On the 2019 Remuneration Committee agenda

KPMG Board Leadership Centre

Successive governance reforms have gone some way to strengthening and increasing transparency in the UK executive pay framework - in particular the requirement for shareholder approval of 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 ten issues that, in our opinion, remuneration committees should keep in mind as they approach and execute their 2018 agendas:

1. Pay ratios and the wider workforce

For accounting periods beginning on or after 1 January 2019 quoted companies with more than 250 UK employees will be required to publish, as part of their directors' remuneration report, the ratio of their CEO's total remuneration to the median (50th), 25th and 75th percentile full-time equivalent (FTE) remuneration of their UK employees.

Alongside this, companies will have to publish supporting information, including the reasons for changes to the ratios from year to year and, in the case of the median ratio, whether, and if so how, the company believes this ratio is consistent with the company's wider policies on employee pay, reward and progression.

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.

Also think about internal communications as the new pay quartile disclosures will allow each UK employee to benchmark their own remuneration package.

2. Broadening the remuneration committee role

The 2018 UK Corporate Governance Code seeks to address some of the concerns leading to the public disquiet over executive pay including 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 new Code not only requires that the remuneration committee should have delegated responsibility for determining the policy and remuneration of the chair, executive directors and senior management, but should also review the workforce remuneration and related policies and the alignment of incentives and rewards with culture – and take these into account when setting the policy for executive director remuneration.

Specifically, the Code goes on to state that the pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce. Similarly, The pension consequences and associated costs of basic salary increases and any other changes in pensionable remuneration, or contribution rates, particularly for directors close to retirement, should be carefully considered when compared with workforce arrangements.

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, the new Code now stresses the importance of designing remuneration policies and practices to support strategy and promote long-term sustainable success; and that executive remuneration should be aligned to a company's purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy.

Where performance-based incentive plans are used, the choice of performance measures is important. Using a range of financial, non-financial and strategic measures can help ensure that targets are aligned with how the company will deliver value over the long-term in line with company purpose. Metrics need to be reliable and credible to satisfy shareholders, and their purpose should be explained.

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 sustained public disquiet 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 various mechanisms for ensuring the views of stakeholders, particularly employees, are considered in board decision making and in particular decisions relating to executive pay.

The new 2018 UK Corporate Governance Code addresses this issue by requiring (on a 'comply or explain' basis) that the board should take steps to understand the views of the company's key stakeholders and, for engagement with the workforce, employ one or a combination of the following methods:

- a director appointed from the workforce;
- a formal workforce advisory panel;
- a designated non-executive director.

Whichever mechanism is employed, remuneration Committees should be mindful of not making decisions around executive pay in isolation. Rather they should be taking into account the views of employees and wider stakeholder views as well as the wider pay and workforce landscape. They should also seek to articulate how such factors have been taken into account when setting executive remuneration rather than simply disclosing generic statement that the company has taken the wider employee views into account with no further explanation about how this has been done.

5. Plan for increasingly active investors

Executive remuneration continued to be the main area of focus during the 2018 AGM season with any pay packages deemed to be excessive being put firmly in the spotlight.

The advisory vote on the Directors' Remuneration Report resolution received less than 80% support at 32 FTSE350 companies and was defeated three times - including one FTSE100 company where the resolution was defeated by a margin of two-to-one. Similarly, the resolution on the remuneration policy received less than 80% support at 22 FTSE350 companies and was defeated three times.

	Resolutions with 20%+ votes against	
Resolution type	**2018**	**2017**
Audit and reporting	1	4
Director elections	56	25
Issue of shares & pre-emption rights	23	26
Remuneration - policy	22	28
Remuneration report	32	30
Shareholder rights	8	5
Political activity	2	2
Totals	**144**	**120**

Source: Investment Association's Public Register
(FTSE 350 data 1 November 2017 to 31 Auguest. 2018)

Shareholder dissent on remuneration matters arose from a number of different issues, rather than a single theme and any of the following could lead to a significant vote against the Remuneration Report:

- Pay not aligned with company performance
- Salary increases above the level received by the general workforce
- A higher salary being awarded to a new director compared to their predecessor
- Increase in the maximum potential pay, such as an increased Long Term Incentive Plan (LTIP) award

Looking forward, the scrutiny on pay is likely to increase further and any company that steps outside the norm will be heavily scrutinised by shareholders. It is also important to stay abreast of changing 'investor practices' such as no longer abstaining from voting on executive pay proposals, a willingness to oppose director re-elections, and opposition to pay awards that outpace ordinary employees. Finally, be alert to the increased 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 is still an area of shareholder focus – not least because the new 2018 UK Corporate Governance Code 'requires' that remuneration schemes and policies should enable the use of discretion to override formulaic outcomes.

One approach to discretion might be to assess the overall reasonableness of the total rewards and recommend adjusting pay awards, for example, where the outcome would otherwise not be aligned to individual performance and results achieved or would not deliver the policy intention. An active decision on whether to exercise discretion would become a normal part of the annual process to determine remuneration outcomes. It will be important to ensure that the terms of individual contracts and scheme rules do not prevent such adjustments.

The exercise of discretion may also be necessary as a result of unexpected or unforeseen circumstances, in order to ensure the remuneration outcome for individual directors is reasonable and reflects the individual's contribution. Circumstances where it may be appropriate to exercise discretion include taking account of share price growth and currency fluctuations, and the impact of a share repurchase scheme or a government support initiative. Any exercise of discretion should be clearly disclosed and explained.

The remuneration committee may wish to consider setting a limit in monetary terms for what it considers is a reasonable reward for individual executives. This could be helpful in addressing the need for a degree of predictability over outcomes, both for the individual director, the company and shareholders, and for guiding the exercise of discretion in some circumstances. It should be prepared to explain the rationale behind its decision.

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 simply a mechanism 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 them 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.

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 carefully about annual bonuses and how the committee can best articulate the targets set for the executives.

Also 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.

9. Innovation

Remuneration policy design is a crucial part of the remuneration committee's role and, as discussed above, remuneration committees are expected to focus on the strategic rationale for executive pay and the links between remuneration, strategy and long-term sustainable success.

Remuneration committees are encouraged to be innovative and to work with shareholders to simplify the remuneration structures. Simpler structures should improve all round transparency and free up time for the committee to review workforce remuneration and for shareholders to engage with the company on other matters.

Restricted share plans are increasingly been looked at as an alternative for traditional LTIP arrangements. Some shareholders continue to be unsupportive of restricted shares though there are a growing number that will support the introduction of restricted shares for the right company, in the right circumstances. However, new remuneration committees should not be proposing a move to the restricted share model on the sole basis that the current remuneration structures are not paying out to executive directors.

Meaningful shareholder consultation is paramount as the failure to properly understand the views of shareholders has led a number of companies to withdraw their resolutions prior to their AGM.

10. Appointing a new committee chair

Compliance with the new 2018 UK Corporate Governance Code now requires that, before appointment as remuneration committee chair, the appointee should have served on a remuneration committee for at least twelve months.

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?

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