

# Remuneration principles for building and reinforcing long-term business success

These principles have been jointly produced by Hermes EOS, the National Association of Pension Funds (NAPF), BT Pension Scheme, RPMI Railpen Investments and Universities Superannuation Scheme (USS). They are intended to provide high-level guidance to companies about our expectations of their remuneration structures and practices. The Principles deliberately avoid prescribing any specific structures or measures; instead we expect companies to articulate clearly to shareholders how their pay policies meet these principles in a manner which is most appropriate for their specific situation.

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## The Principles

- 1 Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage
- 2 Pay should be aligned to long-term success and the desired corporate culture throughout the organisation
- 3 Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect long-term returns to shareholders
- 4 Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance.
- 5 Companies and investors should have regular discussions on strategy and long-term performance.

## Introduction

At the beginning of 2013, Hermes EOS and the NAPF, in conjunction with RPMI Railpen Investments, the BT Pension Scheme and USS Investment Management, the wholly owned investment management subsidiary of USS, published "Remuneration Principles for building and reinforcing long-term business success". Since then, we have held discussions with the chairs and remuneration committee chairs of almost half of FTSE 100 companies, along with executives responsible for reward, remuneration consultants and other institutional investors. We are encouraged by the willingness of many to rethink fundamentally current practices. The principles within this final document reflect the feedback we have received. We believe that these principles provide a sound framework for remuneration committees to use when thinking through, devising and implementing their remuneration policies.

Each company is unique and as such faces different challenges and opportunities. While we hope that our principles will provide a useful framework, it is for boards to determine which specific pay structures will work best for their company's executives and to communicate intelligently their reasoning to investors. We seek neither to prescribe a particular structure, nor to micro-manage pay, but rather to start a healthier and more constructive on-going conversation than often occurs today.

We firmly believe that there is a significant appetite for change and urge companies to consider how they might align pay more closely with the interests of their long-term owners in order to position themselves best for future success. We look forward to supporting those companies who share our desire for change.

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## The Principles

### 1 Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage.

We consider that the best form of alignment between executives and shareholders is the ownership of shares over the long-term, with ownership obligations increasing with seniority. While we recognise that flexibility is needed to ensure that effective executives are appropriately remunerated, remuneration committees should strive to ensure that, to the extent this is feasible and appropriate, the bulk of their variable rewards flows over time from the benefits of being an equity owner.

The meaning of "long-term" will differ from company to company but three years, the most commonly used time period for long-term awards, is often not long enough. In many situations it may

be appropriate for a material proportion of shares granted to be held for a longer period, the length of time would be aligned to the business cycle and strategy of the company and take account of the demographic of the executives.

Wherever possible, we believe that remuneration committees should foster a culture in which executives are encouraged to invest in the shares of the company they manage. It is important, of course, that the board monitors and guards against the possible unintended consequences of long-term ownership such as overly aggressive dividend policies, encouraging takeovers to crystallise awards and overly risk-averse strategies intended to preserve, rather than increase, the value of shares. In particular, as executives approach retirement they may wish to ensure their investments are appropriately diversified, however, they should continue to maintain a material holding. Having "skin in the game" is an important motivator and one that we believe is under-used.

Companies should also consider ensuring that executives are exposed to some tail risk for an appropriate length of time once they leave a company, for example, by requiring that any sale of shares be staggered over time, notwithstanding competitive or regulatory barriers to continued share ownership. In practice, many long-serving executives have significant holdings in the company, but this kind of commitment can help to encourage longer-term thinking to continue right through to the end of a career. While clawback is one way of aligning executives and shareholders it does not necessarily encourage a CEO actively to develop a new generation of talent to succeed the current executive directors. At the same time, it is recognised that outgoing executives cannot be held responsible for the actions of their successors and so remuneration committees must strike an appropriate balance.

### 2 Pay should be aligned to long-term strategy and the desired corporate culture throughout the organisation.

We encourage remuneration committees to design rewards that encourage the specific behaviours required to drive long-term strategic success. Too much of the debate between companies and owners has focused on the minutiae of short to medium term performance conditions. This is exacerbated when the ultimate owners of companies delegate their oversight responsibilities to agents who themselves operate according to short-time horizons. As a result, certain performance measures, such as earnings per share (EPS) and total shareholder return (TSR) have been over-emphasised, with little regard for the company's specific strategy or the timeframe over which that strategy should be achieved. Rather, we believe remuneration committees should take as a starting point the company's strategic plan and key performance indicators (KPIs) and ensure there is a strong read across from the company's strategy to the drivers of executives' remuneration.

While we do not believe that well-structured remuneration is a panacea we do believe that it is a vital indication of and contributor to the desired culture, values and ethos of a company. We therefore encourage a coherent remuneration philosophy which is cascaded down the organisation. For example, it is not always clear why some executive directors receive pay increases that are greater than those awarded elsewhere in the organisation, and which feed through to the bonus and long term incentive plan (LTIP) to widen the pay differentials within the company, or enjoy preferential tax treatment or far more generous pension arrangements – or cash in lieu – than less senior colleagues. Remuneration committees should consider whether they are able credibly to justify any such differentials.

The nominations committee and the remuneration committee must also work closely together, particularly in agreeing the parameters around the remuneration for new appointees to the board. The remuneration committee should ideally be involved at a sufficiently early stage of succession planning to be able to agree the acceptable parameters for pay with the nominations committee during the initial stages of recruitment, rather than waiting until a preferred candidate has been selected.

### 3 Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect returns to long-term shareholders

The desire of some investors to encourage improved company performance by focusing on metrics and targets rather than behaviour and outcomes is at least in part responsible for the increased complexity we have seen in remuneration schemes in recent years. So too is the feeling among executives and non-executives that the outcome of long-term incentive schemes is unsatisfactory, frequently being described as a “lottery”.

As a result of these and other factors, many companies now operate multiple long-term schemes because one or more has been deemed not to have worked well and executives often have outstanding awards under a number of them. There may also be a deferred bonus scheme, or a share matching scheme on top of the short and long-term awards. We wonder therefore whether this multiplicity of awards, with varying performance conditions really helps to motivate executives to give them a clear line of sight over what they need to achieve.

Setting a long-term course and measuring, explaining and incentivising progress annually may be a more effective way to encourage long-term value creation than the current prevailing system. For example, in some circumstances it may be better to have a single bonus scheme – with no long-term incentive plan – using a single balanced scorecard of metrics based on KPIs, over which the remuneration committee may use its discretion, and which pays out predominantly in shares which must be held for the long term. The significant component of the reward is accrued over time through being a share owner. This type of award might be more highly valued by executives than traditional LTIPs due to the increased certainty of outcome. A number of companies have adopted this approach recently and we applaud their desire to ensure that rewards better reflect individual and company performance.

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

Running companies is far more complicated than even the best designed remuneration policies can ever hope to reflect. To distil complex company performance into a few metrics is an oversimplification that can sometimes lead to awards that are not reflective of actual performance, eroding trust and increasing reputational risk.

We wish to see remuneration committees taking greater ownership of, and being accountable for, both the remuneration policy and its outcomes. Remuneration committees consist of experienced individuals; they can, and we believe should, exercise their judgement about the overall performance of the company when determining awards. In particular, the committee should consider how the results have been achieved, not just what was achieved. For instance, if

targets have been met by employing aggressive accounting policies, by deferring important investments in the business or by unnecessarily increasing leverage, then the remuneration committee should consider scaling back payments. Similarly, if the executives have hit their performance targets but the company has had serious reputational issues or has underperformed the market or peer group, there are strong arguments for making lower awards.

We support committees that take a holistic approach to performance rather than applying simplistic mechanistic formulae to determine awards to executives. We recognise that shareholders will require additional explanation to be included in the remuneration report when judgement and discretion is exercised by the committee. Committees should ensure their considerations and judgements are thoroughly explained and appropriately justified; this will be of particular importance if the committee exercises upward discretion. Such an approach will allow investors to have greater confidence that the remuneration committee is acting in their best interests.

### 5 Companies and investors should have appropriately regular discussions on strategy and long-term performance.

While much of the focus of the debate around remuneration has been on companies, we believe it is also vitally important that investors are aware of their responsibilities under the Stewardship Code to engage with companies on a full range of issues. Our preference would be for this dialogue to take place throughout the year, rather than compressed into the period leading up to the shareholder meeting.

We recognise that trust between some companies and investors has diminished over time and believe that both parties have a role to play in helping to rebuild this relationship. Investors should inform themselves properly ahead of meeting a company and ensure that they are able to have intelligent, holistic conversations about the business, its strategy and how remuneration structures support that strategy. Likewise, companies should consider how they might identify and engage with those investors who are committed to stewardship. These should include investors who are outside of their top ten shareholders and asset owners such as those we represent.

As investors, and investor representatives, we encourage remuneration committees to be more innovative in designing pay schemes that drive the behaviours required of executives to deliver long-term business performance. We urge them to be less mechanistic in determining awards. To enable this to happen we recognise that we need to give the companies in which we invest sufficient space to innovate and we must take time to consider carefully new proposals with an open mind.

### Time for change

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

We are confident that there is a significant appetite for change among many to consider how they may more closely align pay with the interests of their long-term owners in order to position themselves best for future success.

The above principles do not seek to prescribe any particular structure or model of remuneration. Instead we encourage companies to innovate and come forward with proposals which are most appropriate to their own business model. We stand ready to support this change which we believe is in the interests of both companies and their investors.

## Hermes Equity Ownership Services

Hermes Equity Ownership Services (HEOS) enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. HEOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

## National Association of Pension Funds

The National Association of Pension Funds (NAPF) has been at the forefront of promoting good corporate governance for over 20 years, and as representatives of major institutional investors we have a real interest in seeing high standards achieved and maintained. We regularly engage with the companies in which pension funds invest on issues including board structures and executive remuneration. Our Corporate Governance and Voting Policy provides guidance to investors and companies on a wide range of corporate governance matters, including remuneration.

### Contact information



#### Hermes Equity Ownership Services

<b>Jennifer Walmsley</b> , Director	+44 (0)20 7680 3777	j.walmsley@hermes.co.uk
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#### National Association of Pension Funds

<b>Will Pomroy</b> , Policy Lead: Corporate Governance	+44 (0)20 7601 1719	will.pomroy@napf.co.uk
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#### BT Pension Scheme

<b>Daniel Ingram</b> , Head of Policy	+44 (0)20 7680 2368	d.ingram@btps.co.uk
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#### RPMI Railpen

<b>Deborah Gilshan</b> , Corporate Governance Counsel	+44 (0)20 7220 5012	deborah.gilshan@rpmi.co.uk
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#### USS Investment Management Ltd

<b>Dr Daniel Summerfield</b> , Co-Head Responsible Investment	+44 (0)20 7972 0300	d.summerfield@uss.co.uk
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