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8 May 2018

Dear Ms Reeves,

Response to BEIS Select Committee Corporate governance: delivering on fair pay inquiry, regarding executive pay

Hermes Investment Management is an asset manager with a difference. With £30.1 billion in assets under management, we focus on holistic returns – outcomes for our clients that go far beyond the financial and consider the impact our decisions have on society, the environment and the wider world. Its stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on £310.7 billion[1] on behalf of over 40 international institutional investors.

Hermes EOS responds to consultations on behalf of many clients around the world. The views expressed in this letter are those of Hermes EOS and clients who have expressly given their support to this response and do not necessarily represent the views of all clients. Our response to this consultation is explicitly supported by Environment Agency Pension Fund (UK), British Coal Staff Superannuation Scheme (UK), Lothian Pension Fund (UK), PNO Media (the Netherlands), and VicSuper (Australia).

Hermes EOS welcomes the opportunity to provide our comments on this consultation on delivering fair pay in the private sector.

Executive summary

We welcome this inquiry into the progress made on promoting fair pay in the private sector and, specifically, the issues surrounding executive pay.

In our submission to the previous Committee's consultation, and in our subsequent paper, *Remuneration Principles: Clarifying Expectations*[2], we expressed our support for remuneration structures that better align the interests of management with those of multiple stakeholders, including customers, employees, society, as well as shareholders. Specifically, we set out 5 principles:

1. Shareholding: Executive management should make a material long-term investment in the company's shares.
2. Alignment: Pay should be aligned to long-term success and the desired corporate culture. Executives should be incentivised to deliver strategic goals, not solely total shareholder return, and be mindful of the company's impact on key stakeholders.
3. Simplicity: Pay schemes should be clear and understandable for both investors and executives. They should be simpler and less leveraged, for example through lower bonus potential in a simplified incentive scheme, compensated if necessary by higher fixed pay.
4. Accountability: Remuneration committees should use discretion to ensure that awards properly reflect business performance.
5. Stewardship: Companies and investors should regularly discuss strategy, long-term performance and the link to executive remuneration.

[1] Assets under management and under advice correct as at 30 June 2017

[2] https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles-Clarifying-Expectations.pdf

We continue to call on large publicly listed companies to overhaul their pay structures in line with these principles in our engagements and when considering remuneration policies and reports put to shareholders at annual general meetings.

Progress in the last 12 months

Change is slow, but we are starting to see some encouraging examples of companies taking bold steps, to positive reception from shareholders. At its 2018 AGM, Weir Group received over 94% support for its new policy, which replaces its conventional long-term incentive plan with restricted shares, providing smaller, more certain sums in the form of long-term share ownership. This is the type of model for executive remuneration that we have been advocating and we are pleased to see it gaining support from a strong majority of investors.

Change to pay structures has, in part, been tempered by disagreement among investors, many of whom continue to favour higher ratios of variable to fixed pay, with performance-based long-term schemes, often with total shareholder return as a dominant metric. This can often be a reflection of the type of incentive scheme used among asset managers.

Companies often tell us in private that they would like to introduce different remuneration policies but fear they will not receive widespread support from investors. Indeed, in 2017, we saw a number of companies float more innovative pay schemes in private discussions, only to withdraw these ahead of their AGMs after a negative reception from investors. As Clare Chapman, chair of Weir Group's remuneration committee, notes in an article in the Financial Times, "Historically only a few investors, including the Norwegian oil fund, Hermes and Old Mutual, have openly backed the cause for pay reform."

We firmly believe that fund managers prefer current long-term incentive plans which rewards, at best, mid-term (typically 3 year) performance against the issuers' index, as this reflects the way that asset managers are incentivised. Therefore, to win the battle on executive pay, the stewardship battle has to be won, to make the asset management industry better long-term stewards of the companies which it owns on behalf of ultimate beneficiaries: ordinary savers and current and future pensioners.

Fortunately, while conventional thinking was that these schemes best incentivised performance, we hope that the support for the Weir proposal is an indication that a growing number of shareholders are beginning to be more open-minded in supporting a move away from them. We would also like to see more investors articulating what they want to see, and communicating this through active engagement with companies, rather than simply voting against AGM proposals or making broad statements to the effect that that the current system of executive pay is broken.

It should also be noted that it is only a year since the previous Committee published its recommendations on pay structures and policies. Due to the three-year cycle by which new remuneration policies are approved, the full extent of changes therefore may not be seen for another two years. The introduction of new statutory instruments, which include disclosure of pay ratios, and an updated UK Corporate Governance Code later in 2018 are also expected to drive further progress.

In terms of improvements to reporting on pay, we have seen progress on the disclosure of targets, although with more to do on non-financial targets, such as personal objectives, to ensure investors can hold companies fully to account. Mandatory reporting on pay ratios from 2019 will bring further transparency for investors to consider whether the scale of pay is appropriate.

We have seen examples of remuneration committees and institutional investors taking steps to combat excessive pay over the last 12 months. In 2017, we saw a number of companies modifying or withdrawing remuneration policies considered excessive or poorly constructed by investors, after engagement ahead of their AGMs. This year, while the majority of votes have been advisory only, on remuneration reports, we have seen notable examples of investors registering their dissatisfaction with excessive pay, such as at Persimmon's AGM, where over 64% of investors voted against or abstained on its remuneration report.

Finally, on the question of what further measures should be considered, the introduction of the Public Register, managed by the Investment Association, is a welcome development. It provides a public list of all FTSE All-Share companies that have received more than 20% votes against a resolution or that have withdrawn a resolution, as well as the steps taken by the company in response to investors. The register makes it easier for many investors to assess the responsiveness of companies and take action again repeat offenders by voting against relevant directors, including the chair, at future meetings.

While the register represents a positive step forward, we should continue to review its effectiveness over time and, if needed, revisit some of the other proposals put forward. For example, an escalation mechanism whereby, if a remuneration report fails to receive majority support, a further general meeting would be called at which a new pay policy and the re-election of the remuneration committee chair would be put to a vote. This could be appropriate if we find that action in light of the register provides insufficient direct impact on bad remuneration practices, for example, leading to dissent against a remuneration committee chair but not a new remuneration policy until the next cycle.

The other area we believe merits greater emphasis is fostering the market for stewardship. While the pioneering UK Stewardship Code (2010) provided a much-needed catalyst, this market remains a hope rather than a reality. Despite significant empirical evidence demonstrating its value, genuinely understanding and engaging with companies is difficult and costly – a burden few investors have been willing to shoulder.

As such, in our response[3] to the FRC's consultation on an updated Stewardship Code, we argued that the code should propel all participants in the investment chain to create and cultivate an active stewardship market, from asset owners and managers to investment consultants. If further attempts to create a functioning market for stewardship end in failure, we and others have suggested the UK government should consider intervening to raise a levy on the investment industry to resource effective investor engagement. However, we do not believe this is justified at this stage, not least because there are mechanisms that have yet to be tried. Indeed, we believe that now is the time to overhaul the code to create a functioning framework that avoids the need for market intervention.

If this response provokes any questions, please do not hesitate to get in contact with me using the details below.

Yours sincerely,

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[3] https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2018/03/hermes-eos-consultation-on-the-uk-corporate-governance-and-stewardship-codes-february-2018.pdf