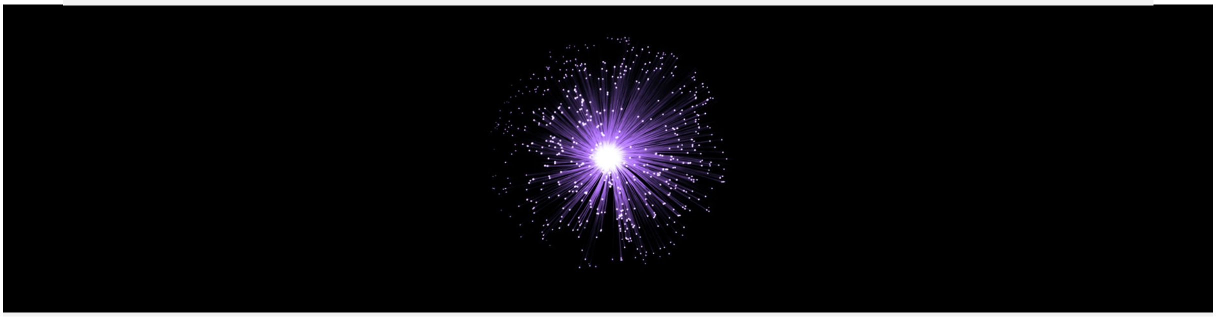

The Investment Association

Principles of Remuneration 2016

1st November 2016

The Investment Association (IA) has 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 (ERWG), which was published in July 2016. 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.

Remuneration structures

The IA have adopted the ERWG's first and overarching recommendation that remuneration committees should have the flexibility to choose a remuneration structure which is most appropriate for the implementation of their business strategy. Companies are encouraged to follow this approach and design remuneration structures which will "reward sustainable business performance and therefore deliver long-term value to shareholders." Further changes reflecting the ERWG's report include:

- Guidance on restricted share awards is now provided. Some of the IA's members are supportive where it is well-justified by the remuneration committee. Other members oppose the loss of the link to long-term performance. It is noted that arrangements featuring restricted share awards are more likely to receive support from shareholders when proposed by a company which has demonstrated a sensible approach to remuneration in the past and has established a relationship of trust with investors. Restricted share awards should be bolstered with significant shareholding requirements.

- If companies move from granting awards under a performance share plan to making restricted share awards, IA members expect a discount to award levels of 50%. Grant levels should be held at this level and not increase gradually over time. Vesting should occur no earlier than the third anniversary of grant and then vest in equal tranches over time.

- If companies recalibrate remuneration arrangements toward annual incentives rather than long term incentive plans, shareholders expect to see a significant reduction in maximum opportunity given the increased certainty of measuring performance over one year rather than three years.

- The wording of the Principles on remuneration arrangements has been made less prescriptive. For example, whilst reference to investors' preference for simplicity has been maintained, the statement that this can be improved by the use of an annual bonus plus one long term incentive plan has been removed; so has the statement that remuneration structures should include a high degree of deferral and measurement of performance over the long term.

Other changes include:

- Executives are encouraged to purchase shares using their own resources in order to demonstrate the alignment of interests between themselves and shareholders.

- Remuneration committees should implement post-employment shareholding requirements, which would require executive to maintain a proportion of their shareholding for a period after they have left the company. The UK Corporate Governance Code also requires companies to consider post-employment shareholding requirements.

Remuneration policy

As a majority of companies will be holding a remuneration policy vote at their 2017 AGM, the IA reminds companies in the letter of the following expectations for the policy:

- Companies should have maximum policy limits for each element of **variable** remuneration.

- Companies should not seek discretions to provide payments outside the scope of the remuneration policy.

- The remuneration policy should contain sufficient flexibility to recruit executive directors. Any additional recruitment limits should be clearly justified in the remuneration policy.

Remuneration committee

In addition, the 2016 Principles now reflect the ERWG's recommendations as follows:

- Non-executive directors should serve on the Remuneration Committee for at least one year before becoming Chair of the Committee and have sufficient skills and experience to manage the remuneration setting process.

- Greater emphasis has been placed on the need for the Chairman and the whole Board to be appropriately engaged in the process of setting remuneration arrangements.

- The Principles now state that "Remuneration Committees need to exercise independent judgement and not be over reliant on their remuneration consultants".

Echoing the debate on the role of the Board, the Principles now state that remuneration policies should support the success of the company for the benefit of all stakeholders (rather than simply shareholders and creditors).

Consultation with shareholders

The guidance which accompanies the Principles has been updated in line with the ERWG's recommendations:

- IA members expect consultation on remuneration arrangements to focus on major strategic remuneration issues rather than the minor details of pay.

- Companies need to respond to feedback from shareholders, as conducting a consultation will allow remuneration committees to decide the best way to enhance their proposals. Consultation does not mean that companies will gain automatic acceptance of their proposals.

- In the instance of a significant vote against a remuneration report or policy (more than 20% against), the remuneration committee should seek to understand the reason behind the dissent. A response should be published, outlining an explanation of the reasons behind the dissent and what the Board is doing to address these concerns.

Target setting and disclosure

The expectations regarding bonus target setting for the 2017 AGM season are outlined in the letter as:

- Full retrospective disclosure of the threshold, target and maximum performance targets for financial measures, the level of performance achieved against these targets and the resulting bonus outcome. IVIS will issue a "Red Top" where these targets are not disclosed or the company has not made a commitment to disclose the target range in future (with an expectation that targets are disclosed no later than two years following payment).

- Companies are now expected to provide an overview of how the performance targets have been set.

- A thorough explanation as to why personal or strategic targets have paid out is required. A description of the non-financial measures used is not sufficient. IVIS will issue an "Amber Top" where insufficient information has been disclosed.

- Additional scrutiny will be given to personal or strategic measures paying out where financial measures do not warrant a bonus payment.

The IA has also amended its guidance on the disclosure of targets for incentive plans as follows:

- Any adjustments to reported metrics should be clearly explained and the impact on the outcome detailed. The impact of share buy backs and other capital management decisions should be taken into account when determining whether a performance measure has been satisfied.

Levels of remuneration

The IA's open letter highlights the level of remuneration awarded to executive directors as a concern for its members, reflecting the current economic and political climate. IA members continue to pay close attention to levels of remuneration, especially any salary increases or increases to variable remuneration, which should be justified with clear and explicit rationale.

The IA highlights the disparity in pension provision for executives compared to the wider workforce. The Principles state that any difference in the pension provision for executive directors and the wider workforce should be clearly justified. Where there is no clear explanation, the company should explain how it intends to reduce the disparity.

A new section has been added to the Principles on the level of remuneration. The Principles now emphasise that "undeserved remuneration undermines the efficient operation of the company and sends a disincentivising message to all staff." As in previous versions of the Principles, the potential for reputational damage arising from excessive remuneration is highlighted. In line with the ERWG's report, the Principles and accompanying guidance now state:

- Shareholders expect the Remuneration Committee to exercise relevant discretion to avoid excessive remuneration payouts.

- The Board should explain why the chosen maximum remuneration level is appropriate for the company.

- The Board must be cognisant of the pay and conditions in the rest of the workforce, and should consider the aggregate impact of employee remuneration (including executive director remuneration) on the finances of the company, its investment and capital needs and dividends to shareholders.

- Pay ratios are considered to be useful reference points for the remuneration committee and the Board, and should be disclosed externally. Executive remuneration should be compared against groups of employees in the workforce including the median employee and the Executive Committee.

- Companies should exercise discretion when granting share awards to ensure executives do not benefit from windfall gains as a consequence of movements in share price. Remuneration Committees should review each year if the grant level is appropriate given the company's financial and share price performance.

The Investment Association's open letter can be viewed here.

The Principles of Remuneration can be viewed here.

The Executive Remuneration Working Group's final report can be viewed here.

Deloitte view

The changes to the Investment Association's Principles of Remuneration mostly reflect the recommendations included in the Executive Remuneration Working Group final report.

Flexibility - As noted at the time, we welcome the recognition that remuneration committees should have the flexibility to adopt the remuneration structure that best support the company's strategy and that shareholders should consider pay proposals having considered a governance and investment perspective. The Principles set out some useful guidance on shareholders' expectations if a company is seeking to move to an alternative model. It also highlights that there are polarised views on some schemes.

Remuneration Committee Chair's tenure - We also support introducing a requirement for the chairman of the remuneration committee to generally have at least one year's experience on the committee before becoming chairman on a comply or explain basis to allow for unusual circumstances. We note that the Financial Reporting Council have stated that they will consider this recommendation.

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 guidelines do not suggest that information is limited to ratios. Given the increased focus on pay differences between the most senior executives and other employees on one side, and on the overall employee cost versus other spend on the other side, broader employee pay is likely to become a topic of discussion during shareholders' engagement. It may be useful for companies to determine the best approach to calculate relevant reference points (including pay ratios) and consider 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 deferred bonus shares and vested long term incentives until the shareholding requirement is met. Companies could potentially use more stringent bonus deferral until shareholding requirement is met.

Pension - The IA is now clearly expecting companies to reduce differences in pension provisions for directors versus other employees where such difference is not justified. Given the potential cost pension represents, the board and its remuneration committee should take this opportunity to review pension provisions but will undoubtedly be faced with the challenges of external benchmarking and consideration of compensation for any reduction.

Bonus disclosure - As the 2016 AGM season highlighted, the spotlight has been directed at target setting and Remuneration Committees may want to review their approach to ensure it is appropriate.

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