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On the 2018 Remuneration Committee agenda

KPMG Board Leadership Centre

Executive remuneration has been in the spotlight for many years, nevertheless, there are persisting concerns in both the investment community and wider society over very high levels of executive remuneration at some UK quoted companies.

At first sight, executive pay structures might be thought to be a private matter between a company and its shareholders. However, a constantly widening pay gap might be telling of a company's attitude towards employees. Any impact on employee morale will compromise a company's productivity and ability to hire and retain talent. Also, at a macro level, there is a cost to society. Corporate leadership does not exist independently of the economies in which it operates and therefore public disquiet about the remuneration of corporate leadership is a legitimate point of view with which remuneration committees must engage and respond.

Successive governance reforms have gone some way to strengthening and increasing transparency in the UK executive pay framework - in particular the requirement to gain shareholder approval for executive pay policies every three years. Nevertheless, remuneration committees are increasingly in the firing line with investors, the media, Government, proxy advisors and others looking to hold the committee to account when executive pay appears to be disconnected from long-term corporate performance.

Drawing on insights from our conversations with board chairs, remuneration committee members and company secretaries over the past twelve months, we have highlighted eight issues that, in our opinion, remuneration committees should keep in mind as they approach and execute their 2018 agendas:

1. Pay ratios and comparisons with the wider workforce: Government plans to introduce secondary legislation to require quoted companies to report annually in their remuneration report the ratio of CEO pay to the average pay of their UK workforce - along with a narrative explaining changes to that ratio from year-to-year and how the ratio relates to pay and conditions across the wider workforce - is one of the few definitive changes to come from the 2017 BEIS Consultation: Corporate Governance Reform.

   Whilst in isolation, a pay ratio may not shed much light on pay practices in any one company and may easily be misunderstood or misconstrued, comparisons with other companies in the same industry and the comparisons year-on-year will be of great interest to the investment community. Shareholders will expect strong rationale if the ratio has increased compared with previous years or appears out of kilter with other companies in the same industry. So pay particular attention to explaining why the ratio is appropriate given the performance of the business and rewards for the general workforce.

   Consideration should also be given to the general climate around pay and transparency, which has an increasing focus on fairness with the introduction of gender pay and national minimum wage reporting.

2. Broadening the remuneration committee role: While the UK Corporate Governance Code already asks premium listed companies to "be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual [executive] salary increases", the Government, media and others have raised concerns as to whether meaningful engagement with the wider workforce actually takes place, or whether wider pay and conditions are properly taken into account in determining executive pay.

Compliance with the 2018 Corporate Governance Code is likely to require that remuneration committees have greater responsibility for demonstrating how pay and incentives align across the company, and to explain to the workforce each year how decisions on executive pay reflect wider pay policy. Does the remuneration committee have visibility over the pay of the wider work force?

3. Linking pay to strategy and performance: The investor community are understandably focussed on the relationship between executive pay, the company's strategy, and performance. From a policy perspective, shareholders want to see a link between the stated key performance indicators and the measures used to assess performance. Also, pay should be linked to performance – performance in achieving the strategic goals. Are incentive plan performance measures set with reference to what the company wants to achieve and its progress in doing so? Has sufficient consideration been given to company performance as a whole, the wider economic environment, how it will be viewed by shareholders and whether any incentive payments are consistent with the overall picture?

4. The employee (and wider stakeholder) voice: There is a growing public disquiet – encouraged by the widening pay gap - in relation to the perception that executive pay is determined without due consideration for the wider workforce. The 2017 BEIS Consultation: Corporate Governance Reform considered the merits of employee board members employee (or stakeholder) advisory panels and having a designated non-executive director responsible for ensuring the views of other stakeholders, particularly employees, are considered in board decision making and in particular decisions relating to executive pay.

   Compliance with the 2018 Corporate Governance Code is likely to require that boards adopt one of these mechanisms. In the meantime, Remuneration Committees should be mindful not to be making decisions around executive pay in isolation, instead taking into account the views of employees and wider stakeholder views as well as the wider pay and workforce landscape. They should also make clear the steps they have taken to address this, as some Directors' Remuneration Reports simply include generic statements that the company has taken the wider employee views into account with no further explanation about how this has been done.

   Compliance with the new Code is also likely to require that remuneration committee chairs should have served for at least twelve months on a remuneration committee before taking on the chair role (unless there is a clear and valid explanation why this may not be appropriate or possible). Have the remuneration and nomination committee factored in the succession of the remuneration committee chair as part of the overall board succession plan? Is there a planned hand-over programme in place? Does the remuneration committee chair actively mentor their successor?

5. Plan for increasingly active investors: It is important to stay abreast of changing market practice such as USS Investment Management's new policy of no longer abstaining from voting on executive pay proposals; LGIM's refusal to abstain and willingness to oppose director re-elections; and BlackRock's recent decision to oppose pay awards that outpace ordinary employees.

   Also be alert to institutional investors' increasing use of targeted voting practices to register displeasure at particular governance practices – including voting against the re-election of the remuneration committee chair to register a perceived unwillingness to change executive pay arrangements

6. Discretion: The level of discretion included in a remuneration policy has been an area of shareholder focus in recent years. It is important for a remuneration committee to maintain a certain level of discretion so that the policy can be applied in unforeseen circumstances, or adjustments can be made where the approved policy would otherwise result in an outcome that is inconsistent with the actual circumstances. Shareholders want to see the remuneration committee considering the wider view of company performance and general economic outlook when determining whether the discretion is appropriate. Are shareholders consulted in the event of any use of upwards discretion? Whilst the exercise of discretion is unlikely to result in a vote against a remuneration policy, it is likely to open the remuneration committee up to further scrutiny over how discretion is applied in future years. There is an element of trust between the remuneration committee and the shareholders. Careful and considered use of discretion is essential to maintain this trust.

7. Shareholder engagement: Interaction with shareholders should be high up on a remuneration committee's agenda, particularly given the potential mismatch in expectations between remuneration committees and investors in the engagement process. Remuneration committees can look to the consultation process as a validation exercise

rather than understanding the need to respond to shareholder concerns. Similarly, there is a perception that investors are sometimes not being clear about their views to companies, or are not representing a uniform view of the company both from a governance and investment perspective.

Does shareholder engagement focus on the strategic rationale for remuneration structures and involve both investment and governance perspectives? Does the committee foster an environment where shareholders are encouraged to be clear with companies on their views on, and level of support for, any remuneration proposals? Is engagement focussed on the material issues and aimed at understanding shareholders' views?

8. Transparency: Directors' Remuneration Reports are subject to detailed disclosure requirements that, in some cases, have resulted in remuneration reports, becoming increasingly long, complex and difficult to follow, with detailed disclosures often seeming to obscure key information, such as a single number showing the remuneration of each director for the previous financial year and going forward. Furthermore, the Government intends to introduce secondary legislation to require quoted companies to provide a clearer explanation in remuneration policies of the range of potential outcomes from complex, share-based incentive schemes.

   Think about how to best present the key elements of pay and supporting information, including how each element supports the achievement of the company's strategy, the potential value and performance metrics. Think of the remuneration report as an opportunity to communicate the committee's message around what remuneration means to the company, how it relates to employee pay and how it is used as a tool for corporate success.

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