EXECUTIVE REMUNERATION WORKING GROUP

INTERIM REPORT

April 2016

Contents

Introduction from the Executive Remuneration Working Group Chairman

The Working Group believes the current approach to executive pay in UK listed companies is not fit for purpose, and has resulted in a poor of alignment of interests between executives, shareholders and the company. This is a difficult problem and there have been several attempts at reform. We are confident that widespread engagement will result in a better outcome.

The FTSE is trading at broadly the same levels as eighteen years ago and 10% below its peak– however executive pay over the same period has more than trebled and there is an increasing disparity between average wages and executive wages. This misalignment has resulted in widespread scepticism and loss of public confidence. Failure has sometimes been rewarded, and use of median comparators has driven disproportionate rises in executive remuneration. This is ultimately damaging to the listed company sector. At the same time, Boards have sometimes outsourced remuneration to consultants, reducing accountability and creating unwanted outcomes.

The Working Group believes that greater transparency, clearer alignment of shareholder, company and executive interests, more accountability on the part of Remuneration Committees and greater engagement with and control by shareholders, working through company boards, are vital to restore confidence in a system widely seen as broken. Company, shareholder and executive interests need to be much more closely aligned and "ownership" of this issue returned to shareholders and the broader public.

Specific concerns where the Working Group seeks further input are:

- **Transparency**: Retrospective reporting of targets should be strongly encouraged so as to allow everyone to understand how bonus was calculated. Full retrospective disclosure of performance targets builds on the excellent work of the Financial Reporting Council in 2012 and would help re-establish trust between companies and shareholders. Remuneration Committees should also report where they have used discretion – upwards or downwards, including impact of share buy backs, employee buyouts and malus.
- **Shareholder Engagement**: Shareholders will need to analyse the proposed structures and payments from both a governance and investment perspective. The Investment Management industry has largely outsourced/insourced remuneration issues to Corporate Governance specialists, and fund managers are largely disengaged on incentives, even though they agree that incentives drive behaviour and outcomes. Greater disclosure of retrospective (and prospective) targets would help re-engage mainstream fund managers and sell side analysts.
- **Accountability**: Remuneration Committees need to be more accountable for the decisions they take. They need to ensure that remuneration outcomes are fully aligned with overall business performance and strategy. Discretion should be used, both upwards and downwards rather than committees relying on formulaic outcomes. Company Annual reports should include the total payment to the firm that provides advice to Remuneration Committee, not just the payment for advice on remuneration – this follows the practice used for auditors.
- **Flexibility**: Companies should move away from a "one-size fits all" remuneration model: remuneration structures should be more tailored to the individual needs of the business and company strategy, moving away from the use of median comparators and "remuneration creep". Remuneration Committee areas of judgement and discretion would include the required percentage share ownership for executives – e.g. 100% of annual total remuneration, including bonuses and LTIP's, which could be 500% or more of base pay – and the division of remuneration between fixed salaries, short-term bonus (where appropriate: these are not especially closely-aligned to shareholder interests) and long-term restricted shares.

Remuneration Committees should use their own judgement and knowledge of the company in setting performance targets, which are clear and transparent. They also need to be able to justify these often-complex decisions - for example explaining bonus plus LTIPs as a percentage of pre-tax profit, as is now the case in banking.

The Working Group's views will be outlined fully in our final report, but for this interim report and consultation we are focused on seeking views on some of the alternative structures which could be adopted and the parameters which would need to be established when moving from the current system to a more company specific approach. We look forward to receiving your feedback and thank you for contributing to this important project.

Nigel Wilson

Chairman, Executive Remuneration Working Group

Background to the Executive Remuneration Working Group

The Investment Association and its members have, in recent years, been reviewing the current structures of executive pay, as there has been a developing view that the system is failing to align the interests of shareholders, businesses and executives. We understand that executives themselves also increasingly share this view.

In the Autumn of 2015, the Investment Association facilitated the formation of an independent Executive Remuneration Working Group to assess whether the current structure of 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 are represented. For a list of members and the timeline of the work to date, for which the Investment Association has provided a secretariat, see Annex 1.

The IA has informed the Working Group of its intention to review, promptly after the publication of the Working Group's Final Report, whether to adopt the Working Group's recommendations in its Principles of Remuneration.

Outline of the Interim Report

This Interim Report has been produced principally to support a series of roundtable discussions with a wide range of stakeholder groups, including remuneration committee chairmen, executives, HR and reward directors, asset managers, asset owners, company secretaries and other stakeholder groups including government and regulators. During the discussions the Working Group's current thinking will be discussed. There are three parts to the report, reflecting three different stages of thinking.

1. Key Proposals of the Working Group
2. Discussion on Alternative Structures
3. Consultation on Parameters

The roundtables will faciliate discussion around the potential benefits or drawbacks of the views expressed in the second and third parts of the report, and allow stakeholders to identify alternative options.

Part 1 – Key Proposals of the Working Group

The Working Group is of the opinion that the near-universal usage of a three-year LTIP model overly constrains consideration of other remuneration structures, which may be more appropriate to a company's own business model and strategy.

The Working Group believes that LTIPs, as currently constructed, while intended to provide a longer-term incentive and align executive reward with shareholder experience, can produce a number of unintended or perverse consequences. For example, LTIPs are intended to motivate executives to achieve certain goals over a longer period. However, companies can find it challenging to set targets that will still be relevant to their strategy and the wider economic environment in three years' time. This can lead executives to feel that they have little or no control over the outcomes of the awards. This can be particularly true when LTIPs use relative measures. This loss of "line of sight" between an executive's contribution and the outcome of the LTIP limits the effectiveness of the remuneration model.

In addition, fluctuations in payouts, the uncertainty attached to LTIPs and the introduction of restrictions such as malus, clawback and holding periods has also had the effect of driving up the overall size of executive remuneration, as remuneration committees increase fixed pay to achieve the remuneration levels they require to retain their executives.

The Working Group also understands that a growing and disproportionate amount of shareholder-company engagement is spent discussing executive remuneration, to the detriment of other potentially more significant issues. A simpler, more aligned remuneration structure could allow companies and investors to focus their engagement time on a wider set of strategic and governance issues.

Despite these issues with LTIPs, companies are generally encouraged to adopt an LTIP-style model to reflect best practice in the market. However, the Working Group believes that, for those companies whose business model is not well-suited to LTIPs per se, alternatives should be used and supported by shareholders.

The Working Group recommends that there is a deliberate re-set in the expectations of companies and asset managers and owners, such that companies will feel able to propose the remuneration structure that is in their judgement most appropriate whilst still meeting certain guidelines (which are detailed below). If adopted, this is likely to result in differing structures for differing companies, which will reflect the individual nature of the company and business model.

Based on the wide-ranging experience of the Working Group, reinforced by interviews with stakeholders, a set of underlying components to an effective remuneration structure are proposed. The Working Group considers that these components act as a guide for companies in the choice of the appropriate structure for them.

1. Structures should be aligned with:

    a. The interests of shareholders – reward for creating shareholder value which should be linked to the shareholder experience
    b. The performance of the company – reward for contribution to good company performance and penalty for failure
    c. The implementation of the company's long term strategy – reward for successfully implementing the strategy
    d. 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
    e. Wider corporate and social responsibility goals

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

Part 2 – Discussion on Alternative Structures

A change to the system also requires an understanding of what alternatives exist, and under which conditions they might be acceptable to asset managers and owners. To this end, and to promote confidence amongst investors and ensure clearer expectations for all parties, the second part of this interim report briefly sets out some alternative structures. Without deflecting from a clear recommendation to embrace alternatives, the Working Group also believes that the current typical three-year LTIP remuneration structure may remain the most appropriate for some companies. The LTIP remuneration structure will therefore be considered in our proposals alongside a range of alternatives.

The Working Group has identified that there is a general acceptance of some elements of pay, such as salary, annual incentives (bonus) and pension/benefit arrangements. While there are specific issues that can be raised with these individual elements (in particular cash bonuses), most stakeholders maintain that these are standard elements of pay and they will remain as components of executive remuneration.

The Working Group has therefore analysed alternatives which have different forms of measurement for long-term performance, as this is the key area of dispute. For each alternative, the Working Group has explored why it might be appropriate for a particular company.

a. LTIP Model

The LTIP (Long-Term Incentive Plan) model consists 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.

<u>Why this structure might be suitable for some companies</u>

Some of the companies that the Working Group has heard from believe that the current system works well for them, with the measurement of long-term performance through the LTIP alongside short-term performance measurement through the bonus motivating their executives. This system also helps to signal which aspects of their long-term strategy are important. They reported that this system works well when it is communicated effectively to participants, as well as if it has performance criteria that are stable over time. Some companies also value the fact that this structure has become embedded and is therefore well understood by participants.

b. Deferral of bonus into shares

Under this structure the bonus is paid partly in cash, with a significant proportion paid in shares that vest over a significant time period.

<u>Why this structure might be suitable for some companies</u>

The deferral structure may be suitable for companies with short business cycles, or where it is difficult to set meaningful long-term targets. It is simple to understand for participants as there is only one variable element - the bonus. It also simplifies the task of remuneration committees when setting targets, given the difficulty that many report in setting long-term targets. A similar structure could be used across the organisation for all employees, with a graduated level of deferral based on seniority. Pay will still vary with performance, as bonus outcomes reflect performance achieved during the year. A long-term holding period for part of the bonus, alongside significant shareholding guidelines, will maintain a long-term interest in shares for the executive and alignment with shareholders. Whilst some investors may have concerns that there are no long-term performance measures, the accumulation of bonus awards leads to an effective long-term share based executive interest.

c. Performance on grant

Under this model, participants receive grant of shares awarded based on performance achieved over the previous 3 years. The grant of shares then vests three to five years after grant.

Why this structure might be suitable for some companies

This structure maintains a similar format to the current LTIP model, but it overcomes some of the problems of setting robust long-term performance targets as well as the issue of executives discounting the value of LTIPs as they are too distant in the future. That is because, at the time of award, the award value has been decided and the remuneration committee base the award on past performance.

d. Restricted Share Awards

An annual grant of restricted shares, which will vest after a period of time based on continued employment.

Why this structure might be suitable for some companies

This structure encourages a long-term view by making executives invested in the company, with their performance measured ultimately by long-term share price performance. This system would be simpler for remuneration committees who operate it because there are no long-term targets to consider. Some companies have reported that they already use a similar structure to this at levels below the executive committee, so it may allow some companies to harmonise their structure throughout their organisation.

Discussion Point: The Working Group would welcome views on this suite of alternative remuneration structures. Do stakeholders think that they are likely to increase simplicity of remuneration structures and provide better alignment between executives, company performance and shareholders? Are there any other alternative remuneration structures that the Working Group should consider?

Part 3 – Consultation on Parameters

The third part of this report considers conditions and characteristics of structures that might be expected commonly to be present or addressed.

In principle, the alternatives outlined in the previous section may work for different companies, but the Working Group believes that it is also necessary to assess the practicalities of applying such structures. There are various questions about the implementation of these structures that need to be considered, such as:

- Given the increased amount of certainty with alternatives such as restricted awards, how would the value of LTIP awards be translated to reduce the quantum?
- What restrictions need to be in place to prevent payment for failure under alternative structures?
- What size of holding period and shareholding guidelines are appropriate to maintain long-term alignment of executives with shareholders?
- Is are there any action/behavioural change required on the part of companies, remuneration committees, shareholders and other market actors in order to implement alternatives or accept a wider range of structures?

The Working Group has considered some of the answers to these questions and how they could be used as parameters or guidance for those moving to alternative structures.

The Working Group would also welcome views on other areas of guidance that should be provided.

a. Discount Rate

These suggested alternative remuneration structures reduce the overall volatility of outcomes and make pay more certain, as it is not dependent on future performance. A "discount" rate would therefore need to be applied to the value of remuneration currently paid under the LTIP awards.

The Working Group has considered views of consultants, remuneration committees, shareholders and some past practice and consider that a discount rate as high as 50% may be appropriate.

Discussion Point: Do consultees have views on the appropriate discount rate? How will this differ amongst the proposed remuneration structures?

b. Length of Holding Periods

Shareholders currently expect that the total performance period plus holding period for long-term incentives should be at least five years (i.e. a 3-year performance period and additional 2-year holding period). It is unlikely that shareholders would support a reduction in this holding period under alternative models. However, individuals 'discount' or reduce the value ascribed to deferred pay once deferral periods are deemed to be too long. Additionally, the short average tenure of executives mean that long holding periods may extend past the likely length of their tenure, and may lead to the retention effect being rendered useless by an executive's deferred pay being bought out by their next employer.

The Working Group recognises that five years is currently the norm, and that further increases may not bring any benefits in terms of long-term thinking, but may start to have a demotivating effect. The Working Group are open to views on whether phased vesting, and whether a equal vesting over years 3-5 would be acceptable to investors and companies, or whether post-employment holding requirements could be workable and/or beneficial.

Discussion Point: Should holding periods be extended past five years? Would phased vesting of awards (e.g. shares released in equal tranches overs years 3-5) be a more suitable option? Would post-employment holding requirements be beneficial?

c. Shareholding Guidelines

It is now considered best practice that executive remuneration structures include provisions for large shareholding guidelines. However, large shareholding guidelines require individuals to concentrate their wealth into the value of a single asset, leading some to question whether, if an executive is so heavily invested in their own stock, they may become too risk averse.

The Working Group considers that in general for large companies a shareholding guideline of 500% of basic salary is appropriate. However, it recognises that the size of the guideline depends on the value of the basic salary and the share price, as well as the need to give executives appropriate time to build up the guideline, depending on their circumstances when they commence the role. The circumstances of the company are also relevant, as an executive at a well-performing company will need less time to reach the guideline.

Discussion Point: Is a 500% of salary a reasonable guide for shareholding guidelines which would mean that executives have a sufficient holding in their company? How should this differ based on the size of the Company? What length of time should executives be given in which to build their shareholding?

d. Avoiding Payment for Failure

For many stakeholders it is important that the executives are rewarded for good performance but not rewarded for failure. This underpins the current variable pay system that operates now. With changes to investor guidelines and the introduction of remuneration policies there have been limited instances of payment for failure, with the majority of departing directors only receiving their contractual notice payments. Some of the alternative remuneration structures outlined in the paper have less variability in pay and provide more certain outcomes. Therefore it is quite possible that executives in those circumstances would receive larger pay-outs than the current model if the company has not been performing well. To address these concerns, in some structures an underpin or override could be introduced that would provide the remuneration committee with the discretion to reduce or claw back the value of restricted shares in the event a threshold level of performance has not been achieved. In others, the social and corporate affect of multi-million payouts needs to be considered.

The Working Group notes that for some of the alternatives involving higher levels of fixed pay, there is greater pressure on remuneration committees to use their discretion responsibly to avoid payment for failure. The Working Group is seeking views on whether this needs to be formalised through an underpin or specified override, or whether it is expected that remuneration committees would exercise discretion without the need for an underpin.

Discussion Point: Should an underpin or performance override be provided in any guidance?

e. Accountability

Giving remuneration committees more flexibility to choose remuneration structures, some of which may involve higher fixed pay, may require committees to take more active judgements on the appropriate overall level of pay or reward in a particular year, given the lack of performance-related pay. The removal of performance criteria in some structures means that these decisions may not be as formulaic as they are now. This will require remuneration committees to take a balanced view of an executive's performance and clearly explain to shareholders why they have taken a particular approach, including explaining the overall division of profits between executives, the wider workforce, shareholders and retained profit for reinvestment in the business. Shareholders will have to listen to the decisions of remuneration committees, but ultimately hold them to account through votes on remuneration reports and/or votes on individual re-election if they are not satisfied. This behaviour may take time to build in, and shareholders and committees will need to build trust to make sure the appropriate outcomes are reached.

Discussion Point: What behavioural change will be needed to implement a system of greater optionality for companies in choosing the appropriate remuneration structure for themselves?

Are there other issues which the working group should incorporate in its considerations?

ANNEX 1

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, Strategic Advisory Board of Lancashire and London Pensions Partnership
- David Tyler, Chairman, J Sainsbury PLC and Hammerson Plc

The Investment Association is acting as secretariat to the Group.

Timetable of the Executive Remuneration Working Group

- Set up in September 2015
- The IA as secretariat gathered views of over 50 stakeholders to present to the Working Group
- Initial meeting of the Group in November 2015 to discuss stakeholder views
- February 2016 – development of the form of response of group and discussion of fundamental questions
- March 2016 – finalised consultation paper
- *Projected* - April/May 2016 roundtables with important stakeholders. The aim of these roundtables will be to get feedback or views and ask specific questions around the range of new structures proposed.
- *Projected* – Early Summer 2016- Publication of final response of the Working Group.
- *Projected* – IA review of Principles in light of output of the Group.

Contact Details

The secretariat to the working Group can be contacted at:

- Email: remuneration.panel@theia.org
- Telephone: 020 7831 0898