Directors' Pay: consultation on revised reporting regulations. Response form.

The closing date for this consultation is 26 September 2012

Please return completed forms to:

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Questions

Question 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.

We support the drive for greater simplicity, consistency and comparability. Overall, our view is that a balance should be struck between what has to be included in the two reports and the exact content, and how it should be presented. These proposals tend to stray too far into a prescriptive approach. We strongly believe that the focus for legislation is best at the principles level and the FRC is the best placed (and credible) body to manage the detailed application and adherence by companies through supplementary guidance. Specific examples where a less prescriptive approach is advised are highlighted in our response such as question 4 (identifying factors to compare directors pay), question 6 (employee views), question 10 (performance metrics) and question 14 (comparisons with total shareholder return).

We suggest the approach to a single total figure should also respect the following in addition to the three key features[1]:

i) Ensures consistency of disclosure with published accounts for transparency and good practice
ii) Represents the cost to the company at the financial reporting date, being of interest to shareholders, rather than benefit to the employee which may be out with the reported period and more subjective
iii) Represents the in-year costs rather than a mix of annual and cumulative amounts.

Single total figure

We agree that the scope should include all those who served as a director in the period. It should be clarified that this should include temporary appointments and those acting up.

Salary & fees
We suggest adding "allowances" for completeness to the definitions table and to legislation (Part 3(5)(a)). An example is a housing allowance paid on top of basic salary.

Benefits
For completeness, the definition should include both cash and non-cash benefits paid in respect of the director's employment, not included within other columns. In addition, where the company/ pension fund is picking up an additional tax liability (which would normally be a personal tax liability) this should form part of the single remuneration figures. This would provide a more complete figure for the cost to the employer.

[1] Consultation paper paragraph 61

Bonuses
The legislation at Part 3 (6)(d) should be expanded to include preferred valuation method if non-cash payments.

LTIP/share awards
The proposal to calculate a current market value for equity awards does not match the cost of the award with the period that the director renders service (nor reflect the risk of the award to the director). Furthermore, it could potentially give the wrong impression of remuneration and performance. For example, if a director is awarded options in year 1 worth £100, and by the time they vest in year 3 they are worth £200; this would hopefully reflect the fact that the directors have done a good job at managing the company over three years, rather than just the fact that they had received options worth £200 in year 3.

The approach would also result in inconsistency between the remuneration report and the accounts which would be difficult to explain in a clear manner. For consistency with disclosure methods in the published accounts, we suggest that the grant-date fair value approach is a more meaningful approach to determining the 'cost to the company' of awarding shares/options, at the point they are granted (IFRS 2).

Observations on the draft legislation
In the legislation for LTIP/ schemes Part 3 (6)(e), the calculation in (ii) & (iii) shows inconsistencies, being market value of shares at the date of vesting for XYZ or average market value of the last quarter if not vested for XYZ. It would be clearer to maintain a single approach and maintain consistency with the disclosure of share values in the accounts.

Secondly, paragraph (iii) appears to be a subset of (ii). If this is the case, it would be clearer to write (ii) "(*XYZ) multiplying the total arrived at in (XY) by the market value of shares at the date of vesting* <u>*OR*</u> ~~*(iii)*~~ *for the purposes of the calculation in subsection (XYZ) where full vesting is not achieved by the date on which the remuneration report is signed off…*"

It would also be relevant to include a statement explaining any conditions around the retention/ sale of shares.

Pension

The BIS proposal mixes methodologies for the pension benefits amount in the Single Figure Table by including company contributions for money purchase (or defined contribution "DC") schemes and value of benefit achieved for defined benefit (DB) schemes. This is confusing and likely to create distortions in the final remuneration figure for directors on different schemes. Additional narrative would be required to explain to readers the implications of the different pension schemes on the single total figure.

For consistency and to provide a more meaningful figure, we believe that the approach for both DC and DB schemes for the Single Figure table should be harmonised. The starting objective should be that the figure represents the cost to the employer, rather than benefit to the employee (being the principle noted in our response to Q1). As such, only the employer contributions for all relevant pension schemes should be recorded in the Single Figure Table.

The inclusion of the accrued in-year values only represents the benefit to those Directors on DB schemes so it is not only inconsistent across schemes, but inconsistent in terms of the purpose of the single figure (to show actual pay). Any disclosure of DB in-year values for Directors would sit more logically out with the Single Figure Table, in a separate note. However this would be a bit one-sided as Directors on DC schemes do not have this additional disclosure.

As a comparison, whilst other public sector accounts show a pension benefit / transfer value (see footnotes 2[2] and 4), these are represented in a separate table and are not trying to fit a meaningful Single Total Figure. The local government DB scheme disclosures notably include in-year pension contributions.

We believe that for a meaningful pensions figure within the Single Figure Table only employer contributions for all pension schemes should be included. This would reduce complexity, improve comparability and remove the need for a more complex (HMRC) valuation methodology.

Definitions should cover all the different types of pension schemes for clarity. Further guidance including scenarios and examples would provide clarity.

Observations on the draft legislation
The draft legislation Part 3(6)(c)(ii) notes that measurement includes company contributions for the relevant financial year or payments made by the company in that year for another financial year. This appears to mix payments for different financial years which risks overstating the annual single total figure and is inconsistent with the measurement approach of other headings. Further clarification is required.

Exit payments
This figure should form part of this table and the single total figure, where applicable. This would enhance completeness better than a separate disclosure[3] and would be consistent with presentation in the published accounts of other sectors[4].

To reduce duplication, a statement at the foot of the Single Total Figure table

[2] http://www.scotland.gov.uk/Publications/2011/09/29132216/0
[3] Consultation paper paragraph 59
[4] http://www.scotland.gov.uk/Resource/Doc/1070/0116807.pdf

should confirm whether the exit payment has been calculated according to the Policy[5]. We are not convinced that a further break down of the amount is required if the Policy section adequately explains how this has been calculated. A simple total could then be more easily included within the Single Total Figure table.

Areas requiring further information

Exit payments – the policy and payments made refer to different scenarios and how performance is taken into account. Further guidance is required on the types (including early retirements, ill-health, dismissal, redundancy etc.) and application of exit policies in different scenarios, with good practice examples to help ensure that the level of detail and consistency of approach are made clear for the purposes of reporting and interpretation.

The legislation does not state how the governance process for the binding and advisory votes will interplay with the regulatory challenges which have changed remuneration policies of companies over the last few years. As an example, the implementation of the FSA Remuneration Code in 2010 meant that banks had to react quickly to update their remuneration policies and approach, and implement the new regulatory landscape within weeks of the regulations being published. All this happened prior to the next Annual General Meeting. How these types of activities are addressed in the future and how this would impact on the timing of the votes and the specifics that need to be disclosed, has not been made clear in the consultation document. This requires further review and provision of clear guidance.

Other areas where guidance would help to improve understanding, consistency and ensure an appropriate level of detail:

i) Scenarios, sample disclosures/ good practice examples, especially for performance, differences in performance versus financial years, pensions, LTIPs, variable pay and exit payments (examples of detailed scenarios for a different sector are available at footnote 4),
ii) How to treat adjustments and explanatory notes (this should be consistent with the accruals concept as used in the financial statements and minimise under and over statement of current period pay),
iii) Clear and precise methodology for calculation of the single sum disclosures with examples,
iv) Disclosures on advisers to the Remuneration Committee. Not all use external advisers. Further guidance should help to clarify the exact content and description of the disclosure including the type of fees and services which would fall under the scope of the reporting and how it is determined, those who are advisors to the Committee versus advisors of the Company when the outcome is used to provide information to be provided to the Committee,

[5] Consultation paper paragraph 25/26 of draft legislation

v) HMRC methodology (see also our response to question 8),
vi) Interplay with other regulatory challenges.

Additional clarification on the following would assist:

vii) A director may choose to pay AVCs out of his salary, this is a personal choice and should not need to be disclosed (as his salary is already shown),
viii) Confirm that accrued benefits relate only to the company scheme (and not other schemes the individual may be a member of either privately or through previous employers).

In conjunction with greater disclosure of actual pay, the Policy Report needs to help focus greater attention and control (including shareholder approval) on negotiation of contracts to control against unjustified pay ratcheting.

Finally, the scope of implementation is left open for companies to come to their own decision as to whether to adopt any/all of the proposals prior to the legislation being enacted in October 2013 which may provide certain levels of confusion/inconsistencies, particularly if areas requiring further guidance and clarification are not resolved before the main period of reporting (being H1, 2013).

Question 2: What costs will companies face in adjusting to these revised reporting regulations?

We agree with the assessment by BIS that there are some quoted companies already adopting much of these disclosures on a voluntary basis for whom work will be to refine their disclosures rather than introducing completely new material.

Question 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 agree with this approach.

Question 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.

Introducing disclosures on remuneration opportunity in different scenarios is useful however there are some practical issues to consider for more effective implementation. We support the intention to compare pay to performance but have concerns that the particular benchmarks proposed and annual percentage movements can risk focusing on short term measures and changes which is inconsistent with current thinking on the benefits of a longer term view of performance and remuneration[6].

In addition, directors pay in the year could be affected by many variables besides just "profit" if there is a balanced scorecard approach to bonuses. Flexibility and discretion is required to provide more meaningful comparisons. Another scenario could be if pay includes LTIP's which may vest due to an excellent performance over two years and a modest one in year three. The director would receive a large pay figure as a result of the vesting which compares to a modest profit growth figure in year 3 and will need explanation.

Our preference is that the legislation is not prescriptive in its identification of appropriate performance benchmarks but a responsibility is placed on the Board to identify their own most appropriate benchmarks for directors' remuneration to demonstrate alignment with performance and fairness. A narrative explanation would help provide further meaning and context.

Question 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 agree with this. Further guidance is required as noted in the response to question 1.

[6] See Kay Report page 13, recommendation 15.

Question 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.

The proposal to include a statement of how employee pay and conditions were taken into account supports the principle of fairness[7]. However, the main thrust of proposals for employee consultation and comparison metrics[8] has failed consultation so the residual proposals of extra narrative if a company has voluntarily done something similar, is adding clutter to the report. This is likely to lead to boiler plate responses and not adding much value.

Improvements already noted in the consultation paper should provide a more effective structure to encourage a greater focus on fairness, in particular greater transparency and disclosures, explaining differences in the payment policy between directors and employees, comparisons with pay and performance and the shareholder vote (views from a group who are in a position to compare performance with remuneration as well as having the responsibility).

The responsibility for a remuneration policy rests with the Remuneration Committee, who are structured to include independent non executives. Employees are not independent. They may however, also be shareholders and can contribute views using that route.

Although we appreciate the intention for proposals in paragraph 28 and 29, there is insufficient evidence around its effectiveness and as such, should not be included in the legislation. Our preferred approach would be for the Remuneration Committee to explain how it ensures balance, fairness and alignment with performance in its remuneration policy; and in the implementation report, to demonstrate that this has been achieved. Any further employee comparison (such as pay medians) or engagement should be on a voluntary basis.

The proposal to show the percentage increase in pay of the CEO to wider employees[9] is valid for those working in the same country and subject to the same inflationary conditions however, it is likely to encounter difficulties for companies working internationally so some flexibility is welcome.

The focus on CEOs suggests that they are the highest remunerated but this is not always the case. In recognition of this, some organisations voluntarily provide details of the most highly paid in the organisation if not the CEO or board member. There is a precedent for this in Scottish local authorities[10]

[7] Paragraph 27 in the draft legislation
[8] Paragraph 28,29 in the draft legislation
[9] Paragraph 30 in the draft legislation
[10] http://www.legislation.gov.uk/ssi/2011/64/pdfs/ssi_20110064_en.pdf

whose Remuneration Reports include (the equivalent of) directors as well as those earning above a certain threshold (by name and post). There is also a table of general disclosure by pay band of the aggregate numbers of staff earning above a certain threshold.

Some quoted companies include these additional disclosures on a voluntary basis[11]. Examples include RBS[12] and HSBC[13] (8 highest paid senior executives by number). We believe it is not unreasonable to extend disclosure to this group in the Remuneration Report for transparency and consistency. Disclosure of post (as a minimum) would be more informative than number. Voluntary disclosures are also provided for bands (HSBC). Guidance could help disseminate best practice and generate greater consistency and transparency of this group across quoted companies.

Question 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?

Yes, subject to concerns noted in our response to question 1.

Question 8: The Government proposes the application of the HMRC methodology to work out the value of defined benefit pension schemes. Is this a practical and informative approach?

The intention to minimise volatility is appreciated, albeit the approach is inconsistent with how other organisations report pension benefits[14] and methodologies used for valuation in the published accounts which could reduce transparency.

Although this method may provide a useful first order approximation, buy-out costs vary with age and expected mortality as well as annuity rates (which vary annually with gilt yields, quantitative easing etc.). Consistency and neutrality should not be substituted for a prudent estimate of the full in-year cost, including past benefit revaluation. Overall we are not sufficiently

[11] as proposed by the HM Treasury consultation paper in December 2011 (http://www.hm-treasury.gov.uk/consult_merlin_remuneration_disclosure.htm)
[12] http://www.investors.rbs.com/download/report/Annual_Report_2011.pdf
[13] http://www.hsbc.com/1/content/assets/investor_relations/hsbc2011ara0.pdf
[14] http://www.scotland.gov.uk/Resource/Doc/1070/0116807.pdf & http://www.legislation.gov.uk/ssi/2011/64/pdfs/ssi_20110064_en.pdf

persuaded that this provides a meaningful number for users and meets the objective of a true and fair view. This is of particular concern given the proposal for the pension entitlements figure to be subject to audit.

One of the implications of the HMRC method is that the Remuneration Report would also require additional narrative notes to explain any significant/ unusual movements which may arise say when annual allowances are exceeded and contributions not paid (draft legislation Part 3 (6)(c)(iii)&(iv)).

Further information in the consultation paper on the HMRC method would have been helpful. Some ambiguity was noted which needs clarified. For example, the relevant legislation (s234 of Part 4 of the Finance Act 2004) uses a multiplier of 10 (which has been updated to 16). A separate calculation would therefore be required for tax purposes if a different multiplier of 20 is required to calculate the pension benefit.

Secondly, the definition of the HMRC method per the proposed regulations suggests that it is to be used to calculate in-year increases (if any) to a lump sum entitlement. However elsewhere in the proposed regulations there is a suggestion that this is used to determine increases in pension entitlement acquired in the year. Finally, if the method is to be used to determine the lump sum, it is not clear how this is possible as in the formulae the lump sum is a ‘given’ not a figure to be calculated.

Question 9: The Government proposes that claw-back is recorded as part of the single figure. Is this a practical and informative approach?

This is a sensible approach to avoid over stating remuneration. The amount should be separately disclosed and explained. This needs to be clearer in the legislation Part 3 (section on single total figure of remuneration) to be consistent with the consultation paper paragraph 73.

Question 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?

We support the intention to link directors’ pay and directors’ performance more clearly, however there are concerns that this is a commercially sensitive area and in practice, one of the unintended consequences could be to change the metrics to focus on less sensitive areas of the business. To get round this, disclosures could be maintained at a more general level. By moving towards a binding vote on the remuneration policy, major shareholders should be able to get the details they need through private discussions with the company (or threaten to vote against).

Question 11: Will the Government's proposed disclosure requirements on pensions lead to reporting of sufficient information on the benefits received by directors?

No, please see our response to question 1.

Question 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?

We support the expected value methodology on the grounds that this is what the company anticipates the director will receive. We appreciate that the calculation of this value requires a number of assumptions to be made but we believe this to be better than a value which is not reflective of what the company expects the director to receive. These assumptions could also be disclosed and supported by narrative explanation.

Question 13: The Government proposes to simplify the reporting requirements regarding directors' interests. What are the costs and benefits of this approach? If an alternative disclosure would be more useful, please give details.

We support efforts to align with the Listing Rules.

Question 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 over the requirement for Total Shareholder Return (TSR) as a metric for all quoted companies. Not all companies are valued on earnings; some such as house builders and utilities use assets, others may use return on capital employed (ROCE) or sales as a key performance measure. In addition a company's strategy can change in 5-10 years so the metric may need to change to keep pace.

We would prefer a company to select its own most appropriate metric to measure company performance. This should combine short and longer term measures and form some sort of triangulation of the comparison. The proposed legislation is too prescriptive which risks generating disclosures that are not a fair reflection of company performance.

See our response to question 6 on the focus on CEOs.

Question 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?

Accountability for the Remuneration Policy and Report and sign-off arrangements should be clarified and formalised (for example including responsibilities to select appropriate performance benchmarks and achieving fairness).