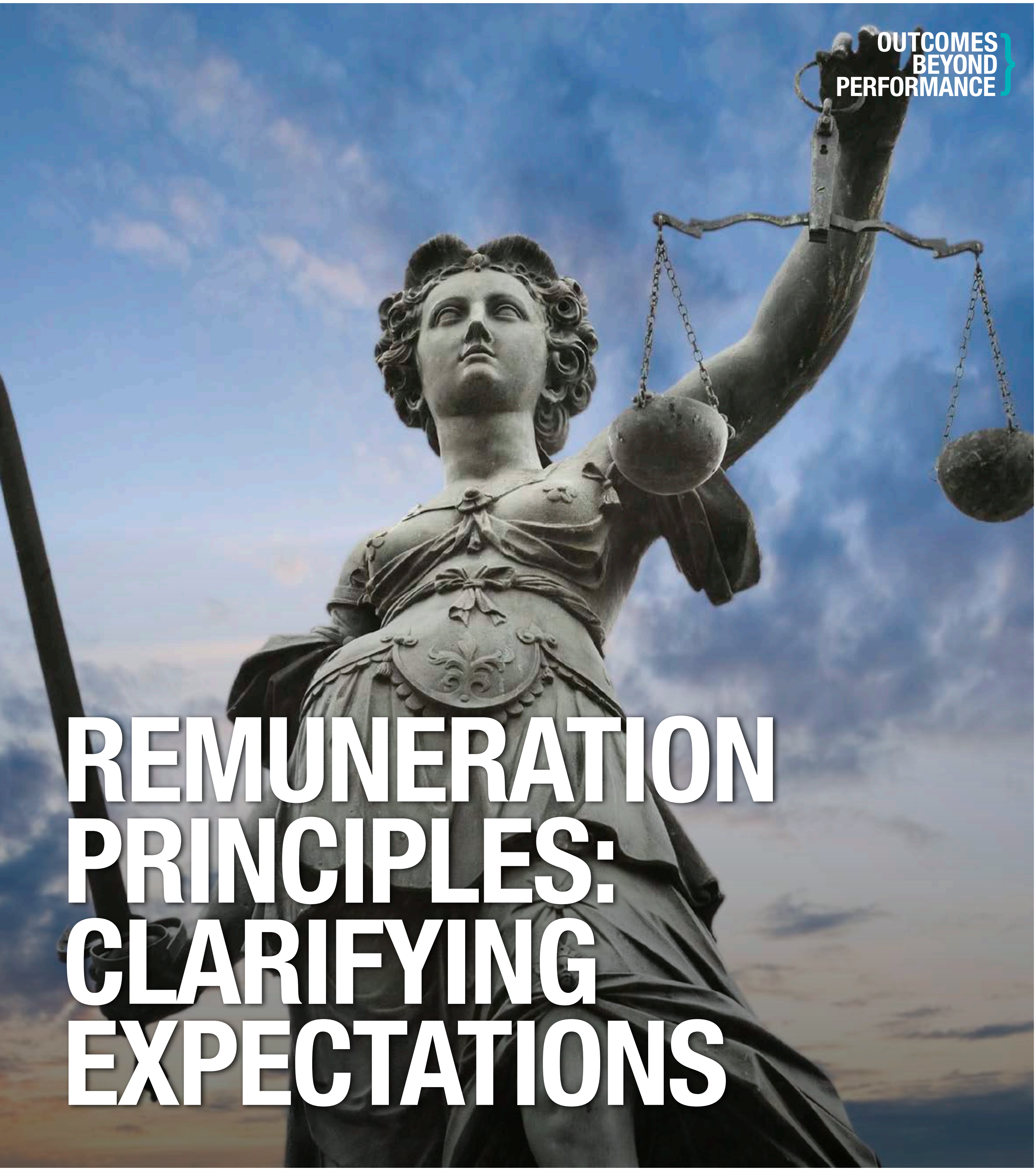

REMUNERATION PRINCIPLES: CLARIFYING EXPECTATIONS

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Remuneration practices are seen as key to aligning the activities of management with a company's purpose, strategy and performance. While not a panacea, we do believe that well-structured remuneration can be an important ingredient to delivering long-term business success and aligning the interests of management and other stakeholders.

Within this paper, directed primarily towards large publicly listed companies, we set out some proposals, which seek to practically improve existing executive director pay practices in the context of the current reality in order to better achieve their intended objectives.

SETTING THE SCENE

Much evidence suggests a relatively weak link between executive pay and company performance. The Executive Remuneration Working Group formed by the UK's Investment Association notes within its interim report, that while the FTSE is trading at broadly the same levels as 18 years ago, executive pay over the same period has more than trebled.[1] Meanwhile, a growing number of studies suggest only a loose correlation, at best, between higher pay and performance.[2]

This divergence has been accompanied by shifts in the distributions of profits and thus a resultant increase in income inequality both within companies and across society more broadly. This is epitomised by the trend in the ratio of CEO pay to the average worker. While calculations vary and source data is not directly comparable, analysis has suggested that in the UK the ratio has doubled in a little over a decade from 70x in 2002 to 140x in 2015.[3] This ratio is higher in the UK than it is in Germany or France,[4] with the US the only major economy with a higher pay ratio which is in excess of 300x and rising.[5]

The phenomenon of rapidly rising rewards for top talent, while not limited to corporate executive pay,[6] is beginning to threaten the public company's licence to operate and thus potential long-term value. Edelman's annual Trust Barometer indicates that the biggest "trust gap" of all institutions in the UK is between British business and its customers. This is reinforced by survey evidence[7] suggesting that two thirds of the population believe executive pay is too high and 72% are angry as a result – it is no wonder that the UK's Prime Minister has indicated a clear intention to respond.

Significant regulatory change has enhanced the level of transparency and introduced triennial ex-ante binding shareholder votes alongside annual advisory ex-post votes. The level of shareholder dissent expressed on remuneration resolutions in 2016 illustrates, however, that investor dissatisfaction with existing remuneration arrangements persists. This dissatisfaction can be split into two categories: one, a lack of connection between pay and performance; and secondly a question over fundamental fairness and a company's social licence to operate.

With the triennial review of remuneration policy taking place at many UK companies in 2017 and further political action being considered in the UK and elsewhere, we believe there is a window of opportunity to encourage fresh thinking.

Based on recent experience, we believe the prevailing model of executive pay has significant problems, which include:

1 **Excessive quantum and unfairness:** Research[8] increasingly questions the marginal motivational gain from the award of additional pay. It is also doubtful that remuneration committees are always aware of the total potential value of the reward packages offered or able to justify the sums to the wider workforce or the public, the majority of whom regard the levels of pay awards as unfair.

2 **Misalignment to long-term value:** Pay structures are often highly leveraged and yet too predictably deliver a consistently high level of pay, with the average FTSE 100 bonus payout amounting to 75% of maximum and four out of five companies paying target levels of bonus every year.[9] This suggests that target calibration is difficult and 'variable' or 'performance-linked' pay are misnomers. Additionally, the most common performance measures, relative total shareholder return (TSR) and earnings per share (EPS), can be volatile over the short term and achieved in ways inconsistent with the creation of long-term value.

3 **Excessive complexity:** Incentive schemes are too often overly complex, diminishing their ability to motivate and resulting in participants viewing them as little more than lottery tickets – although with some elements almost guaranteed to pay out. This, together with uncertainty of outcome, leads to a discounting of the value of possible awards by approximately 50% compared to fixed pay.

4 **Weak accountability:** The system of a binding vote on policy accompanied by an advisory vote on its implementation has not prevented a disconnection between pay and performance, particularly if the policy has not been scenario-tested in advance, is badly implemented or is not subject to discretionary adjustment. Moreover, remuneration-related disclosures are too often boilerplate in nature to reveal genuine insight or create board accountability.

5 **Low levels of trust:** Trust between remuneration committees and investors is at a low ebb and among the public is lower still. While effective stewardship and accountability is needed along the ownership chain, too often remuneration committees fail to exercise their judgement and discretion. Investors meanwhile too often fail to engage meaningfully or hold boards sufficiently accountable.

At the centre of the conundrum of how to tackle executive pay lies the fundamental question of why CEOs of public and private companies are paid so differently from the rest of their workforce and to those at the top of other professions. In most walks of life, employees receive an annual salary in monthly cash instalments and for some perhaps also a modest bonus.

[1] Executive Remuneration Working Group, Interim Report, April 2016.
[2] Are CEOs paid for performance? MSCI, July 2016; Executive remuneration in the FTSE 350 – a focus on performance-related pay, A report for the High Pay Centre from Income Data Services, October 2014.
[3] Just Do It, High Pay Centre, 2015.
[4] Remuneration: pay ratios, The good, the bad and the ugly, Kepler Cheuvreux, October 2014.
[5] AFL-CIO Paywatch, 2015.
[6] There is evidence that CEO pay in listed companies has not risen any faster than pay for others in the top 0.1% of earners in the UK and US, e.g. top sports people, entertainers, surgeons and lawyers, as referenced by PWC in their paper: Time to Listen, 2016, quoting work by Professor Martin Conyon, University of Lancaster and Wharton Business School.
[7] Opinium research for PWC, June 2016, as reported in PWC paper: Time to Listen, June 2016.
[8] The power and pitfalls of executive reward: A behavioural perspective, CIPD, December 2015.
[9] PWC, Time to Listen, June 2016.

Running a public company brings with it the challenge of trust and alignment between the principal (the shareholders) and agent (the executives). Pay structures have evolved to help achieve the necessary alignment. Despite, or because of efforts to control this tension, pay has become complex and excessive while arguably failing to align or motivate. Despite the issues we have outlined it is striking that it is the US and UK pay model which is the precedent much of the rest of the world has or is moving towards.

Hermes has long held the view that the best means of aligning the interests of executives and shareholders is through significant executive shareholdings maintained over long periods of time. This solution is also however, not without its issues. The focus of management in some cases has become too heavily directed towards managing the share price at the expense of creating real economic value. Similarly, this alignment with shareholders risks potentially eroding management's responsibility towards their workforce with employees seen as commodities rather than partners in value creation; or towards society, with environmental impacts, if they come without a direct cost to the company, considered outside of the company's purview. While there are imperfections with the theory that all relevant matters will eventually be reflected within a company's share price it remains in our view the least worst measure of value creation, but one that necessitates company boards being mindful of what is not captured and communicated by the share price.

We believe it is also necessary to challenge the level of overall pay paid to some executives. Public companies, as their name suggests, ultimately need a social licence to operate. Given the responsibility that the CEO role entails it is appropriate that the individual should be paid commensurately. It is also the case however, that the role of CEO of a public company is a privileged one and an incumbent is often the recipient of many highly valued non-monetary benefits. Arguably these additional benefits have been increasingly monetised in recent years and anecdotal evidence suggests that the potential scale of monetary incentives now available may be crowding out more purpose-driven and desirable motivations.

We are therefore proposing a fundamental shift in the structure of executive remuneration packages towards much simpler, more transparent and less-leveraged pay packages. The combination of simplicity with increased certainty of outcome should result in lower average pay-outs without changing the value of the award in the minds of individual executives. Importantly, we believe that pay packages should avoid incentivising unintended behaviour and encourage the creation of sustainable value for all stakeholders, a shift away from heavy reliance on performance related pay should assist with this.

We also recognise that another conclusion might be to suggest that pay practices should be reversed and resort to the simpler models of the 1970s or 80s before commonly discredited ideas associated with classical economic theory influenced practice. This could mean a move to an even more radical option of paying senior executives an entirely fixed salary, based primarily on shareholdings together with a cash salary similar to today's levels. This would provide the ultimate in simplicity and transparency and should achieve long-term alignment. It would also recognise that no set of metrics fully reflects the complexity of managing an organisation, leaving the executives and board free to design and then pursue their strategy of choice. In our discussions with executives to date, this model is often seen as a breath of fresh air. The greater challenge to its more widespread adoption may be in dissuading those in the US and UK who can appear irrevocably wedded to high-leverage remuneration packages.

Importantly, the debate around societal fairness cannot and should not be ignored. It is appropriate that the issue is given due consideration by both companies and investors and that the views of wider society are reflected.

OUR REMUNERATION PRINCIPLES

During 2012, in conjunction with our owner the BT Pension Scheme, and along with the Pension and Lifetime Savings Association (formerly the NAPF), Railpen Investments and the Universities Superannuation Scheme, we published a set of Remuneration Principles for Building and Reinforcing Long-Term Business Success. Our proposition was that pay should direct management to behave more as engaged owners rather than short-term custodians of a business. The resulting success will ultimately be reflected in the long-term share price to the benefit of investors, management and the company.

Our Remuneration Principles deliberately sought to avoid prescribing any particular pay structure and instead encouraged companies to come forward with proposals which were reflective of their strategies and business models. Therefore, the shift in companies of all shapes and sizes to the standardised identikit pay structure described above, which is associated with the problems already identified, has been disappointing.

EFFECTIVE STEWARDSHIP

Given the deep concerns of stakeholders over executive pay in many jurisdictions, it is in the interests of companies and investors to resolve the tensions. To do so requires all parties to engage constructively and be willing to make demonstrable change. To date, public policy has put responsibility firmly on investors to regulate and control executive remuneration and this looks set to continue, following proposals to introduce a binding say-on-pay for annual pay awards. We, within the investment management industry, therefore must recognise our responsibility to engage with companies effectively as interested owners and, where necessary, use our shareholder rights collectively and consistently.

We believe our 2013 Principles have enduring value and relevance across markets. Through this paper we want to reassert the Principles and clarify more explicitly how we believe companies may implement them. Importantly, we stress that pay structures, no matter how well devised, cannot substitute for the leadership by the board and management.

OUR REMUNERATION PRINCIPLES

1. **Shareholding:** Executive management should make a material long-term investment in the company's shares
2. **Alignment:** Pay should be aligned to long-term success and the desired corporate culture
3. **Simplicity:** Pay schemes should be clear and understandable for both investors and executives
4. **Accountability:** Remuneration committees should use discretion to ensure that awards properly reflect business performance
5. **Stewardship:** Companies and investors should regularly discuss strategy, long-term performance and the link to executive remuneration

CLARIFYING EXPECTATIONS

Our Remuneration Principles are intended to guide remuneration committees towards better designed pay arrangements. In addition, we hope that investors and their investee companies will recognise that they each have stewardship responsibilities which necessitate a greater level of constructive engagement and recognition of the wider impact of decisions.

Below we emphasise a few points for particular consideration which are directed towards resolving the causes of dissatisfaction we identified. In addition, in order to provide greater colour to the type of pay structure these principles describe we have set out in more detail what a model pay structure could look like.

Alignment with long-term business success and stakeholder value:

1 Pay structures should be much simpler and less leveraged than at present, for example higher fixed pay and a single incentive scheme

2 Executives should be incentivised to deliver strategic goals (as opposed to TSR) and be mindful of the company's impact on key stakeholders

3 Pay awards should reflect the outcomes for long-term investors and not be blind to erosion in company value

4 Pay packages should be aimed at enabling executives to accrue wealth generation achieved as ongoing owners and in support of the company's longer-term success

5 Pay schemes should recognise that the timeframes of executive tenure are commonly shorter than the timeframes of accountability for their decisions, which are much longer

Fairness:

1 Remuneration committees, guided by the UK Corporate Governance Code's guidance to "avoid paying more than is necessary" should take a more robust view on pay, utilising and being accountable for exercising their judgement

2 The potential outcomes of a pay policy should be rigorously scenario-tested with a published cap on total pay opportunity agreed in advance

3 Boards should be able to justify to the workforce and the public the rationale for pay awards to management, if they are not able to do so convincingly then directors should use their discretion to make adjustments

4 Engagement by investors coupled with and reinforced by voting is likely to be the most effective means of bringing about positive change

5 Investors should demonstrate that their policies can be evidenced through their voting. They should not be supportive of capital distributions which do not support the company's long-term success and should hold individual directors accountable for questionable pay policies or approving inappropriate outcomes

Existing problem	Our Principle	Proposed solutions
Excessive quantum	**Shareholding**	■ Less leveraged pay packages composed of higher levels of fixed pay which include a significant proportion of salary paid in shares (together with individual personal share purchases) ■ An approved ex-ante total cap on overall pay as well as for individual components
Misalignment to long-term value creation	**Alignment**	■ Strategic performance metrics to replace TSR within incentive schemes alongside relevant metrics focused towards impact on stakeholders ■ Remuneration committees to adjust pay outcomes in light of both relative and absolute TSR performance. Incorporating one or both as an underpin may be appropriate ■ Tail-risk built into pay structures, for example sales of shares restricted to a third per year post departure
Excessive complexity	**Simplicity**	■ Single incentive scheme structure reflecting primarily strategic goals, together with operational and personal objectives
Weak accountability and unfairness	**Accountability**	■ More ownership of and accountability for pay outcomes, including greater use of discretion ■ Publication of a pay ratio and associated policy illustrating CEO to wider workforce pay ■ Chair to write annually to the workforce explaining the CEO's pay award in the context of company performance and pay practices at the company and elsewhere
Low levels of trust	**Stewardship**	■ Greater quality engagement along the entirety of the ownership chain with consideration of fairness

Time for change

We strongly believe the time is right for companies and investors to fundamentally rethink their approach to executive remuneration.

We are encouraged that many of the ideas we suggested in 2013 are re-emerging and are confident that there is now a significant appetite for change among many to consider how they may more closely align pay with the interests of their long-term owners, as well as broader society, in order to restore trust and position themselves best for future success.

We stand ready to work with companies to support efforts which we believe are in the interests of the company and their long-term shareholders.

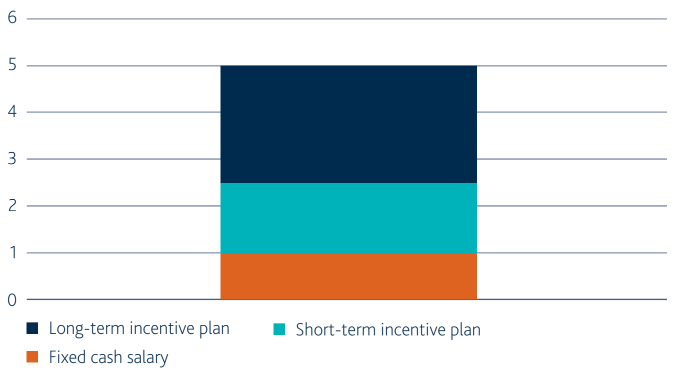
Hermes Remuneration Principles in practice: promoting the long-term success of the company while avoiding paying more than is necessary

Below is an illustration of the type of structure which we encourage companies to consider.

Illustration of a new structure	
Component	**Features and rationale**
Fixed pay	An increase in fixed pay with the portion of variable pay typically "always paid" transferred into a fixed alignment share award: ■ That portion of the incentive pay opportunity should in turn be significantly discounted (~50%) in acknowledgment of the increased certainty of the award. This will result in executives receiving an annual cash salary plus an annual share award ■ The alignment shares to be held for the longer of either: a) until minimum shareholding requirements have been achieved (500% of salary for a larger company) or b) 5 years
Variable pay	A shift to a simplified single incentive scheme which combines today's existing short-term and long-term incentive schemes and which has genuinely variable outcomes: ■ Awards based on a review of performance (looking back over at least a 12-month period) against a transparent scorecard dominated by strategic goals relevant to the business and sector (>50%) and not including absolute or relative total shareholder return together with stretching operational and personal targets aligned to the fulfilment of the company's communicated strategy and its long-term sustainable success ■ Awards predominantly made in the form of shares although it may be appropriate to have a modest cash element (<25%) ■ The awarded shares to be held for the longer of either: a) until minimum shareholding requirements have been achieved or b) 5 years An underpin included to align pay outcomes with outcomes for shareholders: ■ An absolute TSR underpin to be included and relative TSR performance to inform the remuneration committee's decisions – both measures to operate on a three-year period with the remuneration committee adjusting awards as appropriate ■ Stretching goals and targets, with the genuine possibility of achieving zero or close to zero award
Overarching	A significant shareholding requirement: ■ Shareholding guidelines to increase with seniority – for executive directors shareholding guidelines to be a minimum of 500% of salary (for a FTSE 100 company), 300% for a FTSE 250 company and 200% minimum for all other companies and share ownership provisions to ideally be cascaded through the organisation ■ In addition to fixed and variable pay awards, executive directors should be expected to buy, out of their own funds, some shares annually to build up to the minimum shareholding requirement over a reasonable time horizon Post-departure alignment through tail risk element built into the policy: ■ Restrictions on the sale of shares below the minimum shareholding requirement post-departure (e.g. at a minimum 33% per annum over a three-year period) ■ Malus and clawback provisions with the remuneration committee given wide discretion over their enforcement Benefits should not be used as a means to boost salary: ■ 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)

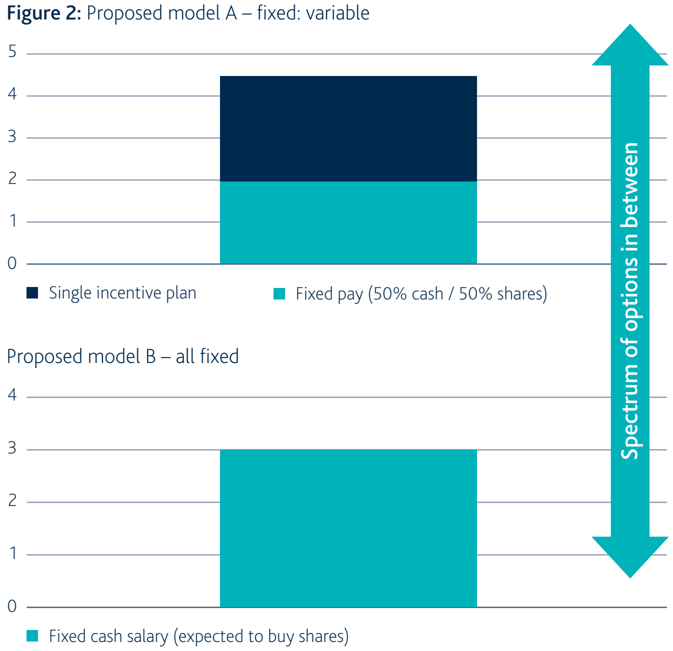
Additional new expectations	
Component	**Features and rationale**
Accountability	Remuneration committees should own the policy and the outcomes: ■ Remuneration committees should use their discretion to adjust the formulaic outcome of remuneration policies. The committee chair should explain within their annual statement whether they have used discretion and if so, how and why ■ Remuneration committee should retain overall discretion for decisions regarding good and bad leavers, with the default position that the awards lapse
Link to workforce	Boards should not be blind to the implications of pay disparities between the CEO and other members of the executive team nor between the CEO and the wider workforce: ■ 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 fora and summarise this process within the remuneration report ■ The company should publish and comment upon the ratio of CEO to median worker pay – comparing internally or externally

Figure 1: Current model – fixed: variable



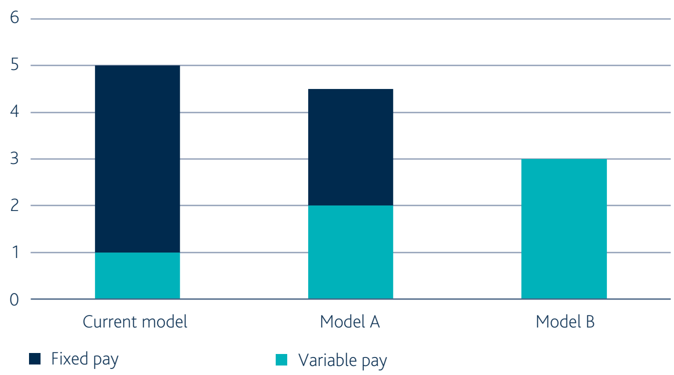
For illustrative purposes only.

Figure 2: Proposed model A – fixed: variable



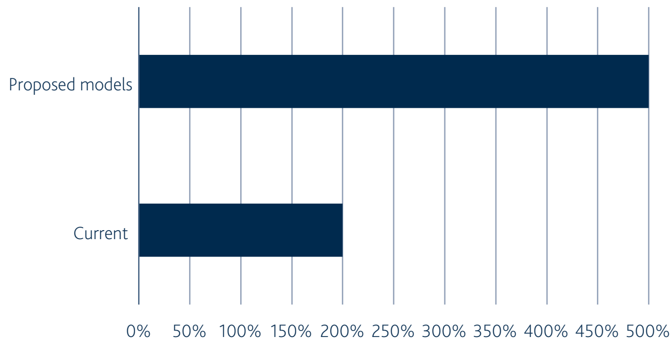
For illustrative purposes only.

Figure 3: The lower leveraged the package the lower the total quantum



For illustrative purposes only.

Figure 4: Accompanied by extended shareholding guidelines



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OUTCOMES BEYOND PERFORMANCE

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