Executive Remuneration News

Cash for gold

The 2016 Rio Olympic Games saw Michael Phelps win his 23rd Gold and his 28th Olympic medal. Phelps was already the most decorated Olympian by quite some margin but his victories in Rio further cemented his place in history.

Before the 2004 Athens Games, Phelps' sponsors, Speedo, offered him a $1m bonus if he equalled fellow swimmer Mark Spitz's record of seven gold medals in a single Olympic Games.

This raises an interesting question about the role of incentives in sport. Did Phelps need this monetary incentive to motivate him to win gold? Is this what drove him to get up at 5am every day and push his body to the maximum? The answer is almost certainly not. Phelps is more than likely driven to win for the reward of winning itself. He swam length after length, day after day because he wanted to be the greatest Olympian of all time – not because of the $1m bonus.

At the 2008 Beijing Games Phelps won a total of eight gold medals, surpassing Spitz's achievement. Phelps donated his $1m bonus to charity, helping promote water safety and encourage youth swimming.

Incentives in sport are not as uncommon as you might think.

While not typically disclosed publicly it is widely acknowledged that Premier League clubs pay bonuses to players for achievements such as scoring goals and improved league places. The press was filled with pictures of dozens of identical BMWs for the Leicester City players as a thank you from the chairman for their surprise win of the Premier League.

In the other kind of football, American football, the Carolina Panthers and Denver Broncos met in the 2016 Super Bowl. Reportedly each member of the victorious Broncos team took home a bonus of around $100,000 with the Panthers team members getting around $50,000 each. This money comes from the NFL and is on top of any payments agreed between players and their team directly. It was rumoured that Peyton Manning, the Broncos quarterback, may have earned up to $4m for leading his team to victory.

Again, on the whole, players are probably not primarily motivated by these monetary carrots. The accolade of winning is motivation enough. What these payments actually do, however, is provide a reward for a job well done and allow clubs to share the team's success with the players.

In some ways, CEOs are the quarterbacks of the corporate world leading their teams to victory or failure.

Like their counterparts on the field, many are motivated not just by the monetary rewards but by achieving success and a job well done.

A recent study by Alexander Pepper[1] claims that executives care more about how they are paid relative to others than they do about the absolute amount they are paid. Michael Phelps may not have been motivated to win because of his $1m bonus but would he have been happy if rival Ian Thorpe had been offered $5m for achieving the same outcome? Perhaps executives see how much they are paid relative to their peers as their badge of success, their own version of a gold medal round their neck and perhaps this is the problem.

1 A. Pepper and J. Gore, The Economic Psychology of Incentives: New Design Principles for Executive Pay (Palgrave Macmillan, 2015)

Re-thinking pay beyond the Board

Few would argue that the focus on executive director pay has reached unprecedented levels. In the listed environment, it is not uncommon for the associated disclosure to run to over 20 pages although it covers just a handful of individuals.

Historically, many companies cascaded the approach at this level down to the rest of the senior management population. That is, the 'typical' structure of an annual bonus and long-term incentive plan would be rolled out below the board to ensure the senior management team are 'all in it together'.

As the debate around the appropriateness of a one size fits all approach on a company by company basis intensifies, perhaps now is the time to also consider whether a one size fits all approach within companies remains realistic.

For UK listed companies, there are constraints around the way in which share incentives operate at board level to ensure plans meet shareholder expectations.

In addition, given today's uncertain trading environment, many companies face practical challenges in operating share plans including the ability to set and prospectively disclose stretching, yet realistic, three year performance targets in volatile markets. Below the board, however, there is more flexibility around remuneration design, allowing companies to ensure that plans appropriately support the business strategy.

Now, more than ever, it is essential that companies are getting the best value from their spend on pay given the current challenging economic environment. It is important that those below board level are rewarded in a fair and transparent way that takes into account performance.

When undertaking reviews, one of the most frequent comments we hear is that participants in incentive plans below the board feel there is insufficient line of sight. This may lead to individuals discounting awards because they do not believe they have the ability to impact performance, or they do not understand how they can drive performance on a day-to-day basis. This particularly applies to incentives that measure performance over the long-term.

Many companies will want to avoid a disconnect in the approach to incentives to ensure that the messaging on strategic direction and performance is consistent at senior management levels. We have seen a number of companies explore ideas which try to achieve the 'best of both worlds'. That is, providing greater certainty on incentive payouts below the board, while maintaining some alignment to the key measures of performance used at board level.

Plans we have seen implemented include using pre-grant performance conditions, restricted share plans with performance underpins, the same long-term plan with shorter time periods and operating an annual bonus with deferral as the sole incentive plan.

Now may be the time for organisations and remuneration committees alike to consider whether a more tailored approach to remuneration below the board is needed to drive the strategy of the organisation.

Recent publications

The heat is on: reforming executive pay	We have recently published a thought piece exploring six areas of potential reform which have been highlighted in the ongoing public debate around executive pay: 1. Encouraging long-term, sustainable business performance 2. The role of shareholders in protecting the long-term interests of the business 3. Taking into account the views of the wider workforce 4. Recognising the contribution of all employees 5. Further disclosure on executive pay 6. Decision-making by remuneration committees To access the thought piece, please click ***here***.
Your guide: directors' remuneration in FTSE 100 and FTSE 250 companies	In September, we published our flagship reports on directors' remuneration in FTSE 100 and FTSE 250 companies. The reports provide market-leading data on all components of pay, executive pay policy and the 2016 AGM season. To request hard and soft copies of the FTSE 100 or FTSE 250 reports, please click ***here***.

Recent developments

GC100 publishes updated guidance	The GC100 and Investor Group updated its ***guidance*** on directors' remuneration reporting. The key points were as follows: • **Link to strategy** – Companies should explain the link between remuneration and strategy in the chairman's letter. • **Flexibility, discretion and judgement** – Investors generally expect committees to give careful consideration to a moderation of formulaic outcomes – through the exercise of discretion – so that the remuneration outcome balances management performance and the shareholder experience. • **Commercial sensitivity** – Non-disclosure of targets should not be assumed but only done when directors have examined the necessary figures and asserted that the information is truly sensitive. • **Change in CEO pay** – The percentage change in remuneration for the CEO disclosed in the directors' remuneration report should be compared against an appropriate comparator group, rather than a small group of senior managers. • **Policy table maximum** – Maximum levels should be provided for each individual executive director. A generic director policy could also be included. Guidance reinforces that a maximum salary should be included. A full summary of the changes to the guidance can be found ***here***.
Legal and General revise executive remuneration principles	Legal and General Investment Management have released ***an update*** to its Executive Remuneration Principles. Some key points of guidance from the principles are as follows: • **Transparency:** the report should set out why remuneration is appropriate and any evidence of use of discretion, pay ratio between CEO single figure/median employees and breakdown of consultant fees. • **Structure:** the guidance recommends the use of only one LTIP (matching plans will generally not be supported), substantial shareholding requirements and bonus being deferred for over two years and paid in cash and shares. • **Performance metrics and targets:** should link to strategy and sufficiently stretching, LTIP targets should be disclosed prospectively and bonus retrospectively within two years. Clawback and malus should apply to all performance related pay. • Recruit**ment/Exit:** remuneration for new executives should be linked to experience and buy-out awards and golden hellos avoided. On departure, share based awards should be time pro-rated and subject to performance.
Executive Remuneration Working Group releases final report	The Executive Remuneration Working Group published its ***final report*** in July. The report set out ten recommendations focusing on strengthening remuneration committees and their accountability, improving shareholder engagement, increasing transparency on target setting and the use of discretion and addressing the level of executive pay. The key principle of the report is the recommendation that there should be more flexibility afforded to remuneration committees to choose a remuneration structure which is more appropriate for the Company's strategy and business needs. A detailed summary can be found in ***this newsflash***. The FRC ***responded*** to the report to say it would consider the recommendations when next reviewing the UK Corporate Governance Code.
IA publishes 2016 Principles of Remuneration	In October the Investment Association (IA) issued ***an update*** of its Principles of Remuneration and an accompanying ***open letter*** to remuneration committee chairmen. The key areas of focus are: • The Principles reflect the findings contained in the Final Report of the Executive Remuneration Working Group. The Principles now include sections on levels of remuneration and shareholder consultation. • A stronger emphasis on setting executive pay arrangements in the context of pay for the wider workforce, including recommending the disclosure of pay ratios. • The continued focus on full retrospective bonus target disclosure (i.e. threshold, target and maximum) and the target setting process. A full summary of the changes made to the Principles can be found in ***this newsflash***.
Theresa May proposals on executive pay	During her leadership campaign in June, Theresa May spoke of the need to make business more responsible in a fight against perceived inequality in British society. As part of this campaign, May proposed: • Employee and consumer representation on boards. • Mandatory publication of pay ratios. • Binding votes on the annual remuneration report, in addition to the existing binding vote on the remuneration policy report. • Fuller disclosure of bonus targets in the annual remuneration report. • Simplification of remuneration arrangements. The Government has announced it will publish a formal consultation on potential reforms in the autumn.

Recent developments (continued)

BEIS Select Committee inquiry on corporate governance	The Business, Energy and Industrial Strategy (BEIS) Select Committee has announced an ***inquiry*** on corporate governance, which is independent from the Government's consultation on executive pay reform. The terms of reference for the inquiry cover three areas: • Directors' duties. • Executive pay. • Composition of boards. The Select Committee will commence hearings once written submissions have been considered. A report on corporate governance is anticipated in the new year.
MP releases report on executive pay in conjunction with the High Pay Centre	Chris Philp, a backbench Conservative MP, recently released a ***paper*** on executive pay in conjunction with the High Pay Centre, which argues that companies require stronger oversight from shareholders. The report proposed three reforms: • The publication of pay ratios – this would require the publication of the ratio between the CEO single figure of remuneration and the median employee total pay. • A binding vote on annual pay in order to make companies accountable for the outcome of their policy. • A new Shareholder Committee, which would replace the nomination committee and would be made up of the top five shareholders. The Company chairman and an employee representative would also be non-voting members of the Committee. The Shareholder Committee would ratify remuneration committee decisions, as assuming well as the existing responsibilities of the nomination committee.
FRC Succession Planning Paper	Earlier this year, the FRC published a feedback statement on their UK Board Succession Planning paper which can be found ***here***. As a result of these responses, moving forward, the FRC will consider providing nomination guidance as part of the revision of the Guidance on Board Effectiveness.
FS Updates	• **Brexit** – Immediately post Brexit, the FCA stated they will remain in close contact with the firms they supervise, along with the Treasury, the Bank of England and other UK authorities, and are monitoring developments in the financial markets. The key point is that any applicable UK financial regulation that derives from EU legislation will remain applicable until any treaty changes come into effect. • **MiFID II** – Another Remuneration Code is coming – SYSC 19F, which will regulate the remuneration of sales staff of MiFID investment firms and financial advisors, as well as corporate finance firms exempt from MiFID. The FCA consultation on the regulations closed on 28 October 2016. The final rules are expected in the first half of 2017. • **European Commission releases report on remuneration rules** – Over the summer, the European Commission released a report on the remuneration rules for credit institutions and investment firms. The report finds that the remuneration rules, including governance of remuneration processes, performance assessment, disclosure and pay-out of the variable remuneration of identified staff, are generally effective in curbing excessive risk-taking and better aligning remuneration with performance, thereby contributing to enhanced financial stability. • **PRA Remuneration Policy Statement** – The RPS templates for Level 1, 2 and 3 firms were updated over the summer. Additional requirements have been included in certain sections, whilst other sections have been streamlined. These include questions under the risk adjustment heading with respect to the PVA adjustment to fair value accounting profits, identification of MRTs in level 2 firms and governance aspects of the Senior Managers regime. • **PRA Supervisory Statement on its expectations of how the remuneration requirements in the Solvency II Regulation should apply in the UK** – In August, the PRA issued its Supervisory Statement (SS) on its expectations of how the remuneration requirements in the Solvency II Regulation should apply in the UK. In particular, there is a focus on key aspects such as the identification of Solvency II staff, deferrals, and performance measurement. At the end of September, the PRA issued a Consultation Paper on its expectations on remuneration as well as a Policy Statement regarding the treatment of buy-outs of variable remuneration. In addition to this the FCA issued its own Consultation Paper entitled Remuneration in CRD IV firms: new guidance and changes to the Handbook. Responses must be provided to the regulators in respect of both Consultation Papers by 28 November 2016. Please see the Financial Services Reward newsflash ***here*** for further detail. For the latest FS Reward updates, join the Deloitte UK Financial Services Reward LinkedIn Group ***here***.

Upcoming Events

6 December	Next meeting of the Reward Network Theme to be confirmed in due course	The Reward Network provides networking events and a discussion forum for senior reward professionals in mid-sized FTSE-listed companies. If you are interested in joining this friendly network, please contact Amber Jackson (amjackson@deloitte.co.uk or 020 7007 3925) for more information.

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