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Executive Pay: The Investment Association publishes updated Principles of Remuneration

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The Investment Association ('IA'), which is the representative body of the UK Investment management industry and represents £5.7 trillion of assets, has published updated guidance on executive pay. The guidance is the first update to be provided since the IA sponsored Working Group reported back over the summer that FTSE All Share companies should be afforded greater flexibility to choose a pay model that best fits their commercial circumstances. Their conclusions contrasted with the current 'one size fits all' approach to remuneration which currently includes a base salary, benefits, annual bonus and long-term incentive.

Notwithstanding the IA Working Group's initial preference for a radical rethink on executive pay, the updated guidance is more 'evolution' than 'revolution' which reflects the broad church of views held among its 200-strong membership base.

The Investment Association has also published an open letter to FTSE 350 companies providing further insight into its current thinking.

In what follows we provide a summary of the key points arising from the IA's updates, which are timely given that many companies are currently finalising the details on revised three-year remuneration policies to be put to shareholder votes at their 2017 AGMs.

Korn Ferry View

The greater flexibility in company pay models included in the guidelines is a welcome development. However, our recent experience of consulting around non-standard pay structures suggest that there remain divergent views across individual investors and so the form and structure of a shareholder consultation remains crucial to gaining investor support for tailored remuneration policies.

It is also noted that the other pre-eminent shareholder protection body, ISS, is soon to publish its own updated guidance which should be considered alongside the update from the IA.

KEY POINTS TO NOTE

- Remuneration policies should be simple and tailored to business circumstance.
- Quantum remains a key issue with institutional investors and companies should explain:
  - How the maximum potential remuneration has been set for future years and why total pay earned in the year under review is appropriate; and
  - the ratio of Chief Executive pay to (i) the median paid employee and (ii) the Executive Committee.
- Remuneration should be aligned with long-term sustained performance and so executives are, for the first time, encouraged to (i) purchase shares from their own funds and (ii) hold a proportion of their shareholding beyond their cessation of employment.
- Full retrospective disclosure of annual bonus targets and actual performance against them should be included in the remuneration report in relation to prior year performance.
- Remuneration Committees are expected to use discretion as an important tool to ensure remuneration earned is appropriate in the context of overall performance. However, discretion is read as 'downward' only.
- Shareholders expect engagement to be at a strategic level and constitute an 'active' consultation as opposed to a validation exercise.

Current areas of IA Focus

- **Quantum:** any proposed increases in quantum in relation to 2017 remuneration policy renewals (salary levels and variable pay) will be the subject of scrutiny and require robust justification.

> **Executive pay quantum is a key focus of institutional investors and at the heart of the recently launched government inquiry into corporate governance. Accordingly, care is required when seeking to make any increases to quantum and adjustments based on the results of benchmarking need to be used with extreme caution.**

- **Annual bonus disclosure:** full retrospective disclosure is required of financial targets (threshold, target and maximum hurdles) alongside actual performance achieved. If this is not possible on the grounds of commercial sensitivity, then a commitment must be made to provide the disclosure next year. With regards to personal/strategic targets, as a minimum, a thorough explanation of the relationship between performance and reward is required.

> **Where the IA's disclosure requirements are not met on financial targets, IVIS (the proxy advisory arm of the IA) will provide a 'red top' voting report on the Company's forthcoming AGM (highlighting a breach of investors' 'best practice') and this will be a significant influencing factor in how investors vote shares at the Company's AGM on the annual report on remuneration resolution. Similarly, there must be a 'thorough explanation' for payouts under personal targets, not just a description of the metrics. This represents an upping of the ante compared to previous guidance.**

- **Policy renewals:** 'hard' maximum limits must be included for annual and long-term incentives; retaining discretion in policy to make payments outside of these limits will not be supported by IA members and recruitment terms will also be an area of shareholder scrutiny.

> **While there must be hard limits on any incentive plans, there do not need to be hard caps on salaries or the value of benefits (even though, arguably, this is a requirement under the regulations). Our discussions with the IA indicate that the current practice of limiting salary increases to those of the wider workforce (other than where responsibilities change) rather than setting a monetary cap remains acceptable.**

- **Pensions:** companies are asked to justify why pension provision is higher at executive level versus other employees and, where there isn't a clear justification, how they intend to reduce the disparity.

> **This is targeted at those companies that operate significantly enhanced defined benefit structures for executives but not for employees generally and where executives have an obviously high pension contribution rate under a defined contribution plan. For the significant majority of other companies that operate relatively standard pension provision this is not something that needs to be addressed in the present policy review, but it does signify a firming of the IA's position on this issue.**

Updated Principles of Remuneration

- **Pay model:** companies are encouraged to adopt a simple remuneration structure that best reflects their own business type and cycle. The guidelines envisage a continuation of the current pay model for many companies (fixed pay plus an annual bonus and long-term incentive) plus, among other alternatives where the business type warrants:

– **A rebalancing in the pay mix between short and long-term performance targets** (which should be accompanied by a reduced incentive quantum overall if the rebalancing is towards short-term pay): it is noted that if a Company's business model is better aligned with annual performance periods then in any rebalancing of incentive quantum towards short-term pay the aggregate quantum should be reduced to reflect the higher perceived likelihood of a payout against annual targets (e.g. if annual and long-term incentives were both 100% of salary (200% total), then under the IA guidance annual bonus could be 125% of salary but long-term incentives would need to be 50% with a clear rationale for moving to short-term performance).

– **Performance on grant schemes** (e.g. higher annual bonus, no long-term incentive): noted as not universally popular but can be adopted if quantum is reduced (like the example above) and other controls are put in place (e.g. introduce long-term deferral for part of the bonus and the potential for this earned remuneration to be reduced if performance is not sustained).

– **Restricted shares** (i.e. replacing a traditional three-year performance related long-term incentive with a reduced award of non-performance related shares): highlighted as not being supported by some institutional investors and, where supported, requiring (i) a seemingly definitive reduction of 50% vis-à-vis the quantum operated under a performance related long-term incentive and (ii) requiring a vesting period of three years plus with enhanced share ownership guidelines.

We welcome the IA's encouragement for greater flexibility in incentive design to tailor remuneration structures to a Company's circumstance. However, our recent experience suggests that the quid-pro-quo for more tailored (and superficially 'simpler') remuneration structures can, perversely, include greater complexity (e.g. through longer and phased vesting periods with enhanced recovery and withholding provisions). Therefore, care needs to be taken to avoid any unintended consequences with a restructuring of the incentive pay model.

- **Quantum:** companies are tasked to explain how maximum remuneration potential was set along with justifying the level of remuneration earned in the year when preparing a remuneration report. This justification is being requested as investment managers are under increasing pressure from their own clients (e.g. pension fund trustees) to justify remuneration levels.
- **Pay ratios:** institutional investors are highlighted as requesting the inclusion of relevant reference points from which to consider quantum. These include the ratio between Chief Executive pay and (i) median employee pay and (ii) Executive Committee pay.

In principle, the production of ratios may serve as a slightly helpful context for the Remuneration Committee when taking pay decisions. In addition, preparing a ratio versus the Executive Committee may also provoke thought around internal succession planning. However, given companies' internal structures (e.g. the size of Executive Committee varies markedly) and number of employees and their type varies by sector and approach to outsourcing, ratios will have limited value when comparing across companies. We believe that the only really useful reference points for the Committee could be to see how the ratio has moved over time (and this could be compared more readily across companies) but the IA has not asked for this disclosure to be shown on a historic basis.

- **Discretion:** the IA guidance envisages Remuneration Committees exercising discretion to avoid excessive remuneration payments.

In practice, we read this as reducing the formula-based outcomes of incentives with this being a response to several high-profile AGM's in 2016 where the relationship between pay and performance was considered to have broken down (e.g. BP). Use of upward discretion remains very difficult and should only be used following shareholder consultation, although this may not be practically possible in the time available between considering a payment and publishing AGM materials.

- **Shareholder alignment:** executives are encouraged to (i) build a high level of share ownership through share retention from vested long-term incentive awards and the purchase of shares using their own resources and (ii) retain shares for a continuing period following cessation of employment. There is no prescription as to quantum or timeframes for either of these feature

Greater share ownership is a continuing focus of institutional investors (ISS continue to push for a minimum 200% of salary shareholding with the IA Working Group also encouraging greater levels of share ownership for the largest companies). There are two new aspects of the guidance here; first, encouraging executives to purchase shares with their own funds and, second, introducing an extended holding period post cessation of employment (which has been Standard Life's recommended approach for some time).

- **Shareholder engagement:** shareholders expect engagement to be at a strategic level and constitute an active consultation as opposed to a validation exercise. In addition, the IA has defined a 20% threshold whereby if opposition at an AGM on a remuneration resolution is at this level, companies should seek to understand the reasons for the dissent and then publish their explanation for the dissent and what they propose to do about it.

> **This is the first time that the IA has defined a level for 'significant' votes against an AGM remuneration related resolution and we read the above to be consistent with the UK Corporate Governance Code requirement to notify the market of 'significant' opposition to an AGM resolution and then explain what the Board's intends to do about it. The IA guidance is also consistent with the recent update from Legal & General but doesn't go as far in suggesting this could result in a retender of the Remuneration Committee's advisers.**

- **Remuneration Committee membership:** effective operation of remuneration policy is considered to include full Board oversight of remuneration decisions, including the Company Chairman, and a least one year's experience for a non-executive director on the Board before being considered for the role of Chair of the Committee. In addition, the Remuneration Committee Chair should also have the requisite skills and experience.

> **Given the public profile of remuneration decisions, the general trend is for the Company Chairman to be increasingly involved in discussions around remuneration and we welcome the inclusion of this in 'best practice' guidance. Furthermore, given the difficulties that being a Committee Chair can include, and the need to align corporate strategy and remuneration policy, we also consider the requirement for a year on the Board before chairing the Remuneration Committee to be progressive. This latter requirement is as per the recent update from Legal & General.**

WANT TO KNOW MORE?

If you want to find out more about how your organization can benefit from our services or would like to discuss the above, please contact:

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About Korn Ferry

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In relation to UK executive pay we are committed to building a full-service Remuneration Committee advisory firm. Please call one of the following should you wish to discuss the content of our briefing note or executive remuneration more generally.