On the 2023 compensation committee agenda

KPMG Board Leadership Center

When submitting the compensation report to shareholders for approval, executive remuneration will be on the agenda and maybe also in the headlines. The economic outlook looks likely to add an additional dimension to the preparation of compensation policies and discussions with shareholders. Compensation committees will need to balance this economic uncertainty with the need to retain the key talent required to navigate the business through these challenging times, particularly when the ability to retain and recruit senior talent remains a challenge.

Four focus topics

Based on recent investor guidelines and our engagement with board members and members of compensation committees across different industries, we have highlighted four areas to keep in mind as compensation committees consider and carry out their 2023 agendas.

1. Cost of living crisis

The cost of living crisis has in Europe and elsewhere undoubtedly been the headline from a people perspective over the large part of 2022. With inflation and interest rates still predicted to remain at unusually high levels in many parts of the world, this will continue to feature in 2023. We have seen business respond to the impact on the workforce with different measures, including targeted pay rises for certain employee groups or advancing the normal annual pay round.

With many executive pay reviews taking place for the first time in this high-inflation environment, investors have called for restraint in executive director salary increases – not least because of the "multiplier effect" that salary has on other variable elements of pay such as LTIP (longterm incentive plan) and annual bonus. Where salary increases are necessary, compensation committees have been asked to consider increases below the rate of salary increases given to employees, given that the impact of the current economic impact on cost of living is felt much less by those on larger salaries.

2. "Windfall" gains on long term incentives plans

In the wake of Covid-19, institutional investors warned that compensation committees would need to guard against "windfall gains" in relation to awards granted when the share price was "artificially" depressed.

With most LTIPs normally vesting over a 3 year period, 2023 will see a significant number of these awards vesting and renewed focus on the compensation committee's application of discretion in this regard. It will be challenging for compensation committees to establish what element of any gain is related to a general business improvement driven by management and what is more of a general market improvement. This will be complicated further by the prospect of a recession in 2023, which will undoubtedly have an impact on the capital markets.

Whatever decisions are made by remuneration committees, investors will expect to see sound reasoning behind any exercise of discretion articulated clearly in the remuneration report. Investors also want to better understand the impact of any exercise of discretion, with an illustration of what payments would have been were it not for the exercise of discretion, so they can consider their response in the context of the impact on the executive team. Similarly, executives will be keen to ensure that the value they create for shareholders is reflected in their total reward.

3. Continued focus on the ESG agenda

The focus on ESG has continued to gain momentum, with an increasing number of companies having an element of their long-term or short-term incentives subject to some measurement against ESG metrics. The most interesting development for 2023 seems to be the weight which investors are now putting behind this important area.

Cevian Capital, a Swedish "activist" investor which has made material investments in a number of well-known blue chip companies around Europe was one of the early movers in this area, but recent statements from Allianz, Amundi LGIM and the Investment Association are clear that this will form a much greater part of investors focus.

LGIM have gone further by announcing that from 2025 they will expect to see climate targets in all long-term incentive plans specific sectors, including automotive, banking & insurance, mining, oil & Gas, REITs, technology, telecoms and utilities. The Basel Committee he also recommended that banks consider amending their compensation policies to take into account climate risk.

The adoption of such targets will need to be more than just a "box ticking" exercise. ESG metrics will need to be designed around the specific circumstances of each company, the rationale disclosed and, as with any performance condition, the targets should be quantifiable and appropriately stretching.

4. The Swiss Angle – By SWIPRA Services

Compensation is expected to move again into the spotlight of shareholders and the public. This is due to the increasing pay differential between executives and average employees as well as compensation's instrumental role in corporate culture and guiding efforts towards reaching strategic ESG goals. A vast majority of the SWIPRA Governance Survey 2022 participants indicated that the economy is generally moving too slowly towards global sustainability goals. About half of the participating institutional investors blamed companies' overly short-term oriented compensation systems as a key factor for this slow pace. Compensation committee members thus should question whether their compensation schemes are sufficiently long-term oriented to provide incentives for sustainability investments that will take many years to materialize.

2022 also saw a large increase of ESG criteria in the compensation structures of Swiss companies, with 47% of the largest 100 SPI® companies stating that they have such an ESG KPI included in their incentives for management. Yet, the majority of these ESG KPIs (58%) remains a black box for external stakeholders with explanations on how they are measured and reflected in compensation largely missing. So, only 17% of participating investors said that they understood the materiality of ESG KPIs and how they were linked to a company's strategy. Absent this understanding, it will be difficult for external stakeholders to judge whether a compensation committee and the board are serious about using sustainability incentives to move the company forward in this regard and to foster a longer-term oriented corporate culture.

Similarly, almost 75% of the institutional shareholders indicated that remuneration systems put too little weight on sustainability factors. Companies tend to disagree, with 60% perceiving the allocated weight was adequate. For the largest 100 SPI® companies using sustainability KPIs in their incentive plans, the weight is mostly between 10–20%.

Hence, for 2023 and beyond, compensation committees are expected to make better use of ESG-related instruments to increase the speed towards a more sustainable business. Compensation committee members need to be fully aware of where the sustainability levers of their company are, how these levers can be forged into the compensation system, and what the potential drawbacks / unwanted motivations of these sustainability KPIs are.

About the KPMG Board Leadership Center

The KPMG Board Leadership Center offers support and guidance to board members. We equip you with the tools and insights you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business. In addition, we help you to connect with peers and exchange experiences.
Learn more at www.kpmg.ch/blc

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