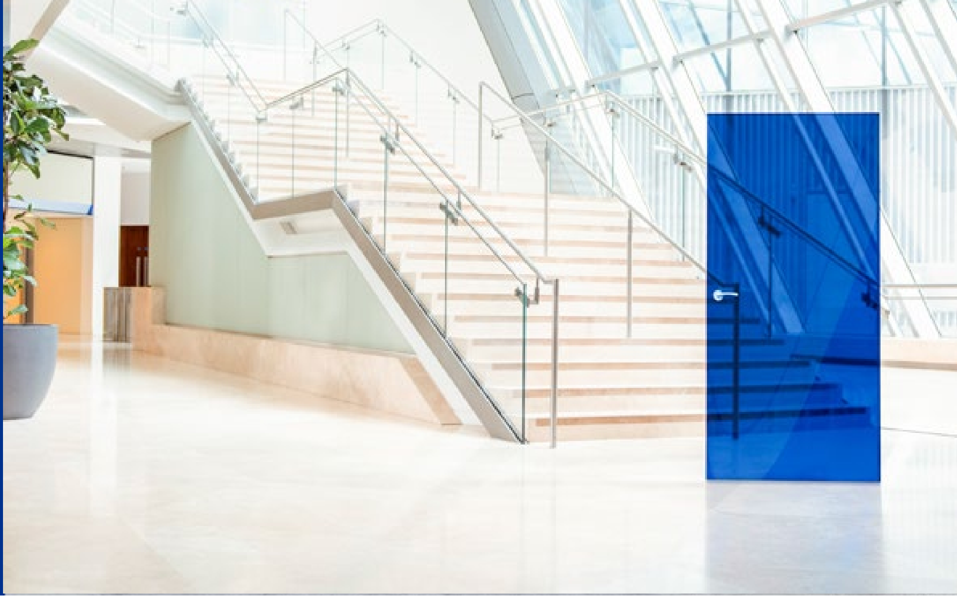

On the 2022 remuneration committee agenda

KPMG Board Leadership Centre

Executive compensation has been under intense scrutiny over the past two years and the heightened scrutiny is unlikely to lessen in a post-pandemic world. 2021 has been a record year for the number of shareholder and investor revolts, therefore, as businesses and economies start to recover, remuneration committees will have to carefully look at their policies and decisions around remuneration with the continuing focus on restraint but also the impact of pay on the wider workforce.

Based on recent actions within the market and our engagement with board members and members of remuneration committees across different industries, we have highlighted seven areas to keep in mind as remuneration committees consider and carry out their 2022 agendas.

Prominence of the Environment, Social and Governance (ESG) agenda

ESG is now a critical consideration for businesses and continues to be high on the agenda of remuneration committees. With the majority of companies now implementing an ESG strategy, it is a primary concern for business leaders as to how they will drive dynamic change in this space. Investors, regulators, employees, customers and other stakeholders will therefore hold clear expectations of how management interests have been aligned to ESG strategies and how they will be incentivised to bring those to fruition.

Linking executive pay and ESG metrics is a continuing conversation with at least half of the FTSE100 having implemented some form of ESG metric into their long-term incentive. With the majority of proxy advisors and investors encouraging the inclusion ESG related performance measures, the question now is, how do you set targets? Below are talking points for boards and remuneration committees:

— Prioritise. Whilst undoubtedly any board will be looking to achieve all elements of their ESG strategy, it is useful to prioritise which areas will be a key focus in the next 3-5 years. This helps to provide milestones for achievement particularly where the objectives are very long term, such as climate related strategies.

— Materiality. Many of the measures we are seeing 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 the importance.

— Culture. How can the wider workforce also be incentivised? Bringing a collaborative approach and linking together the focus of the executives with that of the wider workforce, will not only reinforce a refreshed corporate culture, but also drive performance.

Inclusion, Diversity and Social Equality (IDSE)

Th IDSE agenda continues to be a crucial consideration and is very much front of mind, due to continuing social and political events. The FCA have announced a consultation for proposed amendments to Listing Rules which would require listed companies to publish a 'comply or explain' statement on whether they have achieved certain targets on board diversity. The targets proposed are as follows:

— At least 40% of the board to be women;

— At least one senior board position to be held by a woman; and

— At least one board member to be from a non-white ethnic minority background

These targets are designed to provide a 'positive benchmark', but will mean that boards will need to take affirmative and clear action to improve board diversity.

From a pay perspective, remuneration committees and organisations should continue to review the composition of the total reward package and consider if there are constituent parts which may discourage the promotion of individuals from minority groups.

IDSE is part of the broader ESG agenda and therefore should become part of the performance-based targets linked to executive pay, as discussed above.

Improving 'comply or explain' reporting

In February 2021, the FRC issued a report on 'Improving the quality of 'comply and explain' which aimed to promote the important of reporting on outcomes, rather than process and to also remind companies to report clearly on any departures from the Code, supported by effective explanations.

There were a number of areas highlighted where companies had not sufficiently provided explanations for non-adherence to the code in respect of workforce engagement, chair tenure and describing the work of the remuneration committee.

In terms of pay, further explanation is required where executive pensions are not yet aligned to the wider workforce, which includes a timeline for when these amendments will occur. Given that all executive pensions should be aligned by end of December 2022, this will be a key year for compliance with this provision.

The FRC also highlighted non-compliance with the post-employment shareholding requirement, where a number of companies did not have a specific policy outlining these requirements and instead relied upon a statement that vesting and post-vesting periods apply after the departure of directors from the company.

Overall, the FRC is encouraging companies to take advantage of the flexibility the 'comply or explain' approach offers to develop high quality reporting of good governance and transparency and to avoid formulaic approaches which lead to the use of 'boilerplate language'. Therefore, it should be on the board agenda for 2022 to review their disclosures and ensure that sufficiently detailed explanations are provided for any non-compliance with the Code.

Expanded remit of remuneration committees

In the wake of COVID-19, remuneration committees have had to apply sound judgement on executive pay impacted by the pandemic and should continue to do so in terms of exercising restraint and addressing potential windfall gains or losses.

Monitoring executive pay levels, determining appropriate bonus outcomes and appropriate basis for LTI grants during this period of economic recovery will continue to be a focus, however, we are also seeing a growing need to ensure that these decisions are linked to wider workforce pay and people strategies.

Again, this can be linked to the rise of ESG strategies and the need to have effective change management in terms of corporate culture becoming more focused on a fully inclusive environment and employee engagement and wellbeing.

It is also important in terms of ensuring a strong succession strategy and ensuring that pay policies are encouraging strong career development for a diverse workforce.

Innovative incentive arrangements

The debate around more innovative incentive ideas continues to develop and has only been enhanced by the need for fresh thinking on delivering executive compensation and long term incentives.

We have discussed previously the gaining momentum over Restricted Share Plans (RSPs), but these continue to have a mixed reception from investors.

However, with more companies having a renewed purpose and focusing on creating long-term sustainable business models, this will see an increased focus on the need for a more balanced view in terms of performance conditions (i.e. financial vs non-financial) and also a more behavioural focused reward philosophy.

Reputational dangers and the fairness agenda

According to recent reports, more than twice as many FTSE100 companies have faced shareholder rebellions over executive pay this year compared to last year, due to many investors taking a harder line on the fairness of pay.

As we have previously discussed, 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.

The fairness agenda is not a new topic, but its importance continues to increase and shows the need for continued restraint to be shown in respect of executive pay, but also the growing remit the remuneration committee has to ensure that its pay decisions are reflective of the pay philosophy applied to all employees.

Whilst the majority of companies have frozen executive pay, cancelled or revised bonus pay outs and been more conservative in terms of LTIP grants, investors have continued to vote against remuneration reports where they consider executives to have been shielded from the real impact of the pandemic. In many cases, even with the lower pay levels we have seen over the past year, some stakeholders would still consider the level of reward received by executives to be generous given the economic hardships experienced by the population as a whole, but particularly in cases where there has been a level of government support to protect large businesses.

Therefore, again in line with the ESG focus which should be embedded into all areas of a company's operations and outlook, remuneration committees will need to continue to apply 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.

Investor engagement

Engaging with institutional investors on matters around executive pay has always been an important aspect of the ongoing dialogue between the company and its shareholders.

However, a very recent statement issued by LGIM has suggested that on the basis that engagement has so infrequently changed the position on executive pay to reflect investor views that this is no longer going to be a key focus of their consultation – with companies instead generally directed to their policy statement (other than in very specific circumstances).

Whilst this is currently only the position of one investment manager, to the extent that this becomes more widespread – as investors increase the range of performance indicators which they assess businesses against – it further serves to illustrate how remuneration committees need to be comfortable in their decisions with reference to the stated policies of their key investors.

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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