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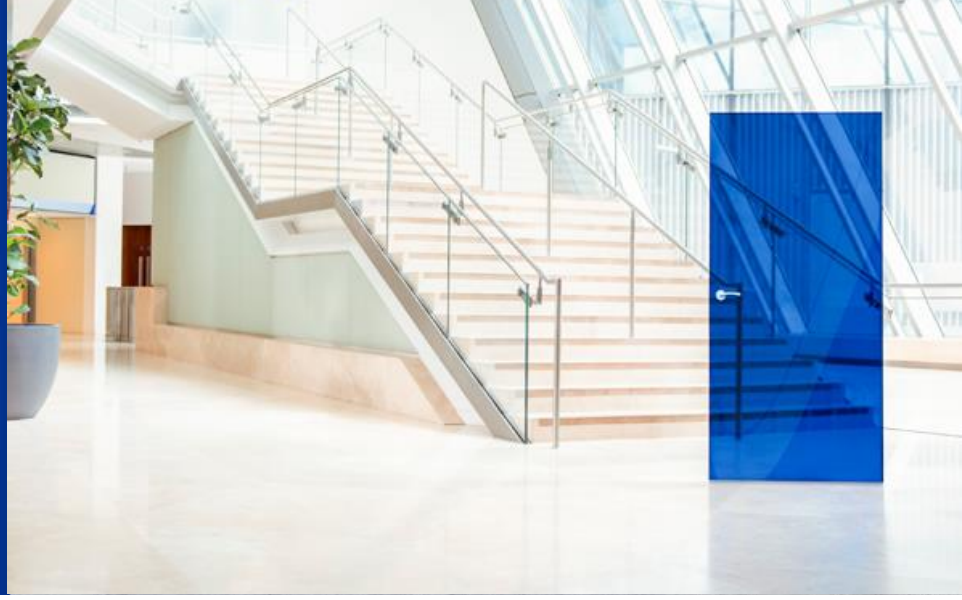
# On the 2021 remuneration committee agenda

**KPMG Board Leadership Centre**



The current COVID-19 pandemic may have a glimmer of resolution with the recent announcement of vaccine trial success, but the longer-term economic impact remains unclear. However, it is evident that companies are adjusting to the new reality that will impact the economy and their businesses. During this period, remuneration committees have made adjustments to their annual agenda and are proactively tracking the impact these changes have on remuneration policies and their implementation. Finding an appropriate and balanced approach to implementing executive pay remains top of the agenda, as shareholder scrutiny of executive remuneration remains high.

Based on recent events and our engagement with board and remuneration committee members across different industries, we have highlighted seven areas for remuneration committees to keep in mind as they carry out their 2021 agendas.

**Rise of Environment, Social and Governance (ESG)**

ESG is a hot topic for businesses generally and high on the agenda of most remuneration committees – in particular, the important question of how to link ESG measures to executive pay and whether it is appropriate to do so.

In the last AGM season, developments in this area were mainly being led by larger organisations, but based on evidence from the latest annual reports, we are starting to see most companies looking to incorporate such measures in the near term. This increased momentum is also driven by elements of the investor community who are beginning to distance themselves from companies that do not have a well-defined ESG agenda.

The main concern is around finding the right ESG metric, but also determining appropriate performance levels when setting targets. There is also significant discussion on whether ESG measures should be adopted into executive pay and whether such performance measures are an effective way of moving the ESG strategy forward.

Linking executive pay with the company's strategy can help drive the right behaviours, encourage a focus on longer-term sustainability and create a more nuanced approach to performance than merely focusing on the financial aspects.

The Investment Association (IA) supports this view and actively encourages the inclusion of ESG measures as a non-financial performance criteria for variable remuneration.

COVID-19 has had an impact too – particularly the "S" bit of ESG and the new emphasis placed on the mental, physical and financial wellbeing of employees and their families; as well as a company's impact on the communities it works in, wider society and social equality.

Remuneration committees should look to:

— Understand the company purpose in relation to ESG and consult with stakeholders in order to ensure that any measures introduced are relevant and objective. It is important that there is a clear link between strategy and purpose.

— Materiality is key. Many of the measures being introduced into long or short-term incentives have a relatively low weighting. However, materiality reflects the importance of the chosen ESG metric and therefore a low percentage rating may not convey how important it is.

— Whilst linking ESG to executive pay is a starting point, in order to embed cultural change and enforce the priority within the business, companies must take a collective view and understand how these measures can be filtered down to the wider workforce and be part of the total reward strategy.

— In determining metrics, companies should review their internal processes and how they can meaningfully measure progress.

## Effective shareholder and investor engagement

Companies continue to struggle to proactively engage with the investor community in advance of any changes to their executive remuneration framework. Inadequate engagement and presenting remuneration policies as a 'done deal' does little more than put shareholders in a difficult position of choosing between 'grudgingly' voting in favour of remuneration reports and policies or taking on an 'activist' role by advocating for change and withholding votes at annual general meetings.

Clear communication of the 'why' is critical. In some circumstances, we are seeing that the motives of the remuneration committee may be valid but the rationale and proposed mechanisms are not clearly articulated and communicated. This can result in a mismatch in understanding of how the proposed changes to executive remuneration reflect the circumstances of the business and are aligned to the creation of shareholder value and other strategic objectives.

Timing is crucial when engaging with shareholders. Early engagement – with time to incorporate any comments – feels a more collaborative approach to investors than leaving things later in the process. While remuneration committees may not need to take on all shareholder views, having the views of the major shareholders will be useful in mitigating any adverse reaction from others.

The current climate has put increased pressure on executive pay, especially with the change in public perception over the value of traditionally 'low-pay' jobs. This manifests itself in the recent calls for the government to support a mandated 'maximum wage' in order to curb excessive executive pay.

During the pandemic, we have seen a number of executives across all industries take pay cuts or cancel bonuses in an attempt to protect the business. Reaction to these measures has been sceptical in some parts, with executives still taking home significant rewards. With the media keeping a close eye and reporting widely on behaviours as well as quantum, we would expect interest from all parties to remain high. It has never been more important to engage early and communicate clearly.

## Refreshing performance conditions

Performance conditions are a critical aspect of executive incentives. Generally, a combination of financial and non-financial measures are used by listed companies in annual bonuses. However, performance measures in long-term incentives tend to be more focused towards financial targets, albeit there is a growing trend towards introducing a non-financial measure to encourage more 'rounded' executive performance.

Deciding on the appropriate performance conditions and setting targets for incentive plans is one of the major tasks that remuneration committees will engage in during the next 18 to 24 months, especially given the impact of COVID-19 and the focus on stabilisation and business recovery.

Some remuneration committees have delayed target setting during this period of uncertainty, but this can only be temporary. Others have adopted a half-yearly approach to target setting and measurement to mitigate any unintended impact. This approach may suffice in the interim for short-term incentives but will not be appropriate for long-term incentives. Adjusting performance conditions for in-flight incentive plans is not perceived favourably by shareholders.

From an investor perspective, there will be a focus on how executives are going to increase shareholder value and it is likely that executive pay will focus much more heavily on performance, particularly in terms of incentivising and rewarding the recovery of the business. At the same time, executive reward will need to be balanced against wider employee reward to avoid windfall gains only for those at the very top and any consequential reputational damage for the company.

While the business outlook may currently seem unsettled, the end result may be different and therefore, proactive monitoring and tracking of performance will be required.

## Inclusion, diversity and social equality

Having a clear diversity and inclusion agenda is critical as some institutional investors are now contemplating withholding votes in the next AGM season for companies whose boards are not sufficiently diverse.

At the board level, diversity provides the opportunity different voices to be heard and a platform for more sustainable decision making; and there is some evidence that companies with more diverse board members perform better than those lacking in diversity.

From a pay perspective, remuneration committees and organisations more widely should reflect on the composition of the total reward package and consider if there are constituent parts which may discourage the promotion of individuals from minority groups. Where these are identified, a plan should be put in place to address this.

Inclusion, diversity and social equality, should be part of the broader ESG agenda and as a result of recent political and social events, some companies are taking steps to put plans in place to link diversity (specifically around gender and ethnicity) and equal pay targets to executive pay. This is a trend that many other companies may look to replicate going forward.

**Incentive arrangements – the debate on restricted share plans**

Executive incentives have been subject to scrutiny by institutional investors and voting agencies for sometime. However, the current climate has proved the catalyst for some fresh thinking on how best to deliver executive compensation and long term incentives. For example, the use of Restricted Share Plans (RSPs) have gained momentum and have now been implemented by a number of listed companies – albeit with mixed reception from investors.

RSPs are similar to Performance Share Plans (PSPs) but based on time vesting only (although generally with performance 'underpins'). Whilst the use of RSPs is gaining traction, it is this lack of formal performance conditions that makes such plans less appealing to shareholders.

Nevertheless, in light of the downturn in both share prices and economic activity, RSPs may provide an attractive option to incentivise executives through this period of business recovery.

RSPs deliver more certain incentive payouts to executives – still exposing them to movements in the share price but without the highly leveraged effect of many of today's PSP awards. The mixed investor reception to RSP proposals means that they should be used with caution and with specific adherence to the IA's recommendation that the quantum of RSP awards should be discounted by at least 50% of a normal PSP arrangement – and also some element of performance taken into account with an underpin, as has become common practice.

RSPs are particularly useful in cyclical businesses where setting performance targets may be difficult, as well as for small capitalised companies and AIM listed businesses, where they may offer a less complicated LTIP in line with the growth phase of the organisation. RSPs also have the potential to deliver an appropriate incentive using fewer shares than stock option plans (which are being phased out in most listed companies) and therefore have a less dilutive impact.

**Use of discretion**

The UK Corporate Governance Code provides guidelines to give remuneration committees the ability to apply discretion and override formulaic outcomes from short-term and long-term incentives. It is important for remuneration committees to note that this discretion can be applied both upwards and downwards.

In the wake of COVID-19, remuneration committees have moved extensively to exercise discretion for in-flight and forward looking executive incentive plans. In most cases, this discretion has been exercised downwards, although there are examples of companies who have looked to adjust outcomes in the opposite direction.

Shareholders generally accept and support the principle of discretion, however, the rationale should be clearly articulated – indeed, disclosure is a requirement of the Directors' Remuneration Reporting Regulations. It is important for remuneration committees to prepare sufficient and robust documentation of the circumstances in which discretion has been deemed necessary to achieve an outcome which is both fair for investors and directors.

In exercising discretion, the "acid test" should be around whether the intended executive incentive pay reflects the current and likely future circumstance of the business.

Remuneration Committees should be cognisant of the likely investor response to any adjustments or the exercise of discretion – and should also consider the wider context of the workforce as a whole in arriving at any decision. Investor bodies have made clear that where there are material share price reductions, award levels should be scaled back proportionately. However, balanced against this, is an ongoing need to retain and incentivise the executives.

Exercising discretion is a balancing act. Features such as caps on long term incentive plan payouts may well be an alternative approach to give investors comfort that management will not benefit from any 'excessive' gains, while providing executive directors with a clearer framework around their potential reward.

**Reputational dangers and the fairness agenda**

Being in the news for excessive executive pay does not send the right message to potential investors and the public. Whilst the reputational impact of executive pay issues may not be immediately quantified, the remuneration committee and other key officers will a spend significant amount of time on issues which are not core to the business itself.

As we have already observed, the economic and societal impact of COVID-19 has put increased public scrutiny on executive pay, particularly as CEOs have had to make tough decisions around salaries, jobs, furlough and the future of their staff.

This, in turn, has led to more questions around the 'fairness' of pay and we expect increasing momentum on this issue to lead companies to look more broadly at how their people are valued and rewarded.

The fairness agenda has been a hot topic for some time; however, its importance has increased exponentially as a result of the pandemic which laid bare the disparities in pay across society as well as highlighting the significant effort and sacrifices made by many employees who would be considered 'low-wage' earners.

As a result, we anticipate a greater focus on social equality and the levelling of pay, with more value being placed on performance across the board and a flatter pay curve effectively 'levelling-up' the wider employee population.

We might also see increased employee participation in long-term incentives to enable them to hold a share in what they have contributed to.

With such a swing in public perception and at a time when companies are striving to stabilise and recover their businesses in uncertain economic times, a failure to be seen as a 'good citizen' and support employees, could result in a significant reputational blow that it may be hard to recover from.

## The KPMG Board Leadership Centre

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