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The UK plc Remuneration Committee: its evolving purpose, effectiveness and challenges

RESEARCH REPORT, JUNE 2015

"The Remuneration Committee has raised its game considerably, especially in its governance, processes and key relationships. We may now be entering a period of more open debate about whether and how executive reward practices can support long-term business success, which includes setting the right 'tone from the top'. RemCo Chairs are increasingly aware that this is the fundamental challenge they have to address."

Wendy Hirsh, Researcher and Report Author

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Foreword

Being a Remuneration Committee Chairman is a tough job to do well. Some readers may not be so sympathetic with this statement; after all, how difficult can it be to determine the pay of a handful of people? However, for many Remuneration Committees, setting executive pay must feel like a constant battle.

Remuneration Committees face opposition from all angles – cynical shareholders, a critical press, pushy executives, envious politicians, and zealous pay consultants. Not surprisingly, Remuneration Committees have tended to take the path of least stakeholder resistance when designing pay policies and packages. This has resulted in a pay landscape that is dominated by the principles of pay limitation, recoupment, reporting, and complexity. However, as this report suggests, many stakeholders accept that the current model is not working well and perhaps the 'governance pendulum' has swung beyond a natural point where it could now damage economic growth, discourage appropriate risk-taking, and stifle entrepreneurialism.

One of the other challenges that Remuneration Committees face is the burgeoning regulatory landscape. Over the past few years, the UK has introduced new regulations to tighten up the governance and disclosure of executive pay. Why? Well, the banking crisis in 2008 and the subsequent recession provided politicians with just cause. For many in the country, executive pay regulation was necessary retribution and 'banker bashing' became a popular sport.

The rate of increase in executive pay is slowing down – although how much of this is due to the new rules is debatable. However, what is most concerning, is the fact that the Government felt it had to intervene in the first place. Clearly, this tells us one thing: society has lost trust in how executive pay is determined; it is a vote of no confidence in the effectiveness of Remuneration Committees and a public humiliation of absentee shareholders.

This report from the Performance and Reward Centre (PARC) explores the changing purpose and focus of the Remuneration Committee and identifies the features that make Remuneration Committees effective. The report also identifies the key challenges that Remuneration Committees will need to tackle in the future.

PARC's report is a must-read for Remuneration Committee members as it highlights clearly the skills and nous required to navigate the complexities of their important role.

There is much work to be done to build trust between companies and their stakeholders with regard to executive pay. This will take time. Regulation can play a part, but the judgement and actions of the Remuneration Committee will be key to restoring public confidence. Remuneration Committees and shareholders will need to be bold, to challenge current 'best practice' norms and to consider seriously some more radical solutions.

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About the author

Dr. Wendy Hirsh is a consultant and researcher on a range of people management issues especially leadership, talent management, succession planning and career development. Her particular interests are in considering both organisational and individual perspectives; aligning resourcing and employee development at all levels more strongly with changing business and skill needs. Wendy advises many leading employers in a wide range of sectors and internationally on these aspects of their employment strategies, often working with senior and line managers as well as the HR function.

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About PARC

PARC was founded in 2004 to provide a centre of excellence for the development and management of high-performing organisations.

Covering a range of reward issues, and setting them in the wider political and economic contexts, PARC continues to promote challenging research, identify expert business and academic input which, combined with our senior level membership, provides a stimulating and participative environment for those seeking improved corporate performance.

THE EVOLVING PURPOSE AND FOCUS OF THE REMCO

1.1
Introduction

The Remuneration Committees (RemCos) of UK plcs are in the front line on the sensitive issue of top executive reward. They take their decisions against a backcloth of increasing regulation, continued public criticism of executive pay, a fragile economic recovery and the need to reward executives fairly in a competitive, and often global, labour market.

The research on which this report is based examines the evolving purpose and effectiveness of the RemCo in UK quoted companies through the experiences and insights of over 40 individuals, 35 of whom were interviewed in depth. The sample included non-executive directors (NEDs) of FTSE-100 companies (mostly RemCo Chairs, who also often have experience of being a CEO and/or company Chairman), leading RemCo advisers, HR Directors (HRDs) and Heads of Reward, a range of researchers and commentators expert in this area and a few leaders in UK corporate governance from major investors and regulatory bodies.

The interviews focused on the purpose and workings of the RemCo, but, of course, interviewees raised some of the major dilemmas in executive reward systems, and they are reported here where relevant.

This report emphasises the perspective of the RemCo Chairs, who were intentionally the largest group in the study sample. Executive reward is a field in which everyone is quick to tell you what other people think. That is not a reliable way of getting towards an evidence-based approach, and is partly why this report includes a good number of individuals' observations in their own words. This study also highlights, however, the need for clearer research evidence on the views and behaviour of other key stakeholders, especially top executives themselves and various types of shareholders, including those who invest in companies other than large plcs.

- This introductory section addresses the **context, purpose and focus** of the RemCo.
- The central section of the report (Chapters 2 to 7) presents the research findings on what makes for an effective RemCo. The interviews highlighted four main **dimensions of RemCo effectiveness** and these are presented as a simple model (in Chapter 2), which is then used to frame the more detailed findings. These dimensions are: **supporting sustainable business performance** (Chapter 3), **managing key relationships** (Chapter 4), **governance and capability** (Chapter 5) and **process and decision-making** (Chapter 6). There is a short summary at the end of each of these chapters.
- Chapter 7 rounds off this central section of the report, pulling together the findings from Chapters 3 to 6 into widely accepted **effective practices**, suggestions of areas for further **improvement** and **ten key practices for RemCo Chairs**.
- Chapter 8 is the third main section of the report, covering the **wider challenges** for RemCo effectiveness posed by the evolving context in which they operate and by current executive reward structures.

- Two practical tools are offered:
  - Annex A – A framework for examining Reward Risk – and
  - Annex B – A tool for the Evaluation of RemCo Effectiveness

1.2
The RemCo in its changing context

The RemCo does its work of setting the pay of executive directors and other top executives against a continuously shifting economic, social and business backdrop and an evolving regulatory environment.

The evolving regulatory landscape

The RemCo in its current form has evolved in response to public and political concern about executive pay, especially instances of high reward for poor performance. By the early 1990s – so more than 20 years ago – there was criticism in the media about levels of executive reward, especially in some of the (then recently privatised) utility companies. A wider debate on corporate governance was initiated in the UK by the Cadbury Report (1992), which proposed a company Remuneration Committee to decide on 'fair' and 'competitive' pay for executive directors. Cadbury also advocated the opportunity for shareholders to express their views on executive reward at the AGM.

The Greenbury Report, which followed in 1995, proposed much of the regulatory machinery we see today: the RemCo focus on executive directors; avoiding excessive pay; liaison with shareholders; formal reporting; and the use of performance-related incentives. Interestingly, Greenbury also suggested that RemCos should be sensitive to the 'wider scene', including pay and employment conditions elsewhere in the company – an issue back on the agenda today.

The legal framework for implementing these proposals, including the requirement for a remuneration report and an advisory vote on this at the AGM, was consolidated in the Companies Act. The law was revised in 2013 to strengthen the status of remuneration policy for directors, including a binding shareholder vote on policy every three years. Regulations also stipulate the content of both policy and implementation reports.

The Financial Reporting Council (FRC) sets overall standards for corporate governance through the UK Corporate Governance Code (referred to throughout this report as 'the UK Code'). Unlike the legal framework, the UK Code operates on a 'comply or explain' principle. The UK Code has also evolved since the first Combined Code in 1998. The most recent iteration in 2014 pays special attention to the role of the Board in establishing the right 'tone from the top' in terms of culture, values and ethics. The long-term 'sustainability' of the business, in contrast to short-term results, is now centre stage. Emphasis is also placed on seeing executive reward in the context of wider company pay, managing business risk, and the ability to protect against paying for poor performance (by paying later and/or clawing some back). The recent UK Code neither encourages nor discourages the use of performance-related pay, but it does say that if performance-related components are used, they should be 'transparent, stretching and rigorously applied'. It downplays attraction and retention as a justification for reward, because companies were seen as using these arguments with little or no evidence. European legislation and regulation may have a growing impact on UK practice over the next few years.

"What the codes and legislation are trying to do is to give companies the ability to set remuneration appropriately and then explain what they're doing and why."

David Styles, Director of Corporate Governance, Regulatory Body

Over this lengthy period of regulatory development, shareholders have been positioned as the interest group to whom the RemCo is primarily responsible. The power of shareholders has grown over time, as has their obligation to agree executive reward in much more detail, both in terms of policy and actual pay given.

Regulators see pay transparency, through reporting, as the way the 'comply or explain' principle operates in practice. Reporting and explanation – available in the public domain – are seen as providing the clearest safeguards against imprudent company behaviour on reward. For the RemCo Chairs interviewed in this study, transparent reporting and the interface with shareholders are key elements of their role.

Public and media debate

"The issue of quantum is a new game in town. Up to now if the company did really well then shareholders also thought the senior team deserved to do really well. Until 'quantum' that held, but no longer. Now it is slightly caveated – 'yes they deserve to do well but not too well'. Potential media embarrassment is an issue for shareholders too."

Roger Davis, RemCo Chair

Regulation has not quelled public comment and media interest in executive reward. The financial crisis of 2007/8 heightened public and political disaffection with both the level and management of rewards in the financial sector. The analysis of this crisis has highlighted the likelihood that reward systems were one of the factors encouraging risky and unethical behaviour by top executives and other employees in high-risk roles. Some commentators, including PARC (in 2009) and speakers at a conference at Harvard Business School (reported by Lorsch and Khurana, 2010), expected the financial crash to lead to a fundamental rethink of executive reward more generally. But the moment seemed to pass without radical change, other than in the banking sector where regulation, including of reward, has been tightened significantly.

Many of those interviewed in this study – including most RemCo Chairs – feel that what they often call the 'toxic' or 'corrosive' impact of reward behaviour in the financial sector, an impact sharpened by the pain of the long recession, has damaged public attitudes to executive reward in other sectors too. By 2014 the general growth in executive salaries in the UK had slowed, although the complexity of longer-term incentives leads to much disagreement about trends in total executive earnings. The media still highlights a good handful of instances each year of high pay coupled with bad behaviour of top executives in a range of sectors. Even though these are exceptions, their visibility in the media depresses public trust and reinforces the continuing need for vigilance.

"Public shame and outrage is the only sanction there is. The media can be superficial and undiscerning in its judgement, and it does sometimes try to whip up emotion and pander to the baying hordes. In its defence however executive pay seems extremely high to most people, it is usually unclear what the executive has done to deserve the money. People think they could have got someone just as able much cheaper."

Anthony Hilton, Financial Journalist

Meanwhile, a broader discourse on executive reward has been evolving as part of a concern about the widening gap between rich and poor in many countries, including the UK. This is sometimes expressed in terms of earnings ratios between the top of the workforce and the median- or average-paid employee, but executive reward also comes up in wider debates about the minimum wage, 'living wage' and 'zero hours contracts'.

Many interviewed in this study are critical of the way that the media report on executive reward, especially their criticism of high salaries or bonuses given to executives when company profits are high. However, a number of RemCo Chairs acknowledge that the risk of public embarrassment through the media, and the knock-on effect this may have on shareholders, may be the strongest real incentive for RemCos to pay adequate attention to the justification for executive rewards. The large institutional investors interviewed in this study are also increasingly concerned about how decisions on executive reward are reported in the media and regarded by the public.

Economic and labour market uncertainty

Executive reward is affected by what happens to business, not just in a general way but also at company level, by sector, and in different parts of the world. The long UK recession may have helped to control executive salaries for a while, but this respite from labour market pressure may not last, especially if the UK has a sustained period of more rapid economic growth. Faster economic growth elsewhere in the world is likely to raise pay levels for those executives who operate in global labour markets. The EU economic and regulatory context will also be a big factor affecting the UK, as might any changes introduced by the new Conservative administration in 2015. As we will see at the end of this report, RemCo Chairs see managing reward through economic ups and downs as a major challenge, and one that they do not think is satisfactorily addressed by current pay systems.

Current approaches to executive reward

The mechanics of executive reward are not the main focus of this research, but they clearly influence the work of RemCos. Current reward structures usually have three main components – salary, annual bonus, and longer-term package (usually called the long-term incentive plan or LTIP) – plus, of course, pension arrangements and arrival/departure components. Two particular features of current systems are worth noting as part of the RemCo context.

- We seem at present to have a strongly embedded current – or **'status quo'** – approach to executive reward systems, especially the operation of their performance-related components. These systems are actually not very old but have recently become very similar between companies. The current climate is not seen as conducive to doing anything unusual, even if it may align with specific business needs.
- But we also find little agreement – and even less solid evidence – as to whether the UK's current executive reward practice is actually effective in business terms. Most of those advising on pay, especially HRDs and Heads of Reward, are pretty used to the 'status quo' but some RemCo Chairs, as we will see later, are more critical, especially of its complexity.

In addition to these broad features of context, the RemCo is influenced by the specifics of its own markets and business performance, the characters and conduct of its own CEO, Chairman and top team, and particular business events such as mergers, acquisitions or major restructuring. International companies often have to take account of several regulatory regimes, each of which is developing over time.

1.3
The evolving purpose of the RemCo

The central purpose of the RemCo is to set all aspects of remuneration appropriately for executive directors and to 'recommend and monitor the level and structure of remuneration for senior management' (FRC UK Corporate Governance Code, 2014). Being a committee of non-executives, the RemCo is there to avoid executives setting their own pay and to make sure that pay levels are appropriate. Defining the purpose of the RemCo in more specific terms involves clarifying whose interests the RemCo is there to serve.

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"The tide for many years has been the inexorable ratcheting up of payscales and the increasing complexity of schemes. You've got to stand firm against that. The RemCo Chair has to look in the mirror in the morning and say to themselves: 'I am here to create the equilibrium between what the people who own this company want and what the people who run this company want and find that balance between the two.' "

Alan Gillespie, RemCo Chair

In its simplest sense the RemCo safeguards the interests of company shareholders. Many of those interviewed chose to articulate this in terms of striking a **fair balance between the interests of executives and shareholders**.

The RemCo is also required to manage executive reward so as to **support sustainable business performance**. In this sense the business is a stakeholder in its own right, as its long-term health does not necessarily equate with the expressed preferences of either shareholders or executives. As business risk becomes a more central issue, the purpose of the RemCo also has a greater emphasis on the mitigation of **reward risk** for the business, especially in relation to avoiding pay for poor corporate performance, poor decision-making, executives who behave out of line with values, or misconduct. **Protecting corporate reputation** is one very important aspect of safeguarding long-term success. Avoiding adverse press coverage may be an implicit purpose, but it is much on the minds of both RemCo Chairs and long-term shareholders.

Some would widen RemCo stakeholders to include the **workforce** and **wider society**. Views differ on the wider societal responsibilities of the RemCo, although, of course, citizens are also investors through their pensions and other financial assets and so are directly affected by executive reward. Most of the RemCo Chairs in this study are also interested – perhaps increasingly so – in how executive pay relates to pay for the wider workforce. They may see this as part of the growing awareness of how corporate culture is manifest in the 'tone from the top'.

Compliance is certainly required of RemCos but those interviewed do not see it as the primary purpose of the RemCo. Reporting and the need to get shareholder approval have become more exacting, and non-executive directors are required to indemnify the company for any payment that is not in accordance with the remuneration policy approved by shareholders. So it is not surprising that RemCo Chairs recognise the danger of the RemCo becoming overly focused on compliance rather than paying appropriately in the light of business needs, the needs of other key stakeholders and changing business and labour market circumstances.

Those involved in this study do not think that the purpose of the RemCo has changed fundamentally in recent years, but its context is certainly much more demanding. This heightens the need for the RemCo to see its work through a wider range of lenses, which we explore in this report. We suggest the following definition of the RemCo's purpose.

The purpose of the RemCo is to:

- set and monitor fair and appropriate remuneration policy, structures and levels for the populations in its scope;
- demonstrate that its policies and reward decisions align with business strategy;
- support sustainable business performance (including mitigating risk and safeguarding reputation);
- show balanced attention to executive and shareholder interests; and
- support an effective and efficient executive talent management strategy.

1.4
The evolving purpose of the RemCo

In this section we look at what interviewees said about the 'focus' of the RemCo: which parts of the workforce it looks at and why; what it thinks about when setting pay; and the boundaries of its role in relation to the management of top executives.

Which parts of the workforce does the RemCo focus on?

The RemCo has a clear accountability to determine reward for executive directors, but today these may comprise only the CEO and one or two others, including the CFO. RemCos also 'recommend and monitor' reward for what the UK Corporate Governance Code calls 'senior management'. This must include the first layer of management below board level, normally the executive committee. In this report we will use the term **'top executives'** to describe the executive population covered by the scope of the RemCo's decision-making powers.

The RemCo must also approve the rules of all **share-based incentive plans**.

Through such plans, and also through annual incentives, the RemCo has considerable influence on the structure of reward for a group we will call 'senior executives' – those below the top executives but whose pay systems are closely modelled on those used for the top executive group and are determined by similar metrics and targets.

RemCos directly set or influence reward for relatively small numbers of people, but they have several reasons for looking wider than just these populations. These reasons include checking the following.

- Rates of pay increase for executives are not out of line with overall workforce pay rises. This appears to be a growing consideration for RemCos.
- Pay levels and structures for successors to top executive positions are appropriately differentiated from those of existing top executives, so as not to compromise their ability to move into such roles.
- Reward risks are being managed in all segments of the workforce where reward systems for particular jobs may present a significant business risk.
- Reward principles are aligned between top executive reward and whole-workforce reward in order to reinforce consistent messages about performance and reward, business and change priorities, and organisational culture, values and behaviour.

Should the RemCo seek to influence company-wide reward principles?

In relation to this last point, some RemCo Chairs feel that the focus of the RemCo should be widened to embrace an interest in – and perhaps a stronger influence on – reward philosophy in the company as whole. Pay systems have, after all, been blamed for examples of mis-selling, risky trading and fatal accidents as a result of executives putting excessive pressure on employees to achieve inappropriate targets.

"A big change since the financial crisis has been the broadening of the RemCo's remit to understand key aspects of remuneration across the group and take that into account when thinking about executive remuneration."

Tom Gosling, RemCo Adviser

"Recognition and reward has to be a big part of how companies influence and shape behaviours at all levels to get the job of implementing strategy done. This applies not just at the isolated top of the pyramid but throughout the company. So surely the RemCo focus needs to broaden beyond top management and the executive needs to give the whole subject of recognition and reward across the workforce more serious attention."

Neil Hayward, Group People Director

In a more practical sense, those interviewed were not always clear about whether there really is a wider workforce reward strategy or set of reward principles, and, if there is, where and how such a set of principles may be agreed. Some of those interviewed, including several HRDs, feel that wider reward strategy is an issue for the CEO and executive alone. In some companies it may be highly devolved by region or business stream. We have also found examples where wider reward strategy is believed to be a key issue at group level and is addressed by the whole Board. But where this is not the case, how can RemCos 'align' executive reward strategy with wider reward principles? How do you align with something that isn't there, or is very diverse across different parts of the company?

The question of whether it is part of the RemCo's remit to ensure that group-wide reward strategy is addressed, either in the RemCo or the Board, is not a new one (Lincoln et al, 2006). However it may become more important given the greater emphasis in regulatory guidance on setting the 'tone from the top', and the likelihood that it will become of increasing interest to shareholders. We return to these questions in Chapter 8.

By what criteria does a RemCo judge reward to be 'appropriate'?

There is no clear theory or accepted set of rules for determining the appropriate level or structure of executive reward. So the RemCo has to make good judgements based on all or any of a wide range of criteria, including the following.

- The **alignment of reward with business strategy**, so executives are rewarded for actions or outcomes in line with agreed business direction, goals or specific aspects of corporate performance targeted for improvement. This business alignment criterion is the one emphasised by the regulators and long-term investors in this study.
- What is justifiable in the light of perceived **organisational performance**? The majority of RemCo Chairs see very high rewards as justifiable in an exceptionally profitable and/or rapidly improving business, but still have to decide how much extra to pay.
- Appropriate **sharing of profit** between the owners of capital (the shareholders) and their agents (the executives).
- **Talent management**, in terms of being able to attract and retain the right people and skills to execute the business strategy.
- **What other companies are paying**, which gives rise to the complex art of choosing comparators and benchmarking pay data.
- What might make executives **feel fairly rewarded and valued**? This psychological criterion is a key one for RemCo Chairs and is much more complex than simply using benchmarked pay quartiles.

Although RemCo decisions may look as if they are all about numbers, they are really all about judgement, usually across several of the criteria listed above.

Attention to entry and exit arrangements

The RemCo spends a lot of its time on the three main components of reward for current executives: salary, bonus and longer-term incentive plan. Some other aspects of the reward package are crucial too, for example retirement income, which is now a much broader issue with the demise of defined benefit pensions. Several leading reward experts said in their interviews that RemCos still pay insufficient attention to how reward is set on entry and for exit. Because these items are included in policy and publicly reported, they are difficult to adjust once a contract is agreed and someone is in post. Setting rewards too high on entry and having to give inappropriate rewards on exit are key reward risks.

The post, the person and wider talent strategy

Remuneration policy should not be built around the individuals in post. In practice, however, executives are in a market where they negotiate individually over reward, and this labour market is far from rational in economic terms (Crystal, 1991).

As we will see in Chapter 3, RemCo Chairs find executives have diverse attitudes to reward, with some keener than others to maximise their pay. There is a tension here between paying some sensible 'going rate' for the job and company results in the labour market, and paying for the individual based on their previous pay history and what they feel they are worth. RemCos can be tempted – often encouraged by short-term shareholder interests – to focus on the particular executive, especially in order to keep him or her. This habit can distort both individual reward and the wider labour market and reinforce the tendency to over-ascribe periods of business success to the capability and impact of the CEO (Koehn, 2014). This over-emphasis on what Peter Montagnon, Associate Director of the Institute of Business Ethics, calls the 'super-hero CEO' may be one reason why talent and succession strategy is often mentioned by researchers and regulators but features very rarely in interviews with RemCo Chairs. Interestingly, the lack of focus by the RemCo on the longer-term succession pipeline was a major concern to long-term institutional investors interviewed in this study. This issue may arise to some extent because executive succession is usually seen as the remit of the Board and the Nomination Committee, rather than the RemCo. However, it should be an important input to the RemCo's consideration of reward.

Performance definition and measurement versus performance management

The performance-related aspects of current pay systems require the RemCo to define 'performance'. The definition of performance is a key focus for the RemCo, and vital in both justifying the reward for success and avoiding payment for failure.

This definition is normally expressed in terms of metrics and targets, strongly informed by Board strategy and business plans. The RemCo then has to judge, based on business data and other inputs, whether these defined levels of performance have been met by the company and, where relevant to the pay system, by the individual.

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"HR goes through the scorecard and the RemCo might spend twenty minutes on that deciding what the CEO has been paid. Some Chairmen will then give the CEO a thorough review but others do not. There can be inadequacy in the way the CEO's performance is reviewed. I think it should be extended either to have all Board members or the RemCo reviewing the CEO in order to give richer feedback."

Alan Gillespie, RemCo Chair

However, the RemCo has to tread a fine line between defining and assessing performance, on the one hand and 'managing performance' on the other. Most RemCo Chairs are clear where this line lies, but some do see the RemCo – through its use of 'stretching targets' and 'incentives' – as being in the business of managing executive performance. As in previous studies (Christie et al, 2008), some in this study expressed doubts about whether the real processes for managing executive performance, through the CEO (for executives) and the Chairman (for the CEO), are always as robust as they should be.

In addressing its purpose (as defined in the previous section), the RemCo has to manage competing pressures from the labour market, investors, societal demands for tighter pay control and far more transparent reporting.

These pressures have increased the RemCo's focus on shareholder relations but also on how it should best support sustained business performance, manage risk and safeguard reputation. In this sense, the long-term success of the business is in itself a stakeholder for the RemCo, in addition to the two more obvious stakeholder groups of investors and executives.

Although the RemCo's specific remit is the reward of top executives and those on share-based incentive schemes, RemCo Chairs appear increasingly mindful of the relationship between pay changes at the top and in the workforce more widely.

This raises the question of who sets reward principles for the workforce as a whole and whether the RemCo should seek to influence this aspect of corporate strategy, especially if the Board is not adequately addressing it.

RemCos use a wide range of criteria in making judgements on appropriate levels and structure of reward, including, most importantly, how reward aligns with organisational performance, but also how decisions might affect executives psychologically, not just financially.

Positioning reward in broad labour market terms and as part of a talent strategy should be central considerations for the RemCo. But these considerations, including attention to the succession pipeline, often seem to be limited by an over-concentration on relative pay as the main way of interpreting the executive labour market.

The desire to attract or retain particular individuals can also dominate the focus of the RemCo and distort the company's strategic approach to executive reward.

RemCos are in the business of clarifying the definition of company performance and assessing performance for pay purposes, but they are not in the business of managing executive performance. This is a key accountability of the Chairman (for the CEO) and CEO (for their executives).

FOUR DIMENSIONS OF REMCO EFFECTIVENESS

Throughout the interviews about RemCo effectiveness, especially those with RemCo Chairs, the research highlights four main sets of issues that the RemCo needs to consider. They often also have to balance tensions between these different aspects – or dimensions – of effectiveness.

Four dimensions of RemCo effectiveness

- **Supporting sustainable business performance** is usually seen in terms of aligning executive remuneration philosophy and policy with business strategy, priorities and corporate values. This is seen in practice, for example, in the balance between short-term and longer-term components of reward and in the choice of performance measures and targets. If we see reward as 'supporting' business performance we also need to address the deeper assumptions made by RemCos about the impact of reward systems on executive behaviour and therefore on individual and organisational performance. Managing reward risk is an increasingly important aspect of the RemCo's potential business impact.

- **Managing key relationships** constructively is about the RemCo's understanding of and communication with the CEO, Chairman, executives and investors, but also with other key players inside and outside the business. This includes making the best use of support from HR and the external RemCo adviser. Nearly all the RemCo Chairs identified managing the in-built tensions between different stakeholders as the very heart of their role.

- **Governance and capability** concerns how the RemCo is set up and resourced to fulfil its purpose. The RemCo is a sub-committee of the Board and its effective operation requires appropriate boundaries and links with the Board and its other committees. The RemCo itself needs to have appropriate membership and the necessary skills and experience. The role of RemCo Chair is especially demanding.

- **Process and decision-making** is about how the RemCo, led by its Chair, goes about its work. The RemCo agenda requires active management throughout the year and at each meeting to ensure that it is sufficiently strategic and that non-executives receive relevant advice, debate issues fully and take well-informed and balanced decisions at the right time. Communication of decisions, both internally and externally, is of growing importance in this sensitive area. Both informal reflection and formal evaluation of the RemCo's effectiveness should also be part of its process cycle.

Four dimensions of Remco effectiveness

In effect these four dimensions constitute 'lenses' through which a RemCo can balance its attention, decision-making process and reflections on its own effectiveness. Solutions that may seem desirable from one perspective may be less so viewed through a different lens. In the next four chapters of this report we look at each of the dimensions, starting with supporting sustainable business performance, as this is the real end-game of the RemCo. We then move to relationship management – a crucial facilitator of RemCo effectiveness. Then we turn to the issues of governance and capability and, finally, to how the RemCo goes about its work in terms of its own process and decision-making. We come last to process, not because it is unimportant, but because it needs to be effective in relation to the other dimensions.

SUPPORTING SUSTAINABLE BUSINESS PERFORMANCE

The participants in the study see the RemCo's primary task as supporting the strategy, priorities and sustainable performance of the business. In other words the start point for executive reward should be what the business really wants to achieve. Several RemCo Chairs made the point that less experienced RemCo Chairs too often start with compliance.

It is not surprising that we find strong agreement on the necessity for clear 'alignment' between reward strategy and business strategy. If reward is supposed to reflect business performance then we need a clear message about how business performance is defined and how achieving it will influence reward. This is primarily what investors look for in their assessment of RemCo policies.

But beyond the apparently clear logic of 'alignment' lies a range of really challenging issues for the RemCos. These are concerned with the mechanisms through which executive reward achieves this alignment and may more actively support business performance.

- How is business alignment shown in RemCo reward policies?
- How do RemCos translate business strategy into performance measures and targets to be used in executive reward?
- What do RemCo Chairs and other key players believe about the impacts of performance measures – and their use in reward – on executive behaviour and business performance?
- How are RemCos addressing the increasingly important business issue of reward risk?

Each of these issues is examined briefly in this chapter and some of their consequences re-appear in the wider challenges raised at the end of the report.

"The less comfortable RemCo Chairs lean first to compliance and then to business alignment."

Bob Stack, RemCo Chair

3.1
Aligning remuneration policy with business strategy

The alignment of the approach to reward with business strategy should reinforce clear messages to both executives and investors about the priorities of the business. The RemCo is also required to justify reward outcomes in an increasingly transparent system, and generally does this by showing that reward is in line with how the business defines its performance. A potential advantage of this requirement is that messages about performance may be clearer and more specific – more 'granular' – than they otherwise would be.

"The number one role of the RemCo from an investor perspective is to ensure that the company strategy is supported by any incentive scheme and that the links are clearly explained."

Corporate Governance, Major Institutional Investor

The RemCo therefore needs to be well informed about business strategy and priorities, both short-term and longer-term, and alert to any significant business changes. These may affect what is required of executives and also – through targets – actual reward outcomes.

The RemCo maintains its business understanding through Board discussions and business plans, but also through ongoing dialogue between the RemCo Chair and both the CEO and company Chairman, who are best placed to spot upcoming issues or risks at an early stage. The wider background and activities of RemCo members, including their sector or market-specific knowledge, is also of great value to the RemCo in its wider appreciation of the business context.

Business alignment should be manifest in the general approach to executive reward, reflected in both the executive remuneration policy and the metrics and targets used in reward.

"We review our principles each year. It's a serious process, not just words. Ours relate to our purposes for the RemCo: the ability to attract and retain; incentivising adding value; transparency; and – increasingly – taking a responsible position in society on executive remuneration."

Ronald Schellekens, Group HRD

How is business alignment shown in remuneration policy?

Ways to demonstrate the alignment of reward policy with business strategy in remuneration policies can include the following.

- Clear statements of what success, improvement and planned change look like in both financial and non-financial terms and over both the short term and longer term.
- How these aspects of performance relate to pay philosophy/principles and are reflected in the main components of executive reward. For example, if the company has both a short-term bonus and a long-term incentive scheme (LTIP), what are these components trying to achieve and what should the balance between them be? If there is significant change expected in the business, how are the activities required to enable change and the milestones assessing progress reflected in the reward system?
- Timeframes for longer-term reward should relate to the timeframes over which business activities influence corporate performance – for example, how far ahead investments need to be made or products developed. These timeframes typically vary considerably by sector, although some institutional shareholders are applying pressure for a longer performance-plus holding period of five years for all LTIPs.
- How, if at all, organisational values, behaviours and culture change are reinforced by the reward system.
- The nature of business uncertainty and risk. Where can performance be projected with reasonable certainty and where does reward policy need to take account of a more uncertain business context?

"Articulating principles has been a really useful exercise, less to constrain what we come up with but more as a checklist when changes are being contemplated. If a proposal does not meet a particular principle, why is that? Is it that the principle is wrong or is the proposal wrong?"

Crawford Gilles, RemCo Chair

RemCo Chairs spoke of the articulation of reward policy as a challenging but useful task for the committee. Reward policy needs to go beyond motherhood and apple pie statements about business alignment. But policies that show only the detailed operating rules for implementing reward (via the standard 'policy table' or matrix) do not explain alignment either. RemCo policy needs to express in clear terms the business rationale for the approaches adopted.

3.2
Setting appropriate metrics and targets for reward purposes

Different types of metrics

The reward-business link is expressed through the range of metrics used to assess performance in order to trigger or distribute performance-related elements of reward. Types of metrics or goals found in this study include measures of the following.

- Financial profit or business growth.
- Return on capital employed.

- Lead factors that create future profit, such as assets (for example, commodity reserves in mining, product development pipelines in pharmaceuticals); health and safety (in construction and power generation, for example); environmental impact (in primary and manufacturing industries for example); customer retention and satisfaction (for example in retail).
- Key milestones for the delivery of business strategy (for instance, the successful integration of an acquisition).

Choosing metrics

Some RemCo Chairs favour using a varied basket of metrics to judge overall corporate performance for reward purposes, often linked with wider use of a 'balanced scorecard' approach. Others favour using financial metrics alone to trigger performance-related aspects of reward, but then may add measures to influence the proportion paid, sometimes on an individual basis against individual performance targets.

The advantage of financial measures is that they will only pay out when the business is delivering to shareholders. The disadvantage is that they may align neither with long-term business performance nor with executives delivering on strategic actions. They also send a cultural signal than only profit and growth matter. RemCo Chairs are mindful of the criticism that wider baskets of metrics may pay out more easily than pure financials, but the trend still appears to be towards this broader approach as being a truer reflection of corporate performance.

There is an argument that investors prefer pure financials, but the governance specialists in long-term investors interviewed in this study strongly favour the balanced scorecard approach. Other types of investors or fund managers may see it differently.

Including adherence to corporate values, agreed behaviours and ethics in pay metrics seems to be unpopular, even where employee feedback surveys are used to measure them. The argument is that all managers and leaders should be setting the right 'tone from the top', or they should simply not be there. This raises the uncomfortable question of whether leaving these behavioural aspects out of reward systems sends the message that they don't really matter.

Using share-price-related metrics to trigger reward is often used to demonstrate the alignment between executives' and investors' interests. However, share price may have little to do with executive performance, and executive behaviour certainly cannot control it. A wide range of interviewees pointed out that executive share ownership gives the required alignment of interests – often called 'skin in the game' – without also using share-related metrics.

Setting targets

Targets to be used in determining reward need to be stretching, but they also need to be achievable or executives may feel alienated by the whole reward process. But if bonuses based on targets pay out too readily, then bonus has in effect become part of the salary for top executives – as indeed seems to be the case in business today. This provokes not only external criticism but also bad feeling among top executives if they are not paid a bonus, even in a bad business year.

"We try hard to use measures that are meaningful and where executives can make a difference. A big part of the current executive package is in the long-term plan, a lot of which is driven by TSR. Executives are not motivated by TSR and often can't impact it, as it is cyclical and depends on too many extraneous factors. Some investors insist on its use as a metric, but this feels at times more about 'feeling our pain' than motivating executives."

Head of Reward

"Ensuring that there is real rigour around performance target setting is the key responsibility of the RemCo and that these targets are reviewed at regular intervals to monitor achievement. The targets must be sufficiently stretching in order to satisfy shareholder expectations, but realistic enough to motivate the executive team to achieve them."

Anne Minto, RemCo Chair

"People outside the company may think it's relatively easy to set the target levels of what profit growth will be possible, but actually it's extremely difficult. There is a view that over many years that people have been paid rather well, sometimes for relatively poor performance. As a result, there's been an overwhelming push from the public via politicians and from fund managers to have measurable targets. I can understand the background to all this, but often it's very difficult to set the appropriate targets and sometimes the targets themselves can actually become counter-productive in leading to behaviour which is against the interests of the organisation."

David Tyler, Company Chairman

A particular concern for RemCo Chairs are those situations – common during the faltering economic recovery of 2014/15 – when executives may be acting in the best interests of the business and performing well against the competition, but in a market where everyone has relatively weak financial results. RemCo Chairs feel that current pay approaches overpay when it is easy to make a profit and under-reward when conditions are tough. RemCos are criticised for revising targets downwards if business performance is lower than expected. But if targets are not revised, then the reward system seems to send the message that executives have not performed well, which may not be what the RemCo wants to say at all.

RemCo Chairs and HRDs are anxious about the confidentiality of business targets and also need to avoid providing forward guidance to the market. They argue that a policy framework needs to build in some flexibility and room for judgement when assessing performance. Investors, however, want performance targets to be clearly set and stuck to.

3.3
The RemCo's mechanisms for supporting business performance

So far in this chapter we have explored the alignment between performance and reward. One can aim for alignment without assuming a causal relationship between reward and performance. However if the purpose of the RemCo is to support business performance, then effective RemCos have a duty to be clear about how they might deliver such support. Here we explore just a few of the diverse beliefs and arguments about the mechanisms through which executive reward might actually support corporate performance. We draw on the views expressed in the research interviews, but this is, of course, one of the most hotly contested areas of theory and empirical evidence in human resource management (see, for example, the extensive recent review of research evidence by Campbell and Pepper, 2014).

A more focused message about desired business performance

The first argument is that the discipline of defining performance more carefully, through the measures and targets used in determining reward, will help executives understand in a more specific or 'granular' way what they are being asked to deliver. Variants on this 'messaging' argument are that 'stretching goals' can raise aspirations, encourage greater 'endeavour' and so on. Such messages, runs the argument, should affect corporate performance if the link with pay reinforces executive attention to these messages, in other words if executives – even almost unconsciously – adjust their behaviour to focus on the targets they will be paid for achieving. But while some reward specialists use this messaging argument, it was not much in evidence among RemCo Chairs. They believe that clearly-defined performance criteria are critical to sound governance, performance management and being able to justify and control reward, but they do not really think that top executives – especially CEOs – need performance messages to be linked with pay in order to help them understand agreed business priorities.

A possible extension of the messaging argument, is a link with how the workforce sees executives being rewarded and whether employees see a clear tone being set from the top in terms of what the business values and how everyone should behave. This will work only if the workforce understands executive reward, which seems rather unlikely at present.

Incentives versus rewards

If senior executives are significantly interested in what they earn, then does an effective RemCo 'incentivise' them to change their behaviour to deliver the specified business results? In other words, do senior executives consciously change their behaviour to get the money?

Here we see a rather muddling difference between how people talk and what they believe. Many of those interviewed – especially HRDs, Heads of Reward and the majority of RemCo Chairs – talked at some point about executive reward 'driving' business performance, often through the use of 'stretching targets' and short-term or longer-term 'incentives'. These turns of phrase imply that executive reward systems cause improved corporate performance by affecting executive behaviour. Interestingly, this language was not used by external RemCo advisers very much, or indeed by regulators or investors, who place more emphasis on business alignment being used to justify reward, as we see below.

The terms 'bonus' and 'incentive' are often used loosely too. Wills (2014) draws the distinction between a bonus and an incentive. He defines bonus as "an ex gratia reward … which typically either ... shares [profit] achievement or … represents post facto recognition of an achievement as in 'if you get it, it's a bonus.' An incentive is part of a performance contract – where the employee is motivated (incentivised) to achieve (or focus on) certain goals and to adopt or change certain behaviours via the contingent offer of money." In these terms the executive annual bonus is not really a bonus, and – for reasons outlined below – the long-term incentive plan is not an incentive.

In deeper discussion, RemCo Chairs do not really think that executive reward 'drives' performance in any simple way. They made a range of more subtle points about their own experience of the motivational impacts of executive reward, as follows.

- RemCo Chairs are sceptical about whether top executives are amenable to being 'incentivised'. They see them as intrinsically motivated to succeed, fairly determined to achieve the business strategy in their own way and having very varied personal attitudes to reward. Money is often important, but maybe more in terms of recognition and a signal of their worth than financial gain itself. RemCo Chairs spend a lot of time and effort seeking to understand what motivates their executives, but they are generally sceptical about pay as a motivator in any simple sense. These are interesting issues, worthy of in-depth research, especially from the executives' own point of view, both at the top and in the wider executive population lower down.
- Current pay systems are seen as too complex to motivate, or even 'focus', executives because they contain too many – possibly conflicting – metrics.
- Some RemCo Chairs and advisers are sceptical about whether executives fully understand their pay.
- The jobs of top executives are very complex and they influence business outcomes indirectly and over long periods of time. Some metrics – notably those related to share price, such as Total Shareholder Return (TSR) – are certainly not under the control of executive behaviour. RemCo Chairs and advisers also tend to think that executives discount the value of longer-term rewards, both because they are so far away and also because their real value is unknown. For these and other reasons there is widespread agreement that LTIPs are misnamed, as they reward but cannot 'incentivise'.

"In big public companies money is important and is something the CEO will argue for. If you ask 'will it change their behaviour?' If it does you've probably got the wrong person."

Tony Ball, RemCo Chair

"A lot of this is about whether an individual feels well looked after, whether they feel respected and can earn a reasonable sum compared to what they think they can earn elsewhere. If you feel you are not being paid your market worth, you may feel quite demotivated. If you feel you are being paid your market worth, you will tend to feel more comfortable about it."

David Tyler, Company Chairman

"The role of remuneration for the individual executive varies from person to person. Some are clued up on what their remuneration is and are driven by monetary reward, often as a form of recognition and status. But also there is reward in having done the right thing and being paid for that, and others for whom monetary rewards are secondary to creating a great company. We need to understand what really drives and motivates individual executives – this may not affect the basic packages but can tweak the emphasis."

RemCo Chair

"Shareholders are mostly wedded to an agency model of the world that says you have to load people up with incentives otherwise they won't get out of bed."

Tom Gosling, RemCo Adviser

- Several very experienced non-execs worry that targets may do as much harm as good, by putting reward pressure on executives to 'hit the numbers'. In these jobs subtle adjustments of priorities and behaviours are crucial to effective leadership and there is a risk of large scale loss in value if the ethics and values of key individuals – especially the CEO and CFO – are compromised. This concern is relevant to the new regulatory emphasis on executives setting the right 'tone from the top', and we return to this challenge at the end of the report.

Pay control, justification and reward risk management

RemCos can perhaps be seen as supporting business performance more realistically and productively through effective pay control and clear pay justification. These two aspects go hand in hand and may improve business performance through containing the cost of executive rewards and improving trust, critically from shareholders but perhaps from employees and the public too. Both control and justification are central to avoiding high pay-outs for poor performance. They are also linked to the growing importance of reward risk management, which is covered in the next section.

Quite a lot of interviewees said that RemCos are expected to use performance-related pay as an 'incentive' because that is how investors think the world works. The long-term investors interviewed in this study were actually primarily interested in pay control, justification and risk management. However several RemCo Chairs and advisers made the point that not all shareholders have this long-term focus.

Share ownership by executives is widely seen as justifiable in the sense that it requires them to experience the same pleasure and pain as their major investors. This does not necessarily assume that shareholding changes behaviour in very specific ways, but it may be an important part of the 'message sending' role of the RemCo. It may also help to avoid behaviour that might directly risk loss of share value.

A rather cynical perspective on pay justification – voiced by several of the most experienced advisers and HRDs – is that current pay systems are really just a way of paying roughly the right total amount in a way acceptable to shareholders. If that is really what the RemCo is up to, one can think of much simpler ways of doing it.

3.4
Lack of evidence that reward relates to performance

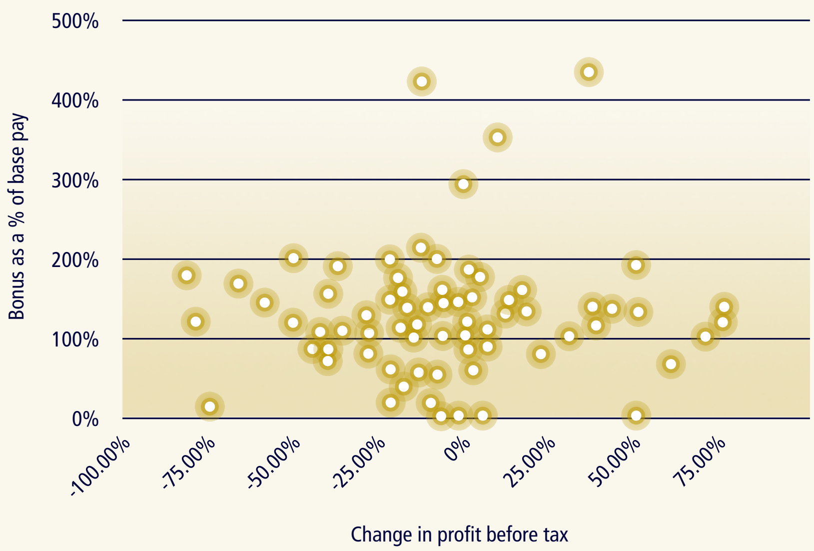
Now that so much pay and corporate performance data is in the public domain, there is a real opportunity to see if the links from reward metrics to executive behaviour to profits are evident. As researchers have known for many years, this logic chain is very difficult to prove in complex jobs with long impact periods. But over much shorter timeframes, if the system were working effectively, one would expect to see at least an association between higher profitability and reward in the simpler areas of salary and bonus. Longer-term reward packages are much more difficult to assess and there is disagreement about how best to value them.

At present, the evidence that salaries or bonuses are associated with differences in measures of corporate performance over time or between companies seems very weak indeed. This is shown by the illustration below as well as in much larger-scale studies (for example IDS, 2014; IRRCi, 2014). Larger companies pay more, but reliable correlations between executive pay and other company performance metrics are not found.

"Using publicly available data on executive reward and company performance, one can see that larger companies do generally pay more, but there is no strong evidence of a correlation – let alone a causal relationship – between the commonly used corporate performance measures and executive reward. The graph below, to give just one example, shows the absence of correlation (in published data as at February 2015) between bonus payments and changes in profitability in the FTSE 100. Many were paying high bonuses when profits were falling. The relationship between short-term or indeed long-term performance and reward is much more complex than simple analysis of headline financial measures will allow."

David Brooks, Executive Remuneration Data Expert

Change in profit v bonus as % of base



Meis Executive Compensation Data, 2015. Note: the graph excludes outliers with bonus payment in excess of 500% of base or changes in profits in excess of 100%.

"We are interested in how risk appetite is reflected in remuneration policies, for example the risk of trying to meet targets but failing to invest in the longer term and the reputational risk of putting in a high package to attract a particular CEO and then having shareholders revolt."

Guy Jubb, Head of Governance and Stewardship, Major Institutional Investor

3.5
Managing reward risk

The management of reward risk is central to good governance and has become a much more significant factor for RemCos in supporting sustainable business performance. There is obvious risk to the business if payments encourage the wrong behaviours in executives and are seen as either too high or too low. Poor handling of reward risk almost inevitably leads to adverse media coverage and possibly long-term damage to corporate reputation. Companies will have different levels of appetite for risk in their business strategy; reward risks should be part of this consideration.

Some reward risks are easier to identify and respond to than others. Risk can arise from financial or business issues that the RemCo should already be aware of, for example the possibility of lower than expected profits or accounting problems already known to the Audit Committee. This study shows that many RemCos already try to identify possible adverse pay consequences of existing business issues, especially through ongoing dialogue with the CEO and Chairman and formal links with the Audit Committee.

A different type of risk is inherent in business plans or reward approaches that may have unintended consequences. RemCos need to anticipate such risks and, perhaps, use the reward system to help mitigate them. For example, it is intrinsically risky to pay exclusively on financial targets in an industry where there are big physical and environmental risks. The management of this second category of reward risk is at an earlier stage of its development but some actions are suggested by this study.

- The explicit use of business scenarios – and asking 'what if' questions – in designing reward strategies and setting targets is a practical approach to addressing unforeseen reward risks.
- In the design and approval of incentive plans, a specific section of the proposal to the RemCo should be devoted to an analysis of potential reward risks and their mitigation.
- There should be a good overlap in the membership of the Risk, Audit and Remuneration Committees, or their equivalents. Occasional formal meetings of the Risk and Audit Committees with the RemCo might help identify, assess and mitigate reward risks.

A tool to assist with the analysis of reward risk is included as Annex A. It defines risk areas to be checked and questions that could usefully be asked by RemCos.

Aligning executive reward with business strategy should be the key consideration in framing RemCo policy. RemCos have found the need to articulate policy and principles challenging but very useful. RemCo policy needs to express the **why** of reward approaches, not just the **how** and **what**.

Setting metrics and targets to be used in the performance-related aspects of executive reward is one of the RemCo's most difficult tasks. There are tensions between using limited financial metrics (high on clarity but dangerous as the only measures of success), wider baskets of measures (more reflective of business strategy, but too complex to give clear focus) and measures relevant to shareholder value (not under the control of executives). Targets need to be stretching but attainable. Targets do not work well in uncertain business contexts and risk distorting behaviour.

There is a lack of clarity about the mechanisms through which RemCos can really support business performance. RemCo Chairs are sceptical about whether current pay systems can effectively 'incentivise' executives to change their behaviour in ways that might lead to improved performance. There is also a lack of evidence that performance-related pay actually relates to corporate performance – hardly encouraging a view that current systems 'work'.

It seems more practical to achieve and demonstrate the alignment between executive reward and business performance through a clearer and more granular definition of 'performance', through improved pay control, through managing reward risk and through offering a clear justification for reward to executives themselves, investors and, potentially, the wider workforce. The share-related components of reward are primarily there to serve the legitimate purpose of demonstrating that executives share some of the risks faced by investors.

RemCos need to pay systematic attention to the management of reward risk in the design and implementation of reward systems.

MANAGING KEY RELATIONSHIPS

"The RemCo is where the rubber of company performance hits the road. It can be very personal. It can be the emotional fulcrum of the Board."

Carol Arrowsmith, RemCo Chair

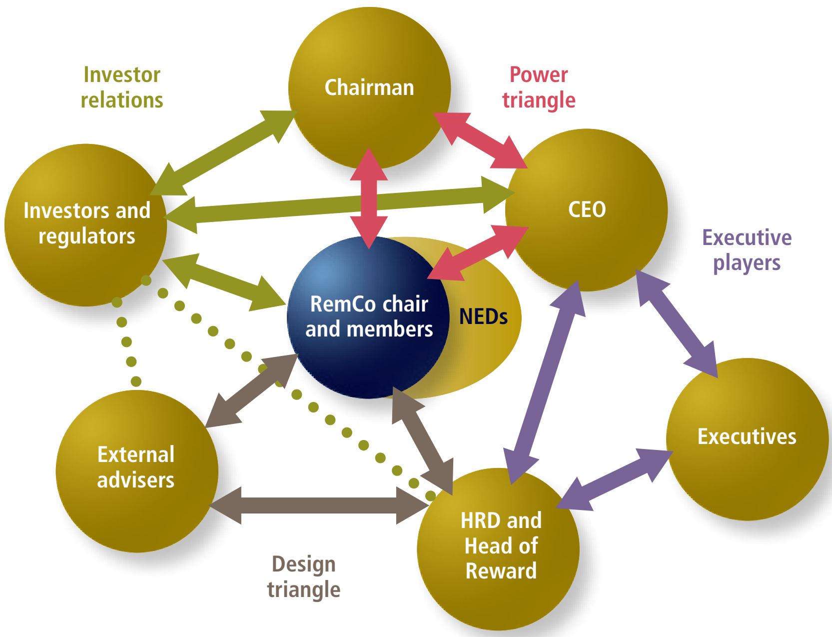
In this chapter we address the key relationships that the RemCo Chair needs to manage, the roles that other players have in the work of the RemCo, and the practical techniques RemCo Chairs adopt for working effectively with others.

4.1
The web of RemCo relationships

Most of the RemCo Chairs interviewed believe that managing relationships, through appropriate communication, is their biggest challenge and where they spend most of their time.

The RemCo Chair needs to deal with an unusually complex web of relationships, some of which are shown on the diagram below.

The web of RemCo relationships



- The RemCo Chair, members and the other non-executives around them are shown in the centre of the diagram. They link with other players on the Board and also need to interact with other Board committees, as we will see in Chapter 5.
- The leading company players in executive remuneration are the RemCo Chair, CEO and Chairman. We will call them the 'Power Triangle', both because of their key influence and because managing the balance of power between them over matters of executive reward is a key factor in RemCo effectiveness.

"In terms of ultimate control over decision-making, what is the balance between the RemCo chair/company chair/CEO? ... it is important to recognise that these three roles will on occasions be reflecting different value perspectives and/or different (legitimate) stakeholder perspectives"

(Wills, 2014)

- What we here call the 'Design Triangle' – the RemCo Chair, HRD/Head of Reward and the RemCo's external adviser (sometimes more than one). They are the main source of data, resource and expertise to support the RemCo. Design lies at the heart of what they do, but in a broad sense, ranging from strategy to policy options to detailed mechanics.
- The executive players – the CEO, their executives (especially the top tier) and the HR function are those from the management most involved in influencing the RemCo and are also personally affected by RemCo decisions. HR also implements RemCo decisions.
- Investor Relations centres on the RemCo Chair for executive reward purposes, but involves a wider range of players – especially the Chairman and CEO – on other business aspects.

The Company Secretary is not shown on the diagram but is a key facilitator in several areas of this web and can smooth the path of issues through complex sequences of discussions. They also play an important role in compliance and reporting.

The RemCo needs to consider other stakeholders too, such as the wider workforce, the media and politicians, but the RemCo Chair does not often have such important or direct relationships with these as a core part of their role.

The RemCo needs the active support of both the top executives and shareholders to deliver on pay policy, detailed design, reporting, approval and execution. RemCo members also cannot let any friction over executive reward compromise their effectiveness as Board members. The management of these key relationships in a constructive way is a really difficult thing to do. It is time-consuming, patient and skilful work and much of it falls to the RemCo Chair. The intervals between RemCo meetings are where the RemCo Chair is often busy building the relationships with their key stakeholders and managing potential areas of conflict or difficulty.

Yet tensions are built into the RemCo's web of relationships, arising from the fundamental purpose of balancing the interests and desires of the CEO and executives, those of investors and the long-term health of the business. Some spoke of the RemCo Chair having to hold these tensions and work with the ambiguity inherent in their situation.

4.2
The Power Triangle: RemCo Chair, CEO and company Chairman

The relationship between the RemCo Chair and the CEO is central to managing executive reward and the potential for conflict is clear. The balance of power between these two key players is difficult to manage well. The CEO is running the business and managing the performance of their executives, while the RemCo Chair represents the interests of shareholders and may need to lead their committee to refuse the CEO's wishes.

"The RemCo needs continuing dialogue with the executive and the CEO. You need to gain their confidence, not in doing what they want but in your objectivity, that you will use data and look sensibly at it and listen to them. It can go awry if the executive feels 'done to' and there is not a dialogue."

Helen Owers, RemCo Chair

In practice, the RemCo Chairs interviewed – most of whom have also been CEOs – seek to establish a constructive relationship over reward issues with the CEO. They do not have a single recipe for success, as the approach will depend on the CEO themselves. Some emphasise that it takes time to reach a satisfactory way of working with a CEO, and that this time has to be put in again whenever either they or the CEO is replaced. The RemCo Chair needs to listen to the CEO, probe carefully and try to reach a really good understanding of the CEO's business thinking, what is driving this and their attitudes or sensitivities around reward, both for themselves and for others.

Although RemCo Chairs do not wish to get too close to a CEO, especially in the run-up to a key meeting, they do often plan informal one-to-one sessions and opportunities for less constrained exploration of pay options with the CEO and HRD, Head of Reward, external adviser and sometimes the Chairman.

The company Chairman is the third player in the Power Triangle and needs to balance the interests of the executives and the shareholders. The Chairman is key to dealing with any tensions in the RemCo-CEO relationship. They have the most important conversations with the CEO about their own reward and performance and can also – often through informal meetings – bring emerging business issues or risks to the attention of the RemCo Chair. The Chairman is especially important but may find themselves under pressure from the shareholder if the CEO is unrealistically demanding about their own reward and/or the business is under-performing so will be under pressure from its shareholders. The Chairman may also be a key link with the Nominations Committee, especially when a CEO or top executive is leaving and a replacement is being appointed. As we have already noted, getting executive remuneration right on entry and exit is extremely important.

The CFO is not shown explicitly on the diagram but is also involved in this area of the web, especially in making sure the RemCo Chair fully understands the measurement of financial performance and any related financial issues.

The HRD can be active in this triangle behind the scenes. One referred to this as 'smoothing issues through' between the RemCo Chair and CEO and keeping the Chairman in the picture.

4.3
The Design Triangle: RemCo Chair, HR and external adviser

"It feels like a partnership, but a partnership on the RemCo Chairman's terms not yours ….. The HRD has to be able to give the Board and the CEO messages they may not want to hear. If the RemCo think you are the union rep for management, your credibility with them will disappear in an instant."

Mark Wells, Group HRD

The Design Triangle consists of the RemCo Chair, external adviser and HRD and/or Head of Reward. They deliver much of the concrete work of the RemCo. The role of this triangle is a strategic one, not just focused on technical solutions. It also has to examine factors both outside the company (for example, pay trends and labour market data) and inside the company (for example, performance evidence).

The role of HR

It is common to consider the relationship between the RemCo Chair and the CEO as the most crucial, but the interviews in this study also highlight the complexity of the role played by HR in executive reward and therefore the importance of the relationship between the RemCo Chair and the HR function, which often involves both the HRD and a Head of Reward.

RemCo Chairs interviewed in this study clearly value the understanding and input they get from HR in at least three areas.

- HR insiders can give the RemCo Chair a much fuller understanding of the business: key people at the top and groups of people lower down, aspects of business and reward history, and internal pay and performance data.
- HR can challenge the RemCo to consider the possible outcomes and implications of its decisions under different business scenarios.
- HR conducts much of the 'heavy lifting' of developing remuneration policy and structures that a RemCo Chair generally lacks the time, resources or expertise to do. The Head of Reward role has become more important partly in response to the growing demands of RemCo work (Hedley May, 2013).
- HR is often a vital communication conduit on the rationale for reward decisions between the RemCo Chair and the executive population, at a range of levels. As we have seen, the RemCo Chair must be wary of getting too close to the CEO; the HRD is often a useful message carrier between these two.

The HRD needs to be independent of the CEO in matters of the RemCo, and yet, of course, also works for them and is often affected by the same pay structures. It may be easier for the Head of Reward to be more independent, being somewhat further from the CEO. The RemCo Chair needs to be able to have absolute trust in the integrity and discretion of both the HRD and Head of Reward.

The split of work between the HRD and Head of Reward (if there is one) depends also on the interests and skills of the HRD. Dealing with executive reward is an interesting and strategic aspect of HR work for many HRDs, but it is also very time-consuming. HRDs need to strike the right balance between their support for the RemCo, especially its Chair, and their wider strategic role for the whole workforce.

The contribution of external advisers

The RemCo appoints its own external adviser(s) to give independent information and advice. With increased reporting, RemCos have no lack of data but may still feel they lack insight into external trends.

The role of external adviser often includes the following.

- Provision and analysis of comparative pay data on other companies, as we will examine in Chapter 6. Interpretation may now be more important as reward data is now mostly in the public domain and new providers are coming into the market with innovative approaches to giving RemCos more direct access to data and the ability to interrogate it.
- Trends and ideas in reward systems come from the specialist expertise of advisers and their daily contact with a wide range of companies.
- Detailed understanding of regulatory frameworks and any changes in these. Advisory firms run seminars on these areas, which also provide RemCo Chairs with opportunities to network with each other.

"It's really important for advisers to say what they really think. My biggest criticism of the remuneration advisory sector is that there are relatively few people who are willing to do that and say 'I think you should do X'. I won't always go along with it but as a Chair, I really value it and don't get enough of it."

Crawford Gilles, RemCo Chair

"You need an adviser who can grasp business strategy, culture and issues and find something to help the company with its objectives. Their ability to communicate with the Board members and management is key – they must be able to tune to their audience."

Bob Stack, RemCo Chair

- Understanding of how investors are responding to remuneration trends and issues is an area of growing importance and is more visible to external advisers than internal HR specialists.

Although external advisers are sometimes criticised by commentators and HRDs for having a vested interest in making remuneration a dark art, the RemCo Chairs in this study really value their advisers. All of the RemCo Chairs interviewed make use of external advisers, but to different degrees, partly reflecting the personal preferences of the RemCo Chair but also depending on the extent of expertise within the RemCo and the company's HR function.

The FTSE-100 adviser market is worth over £10m per annum, with the median fee expenditure for a FTSE-100 company being £81,500 in 2014 (Meis, 2015).

Both the adviser and the RemCo need to use judgement when looking at pay and performance data. RemCo Chairs do not want to be too dependent on their external advisers but do want them to provide genuine insight and advice, making the external adviser more of a strategic consultant than merely an accomplished technician.

Experienced RemCo Chairs choose their advisers with great care, being more concerned about the individual themselves than the firm they work for and regularly reviewing this appointment. RemCo Chairs want the adviser to be technically expert – that goes without saying – but beyond this to understand how other companies and investors are thinking, to be sensitive to business context and an excellent communicator at Board level. The external adviser can sometimes say things to the CEO in a meeting that the RemCo Chair cannot so easily say themselves.

"The real tennis match is happening between the adviser and HR."

John Beadle, Head of Performance & Reward

One of the most intriguing relationships lies along the third side of the Design Triangle – between the external adviser and the HRD and/or Head of Reward. One reports formally to the RemCo Chair and the other to the CEO, so in formal terms they are somewhat in opposition. But they must also work effectively together if the RemCo is to receive coherent proposals. Some of these pairings clearly establish very close working relationships as they hammer out reward options. RemCo Chairs need to make sure that this relationship does not get too cosy, risking the external adviser becoming in effect a member of the HR team and losing their ability to give an objective, external perspective. Partly for this reason, RemCo Chairs often meet with their external advisers and their internal HR team together, but also find time to see their external advisers alone and have some presentations to the RemCo from external advisers with no executive players present.

4.4
The Executive Players: CEO, Executives and HR

"It's very dangerous for non-execs to stray into the executive world. My job is really to talk to the chief executive, and sometimes to involve the CFO in that discussion. They are his executives not mine. My job is to listen to what the CEO says about the views of his executives."

Roger Davis, RemCo Chair

There are obviously very close working links between the CEO, the executives under them and the HR function, which acts as their main internal support on reward issues.

RemCo Chairs are mindful that they should not cut across reporting lines between executives and the CEO, but they still need to understand what executives are thinking and feeling about reward. Some RemCo Chairs do feel they should talk to executives (beyond the CEO and CFO) about reward, but most believe that too much contact may compromise their impartiality. HR in some companies provides a link between the RemCo Chair and executives without cutting across their main communication line on performance and reward with the CEO.

4.5
Relationships with investors

The RemCo Chair is the main contact with shareholders over matters of executive reward, and this role has developed considerably over recent years. There is wide agreement about how to manage these relationships effectively, including the following.

- Ongoing communication between the RemCo Chair and major investors, including early notice of any significant changes in remuneration approach.
- Face-to-face meetings, when necessary, between investors and the RemCo Chair. The RemCo Chair may be accompanied by the HRD or Head of Reward for technical support, or the Chairman if wider business issues are on the agenda. External advisers are not normally present at these meetings but do have significant contact with investors in other settings. The CEO and CFO also meet investors, but not at the meetings with the RemCo Chair.
- All those in the Power Triangle need to be mindful that the fund/investment management teams in institutional investors may be giving messages to the CEO or Chairman that differ from those their corporate governance colleagues are giving to the RemCo Chair.

Where dialogue takes place, good relationships can be built, although effort has to be made to re-establish these when the RemCo Chair changes. As we will see later, ongoing dialogue is more problematic for smaller companies or those with less interested investors.

In terms of what investors are looking for, they obviously expect acceptable returns on investment and a fair balance between capital expenditure, dividends and incentive payments. They also want to see clarity of business strategy and how reward is linked to this; how reward timeframes are balanced; whether the business can deliver on its strategy (for example, not revising targets downwards); how well risk is understood and managed; and management strength, including succession. They also want to be sure that the RemCo is really in control of pay, especially that of the CEO (by being able to give a clear explanation of bonus payments, for example). Investors certainly do not want a company with weak governance or at risk of negative press coverage for its reward practices.

The small numbers of institutional investors interviewed think that matters of executive reward are now taking up too much of the corporate governance agenda. They are not so much interested in executive reward per se, but do emphasise the importance of the RemCo Chair's ability to give a clear and compelling account of the rationale for reward in business terms. That link, in meetings and in written reports, between business strategy and reward strategy, plus clear evidence that non-executives can challenge the CEO over matters of performance and reward, are signals for investors about the strength of the company's governance in general.

"Shareholders want to be able to look the Chair of the RemCo in the eye. They want to be sure that person is on top of matters. I don't believe they want to see advisers with you. I generally take the HRD or Head of Reward with me to answer detailed technical questions."

Crawford Gilles, RemCo Chair

"Many RemCos, and probably shareholders also, care more about the alignment of outcomes than about incentivisation at the top of the shop. This is partly because they are sceptical about the incentive effect of reward and partly because the model of incentives we've ended up with is formulaic and isn't necessarily incentivising."

Mark Reid, RemCo Adviser

"As RemCo Chairman you are not just an advocate for what the HR function has come up with. You are there to listen to the shareholders and take on board their concerns. This builds trust and respect with the shareholding bodies.

Tony Ball, RemCo Chair

MANAGING KEY RELATIONSHIPS

"If as investors we have a good level of communication with the RemCo and we are being consulted on the things that are important, then there should be no surprises and no need for things to boil over at the AGM. "

Corporate Governance, Major Institutional Investor

The RemCo, and especially its Chair, navigate a complex set of relationships. Two sets of triangular relationships within the business are especially important: the Power Triangle of the RemCo Chair, CEO and company Chairman, and the Design Triangle of the RemCo Chair, HR function (HRD/Head of Reward) and the external RemCo adviser(s). Managing relationships with investors on the subject of executive reward is a RemCo priority. RemCo Chairs need to do the following.

- Understand the boundaries of their own role and respect the roles that others are playing and the pressures on them.
- Listen attentively to the business and personal perspectives of all stakeholders and respond to their concerns. It is the listening that helps with judgement and the responding that helps to build trust.
- Judge the right degree of proximity, especially with the CEO – close enough to understand but not so close as to compromise independence.
- Get the best from the expertise available through the HRD, Head of Reward and external adviser(s), and make sure external advice remains independent from internal preferences.
- Respect the normal patterns of management accountability for people and their normal paths of communication.
- Recognise and attend to the key role of communication with major investors.
- Plan in opportunities to keep all stakeholders appropriately informed, to raise issues early, be consistent in communication and avoid sudden shocks or unwelcome surprises.

GOVERNANCE AND CAPABILITY

This section summarises how RemCos are set up, including their relationship with the Board and its other committees. We look at the membership of RemCos, including the potentially tricky issue of who attends RemCo meetings. We also consider here the skills, personal attributes and experience required by the RemCo Chair and members of the committee.

5.1
The RemCo, the Board and the executive

There needs to be a clear view of the relationship between the RemCo and the Board, of which it is a sub-committee. As we have seen, the focus of the RemCo can vary in its breadth, so the boundaries between what the RemCo does and what is debated and decided by the Board are important. Useful questions to determine this might include the following.

- Does the RemCo have clear, appropriate and regularly reviewed Terms of Reference (or Charter) from the Board? Does this make clear which decisions are formally delegated to the RemCo and which come back to the Board for discussion or approval?
- Is the RemCo getting enough clarity from the Board on business strategy, priorities and targets – that is, how business success is defined and how it will be assessed?
- Does the Board establish a clear workforce and employment strategy and monitor its implementation, for example in overall reward strategy, leadership behaviour and ethics, and executive performance management?
- Does the RemCo translate the business agenda and its Terms of Reference into priorities for itself in a particular year? Are these reward priorities shared explicitly with the Board? Some suggest that it would be good practice for the Board to set the RemCo formal objectives each year.
- How do the practical communication links work between the RemCo, the Board and other sub-committees? How do RemCo members keep abreast of key issues in risk, audit and nomination?

The interactions between the RemCo and the Board are essential to its serving the strategic needs of the business. If too remote from wider Board concerns, the RemCo will tend to become preoccupied with compliance or technical pay issues rather than the bigger business picture.

The relationship between the Board committees is important to the effectiveness of the RemCo. No one interviewed thought that existing committees could merge, for example by Risk combining with Remuneration. The workload on remuneration is simply too heavy for this to be practical. However, there were calls for the RemCo to have more systematic dialogue with the Risk Committee, perhaps through regular shared meetings. The research also highlighted the weakness of a RemCo that is not close enough to the Nominations Committee on succession and contracts. The link with Audit seems to be more easily made, its work being more procedural.

"A Remuneration Committee must never forget its umbilical cord to the Board. As a Board committee it is there to help the Board fulfil its responsibilities. Therefore, the Remuneration Committee must always be mindful of how it can assist the Board in promoting the success of the company, by linking pay policies and their implementation to not only operational and financial risks but also ethics and business practices."

Guy Jubb, Head of Governance and Stewardship, Major Insitutional Investor

Beneath the formal mechanisms of governance, there are subtle but important issues around the balance of power between executives and non-executives in determining executive reward. We have discussed these to some extent with reference to the way relationships are managed (in Chapter 4), but they also have implications for the processes we will examine in Chapter 6. For example, it is important that executives do not over-influence the proposals the RemCo sees on executive reward. If the RemCo is too dependent on proposals coming from HR and/or if HR is too heavily influenced by the CEO, the RemCo risks rubber-stamping executive proposals on their own reward. This is one reason why the role of the external adviser is an important one.

5.2
RemCo membership and attendance

The RemCo must consist of at least three independent non-executive directors, including its Chair. The company Chairman normally attends but should not be the RemCo Chair, although they may be a RemCo member. The Company Secretary also normally attends and acts as the secretary to the committee.

This study found considerable variety in the size of RemCos. A smaller RemCo is obviously easier to convene and to brief. A larger one brings a greater range of corporate experience and potential diversity in terms of demographic variables and career background. Meis (2015) recently counted 83 female RemCo Chairs in the FTSE 350.

In some of the companies in this study all non-executives sit on all sub-committees. Those involved in such arrangements find them more efficient than one might expect, as little time needs to be spent on briefing non-executives on what is happening in various committees. It may also be easier for the RemCo to keep abreast of audit, risk and nomination issues and integrate these into reward thinking.

Attendance at RemCo meetings should involve formal invitations to the Chairman (if they are not already a Committee member), CEO and HRD or Head of Reward (sometimes both). Typically, however, this is not the case and their exclusion from the meeting is by exception, for example when their own pay is being discussed. Thus current practice seems at odds with earlier guidance that the CEO should only attend when strictly necessary (PwC, 2006). As pay structures for the CEO and other top executives (including the HRD) are typically very similar, the CEO and HRD do more or less attend the committee that sets their own pay structure. Those involved seem to find this quite normal, but it is a curious arrangement from a governance perspective.

As already noted, in some companies external advisers are nearly always present at RemCo meetings, while in others only attend them by exception – to give the RemCo an overview of external trends, for example. This very varied involvement of the adviser seems to depend on the knowledge, skills and comfort level of the RemCo Chair.

5.3
RemCo capability

What makes for a good RemCo Chair?

The Chair of the RemCo has an exacting and increasingly challenging role. They require the knowledge, skills and commitment to lead an increasingly complex area of corporate governance and to build constructive relationships with competing interest groups.

The research interviews showed a high degree of consensus on what to look for in a RemCo Chair. The list below summarises the interviews.

A RemCo chair needs the following attributes.

Strategic business understanding – both general (usually from direct executive experience) and the ability to acquire an understanding of the specific company context and history.

Relationship management and emotional intelligence (EQ) – the ability to listen to and communicate, negotiate and engage with a range of stakeholders including the CEO, Chairman and investors. Empathy – seeing issues from the other's perspective and understanding what is driving them – is vital. Judging how close relationships need to be is an especially demanding aspect of EQ in this role. RemCo Chairs need to be able to manage ambiguity and negotiate in these relationships while minimising conflict.

Chairing skills – especially in ensuring that meetings are well planned; that time in meetings is spent to best effect; getting input from the whole committee and not imposing their own views; and getting to clear and timely decisions.

The ability to get the best from internal and external advisers – with an awareness of what is driving their advice.

Diligence and ability to master detail and technical information on pay systems, trends and regulation. Numeracy and financial skills are important. The RemCo Chair needs to be willing and able to attend to the details in technical proposals.

Judgement in weighing up the competing interests of stakeholders, reward risks and the impact of decisions on executives and the business. An understanding of where and how reward links with wider aspects of the employment relationship with executives and their engagement with the business.

Moral courage, often called 'backbone', to challenge others' views and stand by what they see as the right thing to do. This may also involve going against prevailing fashions or advice and taking a more independent or innovative view.

"The RemCo Chair and those advising them need IQ, EQ and backbone. Everyone involved is smart. The real challenge lies in the EQ and the backbone."

RemCo Adviser

"You need the ability to understand how executives are going to view certain decisions – a certain empathy with them, but without losing your independence and objectivity. There is a danger that if you only talk about technical issues the whole thing becomes quite a left brain process where in fact success needs a lot of emotional intelligence. A RemCo Chair also needs to fully understand the context of the organisation. Experience elsewhere is useful but also a potential trap. You need to understand not only the business strategy but what has gone before in terms of decisions and rationale for what has happened in the past. What have been the issues, the challenges, the influences, the expectations? What is the baggage that everyone else is bringing to the discussion?"

Crawford Gilles, RemCo Chair

"Investors want a RemCo Chair they can have confidence in, and one preferably with executive experience – not an ex-civil servant or someone based on the West Coast of America."

Company Adviser

"The level of inherent tension is high and it takes a particular skill to maintain that tension at the right level while keeping the discussion productive.

It's a broad generalisation, but I've observed that women can be particularly good at this."

Tom Gosling, RemCo Adviser

"I wouldn't want to see HRDs selected to serve on Boards solely because the company wants them as a RemCo Chair. You must be selected for your all round corporate experience and capability to contribute to all matters on the Board agenda."

Anne Minto, RemCo Chair

The role is especially taxing if the CEO is over-demanding, the Chairman is less interested or unsupportive, or the business doing poorly. In such difficult situations the RemCo Chair has to ramp up their attention to evidence-based considerations and to stand very firm.

Ex-CEOs need to pay conscious attention to their role as Chair of a committee and avoid either being too remote from the detail or too ready to 'come up with all the answers' themselves. Likewise ex-HRDs or CFOs are there as Board members first and just happen to bring more in-depth technical knowledge of HR or finance. Their challenge is perhaps not to get bogged down in those aspects of the detail most closely related to their own profession.

Several RemCo Chairs advised others not to jump straight into the role of Chair on joining their first RemCo. This can be a pressure on ex-HRDs in particular. It helps to see one or more RemCos in action before chairing one.

Skill and experience criteria for RemCo members

The RemCo Chair needs a strong group around them with many of the same skills. Breadth of experience is helpful, including experience of other sectors and geographies. Direct experience of other Boards and RemCos can refresh RemCo processes. Strong financial skills are key and understanding of executive reward needs to be acquired.

It is an advantage in many respects that most RemCo Chairs and members have been top executives themselves. This can bring both business and personal understanding and, of course, credibility with the CEO, executives and shareholders. However this shared background may also contribute to a lack of challenge of current assumptions and executive pay practices. It may also partly explain the slowness with which the UK plc sector has recognised public concerns about executive reward, including 'quantum' – that is, the total amount executives are paid.

Induction and continuing development for RemCo members is taken increasingly seriously but does need to be very thorough for this demanding role. RemCo members should be equipped to challenge existing assumptions and practices of the company, as well as keeping up with regulatory and market changes and being able to master detailed proposals.

"It is too easy to build an induction programme for new RemCo members around established norms and perspectives that have grown up within the company, rather than to recognise that the value of NEDs may come from the challenge that they bring to those established norms." **(Wills, 2014)**

Succession planning for the RemCo is an important task, especially as the role of RemCo Chair becomes more demanding in terms of time, skills and knowledge.

In establishing the governance of the RemCo, the important factors are clear Terms of Reference from the Board, communication of both business and remuneration priorities, and strong links with Risk and Audit sub-committees on reward risk and with the Nomination Committee on talent management, succession and contracts on appointment.

It is important for the RemCo Chair to make conscious decisions about who attends a RemCo meeting and for what parts of the agenda. Both the CEO and HRD are key players in designing executive remuneration but also have vested interests in it. Special care needs to be taken in ensuring that the RemCo's decisions are really independent of the executive.

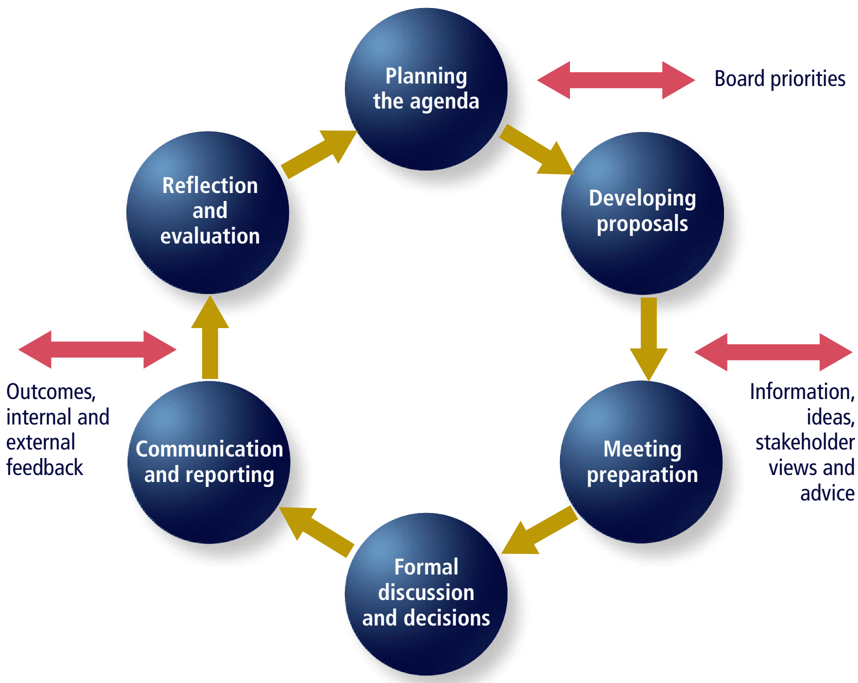
RemCos vary in size but there is widespread agreement that they need strong business understanding and experience, good financial and analytical skills, judgement and the moral courage to stand by their decisions. The RemCo Chair needs these too but also has a complex chairing task in such a sensitive area and needs finely honed interpersonal skills, especially in listening to and understanding the motivations and concerns of the various stakeholder groups.

The RemCo needs the capability to challenge and innovate in executive reward, not just implement previous company practice or current fashions.

PROCESS AND DECISION-MAKING

The RemCo Chairs interviewed often described managing the RemCo process through to decisions as 'common sense', but it is still detailed and exacting work. The diagram below summarises the cycle a RemCo travels round for each of its meetings and also for its work across a year. We will follow this framework in summarising the key areas to attend to and some of the common suggestions from the interviews about good practice. We will also examine some issues in the use of pay and labour market data.

The RemCo process cycle



6.1
Planning the agenda

RemCo Chairs, HRDs and advisers (PwC, 2006) stress the importance of setting a clear annual calendar in advance so that the committee can cover its ground and time decisions appropriately. RemCos meet at least three times a year and most of those in this study meet more often than that, at least four to six times. However, formal meeting time is still very limited for the amount of work to be covered.

Effective RemCos plan at least one meeting in the year for a more strategic look ahead in the light of the effectiveness of current policy, likely business change and external trends. Some RemCos have a separate 'state of the nation' meeting looking at external trends with their advisers, as well as a meeting for setting their own priorities and strategy for the year ahead.

Other meetings are likely to be taken up with the more detailed work of pay mechanics (agreeing targets at year start, reviewing performance at year end) and formal reporting. Some build in a mid-year review of governance and reporting guidelines. If new remuneration plans are required, time to consider the design of these also needs to be scheduled. Ad hoc issues may arise, especially if there is a change of top executive personnel, and these are either dealt with outside meetings or by calling occasional extra meetings.

Later in this chapter we emphasise the need for the RemCo to reflect on its effectiveness and to undergo formal, external reviews from time to time. These evaluation activities should also be built into the planning of the RemCo's work for the year.

6.2
Developing proposals

Proposals and meeting papers need to be clearly planned and developed in good time. It can be helpful to include more informal meetings with varied sets of players, including the CEO and Chairman, to allow freer discussions of options that might not otherwise be considered. More technical conversations, especially among the Design Triangle, are used to hammer out detailed proposals.

The issue of who requests proposals, where ideas or options come from and how papers are drafted seems seldom to be openly discussed. Yet this is an important feature of how the RemCo Chair manages their relationships with the executive, especially HR and the CEO, and their external adviser.

Proposals seem mostly to come from the executive – the CEO and HR function. These proposals are batted to and fro between the key players in both the Power Triangle and the Design Triangle before they go to the RemCo for formal approval. Informal discussions are both of an open-ended brainstorming type and also sometimes more detailed and technical.

One specific governance point for the audit trail is to ensure that RemCo papers are neither authored nor introduced by a potential beneficiary. An executive remuneration consultant pointed out that not all HRDs are as careful as they should be in observing this principle.

6.3
Using labour market information

The RemCo uses several kinds of information in its process cycle, typically in developing proposals and feeding into RemCo discussions. In Chapter 3 we looked at how business data is used in setting and assessing performance. We have also mentioned the role of the external adviser in providing market data (Chapter 4).

Given that paying the right amount relative to the external labour market is a critical issue for the RemCo, interviewees were asked what information the RemCo looks at and whether there is information not used that would improve its decision-making. Two sets of issues were raised by this question in relation to labour market information.

"So many companies have been caught out with no real succession pipeline, not just for the CEO but other executive and non-executive roles too. This makes them vulnerable when the RemCo is told that people are getting higher pay elsewhere. Succession is the first thing investors should ask about when a company uses benchmarking data to claim it needs to raise pay to attract or retain key players."

Corporate Governance, Major Institutional Investor

The lack of broader labour market perspective and evidence

When you ask RemCo members, HR specialists and external advisers about the use of evidence in setting executive reward, they talk about comparative pay data. This seems virtually to exclude other kinds of data and intelligence on the executive labour market and may be one reason why regulators have criticised companies for using arguments about attraction and retention with little or no evidence to support them, other than relative pay.

There are other labour market factors one might expect the RemCo to consider.

- **Trends in demand** – for example, where demand for specific kinds of top executives is growing or shrinking; whether geographical demand is changing; whether different kinds of skills and experience are being sought.
- **Trends in external supply** – for example, what kinds of talent are relatively easy to find and what most difficult? Time and cost of recruitment, incidence of recruitment 'mistakes' or 'regrettable losses', and retention trends are important evidence here. Where are the 'best' executives being grown for our kind of company – for example, by educational and career background? Where will we find the particular skills or experiences we want, such as a track record of innovation or effective uses of technology? In which geographies and sectors have they worked, for example, and to what extent is the US labour market relevant to the UK? What can we find out about the diversity of potential executives?
- **Talent strategy and internal supply** – for example, what mix of 'make' and' buy' options are we pursuing and how are we balancing our supply risks (Cappelli, 2008)? What is the state of our internal succession pipelines, currently and over the next few years?

Many previous studies of RemCos advocate a stronger use of internal succession planning to reduce dependency on the external labour market and curb pay inflation. RemCo Chairs do mention this, but it is not clear how much it really influences reward, especially as we know that succession plans are more often constructed than actively used. If more companies promoted from within, there would be an increase in the number and quality of new top executives, which is not brought about by the same population hopping from one company to another at top team level (Hirsh, 2012; IED, 2014). Institutional investors are increasingly alert to succession issues as part of good governance.

Only a minority of RemCo Chairs and HRDs talked about the labour market in the broader terms sketched above. It is, of course, difficult to assess demand and supply patterns in the relatively small market for CEOs, although much more possible for the various role profiles in top teams in large plcs. Some companies do, for example, look at their executive retention patterns for the top few levels by country. This kind of data can help RemCos challenge the assumption that they all compete in global markets all the time and therefore have to follow US pay trends.

As noted earlier, the habit of thinking about executive remuneration in terms of specific individuals, not broader patterns, may inhibit improvement in labour market intelligence. The separation of Remuneration and Nomination Committees may also distance the RemCo from a talent management perspective, succession planning analysis and experience of filling vacancies.

The need for more effective use of comparative pay data

The second issue in relation to labour market intelligence is whether relative pay information is used effectively. Given the heavy current reliance on pay data, RemCos do need to be effective in its selection and examination. Several of those specialising in market data analysis are critical of how such data is presented to RemCos. They feel RemCos may think that they are looking at larger and more reliable data sets than are actually represented by quartiles and headline numbers from a group of comparator companies. RemCos need to understand each pay component, how this is spread between comparators and how actual pay relates to pay opportunities over time.

Arnold and Brossy (2015) suggest five principles for more thoughtful use of market pay data: using judgement; avoiding false precision; choosing peers rigorously; maintaining consistency from year to year in comparators and method of analysis; and paying below the median when warranted.

The public reporting of pay policies, structures and levels is opening the door to companies accessing market data for themselves, and some online providers are pulling such data together to provide easier access. This may reduce the need to use external advisers to get hold of data – and the cost of doing so – while probably increasing the need for good advice on how to understand it.

"Transparent data not black box analysis should inform RemCo decision-making.

- Analysis should not be restricted to pay quartiles, but for example should include an understanding of the relationship between remuneration and company size (e.g. turnover/market cap) within comparator groups.
- There are many comparator groups you can legitimately compare your company to but they will all give different answers. Take at least three different cuts at this using different indices of size, sector etc. to get a more balanced view and avoid 'cherry picking' the comparisons you like.
- Use analysis to inform pay, not dictate it. Take a business decision not a data decision.

If technological advances in the delivery of data are embraced by RemCos, this will provide greater insight, allow more informed decisions and a substantial reduction in cost."

David Brooks, Executive Remuneration Data Expert

6.4
Meeting preparation

Experienced RemCo Chairs place really strong emphasis on managing the run-up to RemCo meetings and getting everyone fully prepared to take part. Orchestrating the run-up to what some called the 'theatre of the RemCo' is managed typically by the RemCo Chair and HRD (and/or Head of Reward) to make sure they engage the right stakeholders at the right time. The HRD may suggest a draft agenda, but it is vital that it goes through the RemCo Chair before it goes to members.

"Cutting data by statistical divisions – quartiles and so on – leaves the impression that the data are bigger in sample terms and more coherent than they really are. I want the RemCo to see the real data – total pay, pay opportunity and what is actually being paid – when we look at companies around us. If you put summary numbers in front of a Board, they drive the decisions. If Board members see the information in context they may take a different view. Digging behind the headline numbers enables everyone to feel confident that we are taking a rounded view."

Carol Arrowsmith, RemCo Chair

"We have a pre meeting of about an hour, 3-6 weeks before the committee meeting. This is with myself, HR, the CEO, external adviser and maybe the company Chairman. By going through the items ahead of time we can identify the 2 or 3 things we most need input on. Having this agreed up front gets us better quality decisions and also more open conversation or work on several choices between this review and main meeting. You need to create a safe environment for the CEO and HRD to run trial balloons and kick around wild ideas before the committee meeting, which has to focus on decisions. Sometimes you can't narrow things down and need a more open discussion in the committee meeting, but this is a conscious choice and you need to adjust the agenda accordingly."

Bob Stack, RemCo Chair

"The RemCo chair needs to have good lines of communication into management – he needs to be accessible but not too close. For example, unless there is a good and straightforward reason, I'm not accessible to the CEO ahead of RemCo meetings. I don't want to be in a position where the CEO can advocate to, or lobby, me privately, because then you disempower your committee and the wicket has been rolled by the RemCo chair and the CEO."

John Varley, RemCo Chair

In the run-up effective RemCo Chairs strike a fine balance between consulting stakeholders and not allowing such discussions to compromise the decision-making authority of the full committee.

Papers need to be finalised early so they go out in good time. The RemCo Chair will often see several drafts and needs to ensure that all RemCo members are in the best possible position to understand any proposals they will be discussing. Individual briefing may be necessary if an issue is very problematic or technically complex. Inadequate preparation risks proposals either being pushed through or being deferred for more information and analysis. These are both outcomes that effective RemCo Chairs seek to avoid.

6.5
Formal discussion and decisions

At the meeting itself, the Chair has to make sure that time is well allocated to the issues requiring most attention and that all members make an input to the discussion. Discussions may be about understanding an issue, exploring a range of options or taking a decision. The Chair needs to be clear about which of these they are seeking to achieve.

"For complex issues it is sometimes worth investing time in individual pre-meeting calls with committee members and myself with the external advisors and HRD. This allows everyone to be fully prepared for the discussion."

Danuta Gray, RemCo Chair

Decisions should be considered in the light of 'what if?' questions exploring possible business scenarios. This is a practical way of keeping risk at the forefront of the RemCo thought process.

It is important for minutes to be produced as quickly as possible following the meeting, while memories are fresh. Again it is the RemCo Chair, not the HR function, who must control the sign-off of minutes.

6.6
Communication and reporting

Communication is an aspect of the RemCo's work that is growing in importance because of the sensitivity of the subject matter, public and media interest and increased transparency through regulation. RemCo Chairs, as already observed (in Chapter 4), see interpersonal communication as the very essence of their ability to sustain constructive relationships with a range of players inside the business and with investors.

"We normally use three meetings – three bites of the cherry – to get from proposal to agreement, for example of targets. The first time an issue or proposal is put on the table. The second time we discuss any issues or options. The third time we decide. Once agreed, cabinet responsibility kicks in and whether he likes the target or not it is then the CEO's job, not mine, to communicate to the executive. The HRD also sense checks that this communication works properly"

Roger Davis, RemCo Chair

However there are some wider aspects of communication as part of the role and process cycle of the RemCo that were raised in the interviews and may not yet be getting the attention they need in all companies. They mostly relate to explaining remuneration policy and outcomes to various audiences inside and outside the company.

Board interface and the need for clear communication accountabilities

The RemCo has a clear communication duty back to the Board. In terms of other stakeholders, however, it is not always clear which aspects of the communication of executive reward issues and outcomes fall to the RemCo and which to the Chairman or the management of the company.

Investor and external communications

As already noted in Chapter 4, the RemCo Chair plays a key role with investors on the detail of executive reward, but then, on wider business matters, so do the CEO and Chairman, sometimes supported by the investor relations function.

More general external communication is often led by the CEO and CFO and/or the Chairman, supported by media specialists where required. If matters of executive reward are likely to arise in external communication, it is not clear from this study how the RemCo Chair ensures thorough briefing of those who will answer questions on behalf of the company. This is an issue the RemCo should clarify ahead of a difficult situation arising.

Communication to executives

Inside the business, it is important that all executives get clear communication about reward matters, both individually and collectively. In governance terms this is down to the Chairman (in communicating to the CEO about their own reward) and the CEO (for executives), reinforcing their normal management responsibilities. The HRD often supports the CEO on these matters and some RemCo Chairs have an understanding with the HRD that they will ensure that the CEO is well briefed to communicate reward policy and decisions to executives. Sometimes the HRD also checks how these messages are received.

"The CEO should dialogue with their direct reports. The head of HR or reward specialist can make sure the messages are well rehearsed. We have come a long, long way from CEOs just sending emails or leaving letters."

John Beadle, Head of Performance & Reward

Communication to the wider workforce

Internal communication on matters of executive reward to the wider workforce is possibly a missing component, leaving employees to find out who is being paid what from the media. This does not seem to reflect the argument from some interviewees (see Chapter 3) that the 'messaging' sent by executive reward helps to support business performance by reinforcing values, culture and trust with the workforce. One would expect the RemCo to be paying more explicit attention to communication to the workforce, not in terms of doing it itself, but in ensuring it is done appropriately.

6.7
Reflection and evaluation

As so often with people management processes, evaluation is probably the weakest link in the executive reward process cycle. Evaluation in this context should cover both reflection by the RemCo itself and more rigorous, externally-led evaluation of the RemCo as part of corporate governance, most readily as part of the Board effectiveness review.

"We self-assess our effectiveness but the functioning of the committee is also part of the more formal external review of Board effectiveness. This includes the contribution of committee members and the atmosphere in the committee in terms of preparation, degree of challenge and whether the separation of executive management from the committee is sufficient to ensure its independence."

Ronald Schellekens, Group HRD

Reflection by the RemCo

Normal reflection by the RemCo itself on how well it is doing should take place as part of each RemCo meeting and more deeply once or twice a year. Although RemCo Chairs clearly reflect a good deal on how well the committee is working, it is not clear whether the RemCo as a whole always gives itself a more considered opportunity to share views on its processes and outcomes. Some practise a mid-year review of progress, which is useful. If, as mentioned earlier, Boards set clearer priorities for their RemCos, this might strengthen the reflection habit.

Some key questions for reflection suggested by Remco Chairs include the following.

- Are we paying for the right things?
- Are our pay schemes achieving what we want them to achieve?
- Do our reward outcomes reflect how our executives are performing?
- Are we managing our relationships with shareholders well and getting their support?
- Are we protected from bad executive behaviour, poor executive decision-making, unexpectedly poor company performance and inappropriate reward on exit?

"The Board effectiveness review covers the operation of committees, but the main focus is the Board. There is a self-assessment form for committees, but this tends to be tick box and few people give themselves a bad self assessment. It would be interesting to analyse how the impact of Remco decisions drives performance."

Helen Owers, RemCo Chair

Formal audit of RemCo effectiveness

A more formal review of the RemCo should take place as part of the review of Board effectiveness. Several RemCo Chairs in this study are critical of how superficially Board effectiveness reviews look at the workings of sub-committees. They also feel that reviews of the RemCo should obtain feedback from those involved in, and affected by, its work (that is, senior executives and investors), not just Board members.

A suggested framework for RemCo evaluation, following the four-dimension model arising from this research (see Chapter 2), is suggested in Annex B.

The RemCo needs clear processes across the year and for each meeting to give appropriate attention to its agenda, especially the alignment of reward policy with business strategy.

Experienced RemCo Chairs pay particular attention to the run-up to meetings – making sure that members are briefed early and fully so as to be in the best position to understand proposals and make informed decisions.

Specific meetings are often used at least once a year to brief the RemCo on market trends, usually with external advisers making the key input. RemCos should make sure they view relative reward in the context of broader supply-demand intelligence on the executive labour market, retention and mobility data and the strength of the company's internal succession pipelines. Comparative pay data should also be probed carefully. Headline quartile numbers can be very misleading.

The RemCo's role in communicating policies and decisions on executive reward is of increasing importance. On both internal and external communication there needs to be clarity as to what is done by the RemCo, the CEO and the Chairman respectively.

The RemCo should reflect on its own effectiveness but also merits regular, rigorous and objective evaluation involving its key stakeholders.

EFFECTIVE PRACTICE AND AREAS FOR IMPROVEMENT

Drawing on Chapters 3 to 6, the sections below summarise widely accepted elements of RemCo effective practice, highlight areas that may need to be further developed, and offer a short list of key practices for RemCo Chairs.

In looking at effective practices we need to be mindful that many aspects of the RemCo should be handled differently according to context: the business itself, how well it is doing and the character and preferences of the CEO and the Chairman. So some of the items below may be more important in some businesses and at some times than others.

7.1
Widely accepted effective practices

The research has highlighted the following widely accepted, effective practices that many RemCos already attend to and that all should keep at the front of their minds.

- Clear and regularly reviewed statements of the purpose of the RemCo, its Terms of Reference and scope (for example, populations and pay schemes covered). This also needs to clarify where the RemCo takes decisions as opposed to where it recommends to the Board and/or monitors.

- Ensuring the right capabilities in the RemCo, and especially in the Chair, supported by thorough and independent induction and regular updating for all RemCo members on issues of executive reward and its regulation. Although in general the quality of RemCos is seen as much improved, demographic and career diversity is still an area to address.

- Clear and well executed processes, for example in managing the focus of meetings and workload across the year, making time for strategic thinking, preparation for meetings, effective chairing and timely decision-making. The RemCo Chair needs to ensure full discussion of issues, the active participation of all RemCo members and willingness to challenge proposals in a constructive way.

- Building constructive relationships with the CEO and top executives – close enough for real understanding but not so close as to compromise the independence of the RemCo or cut across the reporting relationships between the Chairman, the CEO and the executive population. This is always a challenge but all the RemCo Chairs interviewed keep it at the forefront of their thinking and practice.

- Proactive and genuinely two-way communication with major investors. This is seen as an area that RemCo Chairs have developed substantially in the past few years.

7.2
Suggested areas for further improvement

The research also shows some areas where practice is seen as less well developed and may need further strengthening.

- Ensuring role clarity and adequate information exchange between the RemCo, the Board and the Risk, Audit and Nomination Committees (or equivalents).
- The RemCo keeping a strong, strategic focus on the needs of the business and avoiding a reactive approach, based too narrowly on compliance, existing pay systems and comparative pay data.
- The RemCo Chairs in this study would wish to be bolder and more innovative in their approaches to reward, although we must recognise that the current climate is not conducive to radical change.
- Developing and communicating an executive reward policy that is genuinely aligned with business strategy and explains its rationale, not just its mechanics. Greater clarity is needed over reward principles for the wider workforce, who decides on these and how they relate to the principles used by the RemCo in executive remuneration.
- Attending to reward policy for recruitment, promotion and exit of top executives as carefully as to the reward of those currently in post.
- The RemCo should challenge itself and the Board to see executive reward as supporting effective strategies for both talent management and performance management at the top end of the business.
- In order to manage reward in this broader context, RemCos should require their internal and external advisers to help them examine labour market intelligence on the demand for and supply of potential top talent, both internally (through succession management) and externally. Benchmarked pay data should be examined more critically.
- More systematic attention to reward risk, including assessing the outcomes of reward systems against varied business scenarios, and the inclusion of a specific section on potential reward risks and their mitigation in any proposal on reward considered by the RemCo.
- A greater focus on the communication of reward decisions, including more clarity over who is accountable for broader external communication on executive reward, including with the media. Internal communication to executives must give them a clear understanding of the rationale for their reward as well as their own pay outcomes. There seems to be a gap in current practice in terms of communication to the workforce on matters of executive reward.
- More robust, objective and independent evaluation of RemCo effectiveness, involving a wider range of inputs from those affected by the process, especially executives and investors.

7.3
Ten key practices for RemCo Chairs

The 'top ten' list below distils some practical tips for RemCo Chairs. Such a list is obviously not comprehensive but these items are the ones mentioned most often by interviewees and that emerged most strongly from the research as a whole.

1. Think about the strategic needs of the business first and compliance second. Ensure you understand the business, its strategy, reward history and your CEO and Chairman.
2. Maintain a strong 'umbilical cord' to the Board, with regular review of the RemCo's Terms of Reference and clear priorities or objectives from the Board each year.
3. Require all RemCo members to be thoroughly trained for this role and to participate actively in debate and decision-making. On key issues, create opportunities for open discussion and the exploration of several options before deciding on a specific proposal.
4. Understand the thinking of your CEO, top executives and HRD/internal reward specialist but guard the independence of yourself, your committee and your external adviser(s). Choose your external adviser with care.
5. Be proactive with shareholders. Talk to them early. Listen and respond to their concerns.
6. Plan the agendas of meetings with care across the year, ensuring time is clearly set aside for strategic thinking, probing external pay and labour market trends and relating executive reward to wider talent and succession management.
7. Ensure thorough preparation for each meeting in terms of papers and personal briefing for those attending, if required, when issues or proposals are complex.
8. Examine how each decision may affect reward risk under different business scenarios, including how reward policies, messages and outcomes will play both internally and externally, including with the media.
9. Check that the CEO and executives receive clear, timely and accurate information and explanation of reward policy and their own reward outcomes.
10. Reflect on the RemCo's capability, processes, relationships and outcomes, and involve a suitable range of stakeholders in regular, formal, external evaluation of the RemCo.

FUTURE CHALLENGES

Beyond exploring the changing purpose and focus of the RemCo and identifying the main features of RemCo effectiveness, all those interviewed were asked to identify the current and emerging challenges they see for RemCos over the coming years. Five major challenges were uppermost in their responses and they are outlined below, together with related questions for wider debate.

8.1
Executive reward 'toxicity' and 'quantum'

Many of those interviewed commented on how 'toxic' the public debate about executive reward has become in the UK. They observed societal concerns about how much executives are paid ('quantum') generally and about the rewards given to executives who have underperformed or behaved inappropriately. For some this is all just irritating. A few RemCo Chairs and HRDs feel that the cumulative impact of the negative public discourse on executive reward in the UK will increasingly undermine public respect for, and trust in, business more widely.

"The level of executive remuneration has damaged public trust and their standing in society and therefore their ability to influence things in a positive way."

Peter Montagnon, Corporate Governance Expert

Those interviewed agreed that companies need to be protected from bad executive behaviour and this issue is discussed below in relation to setting the 'tone from the top'. It is also clear that executives should not be rewarded for poor decision-making or generally poor performance. But there were much more varied personal views on the issue of 'quantum'. The majority of business people involved in this study – past or current executives themselves – are comfortable with executives receiving very high rewards when a business is doing very well and/or is growing significantly (for example through expansion in new markets or international acquisitions). Some claim that 'quantum' is a peculiarly British concern, debated less, for example, in the US and Germany where pay is higher. Some policy and governance experts see quantum as a public policy issue not a corporate one, to be addressed if at all via fiscal measures. Some do see quantum as an issue that should be addressed more actively by companies themselves, but find it very difficult to see how that is going to happen.

Most RemCo Chairs regret the very rapid inflation of executive reward over the past couple of decades, but such regret does not help us deal with where we are. The institutional investors interviewed certainly want to see RemCos controlling quantum effectively from now on.

Will the UK just continue to moan about 'quantum' but put up with it?

Is the UK corporate community capable of addressing this global issue even if it wants to?

If RemCos are visibly successful in avoiding high pay for poor performance or bad behaviour, might the 'toxicity' of public debate reduce in relation to quantum?

8.2
Managing pay through changing economic conditions

This study highlights a widespread perception that the long UK recession has made it easier to slow the rate of increase of executive reward. However, more rapid economic growth could quickly lead to acute pressure to increase pay again. Any individual RemCo is ill-placed to withstand widespread reward inflation, especially as comparative pay information so strongly informs their decisions.

Some companies are much more affected than others by executive reward in other countries and may face particular pressures from the US and Asia and from other types of company that are less subject to regulation. Businesses still operating in difficult sectors or markets, but against a national backdrop of faster growth, will face particular tensions over executive reward. More active use of succession and talent management could strengthen the labour market position companies find themselves in, as they would then be less dependent on external recruitment.

In a more fundamental sense, RemCo Chairs are concerned that current pay practices simply do not operate effectively across economic ups and downs. They see executives as often over-rewarded in periods when it is easy to do well and under-rewarded when they are performing very well as individuals but in difficult trading conditions.

Is it inevitable that we will see rapid executive pay inflation again as soon as the UK or global economy returns to more sustained, significant economic growth?

Does the RemCo's existence and remit create an over-concentration on pay as the mechanism for attracting and retaining executive talent?

Does the attention given to pay contribute both to the lack of evidence on how executive labour markets really operate and to the relatively weak focus on talent and succession management?

Do we need to address the issue of how corporate metrics may over-reward executives when corporate performance is relatively easy to achieve (that is, when times are good) and under-reward their contribution to keeping the business on track in tougher times?

"The global financial crisis has had the effect of bearing down on pay inflation and that's been quite helpful to RemCo Chairs in taking a more cautious approach to pay, which is very clearly what shareholders wanted to see. What we will see if things improve, especially in the US and in Asia, will be rapid rates of inflation in senior executive compensation and that will be quite challenging for UK companies because they need to remain globally competitive. One knows that if one puts any significant increase into the pay packet of an executive director, some of the stakeholder community will be very unhappy about that; as the economies of the world start to grow again, this will become an increasing challenge for UK companies and their RemCos."

John Varley, RemCo Chair

"I'm not so convinced that the poaching of top talent between the US and Europe is such an issue outside the financial world. It depends on your sector. If your products and markets are different between Europe and the US, executives moving between these countries is less relevant."

Joachim Roeser, CEO & RemCo Chair

"Shareholders can be cynical that RemCos use 'discretion' simply to pay executives more. The RemCo is there to make decisions and a degree of discretion is important. It's important that you can hold the committee to account, but also important that the committee can make those decisions – otherwise the whole thing is remuneration by remote control"

Carol Arrowsmith, RemCo Chair

"You never know what all your investor institutions think – only what some of them think. It's all shadow boxing in the fog. "

Alan Gillespie, RemCo Chair

"The governance people are thinking long term but not running the money. They can see when somebody is let off the hook because the market sees them as a super-hero CEO. That creates a precedent that creates a mess everywhere else."

Peter Montagnon, Corporate Governance Expert

8.3
Regulation and the future role of investors

For the RemCo Chairs in this study, both increased transparency of pay arrangements and the need to gain shareholder approval for their policies and decisions are key aspects of the management of executive reward.

On the whole, increased reward transparency is seen as a good thing by all the groups represented in this study, but it has some side effects that do concern RemCo Chairs. These include adverse pressure on public companies and their executives created by the 'goldfish bowl' of very detailed public reporting; difficulties over when and how business targets should be shared with shareholders; and too little discretion for RemCos in judging performance and in adjusting salaries in the light of individual performance.

The relationships between major, long-term investors and the RemCos of the largest companies have been maturing. But outside these quite narrow confines, the role of shareholders in executive remuneration is more problematic. Some of the smaller listed companies in this study find it hard to get air-time with investors. There is a growing challenge for all companies in the diversity of shareholders, very few of whom are genuinely long-term. They may not be much interested in executive reward, may be far away geographically and may vote against unfamiliar proposals in a formulaic way. If companies lack the opportunity to explain under the principle of 'comply or explain', they will be discouraged from designing reward to fit the needs of the business.

Current trends also make increasing demands on the capability and resources of investors. Companies are extremely frustrated when fund managers and governance teams within the same investor organisation express opposing views about company performance and their likely support for reward intentions.

At what point does the detailed reporting of executive reward put UK public companies at a competitive business or labour market disadvantage in relation to other types of company or those in other countries?

Do we have the right balance between pay control through the influence of shareholders and a measure of discretion for the RemCo in judging both performance and reward?

Can investors, shareholder bodies and companies work together in a wider, collective dialogue to help companies meet the needs of those varied shareholders who will vote on remuneration but lack the time, expertise, proximity or interest to discuss executive reward with the individual companies in which they invest?

8.4
The future shape of executive reward

Several challenges relate to current executive pay systems, but different interest groups sometimes have different critiques of reward practices.

Annual 'bonuses' often hit the headlines, partly because they are not really bonuses. The rhetoric is that they reward exceptional performance ('stretching targets' and so forth) but bonus has in effect become an expected part of the executive salary. It is therefore difficult to pay a bonus one year and not the next, unless performance is really very poor indeed. Investors do not like what looks like a 'soft' attitude to bonus payments. A number of RemCo Chairs suggest it would be more honest to increase salaries and have smaller and less often awarded bonuses, but do not see this as possible given likely stakeholder views.

For RemCo chairs, the complexity of long-term incentive plans (LTIPs) and the difficulty of valuing them is a bigger problem than bonuses. LTIPs are not seen as 'incentivising' executives – they are just part of the reward package. Many RemCo Chairs and pay specialists would advocate radically simpler systems for executive share ownership, to achieve the legitimate purpose of aligning executives' interests and wealth creation with those of shareholders (Montagnon, 2014). Some RemCo Chairs also see LTIPs as having become too large a component of reward, presenting risks of their own if executives have too much of their personal wealth tied up in the share value of the business. Simpler and less uncertain LTIP rewards might enable the amounts at stake to be reduced, but executives may now regard their LTIPs as in effect their pension.

More general concerns about current executive reward practice include the following.

- The **complexity** of executive reward systems, especially in terms of metrics, targets and overlapping timeframes for money and shares being granted, vested, deferred, clawed back and so forth. For RemCo Chairs, complexity is the biggest bugbear, although HRDs and Heads of Reward are used to current systems. Some external advisers also think reward is too complex, at least when speaking off the record. Investors say they do not like pay complexity, but they may be driving some of it through seeking to control the detail of metrics and delivery mechanisms (for example, LTIP timeframes), and through different shareholders asking for different solutions to be incorporated into pay systems.
- **Uniformity and lack of innovation** is a concern as companies are, de facto, encouraged to adopt vanilla reward solutions to their diverse business needs in the belief that they will be easier to agree with shareholders.
- There is a serious **lack of evidence** that either high reward or the performance-related elements of reward actually improve corporate performance. We have known this for decades, but evidence rarely drives HR fashions (Hirsh and Briner, 2011). Some of the most experienced non-executives in this study question whether any reward systems would be capable of improving executive or corporate performance, and whether today's target-based systems may ultimately do more harm than good.

"Shareholders see many Boards as a soft touch for short-term plans. Many executives do not believe they can influence the outcomes used in long-term plans. They see these at best as working out OK for them over the long term and at worst as a total lottery."

Mark Reid, RemCo Adviser

"To make pay levels acceptable we've had to say it's pay for performance. But of course, unless it's a real disaster, a fair amount of that performance related pay will be paid out and then the criticism is that it's pay for mediocrity. If we were more honest about what you have to pay, what the 'rate for the job' is for a senior executive, then you could have a much simpler set up, but it's very difficult to see how you get there."

Tom Gosling, RemCo Adviser

"The big challenge that we all face is how we can improve the effectiveness of remuneration. It's too similar across organisations. In general it's too complex. I'm always surprised how few executives really understand their remuneration. Many discount what they are awarded until they receive cash because of this complexity. There is a massive need for innovation to simplify remuneration. How do we do that in an environment where shareholders make their views known more clearly, but often picking on specific, different issues? I'm not confident that we know how to do that."

Crawford Gilles, RemCo Chair

"Investors want RemCo schemes to be clearly aligned with business strategy and as straighforward as possible. They hate complex schemes. They want a short, clear explanation on less than two sides of paper. If you can't explain the scheme it's the wrong scheme. "

Company Adviser

"I would consider the benefits that might come from sweeping away current pay systems. Instead, one might simply pay a salary and a good bonus – maybe up to 100% of salary. In addition to this, the executive could simply be given shares vesting in up to 5 years' time with no performance conditions on those at all. The quantum of shares offered under such a system would of course be much lower than the maximum number of shares executives can earn under the current system. Such a system would avoid a great deal of the work relating to the targets and reduce the potential for animosity between non-execs and execs. It would also align executives very closely with the interest of shareholders."

David Tyler, Company Chairman

"For shareholders, the RemCo is a window into the soul of the Board. If the Board don't challenge management on reward then this sows doubt in the minds of investors that management may be riding roughshod over the Board more generally."

RemCo Adviser

Is it more realistic to aim for executive reward that is well controlled and justifiable in terms of clear definitions and assessments of individual and/or corporate performance than to expect it to be capable of affecting performance by 'incentivising' executives?

Could companies and investors achieve the legitimate shareholder interest in executive share ownership with much simpler systems than the current LTIPs?

Can the 'comply or explain' principle be implemented by shareholders in a way that encourages more innovation and explanation of solutions aligned with business needs, and less formulaic compliance?

8.5
Setting the 'tone from the top': from metrics to ethics?

The thrust of regulatory policy on executive reward is in many ways returning to the broad early intentions of Cadbury and Greenbury in the 1990s – namely, to ensure strong corporate governance, encourage good behaviour and avoid pay excess. We see this in the emphasis on long-term business performance in the UK Corporate Governance Code as revised in 2014. We also see it in the addition of a requirement for the Board to set the correct 'tone from the top' by "establishing the culture, values and ethics of the company …. The directors should lead by example and ensure that good standards of behaviour permeate throughout all levels of the organisation. This will help prevent misconduct, unethical practices and support the delivery of long-term success."

RemCos are already adopting the mechanisms of deferral and claw-back to mitigate against the risks of misconduct and of unexpectedly poor results. But 'tone from the top' is a much wider call for proactive, good behaviour, role-modelled by top executives and going all the way down the organisation. It may highlight circumstances in which the company hits the right numbers but not in the right way, or performs well in one year but not in a way likely to be sustainable or to deliver shareholder returns.

"What behaviours will the Board not tolerate? Is this clearly understood by executives and evident in reward plans and RemCo decisions?" **(Wills, 2014)**

The explicit reference to corporate culture and values in the revised UK Code may further highlight the issue of how reward principles used by the RemCo for executives align, via culture and values, with those for the wider workforce. This study showed that some RemCo Chairs are already interested in company-wide reward principles, but that there is often a lack of clarity about what these really are and who sets them. The use of the word 'ethics' by the FRC raises the issue of whether self-imposed, executive pay restraint is itself an ethical matter.

FUTURE CHALLENGES

What will the RemCo's contribution be to setting the correct 'tone from the top'?

Will it place more emphasis on the alignment between corporate values, company-wide reward principles and executive reward policy?

How will the RemCo find ways of adjusting executive reward downwards in cases where there is not executive misconduct but there may be corporate behaviour not in line with corporate values?

"The Board and the RemCo are interested in the overall structure of remuneration right through the company. You can't look at senior remuneration in isolation from rest of the workforce. You don't want a culture where employees think 'the chief exec and a few of his or her mates are doing well and we're doing badly'."

David Tyler, Company Chairman

The past few years have been dominated by metrics, targets and complicated payment schemes that may have placed too much emphasis on reward and not enough on the wider challenge of improving UK corporate performance. But RemCos have been learning how to explain themselves better and how to work much more constructively with major investors. RemCo Chairs are also mindful of the continuous need to find the right balance between supporting and challenging the executive. It will take a while for recent regulatory changes to settle in, but we may be entering a period of more open debate about whether and how reward can support long-term business success through influencing how companies conduct themselves as well as the results they achieve.

In this study we have seen that the RemCo has come a long way and raised its game considerably. Those involved in this research, especially RemCo Chairs, now see their fundamental challenge as whether the RemCo can – and will – judge executive reward primarily in terms of the extent to which it actively supports sustained business success.

"The issue of paying for failure applies only to a minority. The bigger issue is paying more than mediocre money for mediocre performance and regulation is not really addressing that. The real issue is that many companies aren't giving the returns to shareholders that they should and shareholders in this sense are the average person in the street whose money is invested by the City in these companies...... The real elephant in the room is how you generate better corporate performance and whether reward can really do this."

Raj Rajagopal, RemCo Chair

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ANNEX A: ASSESSING REWARD RISK

The questions below, developed by Phil Wills Associates Ltd., can be used to structure initial thinking around key areas of reward risk and assess how well the RemCo is addressing them.

Areas of reward risk	Questions to address
Corporate sustainability	Does all meaningful wealth creation for executives depend on long-term value creation for shareholders? Is top executive reward focused on corporate sustainability, via an appropriate balance between short-term and longer-term reward?
Incentive plans	Does the RemCo understand and approve the inherent risks in group-wide incentive plans? How have we acted to mitigate these risks?
Major risk-takers	In what positions are individuals most susceptible to taking risks to maximise their own reward? Are we sufficiently protected against possible adverse behaviours and inappropriate pay-outs?
Checks and balances	What are the most significant checks and balances in our incentive structures (for example, deferral and claw-back)? How clearly are the circumstances defined (for example, in contracts) as to when these provisions will apply?
Performance	Do performance measures reflect identified risks, and does the RemCo use appropriate business judgement in assessing the quality of performance outcomes? Does the RemCo take account of the reward consequences of unexpected changes in the business environment?
Roles	Who is accountable for the ongoing monitoring of reward risk? Do those involved represent a wide enough perspective on reward risk? Are their responsibilities clearly defined and 'front of mind'?
Reporting	Is the management of reward risk the subject of regular reporting to the Board and to designated Committees? Does this reporting requirement drive the necessary degree of focus on this issue?
External review	Is there an independent external review of the integrity of the overall process of reward risk management?

ANNEX B: ASSESSING REMCO EFFECTIVENESS

RemCos need regular, rigorous, objective, external evaluation of their effectiveness. The tool presented here consists of a series of questions reflecting four main dimensions of RemCo effectiveness identified in the PARC research. These are as follows.

Supporting sustainable business performance — **Managing key relationships**

Governance and capability — **Process and decision-making.**

Key stakeholders, especially Board members, executives and shareholders, should make formal inputs to RemCo effectiveness reviews, addressing the questions relevant to their experience.

Each statement below could be simply scored in any such review. Scoring could be as follows.

(1) To a very limited extent or rarely.

(2) To some extent or sometimes.

(3) To a considerable extent or most of the time.

(4) To a very great extent or nearly always.

Supporting sustainable business performance

- Does the RemCo receive clear strategic direction and business priorities from the Board?
  - Are these updated during the year as circumstances change?
- Does executive remuneration, including performance metrics, support the achievement of agreed business goals and longer-term strategy and profitability?
  - Is the right balance struck between short-term and longer-term rewards?
- Does executive remuneration align with the company's reward values and behaviours as agreed by the Board?
- Does the Remuneration Report clearly explain the link between business strategy and reward strategy?
- Are targets set at challenging but achievable levels?
- Does the RemCo use appropriate discretion in judging performance?
- Does executive reward represent good value for shareholders?
- Does the RemCo approach to reward form part of an integrated talent management strategy?
- Does the RemCo effectively identify, mitigate and formally report to the Board on reward risks?
  - Is the business and its reputation adequately protected against payments for poor performance, adverse behaviour and short-termism?

Managing key relationships

- Does the RemCo have a constructive working relationship with the CEO, balancing understanding and support with challenge and independence?
- Do the Chairman and the Remco Chair work in a mutually supportive way to share and address critical issues?
- Is the RemCo proactive in building its relationships and ongoing communication with major shareholders and collective shareholder bodies?
- Does the RemCo seek appropriate levels of advice from external advisers and the internal HR team, while maintaining its own independence?

ANNEX B: ASSESSING REMCO EFFECTIVENESS

Governance and capability

- Does the RemCo have clear purpose and Terms of Reference from the Board?
  - Are these regularly reviewed?
- Does the Board define clearly the populations for which the RemCo should set and/or monitor the level and structure of remuneration?
- Does the Board set clear priorities and objectives each year for the RemCo and review its progress against these?
- Does the RemCo interact constructively with the Board, keeping it abreast of key issues and the rationale for policies and decisions on executive reward?
- Does the RemCo interact effectively with other sub-committees of the Board, especially Risk, Audit (on the quality and sustainability of financial outcomes) and Nominations (on succession, appointments and contracts)?
- Is the RemCo appropriate in its size, composition, career experience and diversity, given the nature of the company and the challenges it faces?
- Do all members of the RemCo receive thorough and independent induction and regular updating on issues of executive reward and its regulation?
- Is there a clear succession plan for the RemCo Chair and membership?
- Is the effectiveness of the RemCo and of executive reward regularly, rigorously and independently reviewed?
  - Do such reviews include formal inputs from key stakeholders including the Board, executives and shareholders?

Process and decision-making

- Are RemCo meetings effectively planned to manage workload across the year and allow sufficient time for strategic considerations?
- Is there a clear process for preparing papers for meetings of the RemCo?
  - Are agendas, papers and minutes approved by the Chair before they are circulated?
  - Is care taken to avoid beneficiaries of RemCo decisions drafting or introducing RemCo papers?
  - Are papers circulated with due time for members to consider them?
- Are informal discussions with RemCo members and relevant stakeholders used to explore issues, develop proposals and brief those attending a meeting, but without compromising the independence of RemCo decisions?
- Are decisions about who attends RemCo meetings carefully considered and appropriate?
  - Does the RemCo spend adequate time in camera to underpin its independence?
- Does the RemCo Chair facilitate full and open debate and clear, timely, well-informed and objective decisions?
- Does the RemCo present a united front on the decisions it reaches?
- Does the RemCo obtain and consider relevant labour market information, including peer group pay comparisons but also wider intelligence concerning attraction, retention, the external labour market and internal succession pipelines?
- Is the RemCo assured that pay policies, decisions and rationale are communicated effectively to the CEO (through the Chair) and executives (through the CEO)?
- Are responsibilities clear for external communication on matters of executive reward and is the RemCo appropriately involved?
- Does the RemCo reflect regularly and at the end of each year its own effectiveness in terms of outcomes, relationships, governance, capability and its own processes?

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