People Advisory Services

Executive Pay: Insights into the 2020 AGM reporting season

July 2020

Building a better working world

Introduction

This season just under a third of FTSE 350 companies have tabled a new policy to shareholders so far. On this front we haven't seen anything unexpected with companies continuing to align their pay structures with governance requirements and shareholder expectations. See pages 3 to 5 for a summary of the key themes from the season.

As COVID-19 and the disruption and uncertainty it has caused has been the dominant topic so far this year we lead with a summary of how companies have responded from an executive pay perspective, followed by a summary of insights from clients on what the future may hold for executive pay in the current climate.

Response to COVID-19

Given the timing of the pandemic, we have observed minimal disclosure relating to COVID-19 in the annual reports published so far. Companies that have made substantive changes to executive pay have provided the detail via RNS announcements. Investors and proxy voting agencies have published guidance on how companies should act on executive pay in light of COVID-19 with most stating that the executive experience should be commensurate with shareholders, employees and other stakeholders.

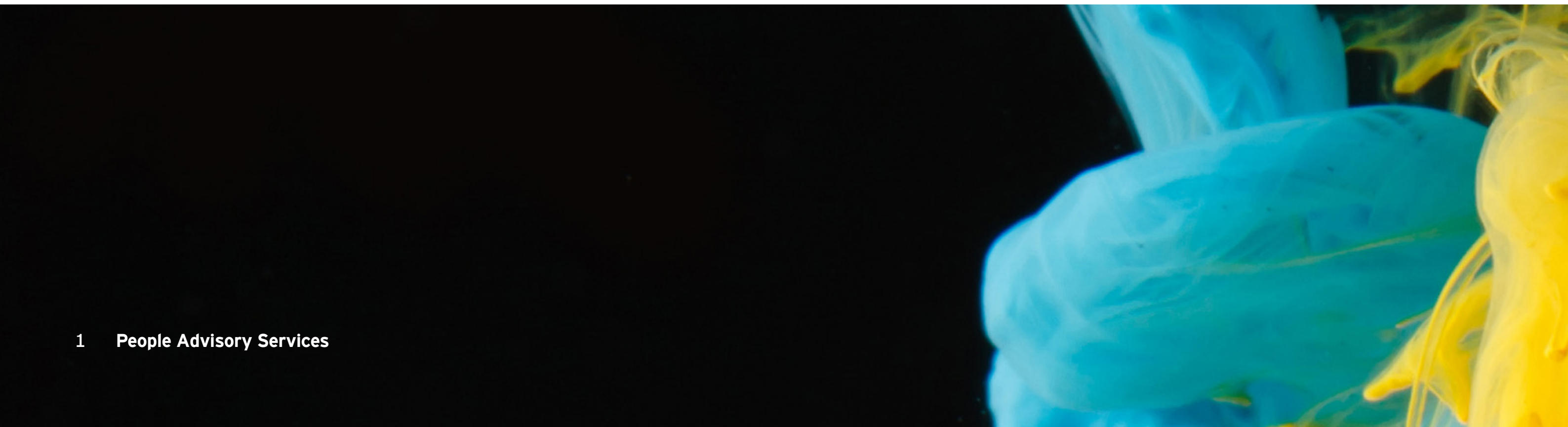
So, how have companies reacted so far and what does the future hold?

The Now

Base pay: To date approximately a third of FTSE 350 companies have announced that they have made amendments to executive pay as a direct result of the business impact of COVID-19. Those companies that have furloughed some employees have typically reduced executive director base pay to align with the furlough reduction of 20%. There is a higher prevalence and quantum of reductions in impacted industries such as travel, leisure, non-food retail and hospitality with a handful of executive directors waving their base salary entirely.

Annual bonuses: Some companies who were yet to pay their FY19 bonus awards when the pandemic hit have deferred payment of FY19 bonuses until the business impact of COVID-19 is clearer. In respect of the FY 20 annual bonuses, a handful of companies in the hardest hit sectors have communicated that they have cancelled these awards outright, partly to demonstrate to stakeholders that they are taking steps to address executive pay as part of efforts to maintain the overall health of the organisation. Most companies however have indicated that they will let the FY 20 award run its course and assess whether outcomes are appropriate at the end of the performance period.

Long-term incentives: Some companies in the hardest hit sectors have cancelled FY20 awards with a handful of directors having waived their entitlement to their LTIP grant this year. Based on our company insights most companies have granted their FY20 awards as normal however some have delayed setting their targets until the landscape is clearer. Given that many companies have experienced a significant share price drop, companies should consider whether LTIP grant sizes should consequently be reduced.



Response to COVID-19

On the whole, investors have indicated that they have been broadly satisfied with how companies have addressed executive pay in light of the immediate business impact of COVID-19. Investors have stated that pay cuts should simply not end when the pandemic is over and that companies should seek to find a new normal in the years ahead which focuses on restraint in executive pay. Most companies who have made reductions to executive director base salaries have done so for an initial period of 3 to 6 months. We expect those companies who are in the hardest hit sectors to keep salaries at the reduced level for at least the remainder of the year and beyond.

What's next?

Our client insights are telling us that:

- Given an increased management focus on cash preservation, companies are considering adding in or increasing the weighting of the cash measure in future annual bonus awards. We expect companies generally to focus on 'business critical' metrics such as cash flow, profit, and revenue.
- Remuneration Committees are considering any unintended impact of taking business rate/VAT relief on cash-based performance metrics and will consider making adjustments if appropriate.
- Some companies are planning to move away from segmented metrics by jurisdiction to company wide metrics to mitigate the varying impact of COVID-19 in each country.
- Companies with market based metrics such as Total Shareholder Return may consider both actual and relative performance as a sense check to ensure payouts are appropriate.
- Some companies are considering setting quarterly or half-yearly targets as a result of the difficulty in setting meaningful annual targets during this time. For those setting annual targets, some companies have indicated that they are making awards as normal but are committing to reviewing the targets periodically during the year.
- With many investors supporting the implementation of a restricted stock plan as long as certain conditions are met (i.e. at least a 50% reduction in awards size, appropriate underpins), some companies are having internal discussions on adopting restricted shares given target setting is so difficult in the current climate.

AGM season review 2020

To date approximately a third of FTSE 350 companies have tabled a new policy to shareholders and on this front we haven't observed anything unexpected in terms of pay design. Broadly, proxy voting agencies are continuing to flag the same issues raised in recent years, these are: **incentive quantum; inadequate bonus target disclosure,** particularly in relation to non-financial metrics; **use of upward discretion; lack of target stretch; base salary increases above inflation;** and **high executive director pension contributions.**

Below we present the voting outcomes so far in 2020 alongside proxy voting agency comments on some companies receiving less than 80% shareholder support.

	Median shareholder support - Remuneration Report	No of companies receiving <80% - Remuneration Report	Median shareholder support - Remuneration Policy	No of companies receiving <80% - Remuneration Policy
FTSE 100	96%	2	96%	5
FTSE 250	97%	13	97%	3

Company A – Remuneration Policy

Pension levels for the incumbent CEO are significantly above workforce levels, no commitment has been made to reduce the level.

ISS recommendation	AGAINST
IVIS recommendation	AMBER

Company B – Remuneration Report

The newly appointed CEO was awarded a 9.5% salary increase. The newly appointed CFO was granted an increased LTIP of award of 400% of salary, previously 350% of salary.

ISS recommendation	AGAINST
IVIS recommendation	AMBER

Company C – Remuneration Report

Due to a highly leveraged variable pay structure pay levels are high compared to peer companies. Despite >20% votes against the report in the previous year no significant changes have been made to address shareholder concerns.

ISS recommendation	AGAINST
IVIS recommendation	RED

Company D – Remuneration Policy

Although pension rates have been frozen for executive directors they are significantly above workforce levels, no commitment has been made to reduce the level.

ISS recommendation	AGAINST
IVIS recommendation	RED

Company E – Remuneration Policy and Report

The structure of the annual bonus plan is uncapped with consistently high payouts.

ISS recommendation	AGAINST
IVIS recommendation	AMBER

Company F – Remuneration Report

The Remuneration Committee applied its discretion to the annual bonus resulting in significant bonus payouts that proxy agencies flagged as not being correlated to company performance.

ISS recommendation	AGAINST
IVIS recommendation	AMBER

AGM season review 2020

Below we present the most notable developments in pay design and disclosure so far this AGM season.

Pension

The alignment of executive director pension contributions with that of the wider workforce has been an investor hot topic in recent years. Whilst the vast majority of companies have reduced executive pension contributions for new hires, guidance from the Investment Association states that companies will need to ensure that the pension contribution for incumbent executive directors are aligned to the wider workforce by no later than 2022.

Based on our research, c.45% of FTSE 100 organisations have either reduced or have committed to reduce incumbent executive director pension contributions. In most cases the reductions, or committed reductions, will align with the pension level available to the wider workforce. Around half of these organisations are reducing executive director pension contributions via a phased reduction over time whilst approximately 15% of companies have frozen the monetary value of the contribution. Interestingly a handful of companies have increased the pension rate available to the wider workforce. 10% of salary is the most commonly disclosed workforce rate in the FTSE 100.

ESG metrics

The Investment Association is now requiring companies explain in their annual report the impact climate change will have on their business model and how these risks are being measured and managed. IVIS will be tracking the progress of companies with investors wanting to see significant movement towards reporting in line with the Task Force for Climate-related Financial Disclosures recommendations by 2022. This will see companies reporting on climate-related risks in a consistent, clear and comparable manner, enabling investment managers to make better informed investment decisions.

Many investors have stated that they are not only making decisions to invest based on a company's reaction to these ESG concerns but are specifically asking Boards to consider using ESG metrics in variable pay schemes. This AGM season we have seen more widespread adoption of ESG metrics, particularly throughout the FTSE 250 however most ESG metrics remain a very small proportion of the total weighting and are most commonly incorporated into annual bonus plans. Examples include:

- **Carbon metrics:** e.g., reducing carbon footprints, introducing carbon management or capture systems
- **Sustainability metrics:** e.g., investing in sustainable projects, increasing use of renewable energy
- **Health and safety metrics:** e.g., accident frequency rate, typically used in extractive industries or aviation
- **People and customer metrics:** e.g., employee engagement, diversity and inclusion, net promoter score

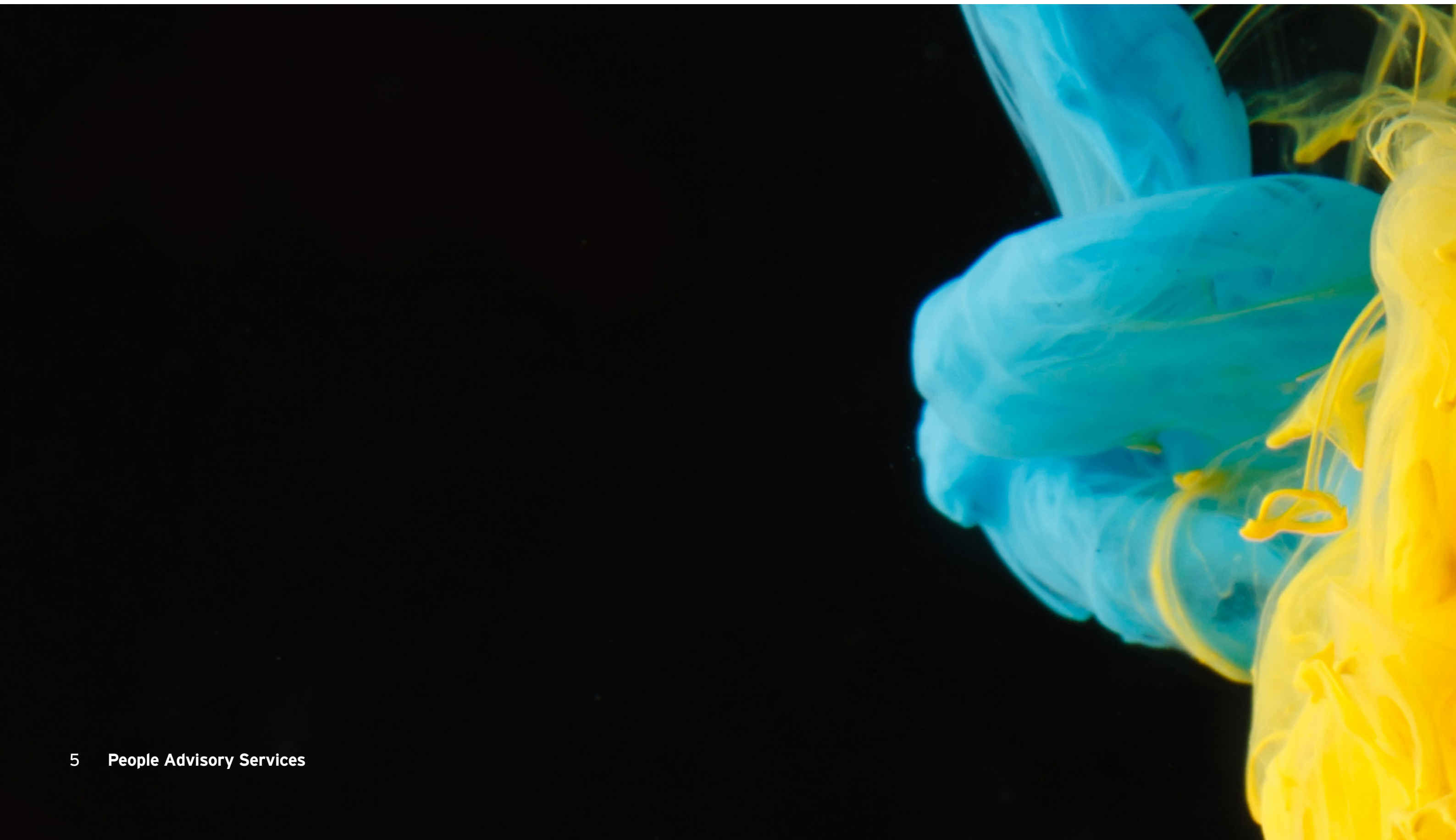
AGM season review 2020

CEO pay ratio

The 2020 reporting season marks the first year companies are required to publish their CEO pay ratio, although many companies did publish on a voluntarily basis last year. As it is the Government's and investors preferred approach, Option A is the most common method used by FTSE 350 companies to calculate the ratio with 64% using this method, followed by Option B (30%) and Option C (6%). Given that for many companies this is the second year of disclosure of the ratio, some organisations have provided a detailed explanation accounting for the variability of the pay ratio year-on-year, in a handful of cases pointing out that the remuneration of the workforce has increased despite the pay ratio increasing. We expect explanatory narrative on the volatility of the ratio to become the norm in the years ahead.

In the FTSE 100 the median pay ratio is 75:1, with a maximum of 2605:1 and a minimum of 17:1. The organisation with the highest ratio also produced a separate pay ratio which excluded the value plan gains which were the main contributor to the high ratio. In the FTSE 250 the median pay ratio is 37:1 with a maximum of 229:1 and a minimum of 8:1. A handful of companies have gone above and beyond the legislative requirements and produced additional ratios e.g., publishing a global ratio or producing ratios with different populations such as the senior management team. Such disclosures can help contextualise the ratio when provided with a compelling narrative.

Practice in relation to the pay ratio narrative remains mixed with those providing a more comprehensive narrative typically explaining the ratio with reference to their lowest paid employees. This includes, for example: referencing how salary progression is structured for those at the lowest pay bands; stating that no employees are paid below the real living wage; and referencing fair pay principles that form the backbone of a remuneration framework that is intended to be fair and free from discrimination. We expect that this is an area of disclosure that will continue to develop as investors have indicated they will pay more attention to the narrative rather than the ratios themselves.



Conclusions

Given the current climate we expect that there will be a heightened focus on executive pay outcomes in the months and years ahead. Investors and wider stakeholders will particularly pay attention to the consistency in decision making from the top to the bottom of the organisation. Companies should be particularly mindful not to be seen as treating executives more favourably than the employee population or risk significant reputational damage as a result.

At year end Remuneration Committees should be prepared to make some decisive and difficult decisions but also recognise that HR governance policies and practices need to continue to apply so that decisions are not made in isolation in reaction to COVID-19 impact. Organisations should continue to make governance-framed decisions that fully considers the shareholder, and wider stakeholder, experience.

Contact

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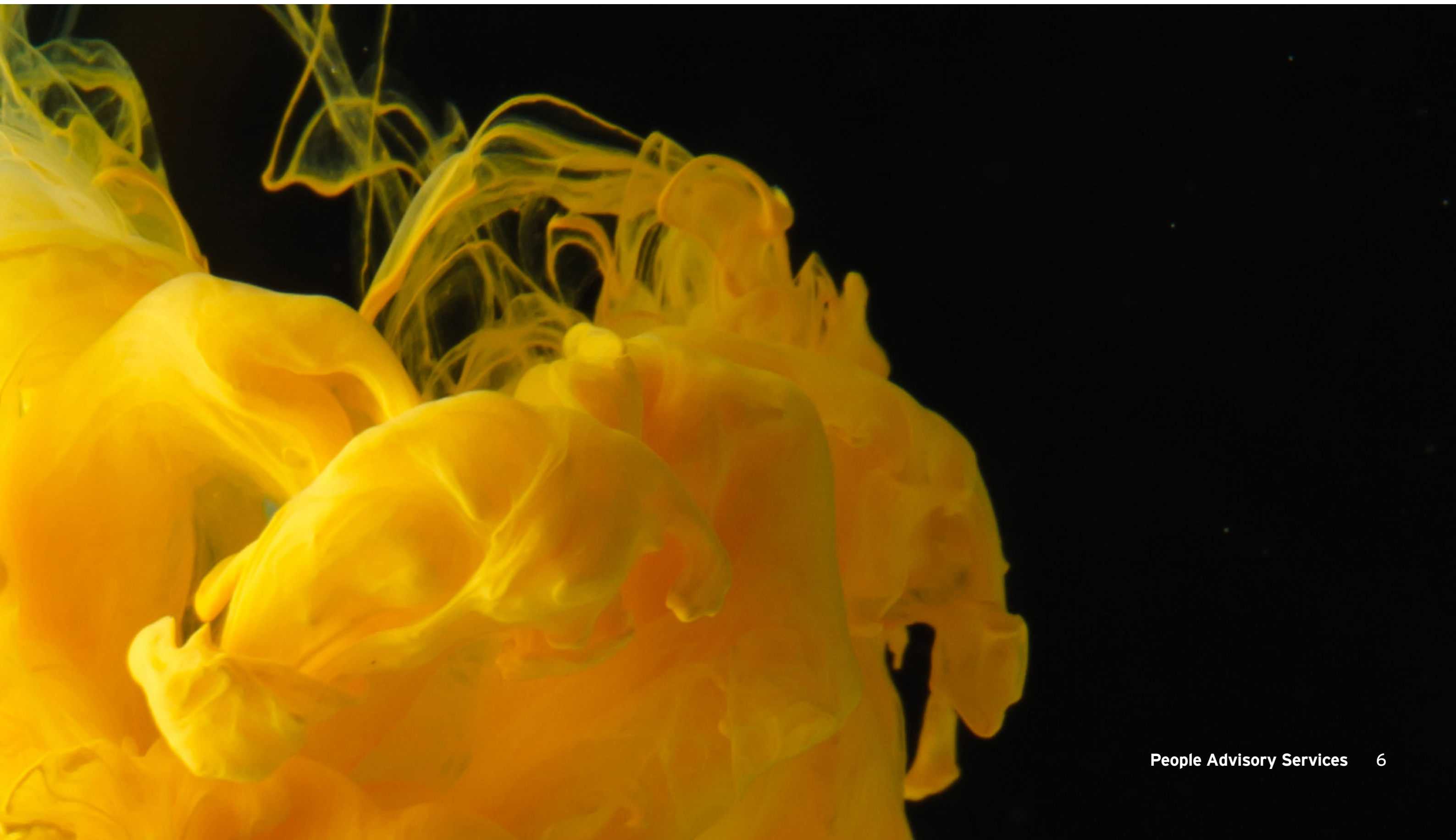

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ED None

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