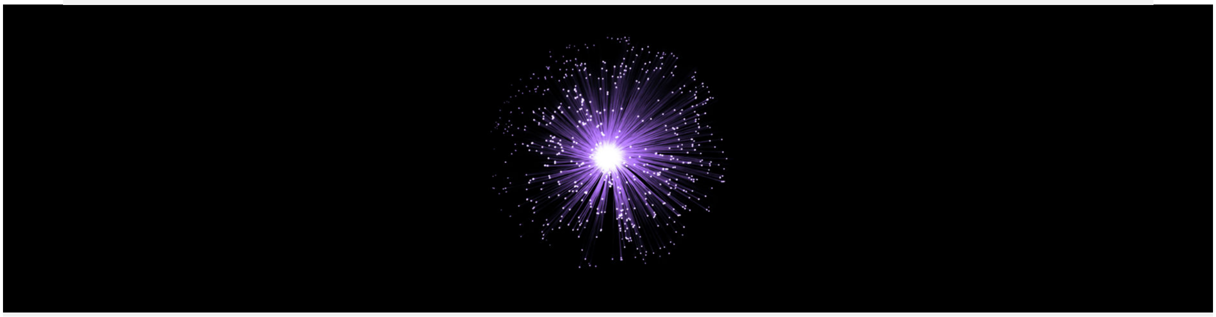

Hermes Investment Management

Remuneration Principles: clarifying expectations

15th November 2016

Hermes Investment Management has published a paper, which reasserts its Remuneration Principles which were published in 2013 and clarifies expectations on how companies should implement them.

Hermes highlights a number of issues (excessive quantum, misalignment to long term value creation, excessive complexity, weak accountability and unfairness and low levels of trust) and suggests a number of solutions aligned with its Principles:

1. Shareholding: Executive management should make a material long-term investment in the company's shares

- Less leveraged packages composed of higher levels of fixed pay which include a significant proportion of salary paid in shares. The proportion of variable pay converted into fixed pay should be significantly discounted (50%) to reflect more certain outcomes.

- Shares to be held for the longer of (a) the shareholding requirement being met or (b) 5 years.

- Bonus awards should be made predominantly in shares (<25% in cash) with shares being held for the longer of (a) the shareholding requirement being met or (b) 5 years.

- Approved ex ante total cap on overall pay as well as for individual components.

- Shareholding guidelines should be high (500% of salary for a FTSE 100 company, 300% for a FTSE 250 company and 200% minimum for all other companies) and should be achieved through personal share purchases as well as grants from the company.

2. Alignment: Pay should be aligned to long-term success and the desired corporate culture

- Strategic performance metrics should replace TSR, alongside other metrics focused towards the impact on stakeholders.

- Remuneration committees should adjust pay outcomes in light of both relative and absolute TSR performance. Incorporating one or both as an underpin may be appropriate.

- Benefits arrangements such as those for pensions should be in line with the wider workforce (e.g. the same pension contribution as a percentage of basic salary).

- Tail-risk should be built into pay structures, for example sales of shares restricted to a third year per year post departure.

3. Simplicity: Pay schemes should be clear and understandable for both investors and executives

- Pay structures should be much simpler and less leveraged than at present, for example higher fixed pay and a single incentive scheme reflecting primarily strategic goals together with operational and personal objectives.

4. Accountability: Remuneration committees should use discretion to ensure that awards properly reflect business performance

- Remuneration committees, guided by the UK Corporate Governance Code to "avoid paying more than is necessary", should take a more robust view on pay, including greater use of discretion.

- Publication of and comment on CEO to median pay ratio comparing internally or externally.

- The chair of the remuneration committee should write annually to employees to explain the basis for the CEO's awarded pay for the current year vis-à-vis corporate and individual performance and wider pay changes throughout the company.

- The chair of the remuneration committee should meet employees and take on board their views through appropriate representative forums and summarise this process within the remuneration report.

5. Stewardship: Companies and investors should regularly discuss strategy, long-term performance and the link to executive remuneration

- Greater quality engagement by investors coupled with and reinforced by voting is likely to be the most effective means of bringing about positive changes.

- Investors should not be supportive of capital distributions which do not support the company's long-term success. Individual directors should be held accountable for questionable pay policies or approving inappropriate outcomes.

Hermes has provided an illustration of the type of structure which companies are encouraged to consider.

To view the Hermes Remuneration Principles, please click here.

Deloitte view

We welcome clear guidance and views from institutional investors. The Hermes principles echo a number of comments and expectations made by other stakeholders, including the Investment Association (IA), whose updated guidelines reflect many of the recommendations of the Executive Remuneration Working Group in their final report.

Remuneration structure - As highlighted in our newsflash on the IA Principles, we believe companies need the flexibility to adopt the structure that best supports their strategy. Whilst the Hermes' views on an alternative pay model are clearly stated, some aspects are rather prescriptive and may not reflect the views of other investors. As it may not be possible for investors to agree on all points, investors do need to appreciate that companies will need to decide what is best for their business, having regards to sometimes conflicting views.

Broader employee pay - We agree that remuneration committees should be aware of remuneration structures and levels for other employees. We continue to believe that pay ratios by themselves are too simplistic and note that the IA guidelines did not suggest that information is limited to ratios. Companies should consider relevant reference points (including pay ratios) and trends over the last few years to assess how such information can be of use in discussions with shareholders.

Shareholding - Although we strongly believe in the role of shareholding requirement in aligning the interests of executives with shareholders, we are not convinced that requiring executives to buy shares is necessary when shareholding can be achieved in different ways, for example by requiring executives to retain vested shares until the shareholding requirement is met or potentially using more stringent deferral until the shareholding requirement is met.

In line with the UK Corporate Governance Code, we agree committees should consider shareholding post leaving for a limited period and we believe companies should disclose clearly whether holding and shareholding requirements apply post leaving.

Pension – Echoing the IA, Hermes is also expecting companies to offer pension arrangements in line with the broader workforce. It will be interesting to see how practice in this area develops and whether, if pension contributions are reduced below current levels, there will be pressure to increase other parts of the package to compensate.

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