NAPF

Securing the future of pensions

Executive Remuneration: Discussion Paper

A response by the National Association of Pension Funds

November 2011

Contents

About the NAPF 3
Introduction 3
Response to consultation questions 4

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About the NAPF

The National Association of Pension Funds (NAPF) is the UK's leading voice for workplace pensions. We represent all types of workplace pension scheme, including defined benefit, defined contribution, group personal pensions and statutory schemes such as those in local government.

Between them, our members have combined assets of approximately £700 billion, and operate some 1,200 pension schemes. Our membership also includes over 400 providers of essential advice and services to the pensions sector. This includes accounting firms, solicitors, fund managers, consultants and actuaries.

Introduction

The NAPF is grateful for the opportunity to respond to the Department for Business, Innovation and Skills' discussion paper on *Executive Remuneration*.

The NAPF and its members have long urged restraint in setting directors' pay. When directors' rewards are significantly more generous than those given to other employees, there must a clear and solid explanation about the link between pay and performance; and, furthermore, there should be no reward for failure. Complex bonus structures and the lack of transparency around boardroom pay are part of the problem. If we are to make progress on executive remuneration, it is critical that boardrooms explain clearly how rewards are linked to performance and how that impacts shareholder value.

The NAPF is generally supportive of the Government's intention to improve links between executive pay and company performance. Key themes covered in the NAPF response include:

- Encouraging more innovative remuneration policies, appropriate to individual businesses, with have clear links between pay and performance;
- Ensuring boards are accountable for pay; and
- Improving transparency of remuneration and how it links to strategy, performance and shareholder value.

We welcome the Government's commitment to improving the links between executive pay and company performance, and we hope the comments provided in our response are helpful.

Response to consultation questions

Question 1: Would a binding vote on remuneration improve shareholders' ability to hold companies to account on pay and performance? If so, how could this work in practice?

We are not in favour of a binding vote on remuneration.

The non-binding resolution on the remuneration report is generally an appropriate channel for registering concern at a company's remuneration practices. Since its introduction in 2002 we believe the non-binding vote on remuneration has already had a significant impact, particularly when coupled with effective engagement between the company and shareholders.

There are other avenues available to shareholders who wish to pursue companies on their remuneration practices. Where severe or persistent infringements of good practice have been identified, or there is evidence from the remuneration arrangements of a policy generally unaligned with shareholders' interests, a vote against the re-election of the chairman (or member/s) of the remuneration committee is considered an appropriate and effective means of influencing change.

Question 2: Are there any further measures that could be taken to prevent payments for failure?

There are a number of points we wish to raise in relation to this matter.

Since the introduction of the non-binding resolution on remuneration in 2002 we have seen a significant improvement in the occurrence of payments for failure. The non-binding resolution is particularly effective when coupled with a good dialogue between the company and its shareholders.

The importance of shareholder action in relation to remuneration (both generally and with respect to termination payments) should not be underestimated. Voting results alone are not enough to determine the extent to which shareholders' engagement with companies is having an impact. In many cases engagement undertaken well in advance of a company's AGM may lead to a company making important changes to their remuneration report. Therefore, where shareholders may have voted against the remuneration report in the first instance, the changes mean they are now in a position to vote in favour of it. We would therefore urge the Government away from using shareholder dissent on company resolutions as an accurate measurement of shareholder action or inaction.

It is also important to recognise achievements that have already been made with respect to this. For example, the joint NAPF and ABI guidelines on termination payments were specifically designed to eliminate payments for failure. We have seen a number of important changes in response to these guidelines, such as a trend towards one-year executive contracts, as opposed to two or three-year contracts.

We do not believe legislative measures are necessarily required to prevent payments for failure, as there may be complications associated with this – including defining what constitutes 'failure' and termination payments made on reasonable grounds. We do however believe there are areas where the Government could provide support and guidance.

We see benefits in the Government taking steps to encourage shareholder collaboration, as we have seen that this can send a strong message to companies on a range of issues (including termination payments). The European Transparency Directive has been cited by some funds as a potential barrier to collaboration, given that an intention to vote at a company meeting in collaboration with other shareholders could require disclosure ahead of the meeting date. This presents potentially severe practical problems to investors and could inhibit effective collaboration. We believe there may be a role for the UK Government in challenging the way these EU rules apply.

Ultimately, a contract of employment is for negotiation between the company and the employee, and there is not a role for the Government in prescribing the individual contract terms. We would suggest, however, that the Government could encourage companies to better explain how the obligation to mitigate loss is encompassed within contracts and how it might play out in practice.

Question 3: What would be the advantages and disadvantages of requiring companies to include shareholder representatives on nominations committees?

We believe the idea of requiring companies to include shareholder representatives on the nominations committee is particularly interesting and may warrant further exploration. We also noted with interest the work by Tomorrow's Company on this subject.

One potential advantage of requiring shareholder representation on the nominations committee is that this would ensure that minority shareholders have a clearer voice when it comes to matters of board selection.

However, there are various practical issues that the Government would need to assess. For example, it would be difficult to legislate such a process. It may be the case that companies are willing to approach shareholders to participate in the nominations process, however if those shareholders are not interested in participating (due to the time commitment or skill/knowledge required, for instance) then it becomes difficult for companies to comply.

Question 4: Would there be benefits from having independent remuneration committee members with a diverse range of professional backgrounds and what would be the risks and practical implications of any such measures?

As we commented in our response to the previous consultation, *A long-term focus for Corporate Britain*, we see few benefits from widening the membership of the remuneration committee to include either representatives from outside the company board or remuneration experts. Such a structure might dilute the cohesion of the board which ultimately will decide on remuneration.

We would also point out that a key role of independent non-executive directors on a company's board is to provide independence and objectivity on such committees.

Question 5: Is there a need for stronger guidance on membership of remunerations committees, to prevent conflict of interest issues from arising?

We do not believe that further guidance on membership of remuneration committees in relation to conflicts of interest is necessary. In our opinion, conflicts of interest are already sufficiently covered by the Companies Act 2006 and the UK Corporate Governance Code.

Question 6: Would there be benefits from requiring companies to include employee representatives on remuneration committees and what would be the risks and practical implications of any such measures?

As per our response to Question 4, we see few benefits from widening the membership of the remuneration committee to include either representatives from outside the company board or remuneration experts.

We do not believe that the structure of remuneration committees is any real cause for concern. Instead, we believe the Government should concentrate its efforts on ensuring that remuneration committees have the right procedures in place to ensure they produce remuneration policies with the right balance between pay and performance.

Question 7: What would be the costs and benefits of an employee vote on remuneration proposals?

We do not believe that an employee vote on remuneration would be beneficial; however we do see merit in employee consultation on remuneration. Remuneration committees and CEOs should be in a position to explain to employees how the structure of the remuneration policy links back to the rest of the company and to its performance. The remuneration committee should be able to explain to employees how different levels of reward reflect different roles.

In the event of there being a significant level of opposition by shareholders the remuneration committee should be expected to explain to both shareholders and employees any action they intend to take.

Question 8: Will an increase in transparency over the use of remuneration consultants help to prevent conflicts of interest or is there a need for stronger guidance or regulation in this area?

We believe that increased transparency is best sought before stronger guidance or regulation is considered.

The Remuneration Consultants Group has produced a Code of Conduct[1], which covers the fundamental principles of transparency, integrity, objectivity, competence, due care and confidentiality. The NAPF encourages all companies to disclose whether or not this Code of Conduct has been taken into consideration when selecting its consultants.

To provide further context in relation to this matter, the NAPF Corporate Governance Policy states that:

[1] http://www.remunerationconsultantsgroup.com/assets/Docs/The%20Code%20November%202009.pdf

- *Consultants to the Remuneration Committee should be independently appointed by the committee and be independent of the company's management. Potential conflicts of interest should be scrupulously and demonstrably avoided.*

- *The remuneration committee is exclusively responsible for the selection and appointment of its advisors.*

- *The remuneration committee is encouraged to disclose whether the Remuneration Consultants Group's 'Code of Conduct' has been taken into consideration when selecting its consultants.*

- *Companies are encouraged to consider submitting the remuneration consultant function to periodic tender and disclose their policy on this matter, including when the consultant was last subject to tender.*

- *If any services are provided by the same remuneration consultants to the company:*

  - *They should be minimised with respect to both the scope and value of services provided to the remuneration committee.*
  - *They should be fully disclosed to the remuneration committee and to shareholders.*
  - *The chairman of the remuneration committee should explain to shareholders why it is appropriate for the committee to appoint the same consultants as the company, notwithstanding this conflict of interest.*

The NAPF Voting Guidelines state that:

- *Consistently poor disclosure of the procedures set out in the Code may result in a vote against the re-election of the committee chairman or against the remuneration report.*

We recognise that some investors are concerned with the extent to which remuneration consultants may provide other services to companies. We would not recommend banning remuneration consultants from providing other services; however consideration could be given to a shareholder resolution on all other services from the provider.

Question 9: Could the link between pay and performance be improved by companies choosing more appropriate measures of performance?

In many cases we believe there could be improved links between pay and performance by companies choosing measures of performance that are more appropriate to their own business and strategy. However, we must reiterate that companies should be given the flexibility to determine the best remuneration structure for their situation.

Furthermore, and very much relevant to the BIS consultation on Narrative Reporting, companies should clearly disclose and explain the links between pay and performance and, ultimately, shareholder value.

We do have some comments about pay structure generally, and the NAPF Corporate Governance Policy and Voting Guidelines state that:

- *The NAPF has suggested that in general, for executive directors:*
  - ***Base pay** increases should be capped at inflation, unless there are sound and compelling reasons for a different approach;*
  - ***Bonuses** should be aligned with profits - thus if profits fall then bonuses also fall;*
  - *In **share plans**, where performance targets are reduced, thus making the target easier to reach, the scale of awards should also be reduced.*

- *In the UK, good practice in remuneration has been set out by the Association of British Insurers (ABI) in its "Executive Remuneration – ABI Guidelines on Policies and Practice". These can be found at http://www.ivis.co.uk/. The NAPF anticipates that most institutional investors and issuers will use the ABI Guidelines as a guide to remuneration policies and has therefore chosen not to re-interpret them in detail here. However it is important that companies tailor their policies to their own particular circumstances and do not slavishly follow established guidelines.*

- *Just as the remuneration committee should adopt a holistic approach when designing and assessing packages, so investors should evaluate remuneration arrangements in their entirety. As noted earlier in this Policy (Page 14) shareholders will seek reassurance that there is a clear link between strategy, performance and reward. Total remunerations should be structured to reflect the ambitions and risks inherent in the business. Performance pay should motivate management to deliver results which are both stretching and sustainable.*

- *Remuneration practices which would most likely cause concern and may trigger a voting sanction in the absence of sufficient explanation include:*

  - *Increases in base salary in excess of inflation*
  - *Over frequent re-benchmarking (we suggest 3 – 5 year intervals)*
  - *Insufficiently demanding performance targets*
  - *Guaranteed, pensionable or discretionary annual bonuses*
  - *Insufficient disclosure on the scope of annual bonuses and performance conditions (retrospective disclosure is acceptable)*
  - *Any provision for re-testing of performance conditions*
  - *Ex-gratia and other non-contractual payments*
  - *Change in control provisions triggering earlier and/or larger payments and rewards*
  - *The absence of service contracts for executive directors*
  - *Unwarranted use of discretion*

Question 10: Should companies be encouraged to defer a larger proportion of pay over more than three years?

We do not believe it is necessary for companies to be encouraged to defer a larger proportion of pay over greater than three years. For some companies, depending on the sector and the nature of their

business, a longer deferral period may be appropriate. But for other companies, a longer deferral period may be less appropriate.

The important thing is that there is a balance between cash, medium and long-term rewards and long-term shareholdings, and that this balance is appropriate to the company and its strategic objectives. Executives must place a realistic value on all of these elements, however they do tend to discount longer-term rewards more aggressively than the maths requires. As a result, longer-term rewards may provide less of an incentive for executives, as the certainty of reward becomes less clear.

Question 11: Should companies be encouraged to reduce the frequency with which long-term incentive plans and other elements of remuneration are reviewed? What would be the benefits and challenges of doing this?

Long-term incentive plans (LTIPs) are often set for periods of some 10 years; however, the performance targets are generally reviewed (and often adjusted) more frequently.

It is important to differentiate between *reviewing* and *amending* LTIPs. We believe it is important for companies to continually review the LTIP to ensure it remains aligned with the company's strategic objectives. Where the strategic objectives change, however, the LTIP would also be expected to change. However if the overall strategy remains unchanged, then we would expect the performance conditions to also remain relatively stable. Changing the LTIP too frequently without changing the strategy may indeed act as a disincentive for executives.

Question 12: Would radically simpler models of remuneration, which rely on a directors' level of share ownership to incentivise them to boost share value, more effectively align directors with the interests of shareholders?

We are certainly in favour of remuneration models which favour a greater emphasis on share ownership, and we agree that this would more effectively align directors' interests with the interests of shareholders. Companies might argue that if the level of incentives to be awarded in shares becomes too high, then executives may become too risk averse. However, we believe that present levels could increase significantly without damaging the risk appetite.

Question 13: Are there other ways in which remuneration – including bonuses, LTIPs, share options and pensions – could be simplified?

We agree that there certainly needs to be simplification of remuneration, however it is difficult to generalise how this might work in practice. Remuneration plans are often logical in how they are developed, yet they become complicated due to the complexities of individual businesses. For example, the use of a balanced scorecard approach is a logical method; however it may add an extra level of complexity. Similarly, deferral of reward is a sensible approach, but again this may add complexity.

What is particularly important is ensuring that the remuneration plan is specific to the company, and indeed the individual, and that companies think about the long-term. Companies need to consider

what the long-term objectives of the company are and design remuneration plans based on those objectives.

We also see a need for company boards to place greater emphasis on addressing the balance of reward between executives and shareholders. The value the company places on human capital (ie attracting and retaining quality management) versus the value the company places on the ability to attract shareholder capital will ultimately determine how a balance is achieved.

Question 14: Should all UK quoted companies be required to put in place claw-back mechanisms?

Yes, we believe companies should have claw-back mechanisms in place in the event of incentives being based on misstated or miscalculated information. In practice, however, claw-back mechanisms are rarely used.

We believe that a well-designed scheme should not have a reliance on claw-backs, and that there are a number of options available for boards to impose claw-back-like mechanisms. For example, we would argue that boards can and should use downward discretion as a form of claw-back. We also believe that payment of rewards on realised profits, as opposed to unrealised profits, can eliminate some of the potential for payments to be made on misstated or miscalculated information. Furthermore, either deferring payment of rewards or requiring the beneficiary to hold larger amounts of shares over a longer period can remove some of the reliance on claw-back mechanisms.

Question 15: What is the best way of coordinating research on executive pay, highlighting emerging practice and maintaining a focus on the provision of accurate information on these issues?

There is already a wealth of material produced by the consultants and is widely available. However much of this research does not necessarily provide an appropriate critique and it is often forward looking or based on current trends in remuneration. We would particularly welcome research on executive remuneration that is more backward looking and provides analysis on how remuneration packages actually worked in practice.