NAPF
Securing the future of pensions

# PRA consultation - CP6/14 - Clawback
# An NAPF response

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# About the NAPF

The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,300 pension schemes with some 16 million members and assets of around £900 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

## Summary

The NAPF welcomes the opportunity to respond to the PRA's consultation with respect to proposals to extend the Remuneration Code to require all authorised firms to amend employment contracts to facilitate clawback of vested variable remuneration on a group-wide basis.

Whilst we agree that the remuneration policies of banks, and public companies more generally, should include the ability for payments to be both adjusted and in more extreme cases recovered, we question whether the approach being proposed is appropriate or necessary.

The NAPF believes that remuneration should be proportionate and aligned with shareholder interests and long-term sustainable value creation. In addition, we believe it is right that companies should ensure their executive remuneration policies include provisions that allow the company, in transparent circumstances, to adjust or recover awards - we of course do not want to see payments for failure. However, we believe that the proposed approach risks incentivising further movements away from variable to fixed pay which would be at the expense of creating positive alignment between shareholders and management, as well as making business more highly geared operationally and thus potentially more unstable.

Instead of a focus on clawback as prescribed within the consultation document, we propose that more flexibility is offered as to how firms seek to align the interests of executives with those of long-term shareholders and include mechanisms to prevent payment for failure. It is vital that remuneration committees are challenged and empowered to consider and develop their own most appropriate practices, are obliged to disclose these and explain any deviations from perceived best practice at any given time and thereby be held to account by shareholders. Binding their hands with detailed rules disempowers them, risks absolving them of responsibilities and reduces the disciplining power of the shareholder accountability mechanism. In a year when shareholders have newly gained rights to a binding vote on remuneration policy, this seems a retrograde step. We would welcome an approach which works more closely with the grain of the UK's existing corporate governance practices.

As per some of the recommendations of the Parliamentary Commission on Banking Standards (PCBS), attention should instead be directed towards extending deferral and holding periods and encouraging the bulk of variable rewards of senior bank staff to flow over time from the benefits of being an equity owner. In this context, and to prevent excessive risk being taken towards the end of an executive director's tenure, consideration should also be given to ensuring that executives are exposed to some tail risk for an appropriate length of time once they leave a company. This could be achieved by for example requiring that any sale of shares post departure be staggered over a period of time.

## Questions

- **The proposal that the grounds for applying clawback should be as wide as the grounds for malus.**

In principle we agree that as with malus the grounds for applying clawback should be drafted fairly widely and importantly should not be restricted to instances of a material misstatement of the financial statements.

In general terms, we believe that remuneration committees should be empowered to adjust or clawback past awards following any instances whereby the basis on which the awards were made and/or vested is called into question. We also agree that predicating clawback upon instances of individual misconduct would be too narrow. As such the scope for the grounds for applying clawback suggested (below) appears sensible giving remuneration committees the ability to utilise judgement.

a. there is reasonable evidence of employee misbehaviour or material error - firms should consider applying clawback to those employees who:

    - could have been reasonably expected to be aware of the failure or misconduct at the time but failed to take adequate steps to promptly identify, assess, report, escalate or address it; or

    - by virtue of their role or seniority could be deemed indirectly responsible or accountable for the failure or misconduct, including senior staff in charge of setting the firm's culture and strategy.

b. the firm or the relevant business unit suffers a material downturn in its financial performance;

c. the firm or the relevant business unit suffers a material failure of risk management.

As we emphasised within the "Remuneration Principles for building and reinforcing long-term business success" which we published in September 2013, we wish to see remuneration committees taking greater ownership of, and being accountable for, both the remuneration policy and its outcomes. Remuneration Committees should in our view exercise their judgement about the overall performance of the company when determining awards and importantly should consider how the results have been achieved, not just what was achieved.

- **The proposal to limit the application of clawback to a period of six years from the point of vesting.**

The PRA will be aware that the FRC are in the process of consulting on amendments to the UK Corporate Governance Code which would require companies to put in place arrangements that would enable them to recover or withhold variable pay when appropriate to do so, or to explain why they have not done so. This we believe is positive and continues to promote emerging best practice while operating within the UK's comply or explain regime. We would encourage the PRA to allow the new Code to be introduced and banks to be able to introduce malus and clawback provisions that are appropriate for their particular remuneration structures.

Given the recent shift in variable to fixed pay resulting from the introduction of the "bonus cap" via CRD IV, we would caution against introducing further measures which may have the unintended consequence of incentivising the shift of more "at-risk" remuneration to fixed pay. In our view the introduction of a clawback measure which exists up to six years after the vesting date may increase the discounting of such awards such that a compensatory increase in fixed pay is introduced.

- **Other issues**

Retrospective element

These proposals would require that firms amend employment contracts to allow for the application of clawback to all vested awards up to six years after vesting.

Retrospective imposition however, would require employee consent; it is not clear what would constitute "reasonable steps" for firms to take to seek to apply the new rules to awards made before 1 January 2015 but which vest afterwards.

Whilst it may be possible in the case of existing employees to make participation in future awards conditional on applying these rules to existing but unvested awards, the position with respect to former employees is less clear.

Furthermore, while the implementation of these proposals from a UK perspective (imposing clawback provisions on future grants to existing affected employees) may not be too onerous; this will not necessarily be the case for affected employees who are based in non UK jurisdictions and whose employment contracts are subject to other local laws. This is of course the case with a large proportion of the Code staff of some of the larger UK banks.

Enforceability

The last point above also opens up the broader concern investors have with the regulatory focus on clawback, namely its enforceability.

Although generally enforceable in the UK and US, it is much more difficult than malus and generally requires much tighter definition of the conditions under which it may occur. There have only been a small number of instances of clawback being utilised in the UK, although we acknowledge that it is much more common in the US. Given this, there is concern that banks would simply end up compensating for the additional uncertainty introduced (resulting in discounting of the value of awards) for a tool that may in all likelihood never be used.

In our view, it would be much better if firms were to have a robust malus policy in place in order that all awards can be adjusted, including to zero and even if it relates to an event prior to the bonus year. If such policies were in place alongside longer holding/deferral period requirements then the need for clawback is effectively removed.

This alternative approach would create strong alignment between executives and senior management and the bank's shareholders through the ownership of shares over the long-term. Given the business cycle of banks, a holding period of at least ten years is often suggested as appropriate and ownership obligations should increase with seniority. With the addition of a requirement for shares to be held post retirement this structure would encourage longer-term thinking to continue right through to and beyond the end of a career.

We look forward to continuing to engage with the PRA and others on this agenda.