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# On the 2020 remuneration committee agenda

## 2020 vision for the year ahead

**KPMG Board Leadership Centre**

Whilst governance reforms continue to drive clarity and transparency in the UK executive pay framework, remuneration committees increasingly find themselves in the firing line when executive rewards appear disconnected from long term corporate performance.

Drawing on insights from our conversations with remuneration committee members and business leaders we highlight the issues that boards should keep in mind as they approach and execute their 2020 agendas.

### Targeting pension parity

As with so much of executive pay, pensions are specifically captured by the requirements of the 2018 UK Corporate Governance Code (the Code), which states that the pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce.

For some observers, the term 'aligned' may be open to interpretation and when combined with the fact that the Code operates on a 'comply or explain' basis, a continuation of the historical arrangement may appear to be manageable. Others however, including proxy voting agencies, are making a more literal interpretation resulting in significant downwards pressure on executive contribution rates.

Pensions alignment is certainly an area which will come under intense scrutiny again in 2020. The remuneration committee not seen to take significant action in an effort to align pension levels across the business by the end of 2022 (per the Investment Association 2019 Remuneration Principles), will find themselves challenged by shareholders.

> "As ever, a continued and close dialogue between companies and their shareholders is crucial. […] where shareholders have demonstrated in their voting that they have concerns, these need to be acknowledged and addressed by the Company.
>
> Jessica Ground and Andrew Ninian, of The Investment Association

### Driving long term behaviours

For remuneration committees and their Chairs, being able to demonstrate the link between their remuneration polices and long-term shareholder value creation will be critical. Incentive plan time horizons, and how long an executive must retain shares after leaving, happen to be two of the most visible incarnations of this theme.

The Code requires that share awards granted as part of an executive's remuneration be released for sale on a phased basis and be subject to a total vesting and holding period of five years or more.

The Code also states that the remuneration committee should develop a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares.

By and large, the vast the majority of companies in the FTSE 350 now comply with the vesting and holding period rule with many adopting a '3+2' approach.

Market practice around post-employment shareholding requirements is still emerging but there is an expectation that by the end of the 2020 AGM season, most large listed companies will have a formal policy in place.

For those who have adopted the requirement already, some are simply rolling forward the 'in-service' requirement for a period of time after employment ceases (typically two years). Others are taking a phased approach under which the holding reduces in steps following cessation.

**Linking pay and performance**

The investor community are understandably focussed on the relationship between executive pay, the company's strategy, and business performance.

The new Code validates this expectation, stressing the importance of designing remuneration policies and practices to support strategy and promote long term sustainable success – that executive remuneration should be aligned to a company's purpose and values, and be clearly linked to the successful delivery of the company's long term strategy.

Where performance-based incentive plans are used, the choice of performance measures is important. Using a range of financial, non-financial and strategic measures can help ensure that targets are aligned with how the company will deliver value over the long term in line with company purpose.

There is a growing interest in 'ESG' targets but like all good performance conditions, they need to be relevant to the business. Performance measures and vesting conditions should be fully explained and clearly linked to the achievement of appropriately challenging financial and strategic goals in order to be credible enough to satisfy shareholders.

**Exercising discretion**

The extent to which remuneration committees are exercising discretion in the application of executive pay policies is also a focus area. The Code states that 'Remuneration schemes and policies should enable the use of discretion to override formulaic outcomes. having featured in the updated Code'.

Knowing when to exercise discretion can be difficult but the most likely circumstances will be those in which a vesting outcome delivers a higher reward than may be warranted the underlying financial performance of the business.

Other events that may trigger the exercise of 'downwards discretion' include a health and safety breach or some other event which may impact on the reputation of the business.

Discretion however need not be limited to vesting outcomes. Shareholders may take a dim view, for example, of circumstances in which a company has suffered a material reduction in its share price but executives continue to be granted long-term incentive awards at the same level as before.

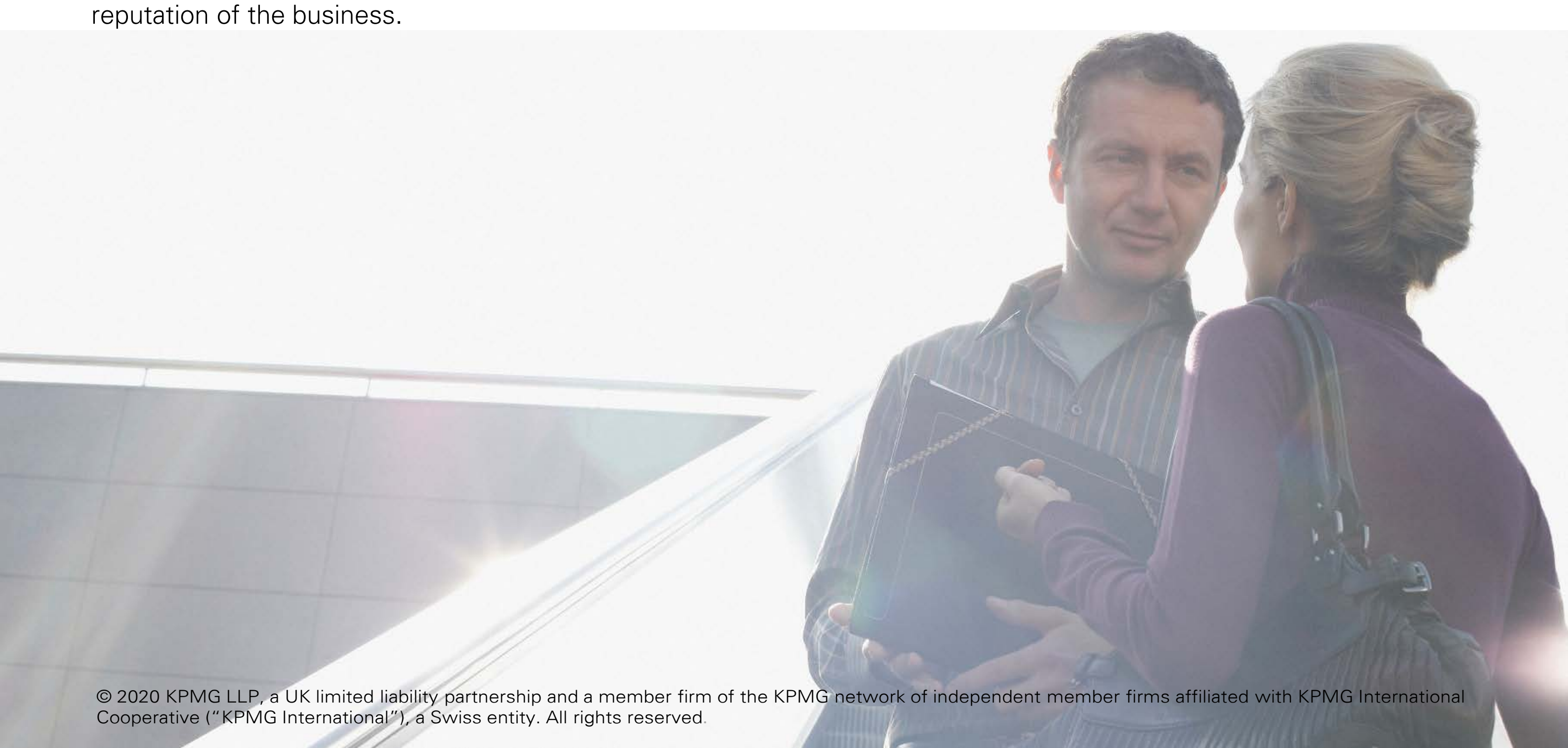
Whatever the circumstances, the goal remains the same – to ensure that the remuneration outcomes for individual directors is reasonable and reflects their contribution. Importantly, the committee must be prepared to make full disclosure whichever route it takes. The process undertaken and the decisions made, as well as the financial impact of any exercise of discretion, should be clearly disclosed and explained.

**Innovation**

Remuneration policy design is a crucial part of the remuneration committee's role. Whilst high pay will always attract attention, focus also appears to be shifting towards the structure of executive remuneration.

There is a growing debate among investors, companies and their advisors as to whether traditional LTIP structures are effective. Although more of a trickle than a wave, a number of FTSE 350 companies have replaced their 'performance share plans' with restricted share plans or so-called 'performance on grant' schemes. Some of the companies introducing these plans cite the cyclical nature of the industry in which the business operates or the impact of external events.

Remuneration committees are encouraged to be innovative – but this can require a great deal of resolve. Balancing the views of investors and participants requires tact and diplomacy and overwhelming shareholder support is not guaranteed. But chairs should take heart that the landscape now seems more open to simpler remuneration structures which are aligned to the long term business objectives, and explore whether their current structures are fit for purpose.



**Engaging with investors**

On the whole, companies continue to enjoy a high level of shareholder support for executive remuneration but when a vote does backfire, it has the capacity to grab unwelcome attention. The 2019 AGM season saw two companies in the FTSE 350 lose a vote on their remuneration reports but many more (around 13%) received a 'significant vote against'.

In an environment where FTSE350 company directors face annual election, institutional investors are increasingly using targeted voting practices to register their displeasure at the board, voting against re-election of directors.

Interaction with shareholders should be high up on a remuneration committee's agenda. Remuneration committees should look to the consultation process as a process for obtaining and understanding the views of the company's major shareholders rather than just a validation exercise.

The most effective committees will look to provide transparent details of the whole remuneration structure so that investors are able to make an informed voting decision.

Increasing levels of disclosures will make it ever easier for activists to identify what they see as bad behaviours. But, those same disclosures can be protective and act as an avenue for communication.

Being mindful of activist investors, will help companies to respond appropriately in both the short and the long term. Understanding their views and preparing a response not need to undermine the board's thinking, but rather challenge them to look at the company from the 'outside in' and use this vision to prompt change from within to benefit shareholders.


Are you up to date with the key themes impacting executive remuneration?

Read our guide to Director's remuneration in 2019 to learn more about how FTSE 350 companies set their policies.

**Growing diversity & inclusion across the board and the business**

The world has changed markedly faster than boards, and the need for relevant experience, diversity and inclusion in the boardroom is a prominent issue for investors, regulators, and other stakeholders.

According to the recently released Hampton Alexander Review, "despite all of the learning and mound of empirical research on the business case, financial and operational benefits of diverse teams, the majority of appointments in leadership teams in the FTSE350 are still going to men."

Whilst the review shows that the FTSE100 is likely to meet the 33% target ahead of the December 2020 deadline, at least 50% of the available roles need to be filled by women over the coming year for the FTSE350 as a whole, to achieve the same target of female representation on Boards.

The requirement for gender pay gap reporting is a key part of the government's efforts to drive a more equal remuneration structure within business and recognises noticing that driving parity at the boardroom level will only be achieved by increasing parity throughout the business.

The increased level of investor and political engagement on this topic highlights frustration over the slow pace of change in boardrooms, and points to the central challenge with board composition: a changing business and risk landscape. Diversity – which can be measured in so many ways: from race and gender, sexual orientation and disability, to geographical heritage – is crucial to the future of any business. And to be part of the solution everyone needs to be informed.

For more on the topic of improving gender balance in FTSE leadership, read the full report, 'Hampton Alexander Review'

**Communicating clearly and early**

Directors' Remuneration Reports are subject to detailed disclosure requirements that have resulted in them becoming increasingly long, complex and difficult to follow.

To present useful and understandable reporting it is crucial to think about how to create a focus on the key elements of pay strategy and the outcomes. Think carefully about how the company performance has impacted the numbers, in particular with regard to annual bonuses, and how the committee can best articulate the targets set for the executives.

Remember that the Director's Remuneration Report is the most valuable communication tool at the disposal of the remuneration committee – an opportunity to communicate its message around what remuneration means to the company, how it relates to employee pay and how it is used as a tool for corporate success.

As of this reporting cycle, quoted companies with more than 250 UK employees are required to publish the ratio of their CEO's total remuneration to the 25th, 50th and 75th percentile full-time equivalent (FTE) remuneration of their UK employees

Whilst in isolation, a pay ratio may not shed much light on pay practices in any one company, year-on-year will be of great interest to the investment community. Shareholders will expect strong rationale if the ratio has increased compared with previous years or appears out of kilter with other companies in the same industry. So pay particular attention to explaining why the ratio is appropriate given the performance of the business and rewards for the general workforce.

## Minding our own business

Rewarding executives requires informed judgement and a thorough understanding of the company and the forces that shape directors' remuneration.

Remuneration committee members do not need expert knowledge, but they do need data to make sound decisions on levels of remuneration, on the link between remuneration and performance, and on the structure and cost of all elements of the executive package.

Compliance with 2018 UK Corporate Governance Code requires that, before appointment, a remuneration committee chair should have served on a remuneration committee for at least twelve months.

Given these demands, committees need to be alive to their needs whether this the extent of the support required from external advisers, the need for training or even the composition and chairmanship of the committee itself.

## Topics for discussion

- What’s your approach to executive pensions?
- Do you have a policy on post-employment shareholding requirements?
- Can you articulate the link between your executive remuneration policy and business strategy?
- When did you last consider the structure of your policy and your incentive plans?
- Are you giving diversity and inclusion sufficient air time in your committee discussions?
- Is your committee properly supported to ensure you are developing appropriate polices?

## The KPMG Board Leadership Centre

The KPMG Board Leadership Centre offers support and guidance to non-executive directors, whether managing a portfolio non-executive career or embarking on a first appointment. Membership offers you a place within a community of board-level peers with access to topical and relevant seminars, invaluable resources and thought leadership, as well as lively and engaging networking opportunities. We equip you with the tools you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business.

Learn more at www.kpmg.com/uk/blc.

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