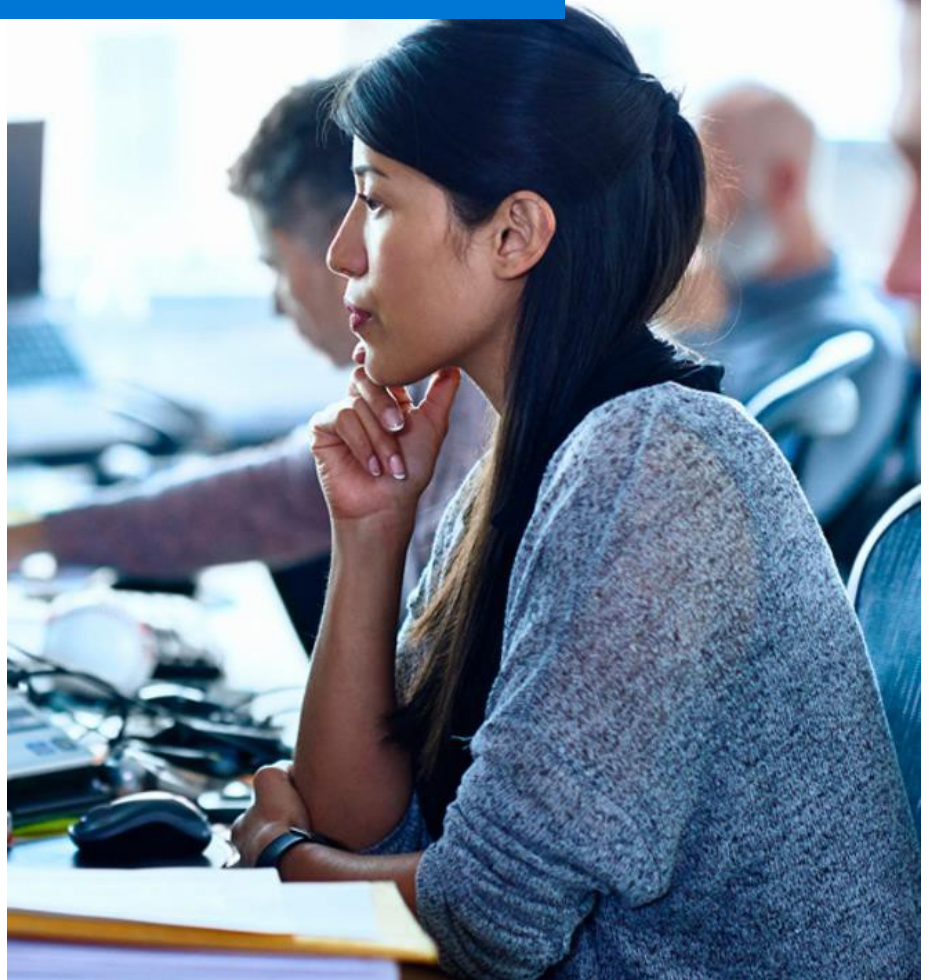


# LGIM's UK principles on executive pay

October 2022



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# UK principles on executive pay

As a long-term engaged investor, we entrust the board to oversee the company and its management on our behalf. This applies equally to the setting and awarding of management remuneration.

We take our voting rights seriously and want to be able to support both the remuneration proposals and the board at your future shareholder meetings. To assist the board in this regard we have developed this summary document of the main principles that support our corporate governance and voting policy on executive remuneration.

**Detailed policy and guidance on executive remuneration** is contained within our [UK policy on corporate governance](#).

**Additional publications on this topic** can be found on our website, [here](#).

# Structure and operation of the remuneration committee

The chair of the remuneration committee should have appropriate knowledge of the business to align remuneration with the strategy of the company. In addition, we would expect the chair to have a good working knowledge of the key people for whom they are setting pay structures and the pay and benefits offered throughout the company. For this reason, the person appointed to the role of remuneration committee chair should have served on the board for at least a year prior to their appointment.

## **We expect the remuneration committee to:**

- Set the remuneration policy for the executive directors and senior management.
- Seek independent advice. External advisers, consultants and internal employees advising the committee should be fully accountable to the committee. The committee should exercise its own independent judgement when considering any advice provided by third parties.
- Consider carefully and be able to demonstrate how they have reviewed pay and related policies on the workforce, the gender pay gap, the ethnicity pay gap and pay ratios when setting remuneration for the executive team. They should be able to show how their decisions are aligned with the culture of the company.
- Challenge management if the company is paying less than the real living wage as set out by the Living Wage Foundation, or if the company is not offering all employees the chance to work a minimum of 15 hours per week.
- Take into account the views of their largest shareholders, whose pay policies are generally on their corporate websites. LGIM communicates these policies with remuneration consultants annually, so that they can provide better advice to companies.

LGIM will vote against the election of individual board directors when we do not support remuneration for the second consecutive year. LGIM may also vote against individual directors when there are particularly contentious issues.

A large voting opposition (>20%) to the remuneration proposals should not be ignored. The remuneration committee should:

- Hold themselves accountable for the decisions taken that led to a high number of votes against the proposal.
- Publish an explanation for the dissent when disclosing the voting outcomes, including what the board is doing to address concerns. This should be sent to the Investment Association for inclusion in the Public Register. An explanation should also be included in the chair's statement in the next annual report.

# Pay principles

## **We apply a set of simple pay principles when looking at remuneration structures:**

- The remuneration structure and the payments awarded should be fair, balanced and understandable. This means: fair in terms of what the company has achieved; balanced in terms of total pay to the executive when compared with employees, shareholders and the wider stakeholder experience; and understandable for the recipient, the board and its stakeholders.
- Awards should promote long-term decision making and be aligned with and support the company's values and the achievement of its business strategy.
- Executives should have meaningful direct equity holdings while employed and thereafter; buying shares is one of the best ways of aligning management and shareholders.
- Significant changes to existing remuneration strategy should be subject to a two-way consultation with shareholders prior to the company seeking specific approval via votes.
- Boards should retain the flexibility to apply discretion and 'sense-check' final payments to ensure that they align with the underlying long-term performance of the business.

## **Simple and understandable**

The remuneration policy should be understandable for all stakeholders and clearly explained in the annual report.

LGIM:

- Will not support a new incentive scheme if it complicates the remuneration structure.
- Will advocate the use of only one long-term incentive plan with no more than four performance measures. Long term is defined as a minimum of three years of performance.
- Will not support matching schemes, performance on grant schemes or bonus banking schemes. One-off schemes are generally not supported.

# Transparency in the annual report

Executive remuneration is a board decision, supported by the remuneration committee. The board chair should support the process of setting pay and this should come through in the annual report.

Companies can build trust with shareholders if they can demonstrate historic restraint, consistency and alignment with shareholders. The board should provide an explanation in the annual report of how this has been achieved and how pay structures help drive company strategy and create value for shareholders.

## The remuneration committee chair's statement should explain:

- Why the total single figure is appropriate, taking into account the delivery of key performance indicators (KPIs), employee pay, shareholder value created and the wider stakeholder experience over the relevant period. Any explanation should avoid comparisons with peer median pay as its main argument.
- Details of engagement undertaken with all stakeholders:
  - Engagement that has taken place with the workforce to explain how executive remuneration aligns with the wider company pay policy.
  - Engagement with shareholders should be outlined, as well as the impact this has had on remuneration policy and the outcomes.
- The exercise of discretion (in revising pay up or down) during the year. We would define discretion as anything that alters the monetary outcome. Where pay has been revised upwards, we would expect to be reminded of when pay was last revised downwards. When discretion is applied, we would expect to understand what the monetary outcome would have been had this change not been applied. This will help us in applying our own judgement on the level of fairness.

## Other disclosures we would expect to find or signposted in the remuneration report include:

- How the chosen performance criteria and targets align with the long-term strategy of the company, thus providing a clear linkage between the front end of the annual report, including company strategy and KPIs, agreed pay structures and targets, and financial performance outcomes.
- A breakdown of fees paid to remuneration consultants, broken down as fees paid for services carried out for the remuneration committee and other HR-related fees.
- Gender pay gap reporting as required by the Equality Act 2010 (Gender Pay Gap Information) Regulations 2017.
- Pay ratios. The Companies (Miscellaneous Reporting) Regulations 2018 was published in August 2018, requiring companies with an average number of UK employees of 250 or more to provide a set of pay ratios based on the CEO's total single figure remuneration versus the 25<sup>th</sup>, 50<sup>th</sup> and 75<sup>th</sup> percentile employee. LGIM prefers the use of option A when calculating these ratios. If a company adopts options B or C to calculate their ratios, we expect a full explanation of why it was not feasible to use option A.
- LGIM expects all companies to provide a pay ratio regardless of whether they have 250 full-time equivalent UK employees or not. Where companies do not have 250 UK employees, a statement to this effect can explain the basis on which the ratio was calculated.

We believe calculating this ratio is an important step in addressing fairness in pay across the different levels of the organisation.

# Quantum

As the executive remuneration landscape continues to evolve to meet the needs of modern corporations, companies must take account of the current social sensitivities around pay inequality.

- We entrust the current board with ensuring that executive pay is set at an appropriate level to drive positive corporate behaviour and performance. In doing so, the board should consider the wider impact of executive pay, e.g. upon the general workforce, the public's perception, and taking into account the economic climate and government policy.
- Boards should not consider increases to individual elements of remuneration in isolation and should consider the effect that an increase in each component will have on total remuneration. The board should consider whether the total package is appropriate for the nature of the role, the size and complexity of the business, and preferably without relying solely on benchmark data.
- **Pay ratios.** Boards are expected to consider whether their company's pay ratio is appropriate within the industry in which it operates. Consideration should be given as to whether the 'year-on-year' changes in the ratio are appropriate in light of corporate performance.
- **Salary.** Increases to salaries should be made in line with the general workforce, unless there has been a genuine change to the role with increased responsibilities, in which case a phased increase is expected. Phasing ensures that the individual is rewarded as they grow into the role and takes into account their continued performance. LGIM expects the committee to use the opportunity when a new director is appointed to reset executive pay and consider the current circumstances of the business as well as the previous experience of the individual. Salary increases for new directors should be phased over time based on their level of experience. When reviewing an individual's base salary, consideration should be given to the impact of any change on the total package.
- **Addressing the cost-of-living crisis** – the remuneration committees of those companies that have decided to give employees on low salaries a significant pay increase to help them navigate the current crisis should exercise caution if they plan to use the average workforce salary increase rate when setting executive salaries. Consideration should be given to the impact of a similar increase on the total pay for an executive given the inclusion of incentives that are based on a percentage of base pay.
- **Pensions.** LGIM expects companies to ensure that the pension provisions for a new board director, and for others for whom contracts are being re-negotiated, are aligned with what is being offered to a majority of the workforce. In addition, and in line with market practice in this area, LGIM expects incumbent directors' pension provisions to be aligned with what is offered to a majority of the workforce by 2023. LGIM will vote against the remuneration policy where there have been no changes proposed to address a disparity in pension provisions.
- **Bonus.** LGIM encourages the reduction of short-term annual bonus levels. A bonus of 200% of salary should be reserved for the largest global companies. LGIM will not generally support increases to the annual bonus opportunity.
- **Long-term incentives.** LGIM expects all variable remuneration schemes to be capped. Regardless of an award cap (as a percentage of salary or fixed number of shares), the remuneration committee should ensure that scheme rules permit the application of downward discretion to reduce the value of vested awards if they reach a value that goes beyond the committee's expectation and could result in reputational damage to the company.
- Where a company has experienced a significant fall in the share price (>20%) since the last award was made, and if any new award would result in a greater number of shares being granted, companies are expected to reduce the size of the new award to ensure there is no prospect of

reward for failure. Where this has not happened, and the committee has not provided an undertaking to reduce awards when they vest, LGIM will vote against the remuneration report.

- COVID-19 measures. Some companies informed shareholders that they would adjust vesting outcomes rather than reduce the initial award. This is not LGIM's preferred solution as it is more complex; however, to ensure that this action does not inadvertently result in a negative vote in following years, we would ask that a clear explanation is provided in the annual report of this intention until the awards have vested. At the point of vesting, LGIM will expect a detailed explanation on how the remuneration committee has applied discretion to ensure appropriate adjustments were made to avoid windfall gains. LGIM will vote against the remuneration report where we believe that the remuneration committee has not been thorough in its decision making and/or not provided sufficient information to explain its final decision.
- LGIM does not generally support retrospective changes to long-term incentive plan awards; therefore, any proposed discretion to in-flight awards that are material and affect the outcome to the benefit of directors should be subject to shareholder consultation and support. LGIM will accept a meeting to discuss these changes in advance.
- Accrued dividends on share awards should only be paid on those shares that ultimately vest.
- **Benchmarks.** The focus on median pay has contributed to the general increase in executive remuneration for all companies, with less focus being given to the actual performance of the individual company and absolute pay. For this reason, LGIM discourages the over-reliance on and over-use of benchmark data, as pay and performance can vary considerably between companies. Benchmarks should only be used at specified intervals, e.g. once in three years or when considering new appointments.
- When considering the constituents of the benchmark, companies tend to select constituents based on revenue or market capitalisation. LGIM encourages companies to consider the appropriateness of their salary benchmark, in conjunction with comparators used across its performance pay disclosures. LGIM believes that performance relative to the chosen peer group should play an important part in determining pay levels.

### Malus and clawback

These should apply to all elements of variable remuneration:

- Employment contracts should be designed to enable malus and clawback to be applied to awards.
- To provide clarity for all stakeholders, the remuneration committee should set out the circumstances under which malus and clawback will be applied. These circumstances should not be too narrowly defined.



# Performance metrics and targets

The board should determine what the right metrics are (e.g. published KPIs) to deliver the strategy, and the level of stretch that is necessary to targets to deliver the right outcomes for all stakeholders.

- Metrics should be linked to long-term strategy and be stretchable and achievable without undue risk taking.
- Companies should consider a basket of criteria to achieve their strategy and to ensure that the same performance achievement does not lead to 'double-dipping' under various pay schemes.
- Financial performance targets should use the reported numbers without further adjustments, except for share buy-backs and other capital changes. Any adjustments should be consistent, explained and reconciled with reported numbers.
- Bonus targets. To highlight the integrity of the target-setting process, companies should disclose as many components of the bonus targets as possible. Any targets that are commercially sensitive to the business should be disclosed retrospectively, within a year after payment; if this is not possible, an explanation of why the target continues to be commercially sensitive is expected.
- Achieving a threshold level of financial performance should be a prerequisite for the delivery of any bonus including the delivery of personal/strategic performance objectives. The exception being in a turnaround situation when changes to non-financial strategic targets may take priority for a few years. However, these circumstances should be clearly explained within the remuneration report.
- Personal performance. LGIM's current view is that for board directors, personal performance amounts to delivering the strategy. We therefore expect strategic targets to be meaningful and quantifiable. We are conscious that the weighting for personal/strategic targets continues to grow. LGIM may vote against the remuneration policy if the weighting is high and the measures are not meaningful/quantifiable or sufficiently explained. LGIM expects a threshold level of corporate financial measures to be met before any element under this section is triggered.
- As a general rule, long-term incentive performance targets should be disclosed in advance and should not be adjusted retrospectively. LGIM does not generally support the setting of targets at a level that is below the previous year's performance targets. However, if due to exceptional circumstances the remuneration committee believes it is appropriate to set lower targets, we would expect to understand why the new targets are considered to be equally stretching. Without such an explanation we would expect a reduction to the award size to reflect the reduction in targets.

## ESG metrics in executive remuneration

- LGIM expects ESG topics to be incorporated into the strategy of the business, the delivery of which should inform how the business operates and its purpose.
- Companies that are exposed to high levels of environmental, social or governance (ESG) risk should include relevant targets that are meaningful, measurable and aligned to the company's strategy. E&S targets should be subject to third-party verification.
- Companies within sectors that can have a significant effect on climate change should link part of their pay to delivering on their climate mitigation goals. The performance targets should be linked to SBTi approved/or equivalent transition plans aimed to achieve net zero by 2050 or sooner. Targets should also be set to create new opportunities that not only improve revenue, but also have a positive impact on climate.
- By 2025, companies will be five years away from reaching their 2030 climate change transition goals. By this time, we expect a majority of companies to have a clear idea of what must be done to hit these crucial targets.

Therefore, from 2025, LGIM will be escalating its policy on climate change. To gain LGIM's support for a new remuneration policy being put to shareholders from January 2025, we will expect to see climate targets within the long-term plan. These targets should be in line with stated transition goals to reaching net zero and across the full value chain (scope 1-3). Ideally, they should be SBTi approved.

This will apply to companies in the following sectors: Autos, Apparel, Aviation, Banks, Cement, Chemicals, Food, Insurance, Mining, Oil & Gas, REITs, Shipping, Steel, Technology, Telecoms and Utilities.

- The weighting for climate targets should represent at least 20% of the overall LTIP award at these companies. For those companies that have adopted a restricted share plan, one of the underpins should be specific to achieving set transitional carbon reduction targets.
- The use of diversity targets would be relevant for sectors that struggle to recruit female talent.
- LGIM discourages the use of employee engagement targets, as we believe this is something a well-governed company with an inclusive culture should be doing. Financial incentives should not be necessary to drive such a programme. A better metric for companies, especially those that have a high level of staff turnover, would be to set targets around employee retention as a way to gauge whether efforts to improve employee retention are working.
- For those companies in high-risk sectors, where the health and safety of employees is key, we expect a health and safety modifier to be introduced to the annual bonus and/or long-term incentive. LGIM expects to see awards reduced by at least 20% or more if there have been fatalities.
- Oil and gas companies. Remuneration should prioritise financial value over fossil fuel production volumes. The use of measures that directly encourage volume growth (such as reserve replacement ratios or production targets) risks incentivising overinvestment at a time when growth in demand seems increasingly uncertain and should therefore be avoided. LGIM prefers financial measures (relating to total shareholder return, balance sheet strength) or other strategic metrics. The use of volume growth targets may result in a negative vote.

# Alternative incentive structures

## Restricted share plans

For those companies considering adopting a restricted scheme, here is further guidance as to what would be acceptable to LGIM as a shareholder in your company:

- Companies will have to justify why this type of arrangement is appropriate and why the existing arrangement is no longer suitable.
- Award levels should be reduced to 50%, or less than the normal long-term incentive grant, to take into account the greater level of certainty. LGIM expects companies to reduce annual awards further in years when the share price has fallen in value by more than 20%.
- The plan should continue to operate through different business cycles.
- Shares should be held for a minimum of five years prior to release.
- The vesting of shares should be subject to a). meeting a threshold level of financial performance that is pre-disclosed, b). the remuneration committee being satisfied that over the period since the grant, the company's overall performance and the individual's leadership is such that the release of shares is warranted; and c) from 2025, for those companies in the sectors with the greatest impact on climate change - meeting pre-disclosed transition climate targets should act as an additional gateway.
- Discretion should be applied to reduce awards if at the end of the holding period the performance of the company and the shareholder experience are not aligned (see: page 23, paragraph two of the [Executive Remuneration Working Group report](#)).
- For leavers, unvested restricted shares should be pro-rated for time and subject to the same vesting time frame and holding requirements as set out above.
- Targets under any annual bonus plan should be retrospectively disclosed in full.
- A shareholding guideline must be in place that is material while in employment as well as post-exit (see below).

# Director alignment – shareholding guidelines

LGIM expects directors to build up and maintain a significant equity holding in the company they are leading. To promote long-term strategic decisions and shareholder alignment, directors should continue to hold a meaningful number of shares even after their departure from the company.

- As a minimum, a shareholding guideline should be equivalent to the value of share awards earned under an LTIP or equivalent to three years of restricted share awards.
- LGIM expects 100% of a vested LTIP and deferred bonus shares to be retained (except those sold for tax purposes) until the shareholding requirement is achieved.
- Directors should be encouraged to buy shares in their company. These purchased shares do not need to be included in the post-exit holding requirement discussed below. If purchased shares are used to make up the in-post shareholding requirement, these should be replaced proportionally as part of the calculation of the shareholding requirement when shares vest from incentive arrangements.
- Vested shares, deferred bonus shares and shares subject to a holding period can count towards meeting shareholding guidelines.

## Post-exit shareholding requirement

LGIM expects a meaningful number of shares to be held by board directors after their departure from the company.

- Post-exit shareholding guidelines should reflect a significant proportion of the prevailing minimum shareholding requirement (no less than 80% of the in-post requirement).
- These guidelines should remain in place for two years following the termination of employment.
- Where a company has set an in-post shareholding guideline that is substantially greater than LGIM's minimum expectations (equivalent to their annual LTIP award or three times the restricted share award plan), then we will support a proportionally lower post-exit shareholding requirement providing it remains at least 80% of LGIM's minimum shareholding expectation.
- Any shares purchased by the director can be excluded from this requirement.
- LGIM will vote against the remuneration policy where a post-exit shareholding requirement that meets our guidance is not included.

# Recruitment and departures

## Recruitment

A new executive director's remuneration should be set by taking into account their level of experience in the role with a view to reaching a market rate over time, subject to performance. It would be prudent to state this intention in the annual report at the time of the appointment and to repeat it annually until all recruitment-related increases have been completed.

- New recruits should be encouraged to purchase shares in the company.
- The use of 'golden hellos' is not supported and should be avoided.
- Any buy-out awards considered necessary, in exceptional circumstances, should be explained and awarded predominantly in shares and subject to performance.
- Additional employee benefits related to moving residence should reflect what is being offered to employees at all levels and have a time limit of no more than two years.
- Employment contracts should be for a maximum of 12 months. LGIM would expect the notice period to be the same for an employer and an employee.

## Departures

- Except in cases of dismissal for misconduct or to avoid a payment for failure where awards are expected to lapse, outstanding share-based awards should be time pro-rated and subject to the same vesting conditions that applied when they were granted.
- The use of 'golden goodbyes' is not supported. Any gifts with a material value should be fully disclosed.

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