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On the 2024 remuneration committee agenda

KPMG Board Leadership Centre

The business and risk environment has changed dramatically over the past year, with greater geopolitical instability, high interest rates, and unprecedented levels of disruption and uncertainty. Against this backdrop, remuneration committees will need to focus on ensuring that performance and reward frameworks continue to attract, retain, and motivate while maintaining alignment with shareholder expectations as they make pay decisions and plan for 2024 and beyond. Workforce planning and reduction will be on the agenda for many companies given the current economic environment, so remuneration committees will need to take this and the cost of living challenge facing the workforce into account when determining the level of variable pay awards for executives.

Based on recent investor guidelines and our engagement with board members and members of remuneration committees across different industries, we have highlighted ten areas to keep in mind as remuneration committees consider and carry out their 2024 agendas.

Cost of living crisis

"At a time when many employees face a cost of living crisis, many employers also face a 'cost of doing business' crisis, limiting the aid they can offer," said Charles Cotton, senior reward adviser for the Chartered Institute of Personnel and Development. Based on recent conversations, the 2024 annual salary budget for many companies will be in the region of 3% to 5%. Companies will therefore need to optimise their pay spend through a targeted strategy and ensure their pay decisions are neutral from a diversity and inclusion lens. They should also continue to assess their wider employee value proposition including their benefits and wellness offering particularly given the ongoing focus on emotional, physical and financial employee wellbeing.

Continued focus on the ESG agenda

The focus on ESG and the implementation of ESG measures into performance and pay frameworks will continue to be high on the agenda for remuneration committees. Most companies have embedded ESG metrics into their short-term and/or long-term incentives, recognising the need to ensure that the metrics are aligned to business strategy and that targets are appropriate, robust, and measurable. The focus is evolving to ensure that ESG metrics are viewed through the commercial impact lens and that there is an appropriate balance between financial and non-financial goals, as well as alignment with a company's overall culture and values.

The ever-increasing focus on ESG continues to be driven by both internal and external stakeholders. Proxy voting agencies are pressing for both greater transparency and more robust oversight of ESG matters at the Board and committee levels.

At their Proxy Season Preview in London in March 2024, Glass Lewis presented their position regarding the ESG component of incentive plan pay-outs stating that "financial vs non-financial metric outcomes will be scrutinised". They state that "large discrepancies may indicate that qualitative measures are being used to prop up remuneration levels."

The UK FCA has referenced sustainability as a key ESG focus area for the next two years, and while their focus is the financial services sector, this serves as a reflection of the wider sentiment emerging from external stakeholders across all industry sectors. The FRC have clarified that where companies have committed to sustainability-related objectives, most notably net zero commitments, they expect these to link this to the strategy, governance arrangements and remuneration structures.

Diversity and Inclusion

2024 is anticipated to be a significant year for focussing on Diversity and Inclusion ("D&I") in the workplace. Recognising the immense value and the role D&I plays in fostering innovation and growth, many companies are prioritising the development of inclusive and diverse strategies and frameworks.

The UK financial services regulators have recently published their much-anticipated consultation papers on D&I. Whilst the focus of this is the financial services sector, it is informative for other sectors as it provides interesting insights into the wider direction of travel in this space.

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The proposals address many policy areas including non-financial misconduct, D&I strategies, data reporting, D&I disclosure obligations, and D&I targets. The proposals are wide-ranging and require consideration from a multi-disciplinary, cross-functional perspective. Companies will need to ensure culture, performance and reward frameworks, training, and processes are in place.

Pay transparency

Remuneration committees are increasingly focusing on the wider employee population in addition to executive pay matters. Pay transparency regulations will be high on remuneration committee agendas, especially those with oversight over European operations given the EU Pay Transparency Directive. Employees will have further rights to access information about their pay to determine whether they are being treated fairly. According to our 2023 Reward Trends Survey, over 53% of UK and European companies are only just starting to consider and plan for their pay transparency needs. It is expected that remuneration committees will want to understand what steps are being taken to ensure the company is ready for increased pay scrutiny.

Investor guidelines

Glass Lewis recently published its 2024 Benchmark Policy Guidelines which set out its updated framework for evaluating the governance policies and practices of UK listed companies and its approach in respect of proxy voting recommendations. When they assess a company's remuneration policy, structure and the levels of granted and realised pay, they intend to take into consideration the company's own benchmarking peer set, if disclosed, in addition to local and regional industry peers. They are therefore encouraging companies to be transparent in their disclosure and justification of individual peers selected when setting pay levels, plus the criteria used.

Institutional Shareholder Services (ISS) has also published its latest Proxy Voting Guidelines report which will apply for AGMs held from 1 February 2024. This report is intended to provide investors with an insight into how ISS analyses companies in the UK and Irish markets. As for last year, ISS notes that investors are concerned that remuneration has become too complex and question its effectiveness in motivating management. They encourage remuneration committees to adopt simpler remuneration structures. In particular, the introduction of new share award schemes on top of existing plans is likely to be viewed sceptically. They state that remuneration arrangements should be clearly disclosed with sufficient detail provided about the performance conditions adopted in order to allow shareholders to make their own assessment of whether they are appropriate. Bringing a remuneration policy into line with accepted good market practice should not in itself be used as justification for an increase in the size of the overall package.

ISS has also added that in cases where a serious breach of good practice is identified, and typically where pay issues have been raised over a number of years, the chair of the remuneration committee (or, where relevant, another member of the remuneration committee) may receive a negative voting recommendation.

Customer focus

The UK FCA recently wrote to remuneration committee chairs in the financial services sector on points for them to consider over the coming two years. Whilst the focus of this is the financial services sector, it is informative for other sectors given its wider customer focus.

Remuneration committee chairs should ensure that remuneration policies and practices continue to incentivise a consumer centric approach that ensures good outcomes for consumers across all products and services. This includes consideration of how companies can use relevant related risk metrics and performance criteria to help inform both individual and company-wide remuneration decisions.

Bonus cap

A specific area of focus for remuneration committee chairs in the financial services sector in 2024 will be the ratio of fixed to variable pay given the removal of the "bonus cap" with effect from 31 October 2023. The regulators view this change as making "the remuneration regime more effective by increasing the proportion of compensation at risk and subject to the incentive-setting tools in the remuneration framework. This should also give companies greater flexibility to adjust variable remuneration to absorb losses in a downturn, or to respond to any material poor performance or misconduct that subsequently comes to light". It is important to note that regulators have not changed other rules regulating variable pay including composition of variable pay, mandatory deferrals and risk adjustment mechanisms. Companies are reviewing if they should set an alternative "appropriate remuneration ratio" between fixed and variable remuneration and how this might then impact remuneration structures for affected employees. Glass Lewis' view is that "any increases in variable incentive opportunity should be accompanied by appropriate reductions in fixed pay and a compelling strategic rationale." This will continue to be a key area of focus for remuneration committees of impacted companies within the financial services sector.

Misconduct, malus and clawback

During 2023 there were a number of high-profile resignations from top management positions, particularly CEOs, attributed to personal misconduct. The Financial Times stated that 50% of the forced CEO departures in 2023 (among the 3,000 largest US companies) were due to personal misconduct, up from 14% in 2017. According to a study by the Harvard Business Review, shareholders generally react negatively to news of misconduct. For the companies in their sample, share prices declined by 3.1% over the three-day trading period around the initial news story.

It is expected that remuneration committees will have this issue near the top of their agenda in the coming year. It is not only important for remuneration committees to understand that robust hiring, promotion and whistleblowing mechanisms are in place, but also to ensure that performance and variable pay programmes, contracts and other agreements adequately address this area. Robust malus and clawback mechanisms should be in place, and steps taken to ensure senior leaders understand these.

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It is also important to have appropriate, well documented governance structures in place to ensure that a company can respond quickly and adequately in all such circumstances.

The Financial Reporting Council published the updated UK Corporate Governance Code on 22 January 2024, applying to periods beginning on or after 1 January 2025 for companies with a premium listing on the London Stock Exchange. The new Code expects malus and clawback provisions to apply to directors' bonuses delivered in cash or in shares.

Further, the Code strives for greater transparency by providing that the annual report includes a description of a company's malus and clawback provisions. This should include the circumstances in which malus and clawback provisions could be used, along with a description of the period for malus and clawback and why the selected period is best suited to the company as well as if, and why, the provisions were used in the last reporting period.

Competitiveness of UK remuneration practices

The Investment Association (the "IA") recently provided FTSE 350 remuneration committees chairs with an update on the their 'Principles of Remuneration' along with their emerging views on the issues which are likely to be important during the 2024 AGM season.

Firstly, the IA has clarified that its "Principles of Remuneration are not rules, but guidelines that aim to foster good practice and align with investor expectations. They are designed to be flexible and adaptable to the unique circumstances of individual companies. Companies should choose the remuneration structure most appropriate for their business, strategy and choose the remuneration approach which the directors consider will deliver business performance and long-term returns to shareholders."

Additionally, the IA acknowledges the ongoing debate on the competitiveness of the UK listing environment and UK remuneration practices." They state that their members "want a competitive UK listing environment that attracts appropriate companies to list and operate in the UK. As a fundamental principle, to support higher potential pay levels, there needs to be clear alignment between pay and performance." This is a clear statement that the IA acknowledge the potential for higher pay levels to drive competitiveness in the UK.

In September 2023, the IA met with nearly 100 FTSE350 companies to discuss their 'Principles of Remuneration' and their views on the competitiveness of UK executive remuneration packages. There was no consensus on any single issue which needs to be resolved to improve the competitiveness of UK remuneration. However, three themes emerged:

- **Increase pay opportunities through LTIP grant levels**: Some companies highlighted the challenges in attracting US executives and competing in the US market, particularly for the UK's largest companies and those that have a significant US footprint. They felt there was a need for more flexibility to offer higher LTIP awards to create a competitive remuneration environment.
- **Hybrid schemes**: Some companies want to use hybrid schemes which incorporate both performance and restricted shares. Global companies are able to use such schemes in the US and other jurisdictions and feel such structures should be used for their executives.
- **UK Corporate Governance Code**: The UK Corporate Governance Code has introduced a number of expectation designed to extend the long-term perspective of directors such as increased holding periods, post-employment shareholding guidelines and malus and clawback. Individually, they are accepted as a means to increase the alignment of executive reward and long-term shareholder interests, but in aggregate there is a view from some that the perceived impact on the value of remuneration received is disproportionate.

Some remuneration committees are already actively reviewing their executive pay packages in consideration of the above and are consulting with shareholders

Non-Executive Director fees

In recent years, fee increases have not kept pace with UK inflation, resulting in a decline in the real value of NED compensation. At the same time, it is widely recognised that the complexity and time requirements of the role have increased. This is likely to exert upward pressure on fees and a renewed interest in the level of non-executive fees in 2024.

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