Executive Reward Briefing

FIT Remuneration Consultants

Executive rewards: paying for success

Background

The Business, Energy and Industrial Strategy (BEIS) Select Committee yesterday published a report which covers the second strand of its inquiry into 'Delivering on fair pay'. The report tracks recent trends on executive pay, as well as the implementation of the recommendations from the earlier BEIS Select Committee report of April 2017 (see our related briefing here).

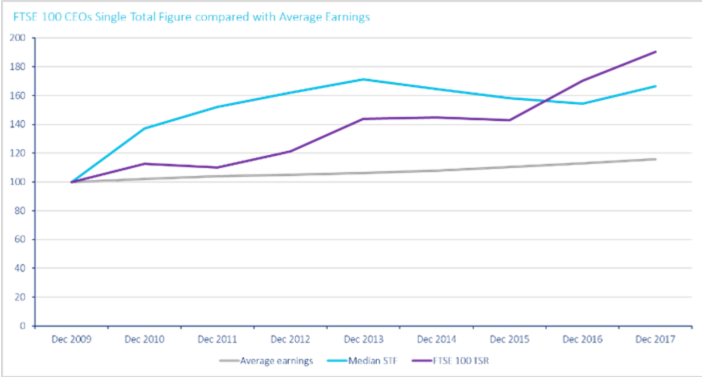
One of our partners, Katharine Turner, provided technical input to the Committee (although she did not input into the policy recommendations of the report).

The report provides a number of conclusions and recommendations on executive pay, which we have summarised below. This is an important report and, while we do not agree with everything contained within it, we consider it 'required reading' for remuneration committee members and reward specialists.

Recent trends

The report provides a useful summary of recent trends in UK executive pay. In particular, it examines the key components of remuneration for listed company executives and the root causes of high executive pay (both in the UK and internationally).

Interestingly, it acknowledges the impact that the 2014 "say on pay" reforms have had on curbing levels of new pay awards. The report also acknowledges that given "that executive pay is generally linked to an extent to company success, as demonstrated by increased returns to shareholders, it is to be expected that executive pay will be pulled upwards in times of economic growth and good company profitability". For reference we have included below a chart from the report showing that total shareholder return has increased in reasonably close step with executive pay in the FTSE100 between 2009 and 2018.



The report also highlights a number of, what are, in the Committee's view, examples of excessive pay that have arisen in the last few years. The Committee notes the reputational damage that these are causing and the resulting "perception of institutional unfairness" held by the public when average earnings have remained relatively flat in real terms – see the chart above. It is less ready to acknowledge that the competitiveness of executive pay at UK listed companies has fallen in recent years both relative to international (particularly continental European) peers and to UK-based private equity-backed companies.

The report's recommendations

Simplification of executive pay: The report notes increases in the realised pay of executives has been primarily driven by performance-related elements such as LTIPs. The Committee therefore argues for a simpler structure of executive pay "based on fixed term salary plus deferred shares, vesting over a long period, but subject to conditions to avoid "rewarding failure"". This is an approach that is consistent with views of an increasing number of institutional shareholders.

The report acknowledges that "very few" companies are adopting restricted share arrangements and that investors, especially those from the US, are not agreed on this approach (which is also consistent with our experience at FIT). The Committee is aware of the diversity of views among investors and that progress has been slow, but flags the 2020 policy votes as the next opportunity for companies to consider new arrangements such as these.

Reduced/ capped pay: A pervading theme in the report is the reduction and/or capping of executive remuneration. To support this goal, the report includes the following recommendations:

- That "Remuneration Committees should set, publish and explain an absolute cap on total remuneration for executives in any year" and to support such caps, the new regulator (see below), should "be more prescriptive and interventionist, where necessary". This is a theme that emerges from the FRC guidance on board effectiveness which supports the new UK Corporate Governance Code.
- The new regulator should clarify and strengthen its guidance "with a view to exerting significant downward pressure, avoiding unjustifiable payments and ensuring that, if they are made, they can be readily recovered".
- Over time the proportion of variable pay "should be reduced substantially" which in turn should lead to a reduction in total remuneration awarded.
- The Committee argues that there is "a strong case" for a cap similar to the one applied to financial services companies (i.e. the bankers' bonus cap of 100% of fixed pay, which can be increased to 200% with shareholder approval), which would be applied via the UK Corporate Governance Code or new legislation. However, it does not acknowledge that the impact of pay regulation in the banking sector has been more to increase fixed pay than to reduce overall pay.
- The new regulator should develop guidelines on bonuses to ensure they are "reward only for exceptional performance, rather than being effectively an expected element of annual salary".
- The use of profit sharing schemes should be increased to share profits "more evenly" amongst the workforce.
- Alignment of pension contribution rates between executives and employees (the report notes the recent focus of The Investment Association (and investors) on this issue, which is already gaining significant attention for the spring 2019 AGM season and is likely to be more so next year).

A tougher regulator: The report supports the recommendation of the recent Kingman report that the FRC should be replaced with a new body - the Audit, Reporting and Governance Authority (ARGA) -which is "tough on those companies that behave unreasonably on executive pay". Indeed, it is noticeable how frequently the report makes recommendations that operate on the premise of a "tougher, more proactive regulator" - we counted at least 14 separate recommendations that were dependent upon action by ARGA.

Many of these actions would result in significant oversight and/or enforcement in relation to executive pay. For example, the Committee recommends that the new regulator would take responsibility for enforcing compliance with the remuneration-related elements of the Code, publishing new guidance to encourage the reduction of executive pay, seeking public explanations from companies and publicly calling out poor practice. If even half of these recommendations were implemented as envisaged, this would be a significant increase in regulatory scrutiny of executive pay in the UK and lead to a very different approach from the 2013 BEIS regulations (which introduced the current statutory regime with three-yearly policy votes and increased transparency, including the “single figure” disclosures). The 2013 reforms were about better informing shareholders and enabling them to hold companies to account. This implies that (despite acknowledging that that regime has constrained pay) the Committee feels that shareholders are not sufficiently delivering on the politically desirable result and that a regulator should intervene. This challenge to shareholder powers is a most worrying aspect of the report.

Criticism of remuneration committees: The report singles out remuneration committees for particular criticism in relation to the controversial examples of excessive executive pay. It argues that the "consensus in the evidence we received was that remuneration committees have largely been unwilling to curb or challenge excessive pay awards, and some have simply not engaged well enough". Whilst there may well be examples of poor decisions by remuneration committees, in our experience at FIT the overwhelming majority of remuneration committees take their responsibilities extremely seriously and often make decisions unpopular with executives and increasingly operate as a 'brake' on what might otherwise be viewed as excessive pay arrangements.

The report also goes on to recommend that remuneration committees "engage early and meaningfully with major investors on executive pay". We think many remuneration committee members will be frustrated to read these comments. In our experience remuneration committee chairs often go to considerable lengths to engage with investors with mixed results. Indeed, in recent years, it has been some investors and proxy agencies which have not (or have not wished to) properly engage with remuneration committees. These comments will only increase the competition for investor attention, especially as a significant number of companies will need to renew their policies in 2020.

Stewardship: The report also argues that shareholders (and to a certain extent proxy advisors) are failing to provide effective stewardship of executive pay in investee companies. The FRC recently issued a consultation on a draft updated version of the Stewardship Code and a final version is expected to be published summer 2019. However, the Committee agrees with the Kingman report that this draft Stewardship Code is "not fit for purpose". It therefore proposes that:

- the new regulator (i.e. ARGA) should revise the Stewardship Code to deliver effective engagement between companies and shareholders on executive pay;
- regulators (including ARGA and the FCA) should apply the Stewardship Code "strictly and consistently"; and
- proxy advisors should tailor policy guidelines for individual investors "so as to resist excessive and poorly designed pay policies and awards".

The report also puts pressure on asset owners (as opposed to asset managers) to step up to their responsibilities as stewards with the threat of sanctions if they do not. The extension of shareholder democracy to retail shareholders could bring responsibilities as well as rights.

Workforce representation: The recently updated Corporate Governance Code introduced three suggested models for workforce representation (i.e. an employee director, a formal workforce advisory panel, or a designated non-executive director). The report acknowledges that it is too early to judge how companies have responded to this new requirement, but argues that the new Corporate Governance requirements do not go far enough and argues that at least one employee representative on the remuneration committee should be mandated.

Pay ratios: The Committee are supportive of pay ratios but argue that the current requirements should be expanded to:

- include the lowest pay band as well as the quartile data that is already required; and
- widen the scope of the regulations beyond the listed sector to all companies with more than 250 employees (including partnerships).

FIT comment: it should be stressed that the BEIS Select Committee is a cross-party committee of MPs. Its role is not to set considered, costed proposals but to hold BEIS (the Government department) and, through it, Government to account and to provide thought leadership, including challenge to existing thinking. In that regard, it is a useful and welcome report.

If this is a precursor to new legislation, we think it may have unintended and undesirable consequences. The report catches the current mood on 'fairness' between chief executives and the "workforce" but it is unrealistic to address societal inequality by looking only at UK-listed (indeed primarily FTSE 100) CEOs without regard to the competitiveness of their remuneration packages relative to equivalent roles in overseas listed companies, PE-backed companies and other organisations (including professional services firms).

When John Lee, FIT's Managing Partner was called to give evidence to a previous Select Committee inquiry, one MP challenged the ratio between executive pay and nurses' pay. We have considerable sympathy with the view that nurses (and many other 'caring' and public service professions) are underpaid in the UK. However, it is the responsibility of politicians to set nurses pay and it is, in our view, a separate policy matter. The pay of chief executives does not constrain nurses' pay and may even, through the tax take, help to fund it.

Many of the proposals are well-intentioned but we think there is a real danger of ARGA (or any other regulator) adopting a 'we know better than your shareholders' approach to executive pay. The purpose of Government is to ensure that reporting is transparent and that shareholders engage with companies and take their duties seriously; it is not to force views on shareholders.

We have recently been involved with a number of overseas companies and PE-backed companies which have hired executive directors from UK-listed companies to fulfil roles based in the UK (e.g. as a UK Managing Director of a subsidiary of a global group) on much higher remuneration packages and without many of the recent governance-driven developments of, for example, holding periods, bonus deferral, discretionary over-rides, post-cessation ownership guidelines and reduced pension allowances now expected in the listed environment. This is not to suggest that all is rosy. There have been cases of abuse (most but not all being well publicised) but virtually all remuneration committees and, indeed, most chief executives are working hard to strike an appropriate balance between the need to provide competitive packages to executives and the need to respect the interests of other stakeholders, including shareholders. This is a complex and nuanced balancing act. We can only hope that poor decisions by the few will not spoil this for the majority genuinely seeking to strike an appropriate balance between being fair and being competitive. Shareholders and others are well within their rights to call out clear cases of abuse but we worry that the pendulum is in danger of swinging too far away from the need to be competitive towards a much heightened and unmanaged risk of shrinking the talent pool for chief executives of UK-listed companies. Some of the changes the Committee advocates may be overdue and appropriate, but there is a danger that the best talent will take flight from the listed environment.

Recent leaver case

Earlier this month the Employment Appeal Tribunal released its judgment in the case of Nosworthy v Instinctif Partners Ltd. The case concerned the forfeiture by a former employee of deferred earn-out shares and loan notes on the basis of 'bad leaver' provisions in the relevant award documentation.

The context of the case means that it can be distinguished from the incentive awards typically granted by listed companies (e.g. this involved the forfeiture of shares and loan notes received as an employee shareholder, as opposed to the lapse of rights to shares, contingent on performance and/or continued service).

That said, it is worth noting that the terms of plc share awards are becoming increasingly more complex from an employment law perspective. For example, most employee share plans now include broad malus and/or clawback provisions, as well as increasingly wide discretionary powers for the remuneration committees (e.g. as required in the revised UK Corporate Governance Code). This case is another reminder that, should a dispute arise, the courts are likely to examine the wording of such provisions very closely.

We recommend that all companies review their award documentation to ensure that the relevant provisions of the plan are clearly drafted, communicated to, and accepted by employees (e.g. using clear, plain English guidance notes and signed employee declarations).

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March 2019

If you wish to discuss anything arising from this briefing, please ask your usual contact at FIT or call us on 020 7034 1111.