# Gaining the high ground on pay

## MM&K Remuneration Committee Dinner

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**25 February 2019**

On Monday 25 February 2019, MM&K held, at the RAC, the latest of its series of dinners for company chairmen, chairmen of remuneration committees and chief executives.

The theme for discussion at the dinner was: **Could Remuneration Committees take a more active approach to gaining the high ground on executive pay?**

## Introduction

MM&K's Paul Norris introduced the subject with the following remarks:

It used to be the case that investors would not be concerned about the level of executive pay provided it could be justified by performance. There is a risk now that a small number of extreme examples may entrench a perception that all executive pay is just too high. It is, therefore, important that remuneration committees are able to explain and justify their executive pay policies and practices.

The BEIS Select Committee is conducting an inquiry into Fair Pay. One element of the investigation will examine the effectiveness of Remuneration Committees and institutional investors in combatting excessive executive pay.

A purportedly independent academic paper published in November 2018 by the Labour Party recommends:

- a total pay cap set by stakeholders (including employees and customers)
- employee votes on individual directors' pay
- abolition of share incentives (cash only in the future)
- employee and other stakeholder representatives on remuneration committees.

The Investment Association (IA) is becoming more aggressive. At a recent QCA meeting, IA Director Andrew Ninian said Members feel they have "no choice" but to vote against for non-compliance with IA Principles of Remuneration.

Following 2018 changes to the UK Corporate Governance Code and disclosure requirements in the Companies Act, the IA wrote to FTSE 350 companies last November, placing particular emphasis on:

- post-employment shareholding requirements (executives must be required to hold shares for at least 2 years post termination of employment) and
- a levelling of pension contribution rates; "red top" if new policies or rates for new EDs fail to match rates for the majority of the workforce



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The IA also publishes a register of companies receiving votes against shareholder resolutions of > 20% (less than 25% of these directly relate to remuneration resolutions).

The governance landscape has changed. Remuneration Committees are cast as the bad guys (including those who clearly are innocent) and must adapt if they are to shrug-off that image. What can they do?

***Actions***

One of the problems for remuneration committees is that the way in which the current governance framework has been applied has encouraged remuneration committees to adopt a standard, formulaic approach to the design of executive remuneration packages.

One consequence has been a tendency for remuneration committees, despite comply or explain, to be reluctant to stand out from the crowd, preferring instead to tread the path less likely to lead to criticism and to negative shareholder votes – which can be distracting for the business.

We believe, however, that the UK's current governance framework now provides opportunities for remuneration committees to take actions to show themselves and their company's remuneration policies in the best light.

There is also a growing interest in environmental, social and governance measures (ESG). A paper published in January by the FCA on revisions to the Stewardship Code cites academic studies which show that active shareholder engagement with investee companies on ESG improves governance and performance and encourages a longer-term perspective – consistent with a theme running through current governance principles.

Here are five areas in which remuneration committees can take positive action to demonstrate their commitment to following good governance principles and designing appropriate remuneration policies:

1. Performance measure and targets:

   Most companies select financial performance measures which they believe drive shareholder value. But in our experience, most of those measures are outcomes, not drivers.

   If it is hard to set long term targets, consider whether both short and long term incentives are right for your company.




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2. Use of discretion

   In our experience, some remuneration committees have been reluctant to exercise discretion but developing and publishing a set of parameters for the exercise of discretion would demonstrate commitment to good governance and communication with employees.

3. Plan periods

   Most LTIs run for three years and operate overlapping vesting cycles.

   However, business investment and return cycles are longer than 3 years, particularly in capital-intensive industries such as oil & gas or mining. Economic cycles tend to be longer than 3 years, too, making it hard, in the context of a 3 - year plan, to measure whether delivered performance is really sustainable or the product of macro-economic factors.

   Despite the practical problems of competing for talent, there are examples of plans with longer vesting periods. MM&K has long advocated that this is a better approach to LTI design, which is not without risk but reflects a closer connection between strategy, performance and reward.

4. Share ownership

   It is common for companies to require executives to hold shares equivalent to a multiple of their base salary – up to 4 times for a CEO.

   Consider offering a premium to take shares instead of cash.

5. Engagement with the wider workforce

   Remuneration committee remits have expanded. Codes applicable to companies of all sizes and types reference the need at least to take account of remuneration for the wider workforce when considering decisions about executive pay.

   Remuneration committees which have a clear policy and process for engaging with the wider workforce will be able to demonstrate their commitment to these principles.

I have identified five areas in which remuneration committees could take action to reclaim some lost ground but they may count for nothing if committees do not, or are unable to, communicate clearly and engage with their major investors.



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Some committees have found it difficult to engage with their investors. Some of the more common complaints are failures to respond (either at all or in a timely fashion) and the use of proxy advisors, who are more remote from the company.

Those corporate governance codes which require companies to engage place no obligation on investors. The proposed revisions to the Stewardship Code may help to address this imbalance.

Proposed revisions to the Stewardship Code address concerns about:

- the use of and the quality of service provided by proxy advisers. The Code sets expectations for proxy advisers; how their role should be supported by values, culture, governance processes, resources, remuneration and conflicts policies
- short-termism. The Kay Review concluded selection of investment managers is based on recent performance (not on investment strategy); leading to a culture of short-termism and a deviation from investors' long-term objectives;
- engagement. This is seen as a key element of stewardship. There is a risk, however. Remuneration committees may wish to engage but investment managers may perceive the costs of engaging to outweigh the benefits. Investors and their advisors will be required to disclose their engagement policies, which should provide some leverage for remuneration committees seeking to engage with their investors.

**Conclusions**

So, yes, we think there are actions remuneration committees can take to regain the high ground – but it will require a will and patience. I am sure that taking no action is not an option. It would risk making those committees who design and implement sound policies based on strategy, culture and philosophy hostage to the minority who add fuel to the argument that all executive pay is just too much and requires legislation to curb it.

## Discussion

Here is a precis of the discussion that followed:

**Engaging shareholders is the key**

The constraint is the amount of time you can spare to spend on shareholder engagement.

It's too complicated, too difficult. Shareholders speak with forked tongues. It's not how much time you invest in engagement; it's the shareholder attitude and commitment that is the problem.

Where has the common sense view gone? – You can do it if you have the trust of the shareholders.





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But the trust often is not there. Shareholders think that companies are trying to pull the wool over the shareholders' eyes, for example by using adjusted metrics.

It's a matter of building trust between the board and the shareholders. The trouble is it takes four meetings a year to achieve this, but the investors don't have the resources for this. So there is a need for investors to pool their resources.

You have got to be talking to the shareholders. I have found that you don't get push back from the shareholders, usually. The interests of the shareholders and the board are usually aligned.

It's OK if you are dealing with the investment team in the shareholder organisation. But in the FTSE 100 it gets pushed over to the corporate governance people.

**Rem Coms feel constrained**

It is difficult to bring the shareholders along with anything out of the ordinary. We decided to change the share option plan by lowering the grant sizes and only having a share price hurdle. We consulted 10 shareholders and they came up with 10 different views. I felt these were people who had never run anything, did not understand reward and hadn't a clue how to motivate executives.

Proxy agents tell you that you cannot use restricted shares – we are so hidebound.

Institutional shareholders have set some bad rules – for example banning bonuses that reward successful corporate transactions.

I'm not sure I agree: we have to be careful with transaction bonuses – they caused the problem with Enron. There needs to be some proof that the transaction has added value before you pay large bonuses.

**How about ditching incentives altogether?**

In my 11 years' experience with 9 rem coms, I have found that our carefully constructed incentive plans either overpaid or underpaid. We never once got it right. We would have done better to pay just a salary. A decent salary for doing a decent job.

Everyone expects a bonus so it is no longer a reward for exceptional performance.

I am not sure that rewarding exceptional performance, in practice, is the prime purpose of a bonus – it is there to make part of pay variable. The problem with bonuses started with Big Bang in 1986 when the American banks moved in and bought up the City firms, setting lower salaries and much higher bonus opportunities so they could sack people cheaply.




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Also attaching performance conditions to rewards lowers their perceived value to the executive. So you have to increase the opportunity in order to compensate.

Our (private company) rem com meets twice a year for 45 minutes. We probably have the wrong people and wrong tools, but the goal of alignment through shares never works. We would do better to provide cash.

**Damage limitation**

It's now a damage limitation exercise for rem coms. It's become much more difficult.

It all went wrong in the 1990s. It started with the corporate governance drive for pay transparency – disclosure of directors' remuneration. Then everyone wanted to be paid more than everyone else. Bonuses expanded. We got it wrong.

With the new Investment Association name and shame register, how do we get sufficient votes to avoid being in the firing line? Does the 80% threshold really have any meaning?

**It takes courage from the remuneration committee**

It does need courage from the rem com to get it right.

However much an individual rem com member tries to be firm on such issues, the rest will say we're being too harsh with the executives.

Can you afford to be bold? Can you afford not to?

It needs a rem com with an expert understanding of the particular business to be able to challenge the executives. Often the rem com members do not have the right level of expertise.

A single owner has more chance of having the right conversation with management.

In all the boards I've worked with, the rem com have wanted to do the right thing. And management have just wanted to be rewarded fairly in relation to their peer group.

In most cases management makes the running – they make the first proposal on business plans and targets. The rem com looks at the wrinkles. What happens is then driven by the investors. The idea of incentivising management is lost in the middle of this process.

**Plan design**

What level of challenge should you set – a comfortable achievable budget or a stretch budget?




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**Private equity model**

I'm interested in hearing participants' views on the Private Equity model of reward. The pay-out is potentially rich, but it depends on the outcome. In plc's, in contrast, everything is set from the salary – the bonus is a percentage of salary; the LTIP is a percentage of salary.

With PE, there is more money for the upside, but people lose their own money if they fail.

But PE pays out for an exit, and plc's do not.

**Short-term vs long-term**

Long-term viability in a company is much longer than 3 years – it is a nonsense to talk about a three year LTIP performance period as long-term. If you accept that companies should be taking a 10 year view of strategy, you should gear the remuneration accordingly. This doesn't mean that performance should be measured over a 10 year period; but it does mean that the targets should be set in light of the long term aims.

But the average job expectancy of a CEO is 3 years, and the life expectancy of everything else for the company is less still – including shareholding periods.

There is always a tension between the shareholders wanting capital growth and those wanting dividends. The chairman must set out the purpose on pay – ie define the remuneration philosophy.

Shareholders love a CEO who turns the company round. But Persimmon got it wrong – and it was tax-payers' money anyway – paid for by the Government's Help-to-Buy scheme.

The old DTI used to say it is for shareholders to decide what to pay executives, not the Government. But shareholders are only interested in the short-term share price.

Short-term performance periods have their advantage – it makes for better incentives. Long-term periods are no incentive – it's too long to have an impact.

Long-term incentive plans have to be thought of as a retention device as well. If a plan is not going to pay out for 8 years it is not going to work as a retention device. An LTIP is a great brake on leaving.

**Other issues**

The CEO to middle ratio is definitely too large. Head-hunters have pushed up pay at the top.




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The gender pay gap is a major issue for the future but the disclosure regulations are already in place and companies are taking it very seriously.

As far as the gender gap at board level, it's for the nominations committee to sort out.

There's a skill in managing inclusion and diversity in a board.

***Summary***

On balance participants at the dinner believed that companies need to establish remuneration policies that fit their needs rather than adopting standard practice. There is a balance to be struck between creating focus on long-term success and not losing the incentive effect by making reward too remote. The key in getting acceptance for policies is good engagement with shareholders and demonstrating alignment of interest and trust. This will take persistence, but the new Stewardship Code should provide a basis for a better relationship.