PIRC

CONSULTATION: PAY FOR A NEW WORLD

2020
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PIRC POLICY

How do companies restore a market salary without having to have 'variable' pay?

In this consultation note we set out 5 principles for a new approach to pay policy.

+ Questionnaire

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Why is PIRC consulting?

It has been commonly accepted that the current approach to executive pay has been broken for many years. Discontent amongst investors has been expressed since at least 1995, following the outcomes of the Review by Sir Richard Greenbury[1].

Since then we have had:

- Advisory and "Binding" votes on pay from 2002 and 2013 respectively
- Theresa May Government Green Paper 2016/2017 – executive pay was not working
- Disclosure of executive to employee pay multiples in new legislation

There has been a consistent theme that 'Quantum of pay does not matter" and that the directional effect of the method of pay schemes is what counts. Quantum does matter, and it is clear that approaches are defective as well as the quantum. The excessiveness is very apparent from looking at multiples of pay to average salaries and wages.

Running public companies is a challenge, but the health crisis has shown that other sectors have challenges as well without excessive pay.

Indeed with pressure on many small businesses of cash flow and losses due to no revenues for several months, it has been apparent that there have been distinct advantages to large listed companies. This includes the Coronavirus Corporate Funding Facility (CCFF) from the Bank of England but also the relative ease of raising rescue capital, very often outside of pre-emption rights.

The ability of financial institutions, a number of which have asset management arms, to self-regulate on pay was betrayed by the Bank of England needing to send its 31 March 2020 letter on bonuses and dividends to banks and insurance companies.

PIRC also considers that overall pay takes up too much company and investor time. This can be seen by the number of pages devoted to pay in annual reports, and the focus on remuneration issues in reporting of stewardship activity.

Nor are companies are well served by those with an interest in perpetuating the status quo in executive pay. PIRC research in 2018 showed that companies that had spent the most on remuneration consultancy had amongst the highest levels of opposition to pay at annual general meetings.

Accounts prepared using International accounting standards which are not suitable for determining distributions to shareholders cannot be suitable for determining any element of executive pay either.

We are sure that companies will have better use of their time by using a simpler approach to pay; such as dealing with board diversity and skills, dealing with the challenges of the environment and climate change and planning for future resilience in the wake of recovery from this health crisis.

The 'binding' pay policy vote has not been effective. The disappointment with the policy vote comes across in the levels of dissenting votes on remuneration reports, which disclose outcomes under previously agreed policies. When there are contentious circumstances with executives leaving the instrument that really matters is the service contract.

To move forward on pay PIRC believes that the fallacy of 'alignment' with shareholders needs to be retired. Not only do schemes not align, but executives are employees of the company with duties to it. The duties including the new s172 duties should already set the alignment.

In the light of that the challenge is how do companies restore a market salary without having to have 'variable' pay. In this consultation note we set out 5 principles for a new approach to pay policy.

[1] https://www.icaew.com/technical/corporate-governance/codes-and-reports/greenbury-report
[2] Ref UK Corporate Governance Review 2018

PIRC's proposed new pay policy

- **A going rate true market salary**, not mark to model, i.e. to avoid remuneration consultants and head hunters effectively being a 'desktop market'.

- **Director service contracts approved by vote**, the fact that there is a problem with the existing pay policy vote is clear by the levels of dissent against pay outcomes (the remuneration report).

- **A single profit pool to be distributed company wide**, to be again voted on as to the amount of the pool and the distribution method.

- **Exceptional bonuses only** - paid as a result of an event that has occurred worthy of a bonus – to be put to the vote

- **No LTIPs**, the arguments against them are well rehearsed
  - alignment is a contractual issue not merely a pay one
  - the schemes are not long term
  - they are complicated
  - the accounting numbers are not suitable for dividends and other distributions (the IFRS problem) and hence aren't suitable for pay.
  - they reward the mundane
  - they can reward share price volatility and pay out where there has been failure, there are further issues where there are buybacks or capital raising
  - they are virtually impossible to pre-approve and create confused expectations

Shares – we accept that there may be a general case why holding shares is beneficial. However, there may be problems in some cases. For example the incentive to gear up a bank as a result of a shareholding would be one. Or management may be invested in a company which has little actual prospect for growth, but continue with the misallocation of capital in the hope the share price will go up. This may be particularly relevant to fossil fuel extractive companies. Also, some executive do sell shares at the earliest opportunity.

So, rather than having one size fits all policies for holding shares, we would expect shares to be purchased from total pay, or other own resources.

The matter of variable pay and the alignment with shareholders

In working towards a new policy PIRC has concluded that the concept of alignment with shareholders' for pay purposes is a fallacy, because the risk and responsibilities are different.

Executives who are directors have unlimited liability, fiduciary duties and Companies Act s172 and contractual duties. The delivery of objectives covered by these duties should not be additionally rewarded with bonuses or LTIPs but considered part of the job.

Delegated agents (fund managers), and trustees have fiduciary duties. Shareholders on the other hand have limited liability and no duties.

In many respects fund managers may have been personified as the 'owners'. For example most pay schemes deal with relative return benchmarks – the same way many fund managers are appraised – however, shareholders experience the actual return and not the relative one.

COVID and dealing with the crisis with existing pay schemes

PIRC believes that bonuses based on existing performance criteria and LTIPS for 2020 are essentially a case of 'force majeure'. We would expect boards to recognise and deal with that. If there are contractual problems with any executives then that should be disclosed. Any claims of confidentiality would merely demonstrate the weaknesses in service contracts.

Some companies have cut bonuses because of the crisis. Some bonuses are unable to be paid where there is state support. Receipt of furlough is state support, not merely Coronavirus Corporate Funding Facility (CCFF) type lending by Bank of England

PIRC also expects there will be diverse approaches to executive remuneration over the forthcoming year in dealing with the crisis. One thing is clear: over the longer term it will not be acceptable to come out of this health crisis with 1:100 plus multiples. A doctor to nurse salary multiple is many times less. Neither doctors nor nurses get incentivised on the number of people they cure or harm.

Section 172 Companies Act 2006 is set out below.

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to factors (a) to (f).

a. The likely consequences of any decision in the long term,
b. The interests of the company's employees,
c. The need to foster the company's business relationships with suppliers, customers and others,
d. The impact of the company's operations on the community and the environment,
e. The desirability of the company maintaining a reputation for high standards of business conduct, and
f. The need to act fairly as between members of the company

Given that is the way directors must act, it is axiomatic that it is relevant to how directors are paid in the normal course of events, not as bonus related 'add-ons'.

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Questions

Thank you for takimg the time to fill out the questionnaire below.
Please return by email to info@pirc.co.uk

QUESTION 1

Do you have any comments on the five principles for reforming pay?

- Going rate true market salary
- Director service contracts approved by vote
- A single profit pool to be distributed company wide
- Exceptional bonuses only
- No LTIPs

QUESTION 2

Which if any of the principles do you think would be the simplest to implement:-

- On an ongoing basis?
- In transition?

Please explain why

QUESTION 3

Which if any of the principles do you think would be the most difficult to implement:-

- On an ongoing basis
- In transition

Please explain why

QUESTION 4

Do you think that there is a case that the focus on incentives being needed to perform a job properly detracts from natural levels of commitment and loyalty that many or most employees have?

QUESTION 5

Do you believe that the principles in s172 Companies Act 2006 (director duties) are relevant to how directors are paid?

QUESTION 6

On the basis accounts prepared under international accounting standards are not fit for the purpose of making distributions to shareholders, how can such accounts be justified for performance related pay for executives?

Note

The default in English Law for the point at which directors' pay is entitled[3] is, either,
A - Shareholder approval
Or
B - Service contracts
The way PIRC's proposed policy fits with that is set out below together with the pay regulations.

	Votes			
		2012 Regulations		
	Service Contract A	"Policy vote" 1	Remuneration report vote 2	All payments require shareholder approva B
Default position	Default unless B	n/a	n/a	Default unless A
2012 regulations, a minimum not a maximum	Not excluded	Payments must not be 'inconsistent'	Non-binding	Not excluded Can override Pay Policy if voted on (subject to the contract) BIS Consultation 2012[4]
PIRC proposed	Included Contract would merely need to say, profit pool distribution and bonuses subject to shareholder approval	Included As is the minimum legal requirement The "policy vote" could be the policy is the service agreement on which there is a vote"		Included (would need to be excluded from the service contract)

[3] HMRC Manual EIM42300
[4] Executive pay: consultation on enhanced shareholder voting rights. BIS, 2012

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