# Changes to executive pay?

The Investment Association's Executive Remuneration Working Group published its final report on executive pay on 26 July 2016 (report attached), following consultation with a wide range of stakeholders over the last few months.

Whilst the report does not contain many surprises, it will be of interest to UK listed companies and investors. The Working Group has made a series of recommendations which many investors, particularly institutional investors, will consider in the run up to the 2017 AGM season. If the Investment Association goes further and incorporates the recommendations into its remuneration principles, those recommendations will have even more force amongst the investor community.

The overall message for companies and remuneration committees is there will be an expectation that committees should look again at current pay structure, decide whether it remains appropriate and be prepared to justify not only any change but even maintaining the status quo if that is felt right. In addition, the report calls for greater remuneration committee accountability, better investor engagement and more transparency in setting performance targets and when using discretion.

## Background

The Working Group was established by the Investment Association as an independent panel to tackle growing concern from both investors and companies that executive pay is too high and too complex. Its report highlights two central causes of the ratcheting of pay –the "one-size-fits-all" LTIP model and executives discounting the value of remuneration due to ever more conditions being attached (malus, clawback and holding periods being key).

## Solution

The suggested solution is to have more choice of remuneration structures so that the LTIP is not seen as the only choice. However, the Working Group recognises that to implement a more flexible system, behavioural and structural changes are needed to repair trust between investors and companies.

- **Flexibility and alternative pay structures**

The Working Group recommends more flexibility for remuneration committees to choose pay structures.

The issues with LTIPs that the Working Group found are not new and are problems often identified. Key concerns are (1) difficulties in setting the right performance metrics and targets and (2) participants discounting the value of LTIPs because payout is seen as a lottery. Despite these issues, there is no suggestion that LTIPs should not be used at all, merely a recommendation that remuneration committees should consider whether the LTIP is right for the company (and the group notes that it fully expects some companies to retain the LTIP).

The group considered four alternative long term incentive structures – (1) LTIPs, (2) deferred bonus, (3) performance on grant plan and (4) restricted share awards. (It also considered market value options but says that it is cautious about recommending" them due to concerns that they do not offer enough alignment between investors and participants). Of the four, the Working Group does not recommend a performance on grant plan but endorses the other three structures.

- **Repairing trust**

The Working Group has made recommendations in 4 areas:

– **Making remuneration committees more accountable**

Recommendations for committees include ensuring that the committee chair has been a NED for at least a year, having the company chair and whole board engaged with remuneration decisions and exercising independent judgment without an over-reliance on remuneration consultants.

– **Improving shareholder engagement**

The system of engagement is seen as being strained with companies feeling that investors will not accept anything diverging from the norm when it comes to pay and investors feeling overwhelmed with the volume of consultation and frustrated that they are consulted at the last minute. Recommendations include focussing on material issues when consulting, clarity and making sure consultation is genuine consultation.

– **Increased transparency**

The Working Group recommends that companies go even further in disclosing the process for setting bonus targets and disclosing them retrospectively. Separately, the group wants to see clearer disclosure on use of discretion and notes that investors need to see a track record of responsible use of discretion.

– **Quantum of pay**

As one would expect, the group does not intend to set limits on pay but it does believe that more flexibility in remuneration structures will lead to simplicity, more certainty about outcomes, less discounting and therefore an overall reduction in pay. Recommendations include more explanation of why maximum pay levels have been chosen and guarding against benchmarking data leading to a ratcheting of pay to an ever-increasing median.

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