

# UK Executive Pay & Governance

## Updated Investment Association and Legal & General Remuneration Principles

November 2018

### Introduction

The Investment Association has published [updated Principles of Remuneration](#), which it has sent to remuneration committee chairs at FTSE 350 companies alongside an introductory [letter](#). The Principles reflect a toughening of the IA stance in some key areas.

Separately, Legal & General Investment Management (LGIM), an influential member of the IA, has published its own [updated Principles on Executive Remuneration](#), which set out its expectations as a major investor in UK companies.

The key points from the IA and LGIM guidelines are set out below, and include:

- Pensions reductions
- Post-employment shareholding guidelines
- Clawback/malus

We note that some of what follows is aspirational and does not require immediate attention; we cover the timing issues in more detail in our commentary on page 3.

### General

- The IA is critical of some remuneration committees as being too close to management and unresponsive to shareholder concerns. Any large vote against a resolution requires a committee response. Individual committee members – and also executive directors – risk damage to their reputations where executive pay is poorly managed.
- The IA also suggests that there remains scope for improvement with remuneration consultations. The strategic remuneration issues are more important than the minutiae of pay. All details of the remuneration structure should be provided, so that

investors have the full picture. The final proposals should contain no surprises.

- Going a step further than the revised UK Corporate Governance Code, LGIM believes that the Remco chair should have served on the board for at least a year prior to appointment.

### Quantum

- For the IA, excessive remuneration is a major problem: it sends the wrong messages, is reputationally bad and can cause long-term damage. Fairness and the wider employee context must be considered when setting executive pay. Incremental increases to fixed and variable pay continue to be a concern. Salary increases should be appropriate against the increases awarded to the wider workforce.
- These themes are echoed by the LGIM guidance. In addition, **LGIM makes it clear that it will not support any increases to annual bonus limits going forward.**

### Pensions

- Following the new UK Corporate Governance Code, the IA makes it clear that **pension contribution rates for executive directors should be aligned with the rate given to the majority of the company's workforce.** New directors, or directors changing role, should be appointed on this rate, and the rate for existing executive directors should be reduced over time ("as soon as possible") to this level. No compensation should be paid.
- **LGIM calls for the alignment with the workforce to happen for new directors at the time of the next policy review;** for existing directors, pension provision should be lowered when contracts are being renegotiated. There is a voting sanction: **from 2020, LGIM will oppose the remuneration policy where there has been no action to**



**address pensions disparity**, unless the company can demonstrate that director and workforce pensions are aligned.

## LTIPs

- This is not a major focus area of the IA update, although the new Principles do state that retrospective changes to performance conditions are not acceptable; LGIM makes a similar point.
- One new IA provision – clarifying a point that has been raised in recent IVIS reports – is that **there is no support for paying LTIPs in cash or cash equivalents** (other than to settle tax). In addition, **any accrued dividends should be paid in shares** (this also applies to dividends accruing on deferred bonuses).

## Restricted shares

- The IA's guidance on restricted share schemes has been enhanced. A majority of IA members are willing to consider restricted shares, but with conditions. Among other things, the strategic rationale should be clear, the vesting period should be at least five years, the discount should be at least 50% and the Remco needs to have the ability to exercise discretion on vesting outcomes. Shareholding requirements should be significant and should also apply after cessation of employment.
- The IA recognises that “some shareholders” like to see a quantitative underpin. LGIM is not in this camp: its approach is to call for a more general underpin based on a Remco assessment of overall performance and individual leadership over the vesting period.

## Shareholding guidelines

- The IA has clarified what shares should be included in the calculation of whether an executive has met the shareholding guidelines. **Unvested shares which are not subject to performance conditions count (on a net of tax basis)**; vested shares subject to a holding period or clawback count.
- Post-employment shareholding requirements are emphasised. **They should be introduced for all new executive directors and for existing directors at the earliest opportunity (at the minimum by the next policy vote). The requirements should apply for at least two years at a level equal to the lower of (1) the shareholding requirement prior to departure and (2) the actual shareholding on departure.** The Remco needs to be clear how it intends to ensure that the requirements are maintained (e.g. through the use of a trust or nominee account structure).

- LGIM has fleshed out its view that shareholding requirements should be linked to the value of total variable pay. For FTSE 1-30 companies, the guideline is 5x salary; for the FTSE 31-50, it is 4.5x salary; and for the FTSE 51-100, it is 4x salary. Shares should be held for two years post-exit and **for FTSE 100 companies the post-employment holding requirement should be at least 3x salary.**

## Clawback/malus

- As indicated earlier in the year in its evidence to the BEIS Select Committee inquiry into executive pay, the IA focuses more closely on clawback. Remcos need to disclose the list of circumstances in which recovery provisions will apply, and this should be broader than gross misconduct and misstatement. Clawback terms must be clearly set out and accepted by executive directors, bolstered by clear, consistent documentation and processes.

## Discretion

- The IA also stresses the importance of up-to-date documentation in terms of the Remco having sufficient legal power to exercise discretion. LGIM wants to see the statement from the Remco chair discuss the use of discretion in detail, for example with the clear disclosure of what the monetary outcome would have been had discretion not been applied.

## Pay ratios

- The disclosure of the CEO:employee pay ratio has been encouraged by the IA for some time. Ahead of the reporting required in 2020 by the new legislation, **the IA is asking companies to publish the ratio in 2019.** Of the options provided by the law for calculating the ratio, the IA favours “Option A” – i.e. determining the remuneration of all UK employees to identify those individuals at the lower quartile, median and upper quartile levels. The IA has dropped its previous position that company disclosures also include reference to the pay ratio between the CEO and the executive committee.
- LGIM echoes the IA's preference for the use of Option A. **It also expects all companies to publish a pay ratio, not just those with more than 250 UK employees** (the threshold under the new law). LGIM further encourages boards to question whether their ratio is appropriate in light of the industry in which the company operates.



## Our View

**There is plenty to consider in these updates but, for the most part, immediate action is not required. Both the IA and LGIM are addressing issues which, under the updated UK Corporate Governance Code, companies need to be reporting on in 2020. One exception to this is where Remcos are introducing a new remuneration policy in 2019, as explained below.**

- The updates give an insight into the direction of travel of investor guidelines in an environment which is focused on themes such as long-term share ownership, fairness, employee and wider stakeholder engagement and the appropriate use of Remco discretion. However, there is little clarity from the IA on how its new guidelines will translate into how IVIS judges companies in 2019. Indications of what will trigger a “red top” or “amber top” rating are absent this year. Our view, based on past experience, is that IVIS will not jump direct into “red top” territory in 2019 for those companies which do not fully comply with the new Principles. But Remcos cannot rest on their laurels. As noted above, LGIM, for one, has already stated that the pensions issue will become a voting matter from 2020. We also anticipate that ISS will fall in line with the IA’s approach when updating its own voting guidelines at the end of next year – potentially meaning that any company which does not address some of these issues for the 2020 AGM may face a significant level of opposition.
- On pensions, the IA is taking a tough line. The grandfathering of existing directors’ entitlements is not acceptable to the IA. Aligning executive director contribution rates with those for the senior executive team will be insufficient: instead, reducing to the rate which applies to the majority of the workforce is required. Remcos will need to consider this carefully, particularly if the remuneration policy is under active review or if an above-average basic salary increase is being contemplated. As a first step to compliance, the Remco will need to understand what pension provision applies to the majority of employees. Remcos are also encouraged to review the whole executive director package in the context of pensions reductions, but the room for manoeuvre is very limited. Compensating directors or increasing basic salary to offset the lower pension will not be supported by investors. Additional thought should be given to the contribution rates for senior executives below board level. Remcos will need to be alive to situations where executive directors are on the workforce rate but their direct reports are on a higher rate.
- Post-employment shareholding requirements cannot be ignored. The IA expects these to be introduced no later than the next policy vote, so companies planning a new policy vote in 2019 will need to bear this in mind. Attempts to set a post-employment requirement lower than the standard guideline may not be acceptable to the IA, but this might be an allowable middle ground for a new policy being introduced in 2019. Some executives are likely to push back, not wishing to be forced to hold on to a substantial equity stake after they have departed, particularly if they left under difficult circumstances. Even in a “comply or explain” environment, we fear that executives (or non-executives) taking a principled stance against post-employment requirements will lead to substantial investor opposition over time.
- Pay ratio disclosures are coming. The preference of the IA and LGIM for the use of “Option A” may disappoint those companies who have already wrestled with the challenges of pulling together the data required for a complete list of single-figure equivalent pay for all employees. We doubt, however, that a different approach will lead to investor ire, provided that an explanation is provided. The other question is whether to disclose the ratio “early” in 2019. We are not aware of this being a red-line issue for any investor, and ISS and Glass Lewis have already indicated they are taking a “watching brief” on this rather than demanding disclosure next year. We do not therefore see early reporting as essential, although we recognise that some Remcos are keen to get their ratio and supporting narratives out in an attempt to control the debate.
- Clawback continues to be a priority issue for investors against the backdrop of Carillion and others. The IA is very keen to ensure that recovery provisions can operate in practice without risk of legal challenge, hence the focus on documentation and processes. Remcos should review what is currently in place and consider where changes may need to be made. Also important is to ensure that the circumstances in which clawback and malus will be operated are extended to cover situations such as corporate failure and reputational damage. This should be done in 2019: investors will be unforgiving if clawback was needed but was ineffectual because the Remco delayed making these changes.
- The structure of incentive schemes is less of a headline priority for the IA this year but, as ever, Remcos need to ensure that target-setting is done properly and remuneration reporting adequately explains the link between performance and reward. On quantum, LGIM’s decision to vote against all bonus increases stands out – and will be tough on those companies which are considering a small enhancement to an already below-market annual incentive. Few other large investors take such a hardline stance.
- As has been evidenced by recent IVIS reports, the IA has come out against LTIP awards being settled in cash or dividend equivalents being paid in cash. The IA’s focus on this issue is a little puzzling. However, the approach to dividends will impact the



many companies where scheme rules permit dividend equivalents to be paid in shares or cash. As a minimum, a review of existing practice is recommended, with payment in shares made the default position.

## Want to know more?

### Please contact:

**Rob Burdett**

m: 07979 537 326

[rob.burdett@kornferry.com](mailto:rob.burdett@kornferry.com)

**Russell Davies**

t: 020 3819 2019

[russell.davies@kornferry.com](mailto:russell.davies@kornferry.com)

**Simon Garrett**

m: 07748 328 560

[simon.garrett@kornferry.com](mailto:simon.garrett@kornferry.com)

**Ian Greenwood**

m: 07408 809 695

[ian.greenwood@kornferry.com](mailto:ian.greenwood@kornferry.com)

**Deborah Hall**

m: 07495 796 619

[deborah.hall@kornferry.com](mailto:deborah.hall@kornferry.com)

**Jonathan Hutchings**

m: 07408 802 787

[jonathan.hutchings@kornferry.com](mailto:jonathan.hutchings@kornferry.com)

**Chris Niland**

m: 07779 270 334

[chris.niland@kornferry.com](mailto:chris.niland@kornferry.com)

**Andrew Udale**

m: 07770 720 888

[andrew.udale@kornferry.com](mailto:andrew.udale@kornferry.com)

## **About Korn Ferry**

Korn Ferry is a global organizational consulting firm. We help clients synchronize strategy and talent to drive superior performance. We work with organizations to design their structures, roles, and responsibilities. We help them hire the right people to bring their strategy to life. And we advise them on how to reward, develop, and motivate their people.

