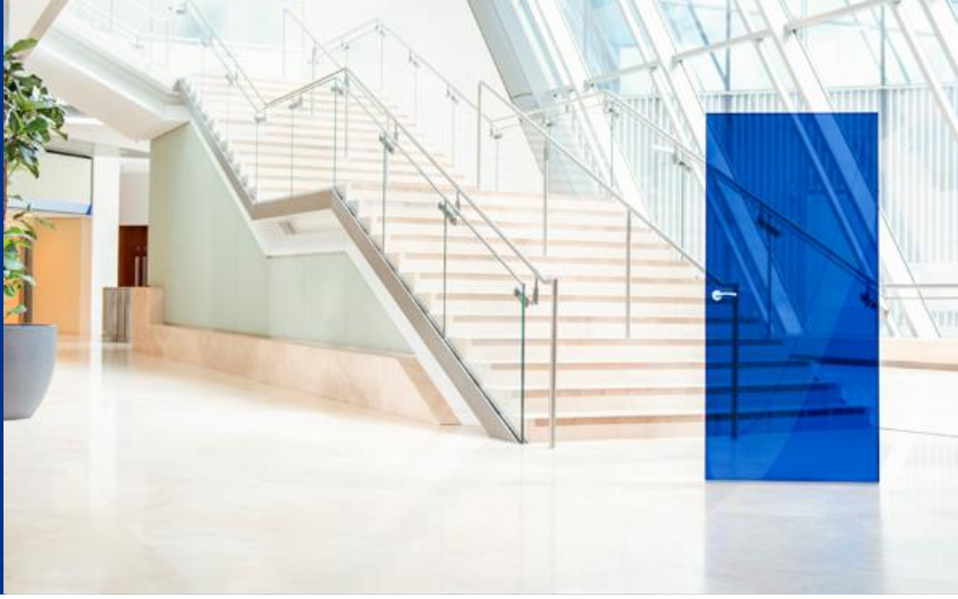
KPMG

A conversation about executive pay

KPMG Audit Committee Institute



In this year where COVID-19 has put nearly every facet of business to the test, Chris Barnes, the Head of KPMG's Reward and Executive Compensation practice in the UK, joined our Board Leadership Centre FTSE350 meeting to lead a conversation around executive pay and some of the current challenges facing remuneration committees.

From an executive pay perspective, business has responded to the COVID-19 challenge with a raft of measures including reductions in pay, deferral or cancellation of bonuses and adjustments to LTIPs. Whilst there has been criticism in some quarters that such adjustments have been token gestures, the pandemic has brought into sharp focus the concept of fairness in the workplace – a theme that has been a constant and growing issue in organisations and society more generally over recent times. It is this debate around 'fairness' that is likely to dominate boardroom (and media) discussions around executive pay over the year ahead.

Pensions.

Pension policies are continuing to evolve to meet the UK Corporate Governance Code 'requirement' that directors' contribution rates are aligned with those of the majority of their workforces. Almost without exception, companies now align contribution rates of new directors with staff levels, but policy is more varied when it comes to existing directors.

Almost all companies indicate that they are working towards alignment for their current directors, but the pace and methods of progress are where policy differs. At the start of the year, many companies were making one-step adjustments to reach this goal but over the latter part of the year the trend has moved towards either phasing contribution rates downwards or freezing them in monetary terms so that, as a percentage of salary, they would reduce over time. Many investors have been clear that this latter approach is not acceptable so that phasing pension contribution rates over time is now the most common approach (although by no means universal).

Some organisations have used other methods such as reducing existing director pension levels by aligning contribution rates with a specific group of staff such as head office employees or senior executives, rather than the whole workforce.

Others have aligned existing director rates with those that are available to staff that joined the firm at the same time. The logic being that while these rates are higher than the staff majority, the policy is equitable because existing directors are being treated the same as more junior staff that have the same or similar job tenures.

Less typical, but nevertheless featuring as an approach for some, are the few organisations that have narrowed their pension gaps by increasing staff pension rates.

This will continue to feed through the next two cycles of year end reporting, as organisations updated Remuneration Policies to come into line with the latest investor views.

Environmental, Social and Governance (ESG)

ESG factors, and how they can be incorporated into incentive packages, continues to gather momentum – though there are challenges in balancing the expectations of investors to deliver against 'standard' KPIs (TSR and profits) and how to accurately and robustly measure ESG targets.

While a range of measures are emerging, their weightings are still generally very small - albeit there are a few exceptions. For example, we have seen LTIPs with social impact weightings as large as 33 percent and annual bonuses with 20 percent weighted to measures like carbon intensity, renewable output, electric vehicle infrastructure, fair tax and the living wage.

And in some businesses, we have seen bonus plans being developed to which *all staff* will have a significant part of their reward determined by reference to their own personal IDSE contribution.

Going forward, the challenge will be to avoid a 'me too' approach and ensure that the measures adopted align with the wider corporate strategy.

Finally, it has been interesting to see the emergence of ESG committees with committee chairs receiving additional remuneration.

Long term incentive plans

The challenge around setting LTIP targets against an uncertain economic background has featured heavily in remuneration policies.

In March, the Investment Association set out its view that remuneration committees could take several different approaches in relation to target setting – including deferring making decisions on performance conditions, or indeed deferring awards until later in the year.

For many companies that opted for the deferral option, hoping for additional clarity and certainty over the longer-term economic outlook – the timeframe during which they committed to arrive at an answer is fast approaching. With the continued worries in relation to a second COVID-19 spike, the increasingly likely outcome of a no-deal Brexit and an unusual US Presidential Election, the landscape for setting performance conditions seems no less challenging than several months ago.

We did see an increase in companies side-stepping the difficult question of performance conditions, by opting for restricted stock for their 2020 awards. After a number of years of restricted stock looking like it will move more mainstream, some larger businesses have introduced such plans.

In many cases, the strategic rationale for making such awards was related to the volatility of the markets, or the much longer term view needed to support the underlying business strategy – with investment or re-direction not necessarily expected to result in share price growth over the short to medium term. In all cases, underpins were incorporated – and remuneration committee discretion retained to adjust outcomes.

Discretion

Whether companies use performance conditions or choose to move to restricted shares, we will inevitably see an increased focus on remuneration committees exercising discretion in determining LTIP and annual bonus outcomes.

There have been many examples of this exercise of discretion in 2020 - but 2020 has been an exceptional year (and not in a good way). In the same way that the public tire of restrictions on freedom, there are lingering concerns around the practicalities of managing an effective relationship between the executive and non-executive members of a board over a longer term, where discretion looms so heavily over some significant amounts of the overall reward package. The judgement necessary when balancing the demanding expectations of investors with the performance of management in exceptionally difficult times, is something that will likely test remuneration committees for years to come.

Minimum shareholding requirements

A final observation relates to how share prices have affected compliance with minimum shareholding requirements, and how companies have responded to that.

For example, we have seen examples of CEO shareholdings increase in terms of numbers of shares by nearly 40 percent, but at the same time the value of that shareholding as a percentage of salary decrease from an equivalent percentage.

Similarly, pressures arise where non-executive directors are required to have a shareholding equal to (say) their basic fee after 3 years in role. Share price volatility has seen some companies change these requirements to a fixed number of shares, rather than as a percentage of fees or salary.

Of course, the hope of investors and management alike would be that the share price would recover, but consideration of the impact of share price on the holdings of executives should be kept under review. In particular, if plan rules are drafted in mechanistic ways so as to automatically restrict sales where the company holding guidelines have not been achieved, this may be another area where we will see difficult conversations with management teams – and once more pressure on the remuneration committee.

With many companies having introduced post-cessation holding requirements for their executives, this will not just be an issue for current but also former management, who may have otherwise expected the ability to liquidate some of their shareholdings to finance their retirement.

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In conclusion, remuneration committee chairmanship is not for the faint hearted and a role which requires the ability to mediate and manage the views of two (or more) groups who can often be quite some way apart. 2021 certainly won't become any less challenging, but the lessons we have learned on the way will hopefully help shape a more positive dialogue and a new way of looking at the whole purpose of reward in businesses over the years ahead – rather than the somewhat one-dimensional debate around quantum which has dominated for the past few years.

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.

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