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NAPF and pension fund investors
Updated remuneration principles and guidance

November 2013

The National Association of Pension Funds (NAPF) have released updated corporate governance policy and voting guidelines.

In addition, the pension fund investors Hermes Equity Ownership Service, National Association of Pension Funds, BT Pension Scheme, RPMI Railpen and USS Investment Management have released an update of the joint paper on remuneration principles published earlier this year.

Remuneration principles for building and reinforcing long-term business success - jointly released by pension fund investors

Following significant debate with remuneration committee chairs and feedback from remuneration consultants, HR executives and investors, the updated paper now includes five principles.

The principles are not intended to prescribe specific structures or measures but to provide high level guidance to companies about investors' expectations in relation to remuneration structures and practices.

Material long-term investment

The first principle is broadly unchanged although the statement that shares should ideally be owned for at least ten years has been removed:

- The best form of alignment between executives and shareholders is the ownership of shares over the long term with ownership obligations increasing with seniority.
- The meaning of long-term will differ from company to company, but the paper states that the standard three year vesting period is often not long enough and that consideration should be given to requiring a material proportion of shares to be held for a longer period and that the length should align to the business cycle of the company.

- The paper notes that it is important to guard against possible unintended consequences of long-term ownership (overly aggressive dividend policy, encouraging takeover to crystallise awards, overly risk-averse strategies to preserve the value of the shares) and also acknowledges that as executives approach retirement they may wish to ensure their investments are appropriately diversified.
- The suggestion that remuneration committees should consider paying some fixed pay in shares has been removed.
- The paper still suggests that the sale of shares after leaving the company should be staggered and that the use of clawback also goes someway to aligning executives and shareholders. However it is now recognised that outgoing executives cannot be held responsible for the actions of their successors and that an appropriate balance must be struck.

Alignment of pay with long-term strategy and corporate culture

This principle is also broadly unchanged:

- Remuneration should encourage the behaviours that will drive long-term business success.
- There has been an over emphasis on measures such as EPS or TSR with insufficient attention paid to the strategy or the timeframe of that strategy. The starting point for the measurement of performance should be the strategic plan and the Key Performance Indicators.
- There should be a coherent and consistent remuneration philosophy throughout the organisation. (The paper states, for example, it is not clear why some executive directors receive higher base pay increases than those awarded elsewhere in the organisation, which then feed into incentives, thereby widening pay differentials, or enjoy more generous pension arrangements or preferential tax treatment).
- The remuneration committee should work closely with the nomination committee particularly in agreeing parameters for the pay of new appointees.

Remuneration structures should be clear and understandable and rewards should reflect returns to long-term shareholders

The main change to this principle is a change from ‘simple’ to ‘clear’ remuneration structures, acknowledging that it may not always be realistic for structures to be simple but that they should always be clear. The key points raised in support of this principle remain broadly the same.

- Many companies operate multiple long-term schemes with executives holding outstanding awards in a number of these. This may not really help motivate employees or give them a clear line of sight.
- An example of a structure which is welcomed by the pension fund investors is where the focus is on annual progress against a long-term strategy – an annual bonus based on a balanced scorecard of measures (over which the remuneration committee may use its discretion) which pays out predominantly in shares which are held for the long-term. It is considered that this may be better than the current system.
- The suggestion that remuneration committees should not make large awards where

return on capital is below the cost of capital without a full rationale has been removed.

Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance

This principle has been changed to specifically focus on the use of discretion.

- Remuneration committees should exercise judgment /discretion over the overall performance of the company when determining rewards – this should include how results are achieved and not just what was achieved.
- Investors want committees to take a holistic approach to performance rather than applying simplistic mechanistic formulae to determine awards. It is acknowledged, however, that this requires additional explanation, particularly where the committee exercises upward discretion.

Companies and investors should have appropriately regular discussions on strategy and long term performance

This is a new principle and puts an emphasis on investors being aware of their responsibilities to engage with companies on a full range of issues.

- The preference is for dialogue to take place throughout the year and not just in the period leading up to the AGM.
- Investors should make sure they are informed ahead of a meeting and companies should consider how they may identify and engage with investors who are committed to stewardship.
- Investors need to give companies space to innovate and to take the time to consider new proposals.

NAPF Corporate governance policy and voting guidelines

The key messages in the NAPF guidelines in relation to remuneration have not changed significantly since last year, although the structure has changed. As last year, NAPF continue to press for simpler plans and for executives to hold more shares for longer periods of time.

The 2013 guidelines now require companies to articulate how their pay policies meet the five principles of pension fund investors as outlined above.

The guidance also states that remuneration policies are expected to stand the test of time and should usually be put to a vote every three years rather than on an annual basis.

Voting

The guidelines note the various mechanisms that shareholders now have to express their views on remuneration. The expectation is that:

- If the policy fails to meet the Principles then investors may decide to vote against the policy and potentially against the chairman and members of the remuneration committee.

- If investors subsequently judge that the policy has been implemented inappropriately, or discretion has been used inappropriately, they may decide to vote against the implementation report.

- If investors judge that discretion has been used egregiously or consistently inappropriately or that the policy is no longer appropriate for the business, they may decide to vote against the remuneration committee chair or even the board chairman.

The detailed guidelines suggest that investors are likely to consider the resolutions on the remuneration policy and the implementation report independently of the other.

Main principles
The guidelines now include five key principles which are aligned with those of the pension fund investors, as outlined above.

Remuneration practices
The guidance now includes both a list of the key practices which are likely to cause concern and may trigger a voting sanction if not adequately explained and a list of those which may trigger a voting sanction irrespective of any explanation.

Those practices which require explanation include:
- Increases in base salary in excess of inflation or that awarded to the rest of the workforce
- Layering of new share award schemes on top of existing schemes
- Insufficient alignment with shareholders, e.g. a shareholding requirement of less than 2x salary
- Inappropriate use (or lack of use) of discretion
- An awarding of a ‘sign-on’ bonus without the inclusion of any conditionality and which pays for awards not already vested at previous employer
- Insufficient disclosure on the scope of annual bonuses and performance conditions (retrospective disclosure can be acceptable)

Those practices which may trigger a voting sanction irrespective of any explanation include:
- Over frequent re-benchmarking
- Insufficiently demanding or inappropriate performance targets
- Guaranteed, pensionable, discretionary or ‘one-off’ annual bonuses
- Any provision for re-testing of performance conditions
- Ex-gratia and other non-contractual payments
- Change in control provisions triggering earlier and/or larger payments and rewards
- The absence of service contracts for executive directors

Coherent remuneration philosophy
The guidelines previously stated that executive pay policies should be clearly aligned with those in the company as a whole. This has now been expanded to state that companies are encouraged to have a “coherent remuneration philosophy which is consistent throughout the

organisation” and that “ever widening pay differentials are often difficult to credibly justify”.

Procedure

The section on procedure now includes the following:

- It is the responsibility of the remuneration committee chair to lead any engagement with shareholders.
- Companies should pay close heed to the GC100 Investor Working Group guidance on remuneration reporting, particularly noting the need for the avoidance of boilerplate language and to provide meaningful and concise disclosure.
- The statement of the implementation of remuneration policy should include details of changes to the remuneration structure and specific details on performance measures and targets for the current financial year (subject to commercial sensitivity) which may not have been determined when the policy was originally approved. Also companies should include a summary of shareholder engagement, including any significant concerns and the response to these concerns.

The joint paper can be found by following this link

http://www.napf.co.uk/PolicyandResearch/Corporate-Governance/Executive-remuneration.aspx

The NAPF guidance can be found by following this link

http://www.napf.co.uk/PolicyandResearch/Corporate-Governance/NAPF-Corporate-Governance-Policy-and-Voting-Guidelines.aspx

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