PRA CP15/14 / FCA CP14/14 Strengthening the alignment of risk and reward: new remuneration rules

An NAPF response

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About the NAPF

The National Association of Pension Funds (NAPF) is the voice of workplace pensions in the UK. We speak for over 1,300 pension schemes that provide pensions for over 17 million people and have more than £900 billion of assets. We also have 400 members from businesses supporting the pensions sector.

We aim to help everyone get more out of their retirement savings. To do this we spread best practice among our members, challenge regulation where it adds more cost than benefit and promote policies that add value for savers.

Summary

The NAPF welcomes the opportunity to respond to this consultation with respect to proposals to extend the Remuneration Code to ensure greater alignment between risk and individual reward, to discourage excessive risk-taking and short-termism and encourage more effective risk management.

The NAPF believes that remuneration should be proportionate and aligned with shareholder interests and long-term sustainable value creation. We also consider that the best form of alignment with shareholders is the ownership of shares over the long-term, with ownership obligations increasing with seniority.

In the above context we have a fair degree of empathy with the objectives which lie behind these proposals, in particular the drive to require senior individuals and material risk takers within banks to receive a greater proportion of their remuneration over a lengthier period of time in order to increase the alignment with shareholders and importantly to focus minds on a more appropriate time horizon.

However, we do have some concern that the new proposals risk inhibiting any flexibility and prescribing a specific pay structure which includes unnecessary complexity. In turn, the overall quantum may increase, or shift more pay towards fixed allowances, in order to compensate for the additional discounting applied to awards by the individuals involved.

We encourage the regulators to focus on the objective of requiring individuals to build up large shareholdings, held for an appropriate period of accountability. For many senior individuals, not least executive directors, the concept of 'hold to retirement' is an apt one, under this a significant portion of vested shares have to be held until the individual leaves the business. Indeed we would suggest that these individuals should be expected to hold a material sum of shares post-retirement in order to expose them to some tail-risk. Such an approach necessitates that the remuneration committee is able to adapt this approach flexibly in light of the age and career profile of those affected.

In generality for banks, we believe that in many circumstances it may be better to have a single bonus scheme – with no long-term incentive plan – which utilises a single balanced scorecard of metrics based on KPIs, over which the remuneration committee may use its discretion, and which pays out predominantly in shares which must be held for the long term. The core aspect is that the significant component of the reward is accrued over time through being a share owner.

The key sentence in the above is the last one and the key word is perhaps *owner*. For this reason we encourage the regulators to avoid an over reliance on deferral periods and instead focus on a wider perspective which ensures that individuals are required to hold onto a material proportion of awarded shares for a "long" period of time. In this context the Code should enable banks to utilise a mixture of deferred vesting periods and extended holding periods to achieve the desired objective.

We have expanded further on the above in answer to the questions posed below.

Questions

Question 1 **Do you agree with the principle of introducing a two-level approach for deferral, with longer deferral for senior managers?**

Yes. The NAPF considers that the best form of alignment between executives and shareholders is the ownership of shares over the long-term with ownership obligations increasing with seniority.

It is right that companies should be encouraged to develop a consistent remuneration philosophy which is cascaded down the organisation and focuses the minds of all those in positions of responsibility on managing risk with a view to the time horizon in which such risks may materialise. Equally it is wholly appropriate that senior managers should have more of their pay at risk for longer.

Question 2 **Do you agree with extending the deferral period to seven years for senior managers?**

We agree that the current common "long-term" incentive period used by many companies of three years is commonly not long enough not least within large banks; the nature of the sector in our view warrants recognition that "long-term" is much longer than three years. The consequences of senior management decisions in many cases do not fully play out until much later.

However, we do have some concerns that these proposed requirements are focused solely on deferral periods; instead we believe the requirements should be more broadly framed towards requiring the holding of a greater proportion of variable pay for a longer period of time; this could be achieved in our view through a combination of deferral and holding requirements.

Question 3 **Do you agree with introducing an additional requirement that no deferred variable remuneration should vest earlier than the third anniversary of award for senior managers?**

We would caution that regulators should be mindful that extending the length of deferral and vesting will likely have a significant impact on the level of discount applied to these awards by individuals. This will in turn significantly reduce or negate any desired behavioural impacts and potentially require a larger quantum to compensate.

In order to achieve the greater alignment without building in excessive complexity and discounting encouragement should be given to creating simpler pay arrangements which have a clearer line of sight for those involved. For example a trade-off for much longer deferral and/or much longer holding periods would be the greater certainty and transparency provided by performance on grant schemes. Such schemes would still provide for malus and clawback, and exposure to the share price, but their simplicity and transparency should enable a materially reduced maximum quantum. These schemes however, do also place a greater responsibility on the remuneration committee to ensure that they maintain vigilant oversight of the scheme and reassure themselves that the rewards are driving long-term sustainable performance.

Question 4 **Do you agree that five years is an appropriate minimum requirement to apply to all other MRTs, bearing in mind the range of roles covered?**

Given the range of roles covered by the definition of Material Risk Takers we suggest that banks are provided with greater flexibility to adapt the requirements as is appropriate to the different roles.

Question 5 **Do you agree with the FCA's proposal to introduce a requirement for a minimum clawback period of seven years for all MRTs, in line with the PRA rule?**

This proposal appears out of kilter with the proposed requirement for MRTs to defer remuneration for a minimum of five years. We suggest that the regulators encourage the establishment of shareholding requirements for MRTs with these requirements increasing with seniority. This approach we believe will better align their interests with the company as a whole and ensure "skin in the game" and a focus on the longer-term.

Question 6 **Do you agree with the proposal to introduce a requirement to provide for a possible extension of the clawback period of up to three years for Senior Managers if there are outstanding investigations underway at the end of seven years?**

This proposal risks adding further complexity to the remuneration regime and in turn driving the individuals involved to further discount the value of their outstanding awards.

We favour an approach whereby remuneration schemes are designed in such a way that the bulk of Senior Managers' variable rewards flow over time from the benefits of being an equity owner. In addition, Senior Managers, in particular Executive Directors, should be exposed to tail-risk for an appropriate length of time once they leave a company. This approach we believe ensures that relevant individuals will continue to be exposed to the risk of malus or clawback, and indeed the share price itself, in a more transparent manner.

Question 7 **Do you agree with the proposal to make explicit in the remuneration rules the presumption against payment or vesting of any discretionary payments, including entitlements to payment for loss of office and discretionary pension benefits?**

It is understandable that the PCBS drew attention to the lack of negative consequences in the recent past for the previously awarded remuneration of senior staff of firms that have required taxpayer support.

As the consultation indicates the existing remuneration Code already makes clear that banks are expected to restrict or stop the payment or vesting of outstanding awards, including discretionary pension payments, for MRTs where the payment of such awards would be inconsistent with ensuring a sound capital base or a timely exit from government support.

We agree with the principle however, we would caution that care is taken to avoid a circumstance where banks in need of significant restructuring and/or support are not able to retain or attract the calibre of individuals needed to bring about the changes needed.

Question 8 **What do you see as the advantages and disadvantages of the approaches identified above?**

Question 9 **What views do you have on the potential options for addressing the disadvantages of particular approaches?**

Question 10 **What are the relative merits of pursuing the different approaches and any alternative approaches that might be identified?**

<u>Approach 1 – banning buy-outs</u>

As acknowledged within the consultation paper a blanket ban on UK regulated firms from buying out unvested awards risks placing UK banks at a competitive disadvantage, not least their peers in Asia and the US; exacerbating the competitive pressures brought about other recent reforms in this space.

<u>Approach 2 – maintaining unvested awards</u>

This approach does risk creating obvious conflicts of interest if an individual was to move to a competitor, a situation which is not unlikely, not least below the executive level.

At executive director level we believe that this approach has some merit. As previously suggested we believe that executives should be exposed to some tail risk for an appropriate length of time once they leave a company for example, by requiring that any sale of shares be staggered over time, notwithstanding competitive or regulatory barriers to continued share ownership. This emphasises our belief that the length of deferral is often not the crucial element but instead the focus should be on ensuring individuals are required to hold onto a material proportion of share awards for a much extended period; in these situations a large proportion of awards would likely be vested but still subject to holding requirements.

<u>Approach 3 – applying malus to bought-out awards</u>

We strongly caution against pursuing an approach whereby the regulator took on a discretionary power to recover buy-outs in cases where the former employer would have had grounds to apply malus. This risks creating significant uncertainty and as suggested in the consultation paper transform malus into a regulatory disciplinary procedure which could have significant implications.

The alternative proposal whereby buy-outs could be held in trust on behalf of the previous employer also creates unnecessary uncertainty. Both circumstances would likely necessitate the recruiting employer compensating the incoming employee for the additional risk.

Approach 4 – reliance on clawback

We broadly favour this approach, in conjunction with requiring an element of tail-risk for senior executives. Given that the new robust clawback regime is only just being introduced this should be allowed to bed in before an assessment is given to introducing significant additional requirements.

As suggested, the scope for applying clawback would be a function of the amount of vested variable remuneration at any point in time. In this context we again suggest that the regulators should focus their objectives on encouraging the *ownership* of shares over the long-term, with ownership obligations increasing with seniority.

General

It is crucial that in respect of senior recruitments, in particular to the Board, the nominations committee and the remuneration committee work closely together, particularly in agreeing the parameters around the remuneration for new appointees. The remuneration committee should ideally be involved at a sufficiently early stage of succession planning to be able to agree the acceptable parameters for pay with the nominations committee during the initial stages of recruitment, rather than waiting until a preferred candidate has been selected.

Question 11 **Do you agree with the proposal to require firms to use the above approach to ensure that the measure of profit used for determining variable remuneration is based on prudent valuation?**

While we empathise with the proposal we believe it generates an unnecessary level of complexity.

We wish to see remuneration committees taking greater ownership of, and being accountable for, both the remuneration policy and its outcomes. In particular judgements should be taken on *how* results have been achieved, not just *what* was achieved. In particular it is important that remuneration committees consider whether targets have been met by employing aggressive accounting policies, by deferring important investments in the business or by unnecessarily increasing leverage; in such events awards should be significantly scaled back. We would prefer to see remuneration committees being empowered to make these judgements and for investors to hold them appropriately accountable for doing so.

Question 12 **Do you agree that there should be a rule that simple revenue or profit-based measures may not be relied on to determine variable remuneration at aggregate or individual level, except as part of a balanced and risk-adjusted scorecard?**

Yes we agree. We would also point out that the relegating of the relative importance given to simple revenue or economic measures negates the proposal above.

We encourage remuneration committees to design rewards that encourage the specific behaviours required to drive long-term strategic success. Our members have consistently voiced their frustration with the over-use and reliance upon certain performance measures, most notably Earnings Per Share (EPS) and Total Shareholder Return (TSR). These output metrics are inherently open to manipulation by executives and risk driving behaviour which is not necessarily linked to the company's specific long-term strategy or focus attention on the timeframe over which the strategy should be achieved.

We believe the company's strategic plans and KPIs should be utilised as the starting point. In general terms, for banks we favour using a single balanced scorecard of metrics based on KPIs, over which (for executives) the remuneration committee may use its discretion, and which pays out predominantly in shares which must be held for the long term.

Question 13 **Do you agree that there should be an explicit rule that non-executive directors should not receive variable remuneration in respect of activity carried out in their roles as non-executives?**

Yes we agree.