Executive Compensation in the UK — Current Issues for Remuneration Committees and Considerations for the 2021 Voting Season

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The 2020 annual general meeting (AGM) season presented challenges for the remuneration committees of U.K. listed companies, which look set to continue into the 2021 season. Executive compensation, the widening gap between workforce and management pay, and reward for underperformance remain key areas of focus for investors. The COVID-19 pandemic has intensified scrutiny in these areas, and has accelerated the move (driven in part by the continuing investor focus on ESG credentials, as detailed in our October 29, 2020, client alert "Finding the 'S' in ESG: Boardroom and Employee Considerations") towards requiring more responsible remuneration practices and appropriate use of remuneration structures. As the COVID-19 pandemic continues into the 2021 AGM season, investors and the public will be assessing how the pandemic's impact on businesses and the wider workforce should affect decisions concerning executive pay. We have set out below the key issues for listed companies to consider.

2021 Pay Reviews

Investors and the public alike will expect continuing pay restraint to reflect the ongoing and widening impact of the pandemic on a business and, more widely, on workforce pay and conditions. In statements published in April 2020 and November 2020, the Investment Association (IA) made clear that where companies have reduced or cancelled dividend payments, sought to raise additional capital from shareholders, or received government support, for example, under the Job Retention Scheme, investors expect this to be reflected in remuneration outcomes. The IA further notes the impact of indirect government support (*e.g.*, tax relief) on the assessment of financial performance and instructs investors to take this into account in determining remuneration outcomes.

- **Salary:** The IA's November statement notes that investors continue look closely at the justifications for any increases in base salary or variable pay for senior executives, and to monitor incremental increases to fixed and variable pay. The pandemic has only increased this level of focus. Many companies cut executive pay or bonuses as an initial response to the pandemic and to parallel salary reductions for the wider workforce. Investors and the public will expect executives to continue to "share the pain" of the pandemic's impact on business, and headline salaries are an obvious spotlight for comparison (especially for businesses significantly affected by the pandemic).
- **Annual bonus/long-term incentive plan (LTIP) payout determinations:** Many companies reduced or cancelled annual bonuses for the 2019/20 performance year in response to the pandemic, and deferred the cash element of annual bonuses and/or paid bonuses in shares to address short-term cash flow concerns. Investors will expect a similar approach in 2020/21 bonus determinations, where appropriate to reflect the impact of the pandemic on the business and wider workforce, with the IA suggesting in its November statement that companies defer a higher portion of bonus awards into shares (and in any event now requiring deferral where the bonus opportunity is greater than 100% of salary, under the IA's Remuneration Principles), and recommending that, unless there are exceptional circumstances, a company should not pay any bonuses if it required government or shareholder support. Such restrictions are less likely to affect LTIP award determinations, where only a portion of the performance year has been impacted by the pandemic. For 2021 determinations, the difficulties for vesting determinations of LTIP awards will come in future years — see the discussion of "windfall gains" below. Institutional investors[1] are clear that they do not support the retrospective or "in-flight" amendment of performance conditions, and the IA November statement asks remuneration committees to confirm in their remuneration

[1] *See* 2020 LGIM "Global Corporate Governance and Responsible Investment Principles; IA's "Executive Remuneration in UK listed companies: Shareholder Expectations during the COVID-19 Pandemic," Nov. 16, 2020.

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reports that performance conditions were not adjusted in the year. Additionally, the statement recommends that where "the performance of the company and shareholder experience is not commensurate with the executive remuneration outcomes," remuneration committees should use discretion to ensure a "good link between pay and performance," engaging with shareholders as necessary and disclosing the reasons for the use of such discretion.

- **Annual bonus and LTIP award grants:** For 2021 awards, determining maximum bonus opportunity or grant size, and appropriate performance conditions for vesting, will continue to present challenges. In relation to share awards, the IA in its November statement continues to urge companies to be mindful of "windfall gains" (essentially, a gain due to market movement only) and grant size where awards are granted at a time of share price volatility. Regarding grant size, companies may be reluctant to lock in a reduction in maximum bonus opportunity or overall quantum at the time of the grant, preferring instead to commit to using discretion at the time of vesting to ensure appropriate remuneration outcomes that are commensurate with the company and shareholder experience. For share awards, the IA expects remuneration reports to detail the approaches and factors that the remuneration committee will consider in determining if a windfall gain has occurred (in relation to 2020 awards, and going forward for awards granted during the pandemic). Regarding performance conditions, the IA acknowledges that setting appropriate performance conditions in the current environment is challenging. It does not repeat the guidance set out in its April 2020 statement about delaying the setting of performance conditions or a related grant; instead, it suggests that a reduction in performance target range or a wider target range may be appropriate, provided that targets remain sufficiently ambitious. The IA expressly states that remuneration committees should be prepared to and commit to use available discretions to ensure remuneration outcomes reflect both the company and executive performance and the shareholder/stakeholder experience (including the ability to reduce vesting where determination of performance conditions is not consistent with overall performance or where windfall gains have occurred).

ESG Metrics in Performance Conditions

With investors' continuing focus on companies' accountability for ESG matters, companies will need to consider the extent to which they include and weight ESG factors in performance measures for incentive awards. In recently published investment principles for 2020, the IA and Legal & General Investment Management (LGIM) acknowledge the impact of ESG risks on long-term value creation as well as the utility of incorporating management of ESG risks into long-term strategy. This particularly applies to companies that are exposed to high levels of environmental, social or reputational risk. However, the IA reiterates its view and cautions companies that performance metrics must be quantifiable, and clearly linked to value creation and long-term strategy (including when ESG targets are chosen). The IA clearly expects that financial metrics will comprise the majority of incentive metrics, and that a threshold level of financial performance is a prerequisite for payment of an annual bonus, even where a portion of the award is based on personal or other nonfinancial metrics.

Pay Gap Reporting

Given the current interest in the comparative impact of the pandemic on executives and the wider workforce, and the increased focus on a fair remuneration structure and the role of remuneration in the social and governance aspects of ESG matters, increased scrutiny of pay gap reporting and accompanying narratives is likely.

Pension Contributions

Following the IA's focus on reductions in executive pension contribution levels in the 2019/20 reporting season, the topic remained a focus for investors during this period. The IA reported in October 2020 that "significant progress" had been made in aligning executive pension contribution levels with those received by the majority of the workforce[2] (as recommended under the UK Corporate Governance Code, and in the IA Remuneration Principles and LGIM Investment Principles). The majority of companies either reduced executive director pension contribution rates to align with the rates for the majority of the work force last year, or committed to do so by 2022. Institutional investors expect continuing progress in this area. The Institutional Voting Information Service (IVIS) will "red top" a remuneration report where the executive pension contribution is 15% or more and the remuneration committee has not set out a credible action plan to align executive pension contribution rates with the rates received by the majority of the workforce by the end of 2022. IVIS will also flag any new remuneration policy that does not provide for pension contributions for new directors that align with those for the majority of the workforce, and any remuneration report where the pension contribution of a new director or a director changing roles is not aligned with that of the majority of the workforce.[3]

Post-Employment Shareholding Requirements

This was another key area of focus for investors in the 2019/20 reporting season. The IA Remuneration Principles have previously set out what has become the market practice approach: post-employment shareholding requirements, which apply for at least two years after termination of employment at a level equal to the lower of either the shareholding requirement immediately prior to an executive's departure or the actual shareholding at the executive's departure. Companies should implement the requirements for all

[2] IA Press Release, "FTSE 100 Cut Executive Pensions Under Shareholder Pressure," Oct. 17, 2020.

[3] IA Memo on Principles of Remuneration, Nov. 16, 2020.

new and existing directors as soon as possible, and no later than the company's next remuneration policy vote. In communicating its updated Remuneration Principles in November, the IA emphasised the need for enforcement mechanisms (*e.g.*, nominee arrangements, or shares held in a restricted account) for these requirements.

New Policies

The IA cautions against making significant changes to remuneration policies in the current market environment, but notes that companies should continue to update policies to align with best practice and the UK Corporate Governance Code, for example, regarding post-employment shareholding requirements, bonus deferrals and malus and clawback provisions.

Conclusion

The 2021 AGM season represents a challenging time for remuneration committees. The difficult trading environment caused by the pandemic, the short-term impact of support measures companies may have relied on during the pandemic and the increasing focus on ESG issues are likely to result in greater scrutiny than ever before of pay levels and reward structures. Remuneration committees will need to balance, on one hand, the demand to make decisions regarding pay that reflect the wider business environment and shareholder and workforce experiences with, on the other hand, the requirement to appropriately reward and incentivise executive performance through demanding times.