

Europe, U.K. & Ireland Policies - European Pay for Performance Methodology

Background and Overview

Recent debates about executive compensation have become increasingly focused on quantum and the alignment of pay with performance and peers. Already in 2012 ISS introduced a robust quantitative methodology to assess pay-for-performance alignment for the US market.

With similar attention for payout levels in Europe, the 2014 ISS policy survey suggested that 83 percent of investors would be supportive of a similar methodology in Europe. After having implemented this methodology for Europe in 2016, the 2016 ISS policy survey confirmed that 92 percent of investors support the methodology as a contributing factor within the current holistic approach to remuneration proposals.

The pay-for-performance methodology is a robust and consistent quantitative assessment to measure alignment between pay and performance and will help in identifying any such situation in a consistent manner.

Key Changes Under Consideration

It is now proposed to formalize the existing process by including a formal reference to the European pay-for-performance methodology in the UK/Ireland (UKI) and Continental European voting guidelines. The reference to the methodology will be as part of the current policy principles. The envisaged change would furthermore include the definition of the methodology, which reads as follows:

"ISS annually conducts a pay-for-performance analysis to measure the alignment between pay and performance over a sustained period. With respect to companies in the European Main Indices, this analysis considers the following:

- *Peer Group Alignment:*
 - *The degree of alignment between the company's annualized TSR rank and the CEO's annualized total pay rank within a peer group, each measured over a three-year period.*
 - *The multiple of the CEO's total pay relative to the peer group median.*
- *Absolute Alignment – the absolute alignment between the trend in CEO pay and company TSR over the prior five fiscal years – i.e., the difference between the trend in annual pay changes and the trend in annualized TSR during the period."*

Intent and Impact

Currently both the ISS UKI and European policies already refer to the appropriate pay for performance alignment principle. The proposed inclusion of the reference will provide a clear, comprehensive, and consistent methodology to measure the pay-for-performance alignment, emphasizing that the outcome alone will not drive the vote recommendations, but that misalignment under the methodology may act as a contributing factor. The proposed formal reference will create additional clarification on the approach, and ensure consistency of approach, namely that pay-for-performance alignment may be a contributing factor where relevant.

Request for Comment

To Investors

- What role does (relative) quantum of pay play in your assessment of pay packages?
- In case of an issue with quantum of pay or an apparent misalignment between pay and performance, are your considerations the same whether it concerns either the short-term bonus or long-term incentives?
- Would you consider voting against the board/remuneration committee members rather than the say on pay voting item in cases where abusive discretionary power appears to be driving any misalignment?
- Do you believe that significant misalignment between pay and performance or pay substantially above median may reveal potential governance risks?

To Companies

- Do you believe that investors should consider both the quantum of pay and pay for performance alignment when voting on remuneration related resolutions at the general meeting?
- What would you consider as a reasonable explanation by a company for justifying an apparent misalignment between pay and performance?
- Do you believe that significant misalignment between pay and performance or pay substantially above median may reveal potential governance risks?