Changing landscape of Executive Reward

Impact of changes to Director's Remuneration Reporting Regulations

10 June 2014

Building a better working world

Agenda

- Introductions
- Changes in disclosures
- Impact on investor sentiment
- Relationship between executive reward levels and company performance
- Future direction of travel and risk-adjusted remuneration
- Questions

Speakers

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In 2013, economic recovery…

In 2013, UK market generally beat expectations

- Global factors such as emerging market anxieties, the US shutdown and a comparatively stronger pound hit profit expectations at the end of Q3, with earnings downgrades spilling into Q4
- A steady stream of positive economic data resulted in round of upgrades for the UK economy towards year-end. The EY ITEM Club expects GDP growth to hit about 1.9% in 2014
- 2014 reflected strong Total Shareholder Return (TSR) growth for the FTSE with 14% increase for the FTSE 100 and 16% for the FTSE 350 on the expectation of future growth
- The number of UK companies issuing profit warnings reached a three-year low in 2013, reflecting an improving economic backdrop across the year

Changes in disclosures

New reporting regime has led to consistent reporting format but varying level and depth of disclosures

Assessment of level and depth of disclosure		
EY ranking		
1	Comprehensive	7%
2	Some strong individual disclosures	44%
3	Largely generic disclosures	39%
4	Generally poor level of disclosure	7%
5	Limited with obvious omissions	3%

*Based on 89 companies reporting a 31/12/13 year end.

"DRR examples which can be described as comprehensive are limited but there are a number of disclosures with individually strong elements"

General themes

- Consistent reporting format and style but divergence of views on level of detail required by new regulations
- Annual statement averages 1.5 pages in length and the remuneration report c20 pages
- The annual statement often lacks impact and not fully leveraged as a communication tool with investors
- The boundaries for use of committee discretion often not explicitly stated in respect of all components of pay with little detail often provided
- 'Maximum' for base salaries is in most cases stated to be limited to those actually received by all employees
- Policy max rarely stated for salary and benefits and for recruitment typically limited to existing maxima (except for 'buy-out' awards)
- Marked improvement in level and depth of retrospective disclosure of performance against targets for annual bonus
- Often limited disclosure on consideration and inclusion of shareholder and employee views
- Few companies introduced material changes to policy during the year although most noted that a review had been undertaken

Examples of comprehensive individual disclosures

Focus	Company	EY observations
Malus / clawback policy	Shell & Rexam	► Shell have summarised Remco intent in respect of claw-back (or malus) for the benefit of shareholders without overly narrowing the ability for Remco to exercise discretion ► Rexam have provided a detailed overview of policy to include reference to the exact circumstances following which Remco will apply claw-back
Wider workforce consideration / impact	Ocado & GSK	► Both companies provide a comprehensive overview of how directors' pay compares with the broader employee population and how the same remuneration principles and pay philosophy apply throughout the organisation ► Information provided to Remco in respect of employee pay matters and how this feeds into the context of their decision making process for directors

Examples of comprehensive individual disclosures (cont'd)

Focus	Company	EY observations
Retrospective disclosure of performance against targets	African Barrick Gold & Keller	► Clear presentation of performance against targets for the annual bonus using a tabular format, easily identifying the targets set, level of performance achieved and resulting amount of bonus paid ► Actual targets, individual metric weighting and link to strategy (in the case of African Barrick Gold) all disclosed
Discretion policy	BP & Ocado	► A comprehensive overview of Remco's approach to use of discretion and the boundaries for its application ► In respect of Ocado, the use of a tabular format also allows the reader to quickly assimilate provisions for use of discretionary powers by plan type

Impact on investor sentiment

Key areas of investor focus

Performance target disclosure

- Somewhat greater transparency in the level of disclosure as a result of the enhanced requirements under the new regulations although articulation of the link between performance and pay outcomes continues to challenge
- In respect of retrospective annual bonus disclosures, c40% of organisations we would describe as making a ‘quantitative’ level of disclosure and c20% a ‘qualitative’ level of disclosure in respect of targets and performance levels
- Unsurprisingly, the disclosure in respect of LTI targets and performance was mainly ‘quantitative’ due to the less sensitive nature of the targets used (e.g., TSR)
- Varying depth if disclosure in respect of forward looking performance measures and targets

Retrospective performance target disclosures

	Annual bonus	LTIP
Quantitative disclosure (e.g., Profit target of £Xmn, achieved £Ymn)	39%	73%
Qualitative disclosure (e.g., Achieved ‘Threshold’ performance)	18%	5%
Other Limited Disclosures	43%	22%

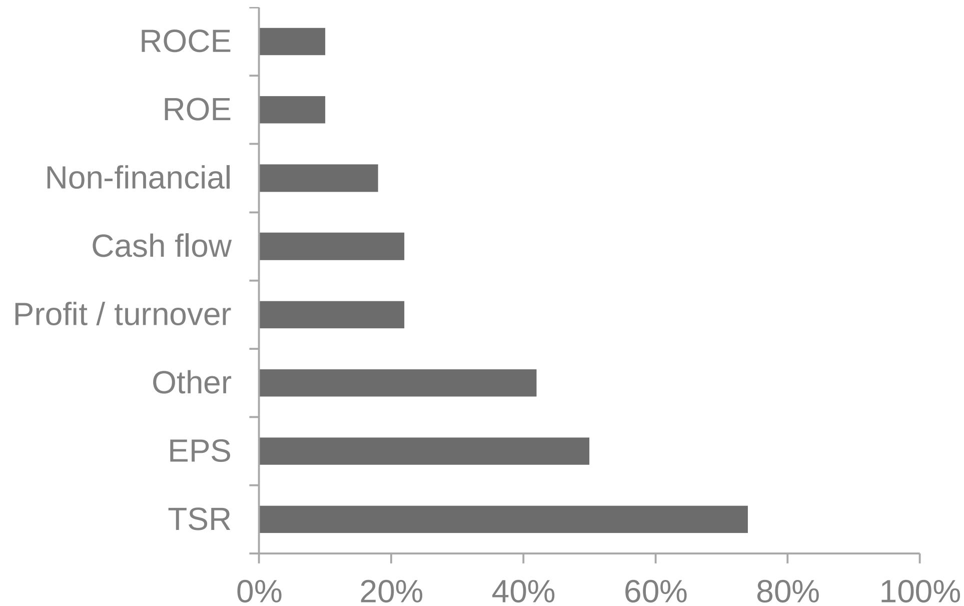
Key areas of investor focus (cont'd)

Use of commercial sensitivity exclusion

- In terms of retrospective disclosure about half (49%) of (December) year-end firms made no reference to excluding information for reasons of commercial sensitivity, suggesting they considered their disclosure sufficient to satisfy the regulations
- Whereas, 51% did cite the need for exclusion of information due to commercial sensitivity, although only 16% stated when such information would be disclosed (as is required by the regulations)

Commercial sensitivity exclusion usage

	Annual bonus	LTIP
Yes, but stated when targets would be disclosed	16%	1%
Yes, but no statement when targets to be disclosed	35%	2%
No reference to commercial sensitivity exclusion	49%	97%



Key areas of investor focus (con'd)

Discretion

- Inappropriate use of discretion and/or a lack of understanding of the breadth of discretion afforded to Remco was a material factor in the 'shareholder spring'
- Although the regulations (and to a greater extent GC100 guidance) explicitly require explanation of the extent of discretion afforded to Remco in respect of "any aspects of policy", the approach to articulating the extent varies:

Stated policy on discretion	
Yes, with extent/circumstances specified (e.g. specific section on discretion)	29%
Yes, but general/vague statement only	21%
Ad hoc reference to use of discretion throughout report (e.g. mentions in AB, LTIP section but not really 'policy')	43%
No disclosure	7%

Key areas of investor focus (cont'd)

Comparisons and relativities

- 60% of companies chose to go beyond the regulatory requirement and compare total pay spend with a metric other than distributions
- Of those companies, 36% chose to compare remuneration relative to profit with examples of 'other' including directors' pay spend and capital invested
- In respect of comparing percentage change in CEO pay against all employees generally for an appropriate comparator group), most (54%) choose the all employee population, with 34% choosing a specific group (e.g., by business unit or region) and only 9% using senior management.

Remuneration relative to other metrics	
Tax	2%
Profits	36%
No. of employees	4%
ROCE	2%
TSR	2%
More than one of above	23%
Above and other	11%
Other	20%

Although they should not be ignored, remuneration packages should not be designed solely to satisfy proxy agencies…

Proxy agencies

- Consistent themes for IVIS red and amber topping with 3% of organisations red topped and 33% amber topped

Top reasons for policy report:

- Absence of a stated salary maximum
- Absence of, or ability to exceed policy maximum applicable to variable pay
- Breadth of discretion
- Absence of, or ability to exceed, policy maximum for fixed pay
- Ability to ‘buy-out’ awards on recruiting new executive

Or in the annual report…

- Lack of retrospective performance target disclosure for annual bonus (and to a lesser degree LTIP)
- Remuneration outcomes relative to company performance
- Payments made to leavers
- Inappropriate use of discretion
- Increase in quantum (e.g., salary increase > 2-3%)

IVIS colour top	
Red	3%
Amber	33%
Blue	63%
Not yet available	1%

“There has been a notable increase in the willingness by companies to clarify aspects of remuneration following publication of the annual report to head off potential misinterpretation by proxy analysts”

Investor reactions are misinterpreted in the press… but continue to pose challenges to some firms…

Actual voting

- Consistent themes for IVIS red and amber topping with 3% of organisations red topped and 33% amber topped
- The voting is generally favourable although can often be misinterpreted by the media (i.e., by deeming votes withheld as a vote against) which impacts public perception
- In respect of rem policy, votes were generally more favourable than for implementation (i.e., rem report)
- Predicted repeat of 'shareholder spring' not likely to transpire (despite high profile of certain AGMs)
- Perhaps reflecting improved shareholder consultation pre-AGM and less controversial changes to remuneration policy

2014 Shareholder Voting				
% of votes for	**Rem report**		**Rem policy**	
	For the purposes of passing the resolution	Including those who abstained	For the purposes of passing the resolution	Including those who abstained
>90%	73%	70%	85%	80%
>75%<90%	20%	15%	15%	15%
>50%<75%	8%	15%	0%	5%

"for the purposes of passing the resolution, 76% of shareholders voted in favour of Barclays remuneration report yet the media reported one in three shareholders as failing to support it (by including votes withheld)"

Voting trends so far broadly consistent with 2013 although examples of significant votes against include…

Name	IVIS top	Proposal	For/ F+A %	Contributing factors
Barclays	Amber	Approve Rem Report	76	Increase in bonus pool despite fall in profits
BG Group	Amber	Approve Rem Report	67	Ability to make LTIP grants above the normal maximum in exceptional circumstances and level vesting for threshold performance
BP	Blue	Approve Rem Report	84	CEO pay triples despite continued legal threat from deep water horizon
ITV	Amber	Approve Rem Report	78	Introduction of a new LTIP which increases the maximum award value to 350% of salary
Ocado	Red	Approve Rem Report	80	Growth Incentive Plan which represent significant extra remuneration for which no real justification has been provided and significant pay-out for threshold performance
Pearson	Amber	Approve Rem Report	66	Ability for Remco to exercise discretion outside of policy by introducing new arrangements
Petrofac	Red	Approve Rem Policy	78	Potential for uncapped recruitment awards

Relationship between executive reward levels and company performance

Executive reward levels were restrained…

Median change in executive pay levels were modest in increases with respect to base salary and static in terms of total benefits

Median annual incentives/short-term incentives increased less than 5% but on average resulted in much more significant increases due to several significant awards

Median change in LTI resulted in a decrease in the size of the award vesting but a significant increase on average (and in some cases where no award vested last year)

Median change in total remuneration results in a total change of less than 5%; however, on average pay increased more significantly due to several significant awards

	Change in CEO Pay		Disclosed Pay Levels	
	Median	**Average**	**Median £000**	**Average £000**
Base	+2.6%	+2.3%	692	737
Total benefits	0.0%	-3.8%	192	324
Annual incentives	+2.5%	+28.5%	549	794
Long-term incentives	-3.1%	+13.0%	1,688	2,173
Total Remuneration	+5.0%	+20.5%	2,662	3,768

Executive reward levels were restrained…

As required, pay was compared to the returns to shareholders with a wide range of results. However, organisations also looked at other metrics such as profit

However when compared to employee groups, we see a muted increase relative to the comparison

The group selected for comparison varied somewhat but was focused on the all employee groups

‘Importance’ of Balance of pay	25th	50th	75th
All remuneration as % of shareholder return	110%	260%	610%

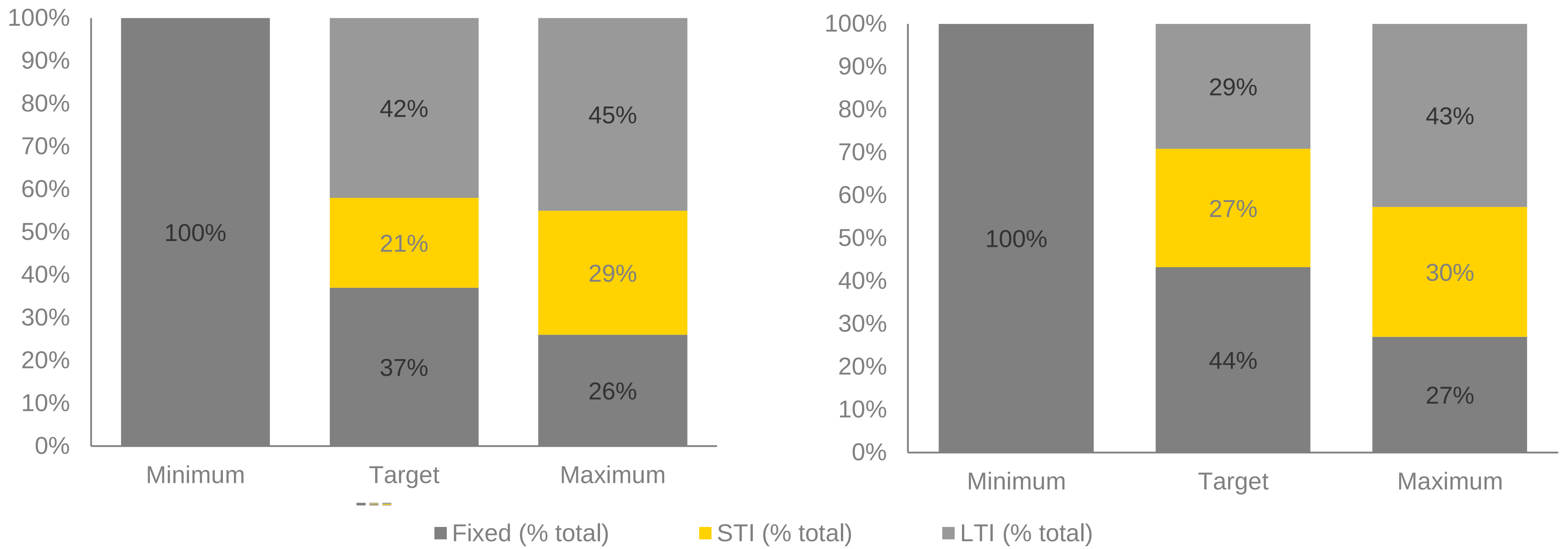
Difference between change in Pay of CEO and employee comparator group		
(Percentage points)	**Median**	**Average**
Base	-1.1	-1.4
Benefits/Pension	-1.6	-9.4
Annual Incentives	-0.4	+5.0

Difference between CEO Pay and employee comparator group	
All Employee Group	53%
Specific Group narrowed by Region or Business	33%
Management Team	9%
Other	5%

CEO policy shifts for target but remains similar for maximum …

2013 Disclosures on CEO Policy

2014 Disclosures to date on CEO Policy



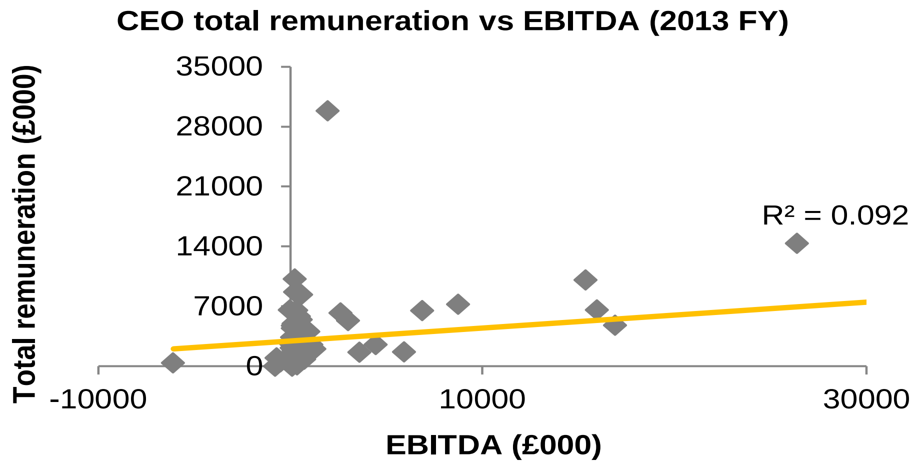
Overall it is relatively unchanged from a year ago

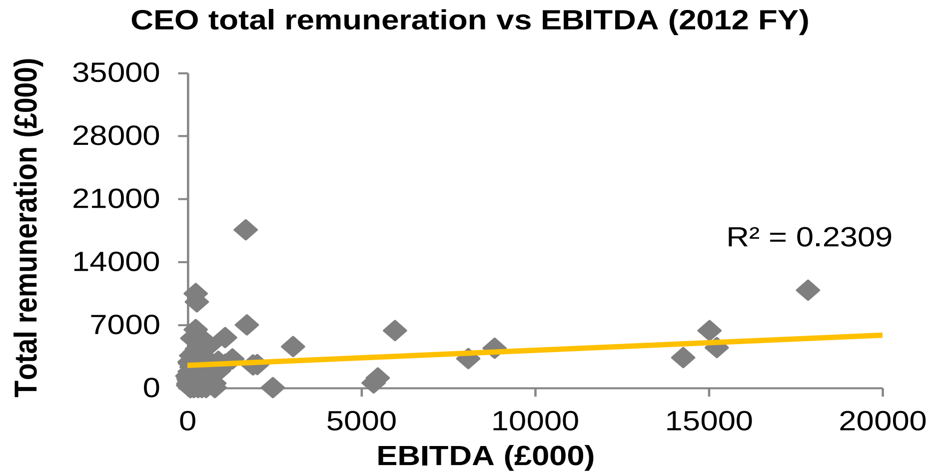
- On target pay in 2013, reflects a mix of pay that balances salary, annual incentives and LTI – shows more weighting towards fixed and annual/STI for 2014 due to the rebalancing of LTI at target
- Maximum pay in 2013 reflects a greater orientation in LTI award for executives – relatively unchanged for 2014

CEO total remuneration versus financial performance

Looking across the FTSE disclosures, there appears to be a low correlation between company financial performance (quantum of profit) and level of CEO remuneration

Perhaps more importantly, the correlation between EBITDA levels and total remuneration of the CEO has weakened in 2013 compared to that in 2012





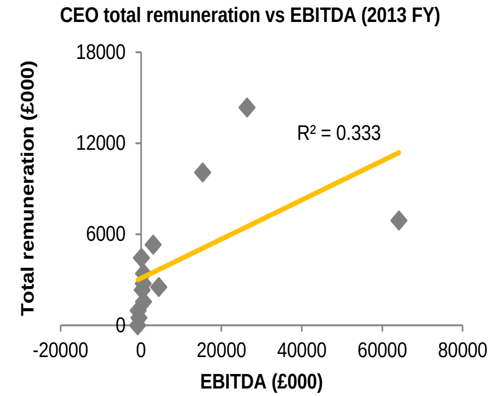
Potential drivers for a weakening link between financial performance and CEO remuneration

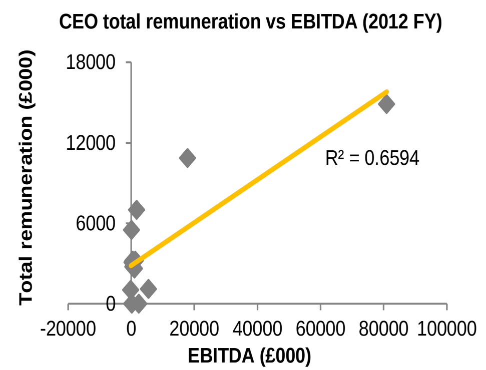
- FTSE index represents a non-homogenous group of companies with a varied mix of industry sectors, business priorities, market realities and business share
- Increased focus on broader metrics such as organisational health (beyond just immediate financial performance)
- Increased political and regulatory pressures have led to a shift in focus from purely financial linkage
- Concerns around attraction and retention have caused labour market influence on remuneration to increase

The relationship between pay and financial performance varies by industry sector

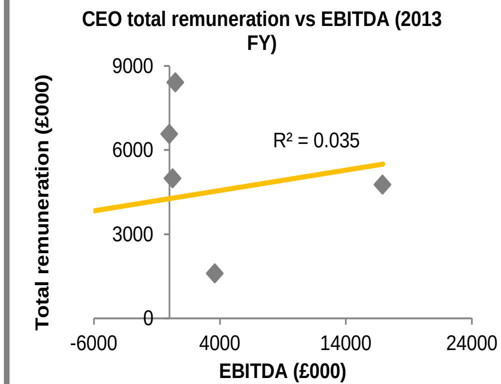
- Oil & Gas/Mining sector shows a higher correlation between profit and CEO remuneration
  - Suggesting a more stable market environment
  - Relatively lower fluctuations in profit performance over the past few years
- Financial services sector presents a lower correlation between profit and CEO remuneration
  - Alluding to the transformational change over the past few years, and
  - Complemented by differentiated approaches to pay

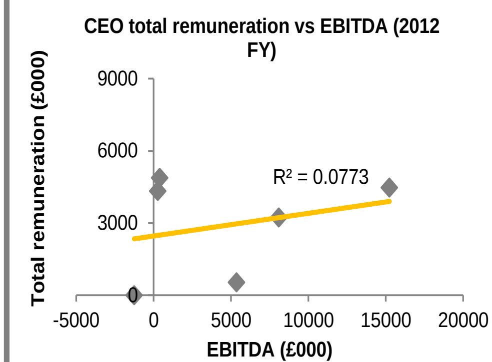
Oil & Gas and mining





Financial services





Future direction of travel and risk adjusted remuneration

Upcoming regulatory events…

	FY 14 Q1	FY 14 Q2	FY 14 Q3	FY 14 Q4	FY 15/16
UK	► PIRC 2014 Guidelines published ► *‘Best practice principles for providers of shareholder voting research and analysis’* proxy adviser code published ► High Pay Centre letter to the FRC	► FRC consultation on Corporate Governance Code published ► Self-certification of tax-advantaged share plans	► Online registration of share plans ► Outcome of OTS review of unapproved share plans expected	► Changes to UK Corporate Governance Code expected to apply	
EU		► Draft Shareholder Rights Directive amendments published			
Financial Sector	► CRDIV and bonus ratio implemented ► FCA Guidance on AIFM Remuneration published	► Revised definition of material risk taker (Code Staff) expected	► EBA Guidelines on remuneration policies and practices under CRDIV expected ► Transition period for compliance with AIFMD ends	► Parliamentary Committee on Banking Standards	► UCITS ► MIFID ► Solvency II

What we are hearing from clients…

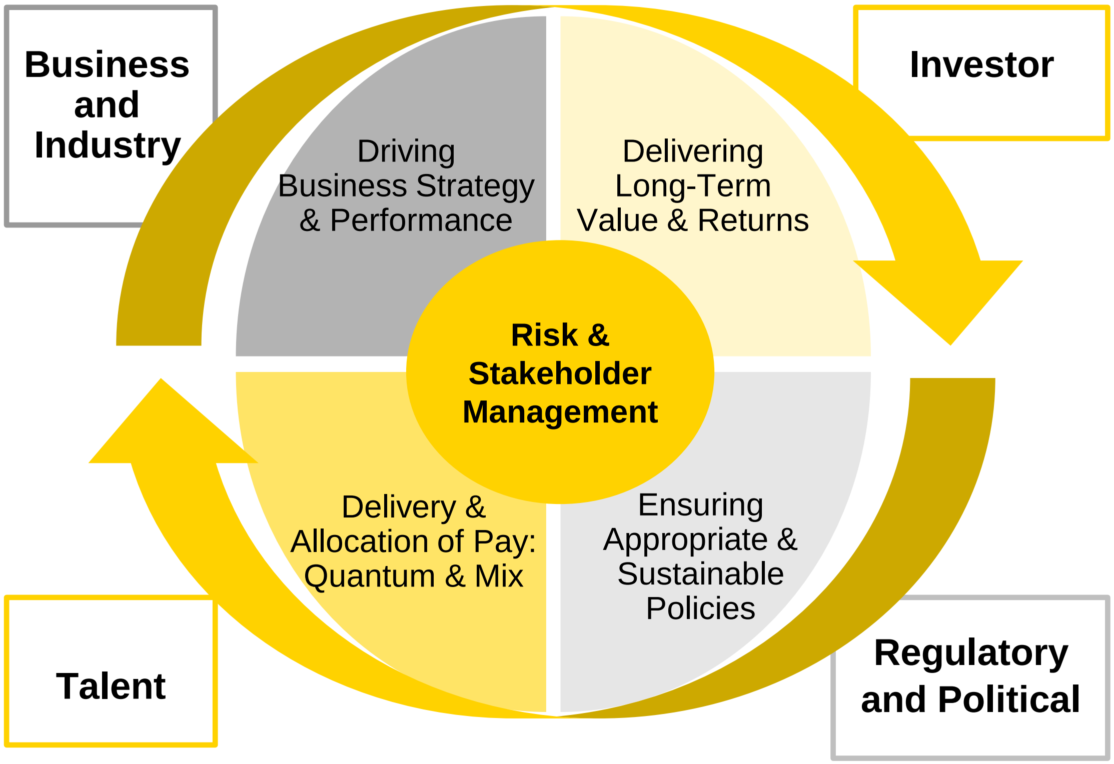
Given the current economic, regulatory and business environment, reward continues to be an issue at the heart of many businesses. EY recently conducted a pulse survey to identify the top issues organisations face in connection with their reward agenda. The key concerns reported were in relation to:

- Ensuring competitive pay to attract and retain
- Driving better business performance through differentiated rewards and incentives
- Improving cost efficiency
- Harmonising pay programs across the organisation
- Meeting regulatory requirements and ensuring appropriate risk management in a global context
- Balancing Risk-adjusted pay

Effective pay programmes manage risks & stakeholders to drive sustainable better business performance

Industry aligned and supportive of company strategy driving better business performance

In-line with shareholder expectations and best practice



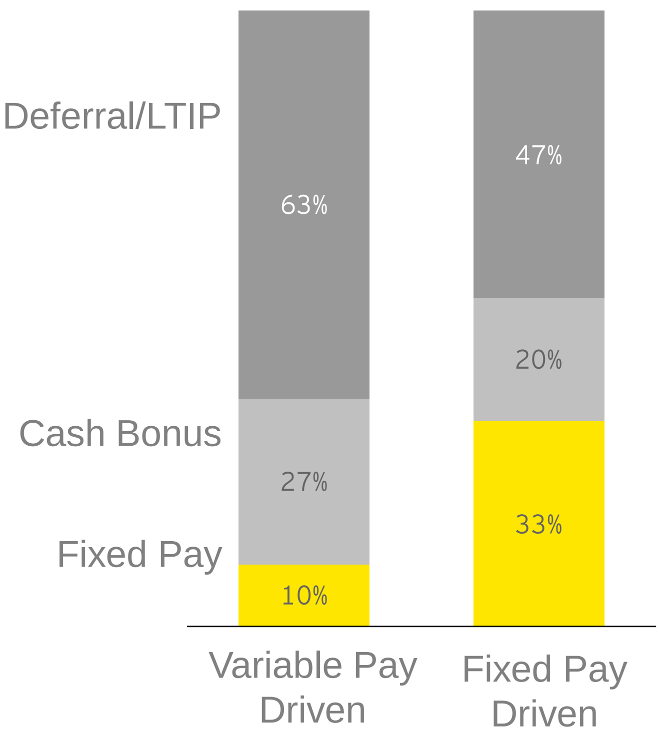
Flexible and differentiated to attract, retain, incentivise and engage the right talent

Regulatory compliant and sensitive to emotiveness & political/cultural issues

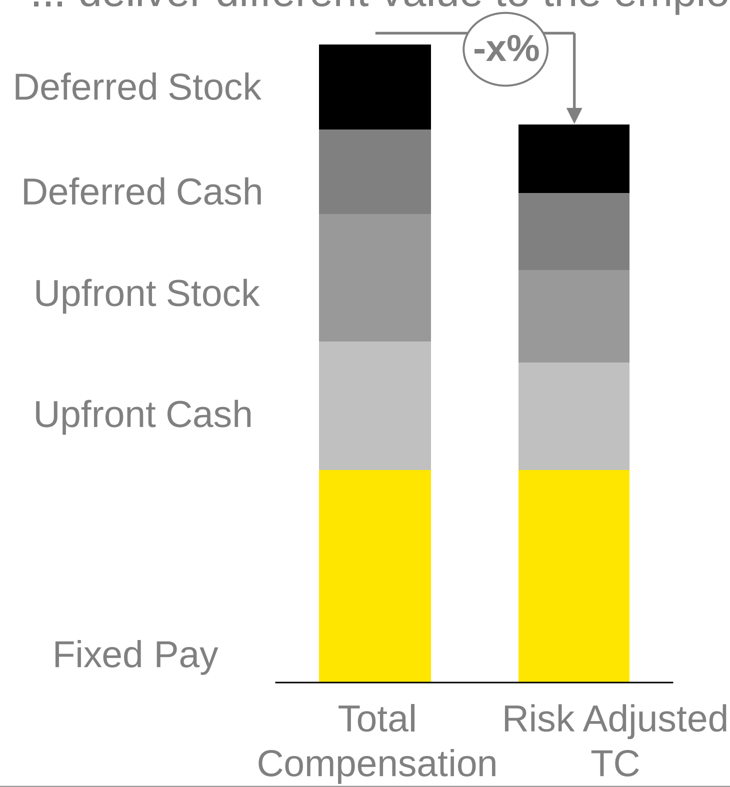
Risk-adjusted remuneration

A focus on communicated or face-value of total remuneration often ignores the varied structures of pay and the risk profile that exists in each individual component of the total remuneration package

Different renumeration structures...



... deliver different value to the employee



EY

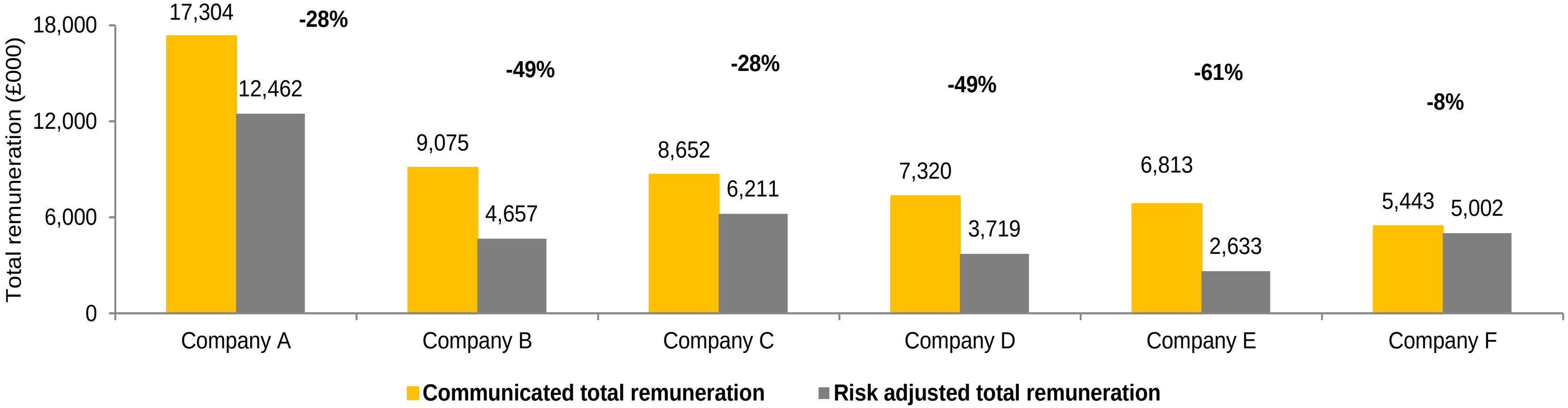
To quantify risk adjustment, we consider inherent risk drivers for each pay component

Pay components

Deferred instruments	► Risk due to performance targets ► Malus and performance conditions ► Volatility of the instrument ► Opportunity costs ► Frequency of vesting
Pay in instruments	► Risk due to performance targets ► Performance conditions ► Volatility of the instrument ► Opportunity cost
Deferred cash bonus	► Risk due to performance targets ► Malus conditions ► Opportunity cost ► Frequency of vesting
Upfront cash bonus	► Risk due to performance targets
Fixed pay including benefits and allowances	► No adjustment needed

Illustration of five organisations

Below, highlights adjustment for inherent risks in pay structure impact our view of risk adjusted compensation that result in a range of ‘discount’ factors for each organisation As a result, the ranking order and market positioning changes for many organisations and should be reflected in pay decisions



Company	Communicated total remuneration	Risk adjusted total remuneration
Top paid	Company A	Company A
Second	Company B	Company C
Third	Company C	Company F
Fourth	Company D	Company B
Fifth	Company E	Company D
Lowest paid	Company F	Company E

Executive Compensation & Reward at EY

Human Capital at EY

Our clients have been asking EY to provide solutions that are:

- Structured to be ‘best fit’ not just ‘best practice’ solutions that are led by business need, and informed by current market practices and trends throughout the year
- Provide an end-to-end solution that is considered and supported from initial design and analysis through implementation
- Innovative and creative solutions aligned to the post financial crisis environment where human resources and remuneration activities are increasing considered risk management activities
- Compliant with the increasingly complex regulatory landscape
- Support global organisations with multi-cultural workforces and talent market
- Understandable and easy to communicate through simplicity and elegant design

EY depth and breadth of resources allows our team the scope to connect our services in a differentiated way through supporting creative, innovative, timely solutions through our thought leadership

EY has invested in people to develop an integrated multi-faceted team of professionals to bring a Remuneration perspective to organisations from a Human Resource, Legal, Tax, Accounting, Risk, Regulatory perspectives

EY has invested in developing global benchmarking and analytics capability to support our clients through world-class analytic solutions and insights to support business performance

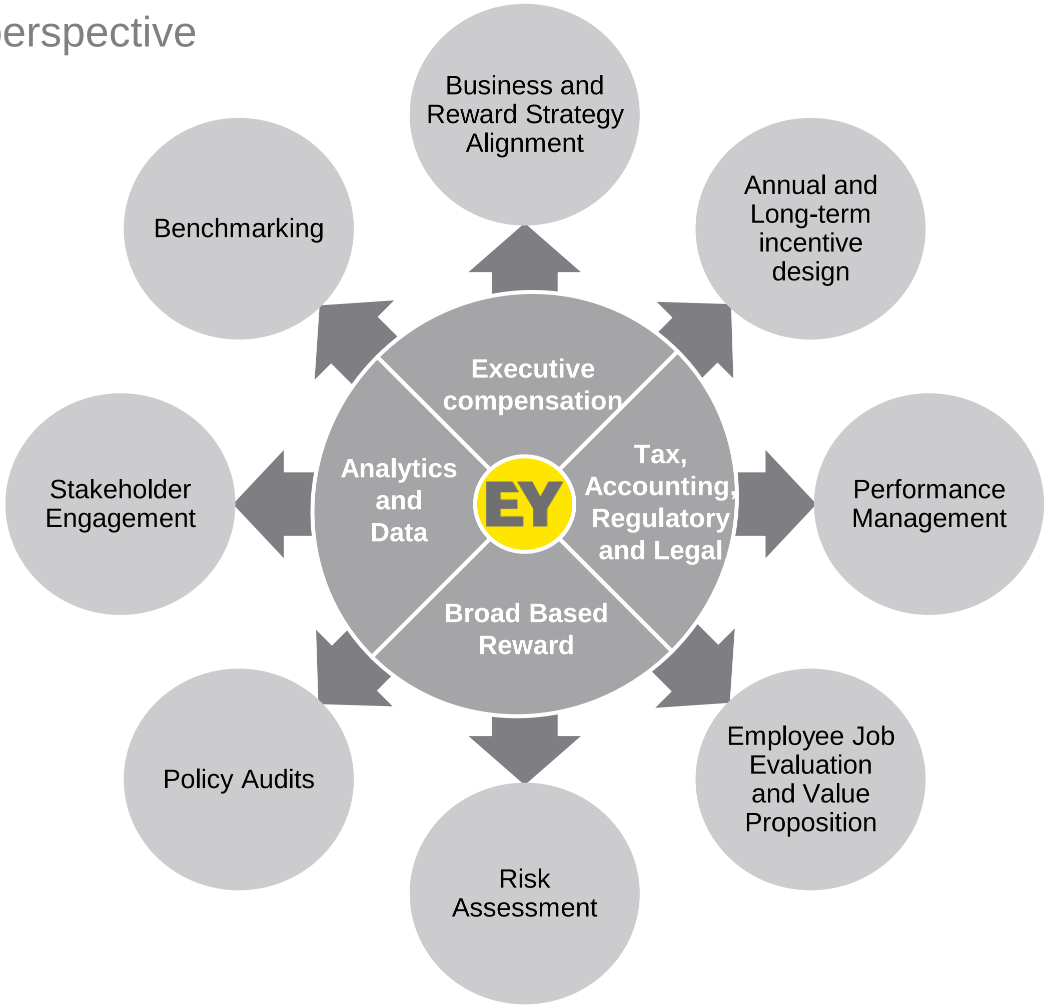
EY is focused on developing the full suite of Human Capital offerings across the globe, in the UK and its regions to provide global and local perspectives

Executive Compensation & Reward at EY

Optimising pay from a considered perspective

Advising Organisations' Committees and Management Teams …

… leading to solutions tailored to each organisation and fit for purpose in an ever increasing global marketplace



Any questions?

Thank you

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