Executive Reward Briefing: October 2018

FIT Remuneration Consultants

Cracking the code: the effect of the Government's executive pay reforms

It has been a busy return to duty for remuneration committee members as they have started to absorb the implications of the Government's reforms on executive pay. These have been delivered mostly through the Corporate Governance Code and the revised regulations which prescribe the disclosure of the CEO pay ratio and additional disclosures of pay which show the effect of share price growth on LTIP awards.

More shareholder rebellions on pay in 2018?

In August, The Investment Association reported "a jump of 25% from 2017" in the number of AGM resolutions appearing on the IA's Public Register i.e. where 20% or more of votes cast went against the resolution or where the resolution was withdrawn. This was inevitably reported as a 25% increase in shareholder "rebellions".

Few readers will have realised that only a quarter of the resolutions concerned pay. Fewer still will have considered that 80% support or more on a pay resolution is a high test especially where boards are trying to innovate and to "do the right thing" in the interests of the strategy of the company and its long-term sustainable success. ISS still comments critically where companies do something different from the market norm calling this not in line with 'best market practice'. From a "good news story" perspective, a company which is on the IA's public register is, by definition, guilty of egregious pay and of exhibiting the "unacceptable face of capitalism". It may, though, appear to make institutional shareholders seem more vigilant. The question is whether they are being vigilant on the right points of corporate policy.

Table 1: Pay resolutions on the IA's Public Register

FTSE100	18
FTSE250	24
FTSE Small Cap	19
Total	**61**

Source: The Investment Association's Public Register

The Investment Association also said that, this year, executive pay has declined overall as a voting matter across the FTSE All-Share although it noted the rise in significant dissent on pay resolutions in the FTSE 100. It reported that 18 pay resolutions attracted over 20% shareholder dissent among FTSE 100 companies (compared with 9 in 2017). Our own figures in respect of resolutions on the advisory vote of the Directors' Remuneration Report (shown because levels of support tend to be lower than for the binding vote on the Directors' Remuneration Policy and because the sample covers all of the All Share) is rather less depressing and headline-grabbing.

Report	Votes polled 95% and over		Votes polled 80% and over	
	2018	2017	2018	2017
FTSE 100	53%	58%	87%	94%
FTSE 250	66%	62%	91%	87%
FTSE SmallCap	64%	69%	88%	94%

FIT's comment: An unintended consequence of the Public Register and the relatively low bar for defining a shareholder 'rebellion' means those remuneration committees which seek to innovate, simplify and reduce pay potential are "named and shamed" and others deterred .

What are we waiting for?

The cross-party BEIS Select Committee is about to start its mini-review of pay in the private sector. The Select Committee has also looked at gender pay reporting this year all under the heading of "delivering on fair pay". The Select Committee is taking evidence on 16th October and again in January to consider recent developments on executive pay and to examine the effectiveness of Remuneration Committees and institutional investors in combatting "excessive" pay. The Chair of the Committee, Rachel Reeves MP, has highlighted at least three concerns:

- Over-reliance on market data and averages
- Pay which goes up when performance is going down
- Institutional investors which fail to hold boards to account on pay

Rachel Reeves also expressed concerns about the top 1% of UK earners—and also tax payers—and implicitly the distribution of income between the top 1% and everyone else.

Here are some facts for reference. The top 1% of UK income taxpayers have gross incomes in excess of £170,000 and contribute 27% to income tax receipts. The top 10% of income taxpayers had incomes of at least £53,000 and pay 59% of income tax. Average earnings across the UK economy are about £29,000 a year.

At the same time, we await the Government's review of the impact on share buybacks "to ensure that they cannot be used artificially to hit performance targets and inflate executive pay" and the further work by the Financial Reporting Council (FRC)'s Lab on performance measures.

FIT's comment: there is little consensus on the "problem" of executive pay. From a Government policy perspective, executive pay in listed companies – now completely transparent and almost always leading to full taxation at income rates (not always the case in privately-held companies) – is often disproportionately high. Executive pay in the UK will always be high (and to some unacceptably high) when compared with average UK pay levels even though, against comparable global data, UK executives are not "overpaid".

Institutional shareholders, not to mention many non-executive directors and executives, take the view that plc pay design has become too complex. The new Corporate Governance Code is encouraging clarity and simplicity. We estimate that only 20 All Share companies have introduced restricted share arrangements for their Executive Directors and many others have faced a daunting level of resistance from their shareholders and changed tack. Attempts to simplify are often met with resistance from institutional shareholders and voting guidance services alike. Where boards have pressed ahead with restricted share plans and other innovations, the quid pro quo has often been the addition of performance underpins and other policy embellishments which, while allowing the reduction of pay potential, undermine simplicity and can alienate the intended recipients. Some of the largest global asset managers - even those with long-hold policies – have diametrically different views on how to link pay to performance. In truth the view that the Greenbury committee took over 20 years ago is still, in our view, sound:

"Performance-related remuneration can be highly effective in aligning interests in this way. In many companies, therefore, there will be a case for a high gearing of performance-related to fixed pay. But there are two constraints on this. First, there will usually be a level of basic salary below which it will not be practicable to go. Second, the requirements and priorities of companies vary. The gearing which suits one company may be quite unsuitable for another."

The Code calls for companies to explain how their remuneration arrangements fit both their strategy and culture. It is noteworthy that most popular performance metrics have not changed materially over the last 20 years despite the current unfashionability of EPS in some quarters. The incentive effect of variable pay may be overstated. Many measures focus on shareholder alignment over the link to strategy leading to pay out-turns which may disappoint both investors and management. In the last year or so, we have been pleased to see a number of our clients introduce more bespoke measures linked to their long-term strategy and, particularly from more activist shareholders, receiving strong support. If this aspect of the Code is to lead to more than just boilerplate wording, we hope this trend continues.

What we think will happen next?

The recent Radio 4 drama called The RemCo by Jonathan Maitland draws an analogy between more-ish puddings (crème brulée being the case in point) and money. Both can have addictive properties. Over the last thirty years, fairness and consistency in pay for Executive Directors have been viewed principally from the external market perspective rather than the internal organisational perspective.

FIT has always emphasised the need for careful and cautious use of market data when deciding on pay but it remains difficult for Remuneration Committees to pay a CEO or CFO they are trying to recruit at the bottom of the market. The middle seems fairer. Good CEOs have negotiating power even in hard times or where corporate performance is lack-lustre.

Here is what we think will happen over the next few years:

- Innovation in pay will continue. More companies will see the merits of paying Executive Directors a simple annual fee delivered in a mix of cash and deferred shares. This will reduce pay potential but will have other side effects. The lack of variability and sensitivity to performance may irk stakeholders. The current approach of fixed pay, annual bonus and a longer-term share plan is, however, likely to remain majority practice
- More companies will be prepared to risk being on The Investment Association's Public Register but, at the same time, as practice develops, institutional shareholders will be more willing to trust non-executive directors to manage simplified pay systems
- Absolute pay caps will emerge on a voluntary basis
- More time and thought on the appropriateness of performance measures and a greater willingness to innovate in appropriate cases
- More companies will consider annual profit sharing in lieu of annual bonus payable against myriad measures and targets based on a percentage of profits with the distribution of the pool based on the attainment of financial and non-financial performance objectives and with more discretion available to the Remuneration Committee. This will allow clearer explanation and demonstration of cost and the distribution of expenditure across the workforce
- Post-employment share ownership will develop slowly and, in many cases, will apply to the next generation of leaders. Institutional shareholders will be willing to listen to arguments for not introducing post-employment share ownership or disapplying the requirement. We foresee one unintended consequence is an upward pressure on pay (which will be applied on appointment) as Executive Directors perceive yet more risk in reward
- Executive pension allowances will continue to come down and may even disappear. This is likely to lead to

increases in other elements of pay (probably base salary) rather than reductions in pay

- “Human capital” reporting will become more systematic and public as Remuneration Committees and boards ensure they have visibility of all-employee pay and conditions to be able to demonstrate publicly why the CEO’s pay is fair and reasonable
- Worker directors will remain minority practice even in highly-unionised companies (unless a Labour government compels such legislation)
- Non-executive directors’ time commitment and fees will increase

Remuneration Committees are going to be even busier over the next year couple of years becoming better informed about pay across the company whose Boards they sit on. They will also spend more time deciding why their Executive Directors’ pay is fair and demonstrating that this is the case. This is at the heart of the Corporate Governance Code.

The impact of the reforms on the level of executive pay remains to be seen. If we want pay for performance, and for a significant element of pay to be share-based and for shares prices to go up, we should also hope for CEOs’ pay to increase! A good result of the new Code would much better explanations, communications (and less boilerplate) thereby improve understanding of why CEOs are paid as they are, based on pay policies which are managed and decided by competent , engaged and an even more diverse range of board members.

In other news:
FIT is really pleased to announce that we shall be sponsoring Wigan Warriors for the 2019 season. FIT’s managing partner, John Lee, is proud to have signed an association with the club he has supported for over 40 years. They also happen to be the most decorated team in rugby league. Wigan will be playing in the League’s 2018 semi-final this Friday and we wish them every success.

If you wish to discuss anything arising from this briefing, please ask your usual contact at FIT or call us on 020 7034 1111 or email us at Info@fit-rem.com.

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