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NAPF
Securing the future of pensions

Remuneration principles for building and reinforcing long-term business success

These principles have been jointly produced by Hermes EOS, the National Association of Pension Funds, BT Pension Scheme, RPMI Railpen Investments and USS Investment Management. They are intended to provide high-level guidance to companies on their remuneration structures and practices.

BT Pension Scheme

RPMI RAILPEN

USS INVESTMENT MANAGEMENT LIMITED

Remuneration principles for building and reinforcing long-term business success

1. Management should make a material long-term investment in shares of the businesses they manage
2. Pay should be aligned to long-term success and the desired corporate culture throughout the organisation
3. Pay schemes should be simple, understandable for both investors and executives, and ensure that rewards reflect long-term returns to shareholders
4. Remuneration committees should fully explain and justify how their decisions operate to deliver long-term business success

Introduction

Most companies have developed practices over the years which command significant support from shareholders at their AGMs. But are the high votes in favour really positive endorsements or are investors merely acquiescing to the current standards of the market?

In February 2012 the National Association of Pension Funds and Hermes Equity Ownership Services (which undertakes voting and engagement for BTPS and other pension schemes) held an event on executive remuneration which was attended by 44 FTSE 100 companies together with large pension funds both from the UK and overseas including RPMI Railpen and USS Investment Management.

Our sense from this, and other private and group meetings with remuneration committee chairs and executives responsible for reward, is of a growing desire among many companies to re-evaluate current remuneration arrangements and embrace a new approach.

Furthermore the Kay Review called for a revision of executive pay as part of the solution to short-termism in the markets. The UK government has also reacted with further regulation which is intended to enhance the role of investors. We therefore believe that now is the appropriate time to provide some high-level principles for how companies might develop their thinking, incorporating some of the views that we have heard over recent months.

There is an opportunity now to align pay more closely with the long-term owners of companies. It is our view that the approach that we suggest will help position companies for future success.

1. Management should make a material long-term investment in shares of the businesses they manage

The best form of alignment between executives and shareholders is the ownership of shares over the long-term, with ownership obligations increasing with seniority. While we recognise that performing executives deserve to be well remunerated today, the bulk of their variable rewards should flow over time from the benefits of being an equity owner.

The standard three year vesting period for a "long term" incentive plan (LTIP) is surely medium term at best, particularly for the largest, most complex companies. We would strongly encourage remuneration committees to reconsider what long-term really means in the context of their company.

Shares granted to executive directors should ideally be owned for at least ten years, whether or not the executive is still in the post. In some situations it may be appropriate for a proportion of shares granted to be held until retirement age, even if the individual leaves the company. While we recognise that the average CEO tenure today is substantially shorter than this, we believe it is this that needs to change rather than for companies to design remuneration schemes which exacerbate the situation.

Executives should be exposed to tail risk, for example, by requiring the staggered sale of shares by executives. Owning shares post-departure encourages long-term thinking, and within that, the need for strong succession planning. While we recognise that this it not straightforward to achieve in practice, boards and nominating committees should be wary of appointing executives who are unwilling to accept this sort of longer term share ownership as part of their remuneration package.

While clawback is one way of aligning executives and shareholders, it does not solve the problem of CEOs who make bad strategic choices that only come to light after their departure. Furthermore it does not encourage a CEO actively to develop a new generation of talent to succeed the current executive directors. Long-term share ownership would help encourage executives to lay the groundwork for the company's success after their departure.

The board should monitor and guard against the possible unintended consequences of long-term ownership such as overly aggressive dividend policies, encouraging takeovers to crystallise awards and overly risk-averse strategies to preserve, rather than increase, the value of shares.

We strongly encourage remuneration committees to consider paying some fixed pay in shares. This might be particularly apposite in the case of recruitment or salary increases that are greater than the norm. Therefore it is our view that greater long-term ownership of shares that are not all released on departure may reduce the necessity of golden handshake awards.

2. Pay should be aligned to long-term strategy and the desired corporate culture throughout the organisation

Remuneration committees should be expected to design rewards that encourage the specific behaviours required to drive long-term strategic success. Too much of the debate between companies and owners has focused on short to medium term performance.

This is exacerbated when the ultimate owners of companies delegate their oversight responsibilities to agents who themselves operate according to short time horizons. As a result, certain performance measures, such as earnings per share and total shareholder return have been over-emphasised, with little regard for the company's strategy or the time frame in which that strategy should be achieved. We believe that remuneration committees should take as a starting point the company's strategic plan and set Key performance indicators (KPIs) which best reflect executive objectives. It should be stressed, however, that a proliferation of KPIs increases the chances of gaming and complexity and should be avoided.

While we do not believe that well structured remuneration is a panacea we do believe that it is a vital indication of the desired and prevailing culture, values and ethos of a company. Additionally we expect to see a coherent remuneration philosophy cascading down the organisation, including increasing share ownership obligations with seniority. For example, it is difficult to understand why some executive directors receive pay increases that are greater than those awarded elsewhere in the organisation or enjoy far more generous pension arrangements – or cash in lieu – than less senior colleagues. Remuneration committees should be able credibly to justify such differentials.

Quantum is now progressively more a factor in our views on pay. Increasingly we are seeing very generous awards, particulary in cash or shares which can be sold after short periods, as inappropriate, especially if there is no clear link to performance.

The nominations committee and the remuneration committee must work together particularly in agreeing the parameters around the remuneration for new appointees to the board. The remuneration committee should be involved at a much earlier stage of succession planning and agree the acceptable parameters for pay with the nominations committee during these initial stages, rather than waiting until the company has selected a candidate to start talking about pay.

3. Pay schemes should be simple, understandable for both investors and executives, and ensure that executive rewards reflect returns to long-term shareholders

The desire of some investors to encourage improved company performance by focusing on metrics and targets rather than behaviour and outcomes is at least in part responsible for the increased complexity we have seen in remuneration schemes in recent years.

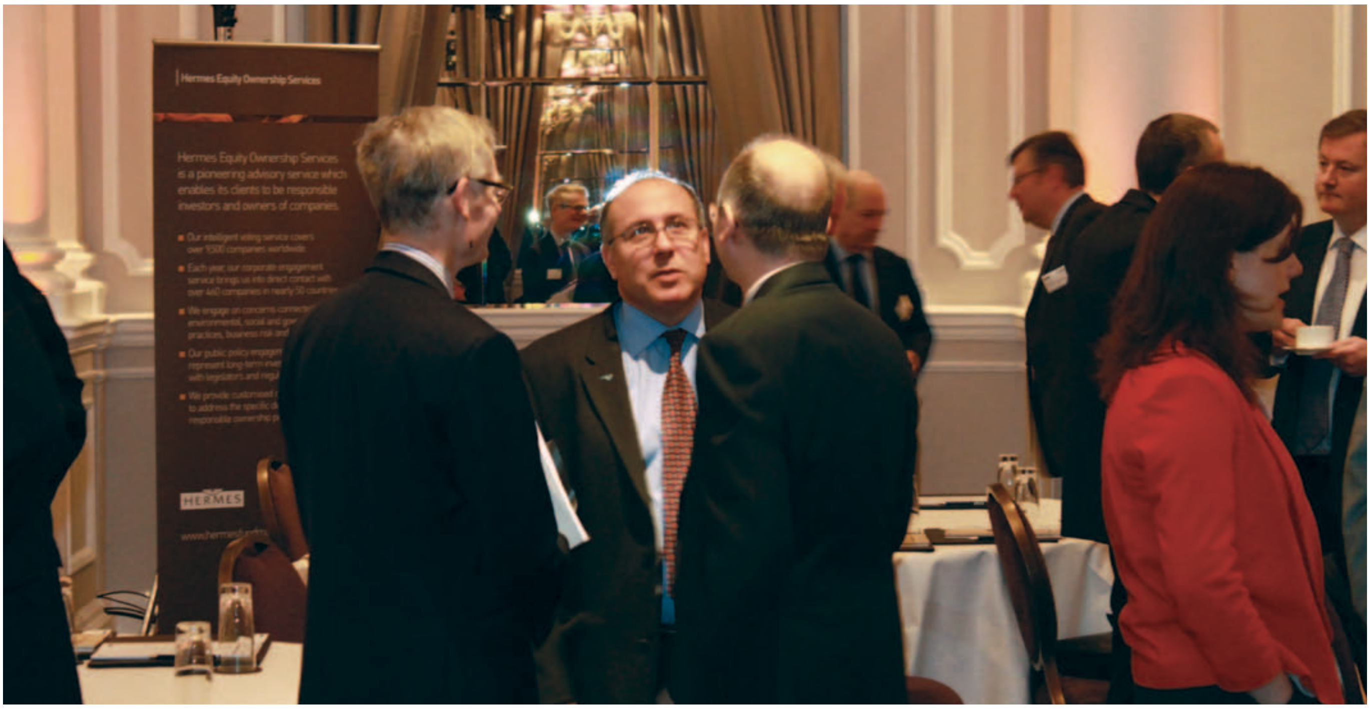
Companies have responded to concerns raised by investors, or to unintended outcomes in the chosen schemes, by amending existing or developing new arrangements.

As a result, many companies operate multiple long-term schemes and executives often have outstanding awards under a number of them. There may also be a deferred bonus scheme, or share-matching scheme on top of the short and long term awards. We wonder whether this multiplicity of awards with varying performance conditions really helps to motivate employees and give them a clear line of sight over what they need to achieve.

Running companies is far more complicated than even the best designed remuneration policies. To distil complex company performance into a few metrics is an oversimplification that can sometimes lead to remuneration payouts that outside share-owners do not believe are reflective of actual performance.

Setting a long-term course and measuring, explaining and incentivising progress annually may be a better way to encourage long-term value than the current system. For example, it may be better to have an annual bonus scheme – with no long-term incentive scheme – using a balanced scorecard of metrics based on key performance indicators, over which the remuneration committee may use its discretion and which pays out predominantly in shares which are held for the long term. It would be essential the scheme was explained well to investors, both in meetings and in the remuneration report, to ensure that the payments are appropriate and shares accruing are owned for the long-term.

Remuneration committees should take account of returns on capital when making decisions and should not make large awards where returns to shareholders are below the cost of capital without full consideration of the circumstances around this and an explanation to shareholders.



4. Remuneration committees should fully explain and justify how their decisions operate to deliver long-term business success

Remuneration schemes can create inappropriate incentives with even the best designed remuneration schemes resulting in outcomes that do not match up to a deeper analysis of company performance.

Remuneration committees must have the ability to exercise judgment over the overall performance of the company when determining rewards. In particular, the committee should consider how the results have been achieved, not just what was achieved.

For instance, if targets have been met by more aggressive accounting policies, by deferring important investment in the business or by unnecessarily increasing leverage, then the remuneration committee should consider scaling back or eliminating awards.

Similarly, if the executives have hit their performance targets but the company has had serious reputational issues or has under-performed the market, there are strong arguments for lower awards. It is important for share-owners to see remuneration committees showing their authority when negotiating pay and being willing to take difficult decisions.

A balanced scorecard approach, combined with appropriate judgment, may be better able to reflect the complexities and nuances of performance and the importance of how results are achieved.

We believe that well debated and explained decisions on a broader basis rather than using simplistic mechanistic formulae, are the way in which trust between remuneration committees and share owners can be restored and maintained. Boards and remuneration committees have to ensure that their judgment takes a holistic approach to performance. We will support those committees that use this trust well and exercise their judgment in a way that we believe places long-term shareholder interests at the centre of their deliberations.

Hermes Equity Ownership Services

Hermes Equity Ownership Services (HEOS) enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. HEOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

National Association of Pension Funds

The National Association of Pension Funds (NAPF) has been at the forefront of promoting good corporate governance for over 20 years, and as representatives of major institutional investors we have a real interest in seeing high standards achieved and maintained.
We regularly engage with the companies in which pension funds invest on issues including board structures and executive remuneration.
Our Corporate Governance and Voting Policy provides guidance to investors and companies on a wide range of corporate governance matters, including remuneration.

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