Working Group is also in favour of the approach which would define the shareholding guideline at the level of maximum annual aggregate variable pay, with executives having to retain up to 50% of the post-tax vesting amount until the guideline level had been achieved. The requirement to have a post-employment shareholding guideline was generally welcomed by consultees with most considering a year as an appropriate time period.

Payment for Failure

It is important that executives are not rewarded for failure. LTIPs are designed such that, in theory, commercial failure will result in the executive not receiving a pay-out. Some alternative structures, however, are structured such that executives may still receive larger pay-outs than the current model where there has been poor performance.

This is a problem for the restricted share awards in particular, as there are no long-term performance measures. The Working Group considered the use of an underpin or override to ensure that these scenarios could be managed. It can see that some remuneration committees might wish explicitly to incorporate an underpin and it has no objection to that if that is what individual companies wish to do. However, every remuneration committee should always retain the option for discretion (negative or positive) in the case of all incentive schemes and be ready to use this discretion in extreme circumstances.

The Working Group therefore sees no general requirement for an underpin in restricted share awards. By insisting on one, there would be the danger that the clear merit of simplicity would be lost, and that executives might regard these schemes as another form of LTIP. As a result, it would be much more difficult for a typical discount factor (compared to existing LTIP schemes) of 50% to be achieved because executives could be nervous about how the underpin would operate. In other words, remuneration would then often be higher than it would otherwise need to be.

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