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REWARD MATTERS

THE KEPLER NEWSLETTER ON TRENDS IN EXECUTIVE REMUNERATION

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"The 2017 AGM will, for most FTSE companies, mark the end of the first 3-year term for their remuneration policy and involve a second binding vote. Discussions around whether remuneration policies remain fit for purpose, and how to take into account developments in best practice over the last three years, will take place over the coming months. In the article (right), Jenny Martin discusses key considerations for the forthcoming policy reviews.

In the article below, we take a closer look at one of the areas where binding remuneration policies have had an impact on UK companies – executive director recruitment. On page 3, we take a closer look at the new ISS pay-for-performance analysis published for the first time in the UK for this year's AGMs. We look at the methodology and suggest ways in which companies can anticipate the ISS concern level and if necessary respond. On page 2, we take a look at recent developments in financial services pay, while page 4 summarises the recent changes to pensions taxation.

If you would like to discuss any of these matters further, please contact me or one of the team on 020 7178 5112.

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Who is best placed to determine what an executive is worth, shareholders or the Board?

Demands for UK executive pay packages to be more tightly controlled and more transparent have come from all sides: from Westminster, from institutional investors, regulators, Brussels etc. But the more you limit a Board's freedom to set pay, the more difficult it may become to recruit and retain the best talent - particularly when your European, US and private equity competitors operate under very different rules.

And that's the dilemma. At what point does sensible governance become a straitjacket? And how do you arrive at a remuneration policy that strikes an appropriate balance between specificity and flexibility?

Recruiting new directors is one area where companies are struggling to reconcile the practicalities of hiring with the requirements of an acceptable policy.

Simplicity, transparency and limits

Following shareholder reactions to some of the originally-proposed recruitment policies in 2014, the majority of recruitment policies at UK premium-listed companies have become rather boiler-plate, limited to the normal remuneration policy plus the ability to buy out outstanding incentives from a prior employer at fair value.

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Refreshing your remuneration policy

"Many readers will be familiar with the current debate on whether and how long-term incentives can be radically simplified at the same time as providing better alignment with shareholder interests, and better line of sight. The Investment Association (IA) sponsored Executive Remuneration Working Group (ERWG) has held numerous roundtable discussions to debate four potential remuneration structures:

- *Traditional LTIP* (3 – 5 year performance period, 2 year holding period)
- *Annual bonus with significant deferral*, operating alongside significant shareholding guidelines
- *Performance-granted shares*, where awards are based on 1 to 3-year performance prior to grant, and vest over the next 3-5 years
- *Restricted shares,* which vest over a period of time.

The ERWG is consulting with companies and other key stakeholders on these suggestions and key parameters, including the exchange rate when converting between different long-term incentive structures, length of performance and holding periods, levels of shareholding guidelines, and use of Committee discretion.

The suitability of each alternative, and other potential structures, varies by company. We recommend investing time in figuring out what design will be best for you, balancing simplicity, alignment and line of sight.

5-year time horizons. The move to increase long-term incentive time horizons to 5 years was given impetus in September 2013 by Fidelity's strongly-worded letter to Remuneration Committee Chairs. However, this letter arguably came a little late for many companies developing their first remuneration policy prior to their first binding shareholder vote.

Since then there has been an increasing number of companies introducing post-vesting holding requirements, and we expect this trend to continue as companies refresh their remuneration policies this year.

The IA has strengthened the guidance in its Principles of Remuneration to refer to the expectation of investors for long-term incentive time horizons (i.e. performance period plus holding period) to be at least five years. However, this guidance may change as a result of the ERWG recommendations.

Continued on page 2

Developments in financial services pay

"Pay in financial services continues to be heavily influenced by changes in regulation. Important developments in the last 6 months include the final guidelines on remuneration from the European Banking Authority for firms subject to CRD IV (banks, building societies and certain investment firms) and new remuneration requirements for insurers under Solvency II. These are summarised below. Our latest *Financial Services Survey* found that the most effective levers for fostering sounder risk management at financial services firms are (i) ensuring the right 'tone from the top', (ii) penalising non-compliance in pay and promotion decisions, and (iii) strengthening internal performance management processes. Meanwhile, in response to the bonus cap, fixed pay has become a larger proportion of the package – compounding the challenge for firms to keep down fixed costs when competing for the best talent.

EBA remuneration guidelines for CRD IV

The EBA Guidelines will become effective for firms from January 2017.

Key changes include (i) the potential removal of proportionality to establish a "more harmonised approach", and (ii) the move away from capturing the value of incentives at grant to the financial year prior to vesting, a change with implications for calculating the fixed-to-variable pay cap and deferrals.

Under the proportionality rules, smaller less complex firms can currently disapply certain regulatory requirements for remuneration. The EBA considers proportionality to be in legal conflict with the Directive, but published an Opinion to say it would prefer proportionality to remain for all areas except for the bonus cap. The exclusion of the bonus cap disappointed many level 3 firms who were hopeful that the final guidelines would confirm the existing use of proportionality. The PRA and FCA have said they will not be removing proportionality for the application of the bonus cap for the time being. Changes to the approach to valuing incentive awards at large, more complex firms, could have significant impact on how firms structure variable and deferred variable pay to maximise their effectiveness. We are continuing to monitor developments to understand how regulators intend this guidance to apply in practice, and to help understand the implications for UK firms.

Remuneration requirements for insurers

Solvency II remuneration requirements for insurers are a less onerous version of those introduced in banking.

The PRA published a consultation paper outlining draft guidance on the Solvency II requirements, and stated it would be important for large insurers to apply the rules in the same way. Firms have welcomed the additional clarity provided on the identification of Solvency II Code staff and deferral requirements.

The PRA expects the population subject to the remuneration requirements to include members of the board and executive committee, key function holders (as identified for the Senior Insurance Manager Regime) and Material Risk Takers (MRTs). The PRA expects firms to put in place an appropriate process for identifying MRTs that includes both qualitative and quantitative criteria, including a materiality threshold.

On deferral, the guidance interprets 'a substantial portion' of variable remuneration to mean 'at least 40%', and expects the deferral period to be 'not less than 3 years'.

Insurers can calculate the percentage deferral across all variable pay elements, including LTIs, making it easier to achieve the 40% deferral requirement than in banking (where deferral requirements apply to each component of variable pay).

For more information on the latest FS regulation, please contact me or one of our FS team on 020 7178 5112.

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Refreshing your remuneration policy *(cont.)*

Flexibility. During the 2014 AGM season when most policies were initially approved, a number of companies attracted negative shareholder comment around the extent of Remuneration Committee discretion and released statements clarifying their policies on certain aspects, particularly recruitment policies. Whilst shareholders like to see remuneration policies being as specific as possible, in designing something to last three years, Boards need to retain flexibility to respond to business circumstances without having to revert to shareholders for a further binding vote.

We suggest Committees consider whether their existing remuneration policies strike the right balance between specificity and flexibility. For example, policies should give the Committee flexibility to alter the selection and weighting of performance measures from year to year to better align with a changing strategy.

On quantum, greater flexibility can be obtained by linking the cap to a maximum desired positioning relative to peers, for example LTI grants as a % of salary not to exceed upper quartile vs. international peers.

Most FTSE-listed companies will be reverting to investors during the 2017 AGM season and, whilst not all will be making fundamental changes, institutional investors will likely be busy. To ensure a meaningful dialogue, we recommend starting discussions with shareholders early.

For a discussion on renewing your remuneration policy, please contact me or one of our team on 020 7178 5112.

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New ISS pay-for-performance analysis

"The 2016 AGM season has seen ISS publish its pay-for-performance analyses in the UK for the first time. Our analysis suggests it is having a big influence on the ISS voting recommendation. Indeed almost half of the analyses resulting in a High concern have received an Against recommendation. On average ISS's recommendation moves the vote by 24%.

The ISS analyses comprise 3 tests of pay-performance alignment (see box below). ISS combines the scores of the three tests into an overall assessment, ranging from 'low' to 'medium' to 'high' concern. Note that:

- If one or more tests has a 'high' concern level, the overall assessment is 'high'
- If two or more tests have a 'medium' concern level, the overall assessment is still 'high'

To achieve an overall concern level of 'low', companies have to score 'low' on all 3 tests. Less than 10% of companies with a 'low' concern level receive a vote recommendation against their implementation report, while around 40% with a 'high' concern receive a recommendation against.

The ISS analyses are based on actual pay, not target or 'fair' value, and assess both absolute and relative alignment (see below) and consider pay and performance over multiple time horizons (1, 3 and 5 years).

However, as with any such methodology, there are limitations, including that:

1. the analysis is highly sensitive to the selection of peers
2. there is a misalignment of the time periods for the RDA analysis – the pay figure reflects performance over *5* years, whereas performance is over *3* years
3. the analysis focuses solely on TSR and therefore favours companies with a heavy weighting on TSR in their incentives.

Our research shows that apparent misalignments between pay and performance identified by ISS may be attributable to:

- Remuneration policy
- Implementation of policy
- ISS's methodology

Kepler can identify which of these is relevant for your company and calculate the risk of 'medium' or 'high' ISS concern. Where limitations in the methodology are wrongly highlighting concerns, we can show the impact of a more accurate analysis, e.g. matching the time periods for pay and performance or adjusting for sector and country differences.

ISS's pay-for-performance tests

1. Relative Degree of Alignment (RDA)

The first test compares 3-year TSR performance to the 3-year CEO single figure of total remuneration. Both measures are ranked vs. 12-24 peers ISS chooses on the basis of sector, size and country of listing.

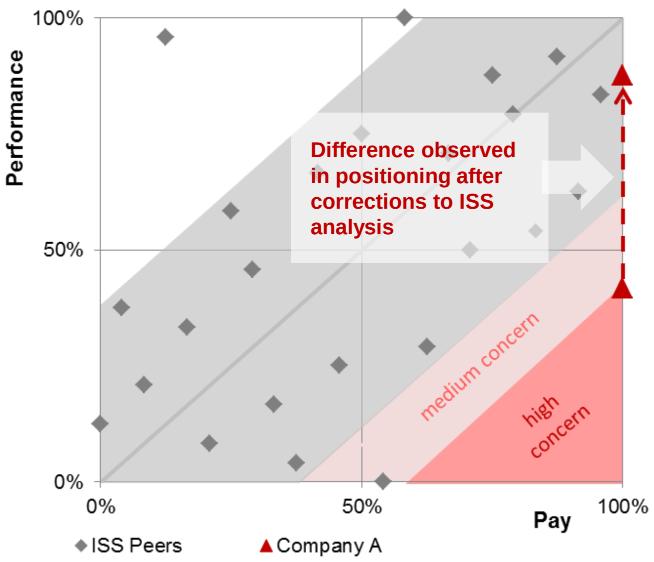
2. Multiple of Median (MOM)

The second test shows the CEO single figure of total remuneration for the latest year as a multiple of the median for the 12-24 peers.

3. Pay-TSR Alignment (PTA)

The third test plots the CEO single figure of total remuneration over the past five financial years vs the value of a £100 investment made at the start of the period. ISS calculates the trend in the value of an investment and CEO pay over this period and scores the difference between the slopes of the trend lines – if CEO pay is rising faster than the value of the investment by too much then this will be highlighted as a concern.

Illustration: RDA analysis



Kepler's model helps clients by calculating the pay ranges that correspond to a low, medium or high ISS concern for the RDA and PTA tests, taking into account cumulative single figure pay and TSR performance to date. This helps clients minimise the risk of a high concern and an ISS recommendation against.

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2016 pension tax changes

"Last month saw one of the most fundamental changes in pensions taxation for many years, with reforms that are expected to affect hundreds of thousands of people.

Reduced and uncertain Annual Allowance for higher earners

Those with total earnings of more than £150,000 (including pension contributions and non-work-related taxable income) are now subject to a Tapered Annual Allowance that reduces by £1 for every £2 of income over £150,000, from a maximum of £40,000 to a minimum of £10,000. Exceeding the Annual Allowance results in double income taxation and depending on the individual's circumstances, overall marginal tax rates up to 75% are possible. These changes will have serious implications on pension provision.

- Individuals with total earnings above £210,000 will have significantly reduced scope to build up tax-approved pension savings (just £10,000 per annum).
- For many individuals with total earnings between £150,000 and £210,000 the situation is fraught with uncertainty. In the private sector, individuals at this level will often be eligible for significant bonuses; however they will generally not know the value of their next bonus – and therefore their total earnings – in advance. Indeed, as many companies pay bonuses in February or March, i.e. towards the end of the UK tax year, individuals will need to act quickly.

Lifetime Allowance reduced to £1m

The Lifetime Allowance has been reduced once again from £1.25m to £1m, with effect from 6 April 2016, and will then increase in line with inflation (CPI) from 2018.

Some "protections" are available for individuals wishing to retain a higher allowance.

Life Insurance and the Lifetime Allowance

Another dimension to the changes is the impact of the reduced Lifetime Allowance on lump sum life assurance benefits. Many companies insure these benefits under a Registered Life Assurance Scheme and, in the event of a death in service, any lump sum life assurance benefits will count towards the Lifetime Allowance. Our experience suggests that companies have been slow to identify and tackle this issue.

How are companies responding?

A recent Mercer survey reveals a change in the mindset of employers from "why should we do something" to "why wouldn't we do something". Around 70% of employers already offer, or are planning to offer, an alternative to continued pension provision (most commonly cash supplements), generally to individuals at certain grades and/or above a salary threshold.

Individuals will then be faced with a choice and may require independent guidance. Whilst some companies are offering individual support, there are also cost-effective approaches for companies with large affected populations, including interactive online content.

For life insurance, the good news is that there are alternative arrangements that can be put in place – although these need to be implemented correctly to avoid unintentional tax liabilities.

To see how we can help, please get in touch with me or contact my colleagues: nigel.roth@mercer.com (pensions) or rachel.lewis@mercer.com (life insurance).

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Who is best placed to determine what an executive is worth, shareholders or the Board? *(cont.)*

One third of FTSE350 recruitment policies allow for higher incentive opportunities in the first year. By contrast, US and private companies are still able to offer big sign-ons.

Boards want flexibility

Kepler's experience suggests that the 2014-approved recruitment policies are in some cases hindering companies from hiring their first choice executive. This is particularly the case for listed companies competing for talent vs. US companies, private companies, or European companies with generous DB schemes.

A company wishing to stray outside its approved policy has two options. On the one hand it can offer a higher salary. On the other hand it can seek approval to revise its policy. The latter approach is generally not practical in the middle of a hiring negotiation - unless the appointment has already been made public.

A formal consultation will normally require a commitment from the candidate before the company can confirm the package, while an informal consultation provides no guarantee of shareholder approval.

Consider a company in a turnaround situation where the share price has collapsed, the CEO has resigned, and the Board needs to find a new CEO to rescue the company. Your first choice candidate may be concerned about reputational risk, particularly if she is currently in a secure role.

Shareholders may prefer to offer the candidate a lower salary, and a significant performance-based opportunity aligned to the fortunes of the company and its shareholders. The candidate may want some protection around a Change of Control in their first 12 months. However, other than buying out any outstanding incentives from a previous employer, the average recruitment policy has no flexibility to do this and the solution ends up being to increase salary. Can this really be the best solution? The alternative would be to go to shareholders with a plan of action but, with a company on its knees and an unsettled Board, this would be a difficult course of action.

Is there a compromise?

So what should companies be thinking about when reviewing their policies? One suggestion is to ensure that your limits on variable pay are sufficiently flexible to ensure that an inflated salary isn't the first option in a recruitment negotiation.

To discuss how we can support your review of recruitment policy, please contact me or one of our team on 020 7178 5112.

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