Directors' pay – Consultation on revised remuneration reporting regulations

A response to the Department for Business Innovation & Skills (BIS) consultation

About us

Starting from October 2012, employers in the UK will have a statutory duty to automatically enrol some or all of their workers into a pension scheme that meets or exceeds certain legal standards. They will have to make minimum contributions for these workers.

NEST is an occupational contribution pension scheme that UK employers can use to meet their new legal duties. NEST is an easy to use, low charge scheme that has a public service obligation to accept employers of any size or sector that want to use NEST.[1]

NEST Corporation is the trustee body responsible for NEST. It's a non-departmental public body (NDPB) that operates at arm's length from government and is accountable to the UK Parliament through the Department for Work and Pensions (DWP).

NEST Corporation has a Chair and 10 Trustee Members. Together they form the Trustee of the scheme. As the Trustee they have to act solely in the best interests of the members of NEST when taking investment decisions.

NEST invests and owns stakes in hundreds of UK-listed companies and is likely to be among the very largest institutional asset owners in the UK. How these companies are governed and run is a concern for the members of NEST as it will affect the performance of NEST's funds and therefore members' incomes in retirement.

About NEST's interest in responding

Since launch, NEST has been committed to developing evidence-based policy and delivery solutions to provide a suitable investment approach for its members. To support this we've conducted an extensive investment consultation, published an international benchmarking report on ownership best practice, forged links with pension schemes across the EU and conducted ground-breaking primary research into the characteristics and aspirations of NEST's target group.

The evidence we've gathered has led the Trustee of NEST to firmly believe that paying attention to issues such as corporate governance in its investment process improves long-term outcomes. This will result in better and more sustainable returns for NEST members and more robust global markets.

Based on this evidence-led belief, NEST works with fund managers, other pension funds, trade bodies and social partners to influence regulators and policymakers to provide the best regulatory environment to support economic growth and sustainable corporate performance.

NEST has also signed the FRC's UK Stewardship Code, which aims to improve the way companies and shareholders work together in the long-term interests of shareholders.

1 More information about NEST can be found at: http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/key-facts-myths,PDF.pdf

In our published statement as a signatory of the Financial Reporting Council's Stewardship Code **(http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/Stewardship-code-statement,PDF.pdf)**, we say:

'To us, being a good steward means understanding how the companies we invest in, on our members' behalf, affect the societies and environments around them, and encouraging them to operate appropriately day in day out, year in year out. We believe that corporate governance will remain sound if owners of shares take a strong interest in the long-term health of companies.'

Responding to consultations like this is an appropriate and expected means of delivering on this commitment to good stewardship. By participating in policy debates – in our capacity as a Trustee of a pension scheme with considerable assets under management – we have the chance to make a significant impact on the way companies are run.

This consultation comes at a time when average pay increases for workers in the private sector have been running significantly behind inflation. This contrasts to the very significant real terms increases in the pay of those leading Britain's companies. The growing pay gap between top and bottom at Britain's companies is a concern to many, particularly where the growing rewards at the top don't reflect increased productivity or performance of the companies in question.

Responsibility for better corporate performance

NEST Corporation welcomes BIS's consultation on revised remuneration reporting regulations for directors' pay.

This consultation places shareholders at the heart of solving failings in the corporate governance framework for executive remuneration.

It does so by proposing improvements in transparency and accountability in directors' pay and introducing a binding vote on companies' executive pay policy.

We're pleased to see the debate and consultation placing shareholders at the heart of reforms on executive remuneration. However, we believe there is a limit to what shareholders alone can do. They need support from strong and vocal non-executive directors - particularly independent ones - better constituted remuneration committees and improved succession planning so that the remuneration committee does not feel beholden to its current board composition. It's also vital that the remuneration committee has clear and transparent terms of reference and is attuned to pay elsewhere and the wider concerns of the public, whose interests large shareholders often represent.

In recent years it has become apparent that boards meet and talk about their own pay frequently. In 2009 remuneration committees at FTSE All-Share companies generally met twice as many times as the audit committee met and three times as often as the nomination committee. In only one-third of companies did the audit committee meet more times than the remuneration committee.[2]

Meeting to discuss directors' pay 13 times a year, as the data says some companies do, has the potential to distract from the principal purpose of the board: to discuss, set and execute a strategy to grow and develop the business while ensuring the company remains financially sound.

We believe that boards must look to change this balance. Pay should not take priority over other corporate matters.

We have some concern that further disclosures on pay, metrics and a new binding vote on remuneration policy could move remuneration to centre stage at companies, displacing more important corporate governance and business matters. While we welcome shareholder empowerment, we're mindful that a considered and principled approach to share ownership will ultimately deliver the best outcomes.

Six principles inform NEST's approach to executive remuneration as a shareholder.

2 Pensions Investment Research Consultations, corporate governance database, 2009

NEST principles on executive remuneration

An independent and considered process

We believe in an independent and transparent procedure for developing, recommending and monitoring director remuneration and payout. The committee's remit should include the remuneration of individual directors and senior management. This committee should be wholly comprised of independent directors, including the company chairman, who we would expect on appointment to the company to meet independence criteria. We believe that the committee is more able to remain neutral and objective when the company chairman is not the chair of the remuneration committee.

The 2009 Walker Review on Corporate Governance sounded the right note in highlighting a growing disconnect between how remuneration for executive directors was arrived at and how things work further down the organisation. We support recommendation 28 of the Walker Review:

'The remuneration committee should have a sufficient understanding of the company's approach to pay and employment conditions to ensure that it is adopting a coherent approach to remuneration in respect of all employees. The terms of reference of the remuneration committee should accordingly include responsibility for setting the over-arching principles and parameters of remuneration policy on a firm-wide basis.'

Pay only what is necessary

Companies should pay no more than is necessary for the purpose of attracting, retaining and motivating directors of the quality required to run the company successfully. We believe that executives should not be paid more than is necessary to support these goals.

A healthy succession programme will help to keep control over remuneration and other terms and conditions. To us, succession planning is at the heart of long-term board effectiveness.

We believe the remuneration committee should consider the level of executive pay in the context of the individual, the company overall, and in relation to all employees. Broader still, the remuneration committee should be informed of pay levels in equivalent sectors and industries both private and public - and wider societal concerns.

Contract design should avoid excessive payments to departing directors regardless of their reason for leaving. Contracts should not entitle executives to significant compensation for early termination of their contract, including pension contributions. The compensation of independent directors should not risk compromising their independence or aligning interests too closely with those of management.

Aligned to shareholders' interests

The remuneration committee should aim to align the interests, incentives and behaviour of directors with the interests of shareholders.

This should be a long-term approach that encourages sustained shareholder value and sustainable value creation. Doing so will help to ensure that the interests of shareholders and executives don't become misaligned and that the company remains financially sound.

As a long-term investor we're interested in safety and financial stability alongside performance so we can see no reason why a company's credit rating, or other similar measures, should not be used in board pay structures, especially regarding clawback. We believe too that remuneration policies and structures should serve to reinforce the right corporate culture and moral compass.

A significant element of our asset allocaion is invested in equities as we're seeking inflation-plus returns on investment. However, we wouldn't want to see that 'plus' pursued to such an extent that it endangers the ongoing financial soundness of the company. It's the remuneration committee's task to mitigate the risk of directors focusing on equity price performance at the expense of long-term shareholder return on capital and arrive at appropriate performance targets and metrics that encourage the right risk-taking and decision-making.

Nothing should encourage inappropriate risk taking at the expense of longer-term performance. For this reason we're not in favour of annual bonus arrangements where the size is generous compared to longer-term performance arrangements. By long-term performance we mean at least three years and more usually five. All variable aspects of pay should be weighted towards sustained performance over the long term.

Incentive plans, where they are used, should clearly link to execution of the agreed corporate strategy. Performance metrics should link to key performance indicators (KPIs) identified to facilitate meeting the agreed strategic objectives.

We believe that a substantial proportion of remuneration should be paid on a deferred basis (a minimum of three years and preferably five). We'd welcome further research on the specifics but it feels right for over half of variable remuneration to be deferred when paid to executive directors. In cases where variable remuneration represents a particularly large part of total remuneration we believe that the portion deferred should be even higher.

A clawback policy is essential for cases such as performance rewarded in previous years later found to be based on erroneous financial reporting, or found to be as a result of regulatory infringement. We would expect to find clawback terms within the rules of the company bonus plan, long-term share schemes, and/or executive contractual terms.

We think executive directors and senior management should be encouraged to build up meaningful personal shareholdings in the companies they run. However, this should be just one part of any package and should be done in a way that does not incentivise directors to attempt to inflate the price of the stock. We support the idea of the remuneration committee setting a target level of share ownership for key senior employees. Unvested share-based incentives should not count towards any calculated number.

Externally and internally audited

External audit provides shareholders with the assurance that all information audited is fair, reliable and free from material error. It follows that external audit should also sign-off remuneration reports, including benchmarks used, the suitability of metrics and the calculation of performance.

Informatively disclosed

Disclosure provides assurance to shareholders. We believe that annual disclosures on remuneration should be meaningful, relevant, clear, transparent and understandable.

Dense and cluttered reports don't serve shareholders or other users of reports and accounts. Good disclosure explains the link between remuneration and value-creation, performance, risk management and alignment with shareholders. Disclosure should include advisers used by the remuneration committee and their relationship and independence. We expect companies to explain the circumstances when they have applied clawback.

Approved by shareholders

We believe that companies should give shareholders an annual vote on remuneration. We believe too that there is more to the conversation than just a binary yes or no vote. Companies need to communicate with major shareholders on remuneration as an ongoing process. We would expect dialogue to cover policy development, the design of pay schemes and metrics, performance against metrics, major changes and the level of pay.

A significant weakness in the voting chain is that a vote withheld is not a vote in law. Investors casting an abstain vote often do so with meaning, yet an abstain vote remains a withheld vote in law. It's regrettable that the meaning of an abstain vote is, to a large degree, lost.

We raise the issue here because several major shareholders cast votes to abstain on executive pay more than they vote for or against.[3]

The consideration of legislation to require companies to count abstentions as a vote in law would be welcome.

The introduction of similar recognition within the UK Corporate Governance Code would in our view be a positive step forward. The Financial Reporting Council could consider introducing a best practice recommendation for companies to recognise abstentions based on a comply or explain approach. The Stewardship Code could then call on signatories to consider not using an abstain vote at companies that fail to attach meaning to withheld votes cast.

Our response on consultation questions

1: The government seeks comments on how well the draft regulations attached at Annex B give effect to the policy set out in this consultation document.

The introduction of a binding vote on a company's pay policy is most welcome and we congratulate BIS for taking this step. We believe a binding vote will empower shareholders to vote intelligently and encourage companies to discuss remuneration more widely with shareholders before company AGMs. We're generally supportive of a triennial vote, unless there are changes to the policy in intervening years, which will encourage companies and investors to think longer term.

The draft regulations set out by the government look to bring simplicity, succinctness and transparency to what are often dense, cluttered and complex remuneration reports. We're particularly pleased to see the introduction of a standardised approach so shareholders are able to make comparisons across companies more effectively.

We're in favour of seeing a single total figure of remuneration for each director annually and see merit in the table format highlighted on page 23 of the consultation document that depicts a breakdown of this information. A table of standard measures will make it easy for companies to regularly divulge this information and for shareholders to understand how each director is remunerated and track progress over time.

3: The government intends to introduce a table which sets out the key elements of remuneration and supporting information on the pay policy. The government does not propose to prescribe the specific disclosures that are required for each element of pay. Is this a practical and informative approach?

We consider that introducing a table will be useful to clearly set out key elements of remuneration. There are significant benefits for shareholders in seeing a familiar format and accepted standards in disclosing the basics of the remuneration strategy.

The 'Purpose – Operation – Opportunity – Performance Metrics – Changes' rubric is welcome and will help shareholders make clearer comparisons, especially at the height of AGM season.

We generally support a principles-based reporting framework. We agree that there should not be specific disclosures prescribed for each element of pay as we recognise that each company's pay policy will differ to suit their own business model and strategy.

3 TUC Fund Manager Voting Survey 2011, pg 54

4: The government intends to introduce reporting requirements on service contracts, what remuneration directors can receive in different scenarios and the percentage change in profit, dividends and overall expenditure on pay in the reporting period. Is this a practical and informative approach? If an alternative disclosure would be useful, please give details.

We think the style of the graph on page 18 of the consultation document is a good approach. We expect that proxy service providers will lift the style and set it against a peer group and sector context for their clients to further illustrate relative positioning.

The percentage breakdown of total remuneration is a useful marker that will enable shareholders to easily analyse remuneration reports and the amount awarded from one year to another. This is especially relevant during the spike of the AGM voting season when the resources of investors who are keen to apply high standards of stewardship to their investee companies are stretched.

5: The government proposes that a company's statement on its approach to exit payments sets out the principles on which the determination of the payment will be made. If additional information would be useful, please give details.

We see merit in companies setting out their approach to exit payments in the policy report. We see a need for shareholders to have sight of the exit payment approach in the policy report and how these are calculated for each director.

Often when a director suddenly leaves there is little transparency around exit payments regardless of the reasoning behind the departure. Shareholders should have access to how exit payments are calculated in all circumstances. The most common examples of payments for failure relate to the application of discretion, usually in an upwards direction, by the remuneration committee and event-driven payments such as those triggered by contractual termination or a change in control.

The levels of discretion non-executive directors have in determining whether an executive is a good leaver or otherwise can be problematic. Given the uncertainty regarding the nature of the circumstances prevailing when a director leaves a company there is tremendous potential for significant reward for failure as things stand.

We support greater disclosure relating to the nature of departure and how this equates to the payments made with a view to offering comfort to shareholders. Additionally, further information on how discretion has been applied in relation to mid-cycle-performance share awards when pro-rating is applied for time and performance would aid transparency.

6: The government would welcome views on the proposal for the policy part of the remuneration report to include a statement on whether and if so how a company sought employee views on the remuneration policy.

We consider the involvement of employees in the decision-making process of remuneration policy to be an interesting concept and would be interested in seeing examples of how this would work in practice.

We expect the remuneration committee to understand the pay levels of employees and set the policy for the company in a holistic way. Directors' pay is just one part of a company's remuneration policy and we believe that this should be put in context. If operating effectively the remuneration committee should take into account all data and be mindful of excessive pay differentials across the company.

We think that employee salaries should be considered when setting directors' pay, especially against the backdrop of companies that have adopted the living wage and the High Pay Commission's work on pay ratios. This is a method already implemented by some remuneration committees, but which could be given greater value in order to attune remuneration packages more to the business and its employees.

We believe that the remuneration committee should be populated by fully independent legally accountable non-executive directors. An employee remuneration committee that reports to the board might be one way of implementing employee opinion.

7: The government's intention is that the single total figure includes remuneration that becomes receivable as a result of the achievement of conditions relating to performance in the reporting year where the reporting year is the last year of the performance cycle. Do the specific disclosures set out in the table below correctly give effect to this intention?

We believe the specific disclosures set out in the table are appropriate measures to help determine a single total figure. MM&K/Manifest Total Remuneration Survey includes the measures in question in their methodology and we're very much in favour of it.

The key is detailing the total amount realised in the relevant financial year against the potential total that could have been awarded based on scheme caps. The multiple elements that comprise total remuneration can be open to creative interpretation and a standardised approach accompanied by justification would help investors making comparisons.

The current position is that estimating total remuneration can be an extremely protracted and demanding exercise and figures are rarely comparable between companies. A logical distinction is between fixed and variable elements of remuneration. 'Golden hellos' received or 'golden goodbyes' should be detailed in the same section.

The inclusion of historical pay and projected pay for upcoming years would also be a useful addition here and could help companies explain their remuneration policies.

Overall, we feel that the specific disclosures set out in the table are acceptable. It's important to bear in mind that companies are not being capped on the amount of information they can provide, but should include further explanation or definition if necessary to explain their individual remuneration schemes.

9: The government proposes that clawback is recorded as part of the single figure. Is this a practical and informative approach?

Clawbacks impact pay, and therefore we believe they should be recorded as part of the single figure on remuneration and agree they should be subject to the same levels of transparency as other elements of pay. To avoid confusion and limit discrepancies we'd prefer to see actual values that have vested before the date on which the remuneration report needs to be signed off.

Where clawback does occur companies should be encouraged to set out the circumstances and factors that affected the decision in supporting disclosure.

10: The government would welcome views on whether it would be commercially sensitive to require companies to publish full details of performance against metrics. If so, how can an appropriate degree of flexibility be achieved?

It's important that shareholders are able to see a clear link between the pay awarded to directors in the reporting period and previously agreed performance measures. However we're concerned that greater annual disclosure of performance against metrics may lead to more focus and time spent on performance numbers giving increased weight to performance related pay, which we don't necessarily advocate.

We appreciate the benefits that increased transparency brings, but encouraging companies to publish full details of performance metrics could detract shareholder attention away from other important aspects of the board or business strategy. In any case major shareholders will be talking about performance metrics in their broader discussions with the company.

As long-term investors we'd like to be able to see performance metrics that help us form a long-term view of businesses. These metrics could also help demonstrate a stronger alignment between remuneration and the sustainability of the company.

On the topic of discretion, details of how often discretion has been used in the past would provide further context for shareholders.

12: The government proposes that scheme interests awarded to directors during the reporting year are disclosed at face value. Is this a practical and informative approach?

Yes. Scheme interests awarded to directors during the reporting period should be disclosed at face value. To clarify, we understand face value to mean share price at grant date multiplied by number of shares granted expressed as percentage of salary.

14: The government proposes that the remuneration report includes a graph that plots total shareholder return, as a proxy for company performance, against CEO pay. Do you agree that this graph would be useful? If so, do you agree that total shareholder return and CEO pay are the best proxies for company performance and pay? If not, what measures would be more appropriate?

We have concerns about the use of total shareholder return (TSR) as a proxy for executive pay. We don't believe TSR graphs are an effective way of communicating to shareholders how effectively pre-agreed strategies are delivered as good financial and strategic measures.

In addition, TSR is affected by drifting valuations and external economic and industry factors that distort the measurement of management's added value. The use of TSR as a proxy encourages short-term thinking and does not solve the issue of excessive executive pay.

An article in the *Rotman International Journal of Pension Management*[4] identifies the complex issues associated with the 'unconsidered use' of TSR as a metric to represent the gains (or otherwise) in shareholder wealth. Not all TSR is created equal. The article suggests that other measures, such as economic profit (EP), return on invested capital (ROIC), and future value (FV), need to be introduced to effectively interpret the quality of TSR.

4 Total Shareholder Return (TSR) and Management Performance: A Performance Metric Appropriately Used, or Mostly Abused? *Rotman International Journal of Pension Management*, Roland Burgman and Mark Van Clieaf, Fall 2012

We believe many of the metrics used in determining remuneration policies disregard the safety and stability of the company and focus solely on the upside.

We believe that the credit rating of the company should also be considered alongside its growth and development to help determine CEO pay. Including bondholder perspectives within the thinking process of companies' corporate governance arrangements heralds an important restoration of interest in prudence, strength and security.

As a long-term investor we're interested in safety and financial stability alongside performance. We wouldn't want to see performance encouraged at the expense of financial soundness, which is conceivable where performance-related pay is a large portion of total remuneration. We also support including other non-financial performance metrics in setting long-term executive pay, such as customer satisfaction, decision-making, reputation, diversity and board composition.

15: The government proposes that the single figure, detail of performance against metrics, total pension entitlements, exit payments made and detail on variable pay are all subject to audit. Are there any other sections of the report that should be subject to audit?

We believe that audit and assurance has an underpinning role to play in ensuring that the information disclosed by companies to shareholders is fair, reliable and free from material error.

That said we believe there is scope for some of this information around remuneration to be audited internally. This will allow for the measurement and monitoring of performance against metrics designed by the remuneration committee. This would make the audit and remuneration committees more directly accountable to shareholders.

By having all performance metrics externally audited there is a concern that audit work could become overly preoccupied with remuneration and will only serve to move performance-related pay to the top of priorities to be discussed by boards.

As long-term investors we are keen on companies integrating sustainability metrics into executive incentives and welcome the growing number of companies that choose to instil such measures at the highest levels. Audit and assurance of these measures will make sure that pay is based on measures that are verified and reliable.