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UK Executive Pay & Governance

New Investment Association Principles of Remuneration
ISS and Glass Lewis Update

November 2017

New Investment Association Principles of Remuneration

The Investment Association has issued an updated version of its Principles of Remuneration (click for link). As in previous years, the Principles are accompanied by an introductory letter setting out the changes to the Principles and reiterating some of the main areas of focus for IA members. The key takeaways are set out below.

Annual bonuses

- The IA reiterates its expectation that financial targets are set out in full on a retrospective basis, with threshold, target and maximum numbers disclosed. Non-disclosure for reasons of commercial sensitivity gets shorter shrift than previously: in such cases the sensitivity must be explicitly explained, and **the targets must be disclosed no more than 12 months after payment** – a reduction from the two-year limit set out in the previous version of the Principles.

- **Differences between financial numbers used in KPIs or wider corporate reporting and those used for bonuses should be explained**. Any adjustments should be disclosed and the impact of the adjustments on the pay outcome should be made clear.

- Meaningful disclosure of non-financial performance targets is expected. Bonus payments linked to personal or strategic targets need to be fully explained, particularly in cases where financial targets have not been met.

- On structure, **the IA now expects deferral into shares to apply where bonus opportunity is more than 100% of basic salary.** However, this should not result in an increase in the overall bonus quantum.

Long-term incentives

- One small but notable addition to the Principles is that they now state that remuneration policies should support ***long-term*** value creation, although the Principles ostensibly promote no particular long-term structure over any other.

- **The IA recognises that restricted shares are becoming acceptable to more institutional investors "in the right circumstances"** and where a convincing case for their use has been made. The absence of vesting of past LTIP awards is not seen as an appropriate reason for introducing restricted shares. The Principles indicate that restricted shares have a greater chance of success where there is a ***minimum*** 50% discount when compared to performance shares and where there is at least a five-year vesting and post-vesting holding period (increased from three years). Some IA members also expect restricted shares to be subject to an underpin.

- The wording suggesting that "performance on grant" schemes are not universally favoured has been removed.

- A provision has been added to the Principles stating that any discretion specific to a particular incentive scheme should be disclosed in the remuneration policy as well as the scheme rules.

Quantum

- The IA is again flagging concerns about increases to pay and urging remuneration committees to show restraint. **Question-marks are raised over whether automatic inflation-linked salary increases are always appropriate**, and whether incremental increases to incentive opportunities are necessary. The IA reiterates that committees should be able to justify levels of executive remuneration, and that benchmarking is not a valid explanation.

- It is supportive of those FTSE 100 companies where pay levels have been reduced, and would welcome others across the wider market taking similar steps.

Pensions and benefits

- Pension provision for executives should be in line with that for employees as a whole; the qualifier "where possible" has been removed.

- A provision on relocation benefits has been added, with the Principles now stating that such benefits should be disclosed at the time of appointment as well as in the remuneration report. They should apply for a limited time only.

Pay ratios

- **The IA is encouraging companies to voluntarily disclose CEO pay ratios in 2018**, ahead of the mandatory disclosure required when the proposed legislation is enacted. The IA expects disclosure of the pay ratio between the CEO and the median or average employee as well as between the CEO and the executive team.

- The Principles state that for pay ratios and for other reporting obligations such as gender pay gap figures, remuneration committees should "provide these numbers in the context of their business and fully explain why these figures are appropriate."

Interactions with shareholders

- The Principles now make the point that **during a consultation exercise, the whole remuneration structure should be detailed and not just the proposed changes**, thus ensuring that the entire picture is provided. Further, the remuneration committee should review any proposals in the context of events occurring between the end of the consultation period and the implementation of the new policy to ensure that they remain appropriate.

- The IA suggests that one reason for AGM resolutions being withdrawn in 2017 was because of a failure to properly understand shareholder views. A company which has withdrawn a resolution should undertake a full analysis of shareholder feedback and engage in further consultation before resubmitting its remuneration policy for formal approval.

- The IA highlights that investors are increasingly willing to vote against individual remuneration committee chairs at AGMs.

Our View

- The IA's Principles remain influential as generally accepted UK institutional investor best practice. The updated Principles contain no major developments – save perhaps the door being slightly opened for restricted shares – but some ongoing themes are evident. Expectations around bonus target disclosure are increasing year-on-year, with IA members clearly losing patience with the "commercial sensitivity" argument. In practice, investors typically expect full target disclosure immediately after the end of the performance period.

- Given that we expect ISS to also focus on these areas in 2018 (see below), companies will need to review their remuneration report disclosures closely, paying particular attention to the transparency of non-financial targets and the definition of financial metrics and any adjustments. This latter point is part of an ongoing debate about the appropriate treatment of "exceptional" items for bonus purposes.

- The expectation that deferral applies to bonus opportunities above 100% of salary also needs close attention, given that deferral is absent in a sizeable minority of cases. We estimate that around one-third of FTSE 250 companies and c. 45% of FTSE SmallCap companies do not operate bonus deferral (although in many of these cases the overall bonus opportunity will be capped at 100% of salary).

- The suggestion that restricted shares are becoming acceptable to more investors will be welcomed by those who have been frustrated by shareholder opposition to new models in 2017. The greater clarity in the Principles on what is appropriate is useful, although there will be ongoing debates about how far a restricted share underpin differs from a conventional LTIP performance condition.

- The focus on quantum continues. In practice, small basic salary increases or relatively limited increases in bonus opportunity have not encountered any opposition during 2017, but the IA is starting to be troubled by these modest increases being accepted as "business as usual." Put simply, increasing pay is becoming more and more difficult, and the IA is further arguing that pay **reductions** across the market would be more appropriate. It is arguably easier to scale back pay at a large company where remuneration levels are already very high, and as a result we suggest that this is aimed at the larger FTSE 100 companies. It is possible that the focus on pension contribution rates being aligned with the wider workforce will become relevant for existing as well as new directors.

- Pay ratios will get considerably more attention over the next year as draft legislation is published and some companies rise to the IA's challenge of disclosing early. Given the significant publicity expected to be generated by ratios, we encourage remuneration committees to start thinking about this issue now and to give careful thought to the narrative accompanying the disclosures. That said, we would be surprised if ratio disclosure is majority practice in the 2018 AGM season unless the formal legislation explaining how the calculation should be undertaken is available by then, and we urge caution regarding early disclosure for this very reason.

- Separately, expect the IA to gain an increased public profile through its role as custodian of the new Public Register of shareholder votes, as announced by the Government in August. Resolutions which received a 20%+ vote against in 2017 – or which were withdrawn – will be named on the Register, and the IA has invited the companies affected to provide a public explanation on how shareholder concerns have been addressed. Media interest in the Register will be high, and we expect investors to take a dim view of explanations which are boilerplate, high-level or which blame proxy advisers for a high vote against.

ISS and Glass Lewis Update

Talking of which, in recent weeks we have held client breakfast briefings with both ISS and Glass Lewis, to understand where these important advisers stand as we look ahead to 2018.

ISS has surveyed its clients to gather views on the merits of restricted shares. The survey results indicate a continuing split in views among ISS' investor clients: although 49% believe that restricted shares may be appropriate in certain circumstances, 37% do not (with the remaining 14% answering "it depends"). For those investors prepared to consider restricted shares, 59% believe that the discount when compared to performance shares should be determined on a case-by-case basis. A significant minority (26%) believe that the discount should be at least 50%.

The lack of a clear consensus on this issue means that ISS is not proposing to make a formal change to its voting guidelines on this issue for 2018, although it will continue to consider proposals in the round. After a year in which ISS has proved generally unwilling to recommend a vote in favour of restricted share schemes, it recently supported Hargreaves Lansdown's replacement of an LTIP with restricted shares – a policy which ultimately received 99% support at the AGM.

ISS is currently consulting on policy changes for 2018 (with the comment period ending on 9 November) and there are no indications that any of its formal UK guidelines on remuneration will change for next year. However, companies should expect ISS analysis to focus on the following areas (many of which are consistent with the updated IA Principles):

- A desire for more detailed retrospective disclosure of non-financial/personal targets used for bonus schemes
- Less acceptance of bonus targets remaining commercially sensitive after the end of the performance period
- A requirement for basic salary increases always being accompanied by a good explanation
- Long-term incentive grant sizes should be reduced where performance targets are being reduced and/or where there has been a significant share price fall
- Increased concern regarding high levels of awards vesting for threshold performance (particularly where grant sizes are high)

ISS's 2018 voting guidelines will be published later this year and will apply to AGMs on or after 1 February 2018.

Separately, **Glass Lewis** is continuing to grow its presence in the UK market. It opened a London office earlier this year and now welcomes dialogue and engagement with companies on remuneration and other corporate governance issues. Unlike ISS, Glass Lewis does not provide companies with a pre-publication draft copy of its research for comment, but it does offer an "Issuer Data Report" where companies can check the data which is due to be used in the Glass Lewis report for accuracy.

Similar to the IA and ISS, Glass Lewis places a lot of emphasis on the importance of good disclosure and on pay decisions being well explained in the remuneration report. It also has specific preferences on incentive schemes, stating that metrics for short-term and long-term schemes should be different, and that long-term plans should include at least two performance measures. Glass Lewis has been following the debate about new pay models and has recommended support for restricted shares on more occasions than ISS during 2017.

ISS has announced that the window for companies to submit a peer group for consideration in its quantitative Pay for Performance (P4P) model will be open from 20 November to 8 December 2017. This group should include the companies used for setting pay for the current financial year, and will be taken into account by ISS when constructing the P4P peer group to be used ahead of the 2018 AGM.

Our View

- We are not expecting radical changes to ISS' approach in 2018 but there are signs that – like the IA – it will increase the pressure on companies where annual bonus target disclosure lags the market, with non-financial metrics under particular scrutiny.
- ISS's generally negative response to new pay models presented in 2017 has been a source of concern for companies wishing to do something different. We do not anticipate a fundamental change for 2018, particularly given the diverse views of ISS clients. However, remuneration committees continue to have a chance of gaining ISS support for restricted shares if the discount to LTIPs is high, an underpin is in place, the overall policy is simple and a good strategic case can be made for the new model.
- Companies considering participating in the P4P peer group submission exercise should take into account the group used by ISS in the model earlier in 2017 and to what extent this differs from the peers used internally for referencing pay. Also, the peer group will need to be disclosed in next year's remuneration report in order for it to be reflected in the P4P model which will be displayed in the ISS report on the 2018 AGM.
- Given the increasing profile of Glass Lewis and its willingness to engage, we encourage its inclusion in shareholder consultation exercises (alongside the IA and ISS) as a matter of course.

Want to know more?

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