On the 2025 remuneration committee agenda

KPMG Board Leadership Centre

In 2025 remuneration committees are likely to face a backdrop of continuing global economic uncertainty. They will need to devote attention to ensuring that performance and reward frameworks continue to attract, retain, and motivate, while understanding evolving shareholder expectations. Based on our discussions with remuneration committees, there is an expectation that 2025 salary budgets are likely to return to pre-pandemic levels making it essential to optimise pay spend through a targeted strategy.

Drawing on insights from our latest survey work and interactions with directors and business leaders, we highlight seven areas to keep in mind as remuneration committees consider and carry out their 2025 agendas.

Following our review of changes to guidelines, regulation and our discussions with various stakeholders, we have highlighted several areas to keep in mind as remuneration committees look ahead to the coming year.

Competitiveness of UK remuneration practices

The competitiveness of the UK is an overarching theme that runs through several recent changes such as the Investment Association's (IA's) long-awaited update to its Principles of Remuneration ("Principles"). The update marks a key development in the Principles and there are several important changes that UK listed companies should be aware of, particularly as the annual reporting season is fast approaching.

The updated guidance is based on three overarching principles:

- Remuneration policies should promote long-term value creation through transparent alignment with the board's agreed corporate strategy.
- Remuneration policies should support individual and corporate performance, encourage the sustainable long -term financial health of the business and promote sound risk management for the benefit of material stakeholders.
- Remuneration policies should seek to deliver remuneration levels which are clearly linked to company performance.

The updated Principles signal a change in the IA's thinking to reflect the UK's competitive landscape and evolving investor expectations.

The Principles do not seek to prescribe any particular remuneration structure or quantum and are intended to assist in the making of informed and responsible decisions that are consistent with the long-term interests of the company and its shareholders.

The language used in the updated Principles moves away from a prescriptive tone towards more nuanced, flexible language. This encourages companies to shape their remuneration approach to align with their own journey, market and strategic objectives. Indeed, the Principles recognise that a "one size fits all" approach is not appropriate. This in turn places an emphasis on the need for companies to provide a clear rationale for their decisions.

Simplicity and alignment of pay outcomes with wider shareholder outcomes and long-term strategy is key. A clear link between pay and performance remains a central theme.

The updated Principles encourage a proactive, constructive and transparent approach for shareholder engagement on changes under consideration and emphasise the importance of early dialogue with investors to allow time for feedback.

They refer to situations where a company is "deriving significant revenue from particular markets such as the US or competing for talent globally", which prompts UK companies to consider how competitive their pay is in comparison to pay in other markets internationally. Given this, it is expected that this year's round of remuneration policies may see additional investor scrutiny and media attention.

This changed approach should be seen as an opportunity for remuneration committees and boards to review current executive and senior management remuneration packages. A detailed analysis of the Principles can be found here Principles of Remuneration 2025.

Proxy Voting Advisors

Glass Lewis

Glass Lewis have issued their 2025 Benchmark Policy Guidelines which set out its updated framework for evaluating the governance policies and practices of UK listed firms and its approach to proxy voting recommendations. They provide more flexibility to adopt tailored remuneration policies.

Glass Lewis state that they apply a "highly nuanced approach when analysing executive remuneration" and will review companies holistically when making recommendations. There is a new emphasis on flexibility within long-term incentive plans and the need to fully disclose the rationale of decisions that deviate from standard market practice.

The key remuneration updates are as follows:

Pension contributions. Glass Lewis will generally recommend against the relevant remuneration proposal where executive pension contribution rates exceed those applying to most of the workforce. No element of variable pay is to be pensionable.

Hybrid plans. This new section clarifies their general expectation that companies provide:

- A rationale as to why a hybrid model is preferred over a single structure.
- A reduction in maximum opportunity compared to the previous LTIP, with an explanation on the methodology used to determine the discount rate.
- A total vesting and post-vesting holding period of at least five years.

Where competition for talent in the United States or internationally is cited as part of the rationale for introducing a hybrid plan, the benchmark policy expects companies to disclose their consideration of relevant peers.

Dilution limits. In consideration of recent changes to the Investment Association's Principles of Remuneration, potential dilution of over 5% over a ten-year period in relation to executive (discretionary) schemes will no longer generally lead to a recommendation to oppose equity awards

Overarching approach. The nuanced approach has been expanded to reviewing executive remuneration proposals. Specifically, a holistic review of all relevant factors will be conducted, with a negative recommendation being based on an individual factor only in particularly egregious cases.

Remuneration committee engagement. The guidelines have been updated to encourage companies to provide enhanced disclosure concerning their remuneration consultation process following engagement with shareholders

Salary. Where a newly appointed executive is recruited at a higher salary than their predecessor, the expectation is that the remuneration committee's rationale should be fully disclosed.

Annual bonus deferral. Where the remuneration policy otherwise provides adequate long-term alignment, and executive shareholding guidelines have been met, Glass Lewis will generally support a reduction in the level of annual bonus deferral, provided awards remain subject to malus and clawback provisions

Restricted share plans. The guidelines have been updated to more closely align their benchmark policy approach with updated Investment Association guidance in relation to the operation of restricted share plans.

While Glass Lewis support greater flexibility, this needs to be supported by a detailed narrative with the rationale and why any changes are important for the company's aspirations.

Institutional Shareholder Services

Institutional Shareholder Services (ISS) are still preparing their 2025 Voting Guidelines, but they have indicated that they will take the IA's Principles of Remuneration into consideration. It is likely that at least some of their changes will be aligned to the updated IA Principles.

UK Corporate Governance

The Financial Reporting Council (FRC) has published their annual review of corporate governance reporting as companies prepare to implement the new 2024 UK Corporate Governance Code from 2025. The 2018 UK Corporate Governance Code (the Code) remains in effect for annual reports to be published in 2025.

This report highlights ongoing improvements in the quality of reporting against the UK Corporate Governance Code but also identifies areas where many companies are still falling short. The following are some points of interest from a remuneration perspective:

- The FRC encourages wider adoption of clear and transparent disclosures regarding remuneration, enabling shareholders to engage effectively.
- The 2024 Code will introduce increased malus and clawback requirements which will apply to companies with financial years beginning on or after 1 January 2025. Directors' contracts and/or other agreements or documents covering director remuneration should include malus and clawback provisions and the circumstances in which they operate. Companies will also be required to include a clear and enhanced description in their annual report.

Continued focus on the ESG Agenda

The focus on ESG and the implementation of ESG measures into performance and pay frameworks continues to be high on the agenda for remuneration committees - driven by both internal and external stakeholders.

Many 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 amongst many external stakeholders is evolving to ensure that ESG metrics are viewed through the lenses of commercial impact, and that there is an appropriate balance between financial and non-financial goals, as well as being in alignment with a firm's business strategy and overall culture and values.

Proxy voting advisory firms are pressing for greater transparency in disclosures and more robust oversight of ESG matters at the Board and Committee levels.

Non-Executive Director Fees

More technical expertise, an increased time commitment and greater risk – the demands placed on NEDs have ramped up, but remuneration has generally not followed suit. Nevertheless, there is now some evidence that NED fees are rising with a higher number of firms increasing NED fees compared with the prior two years.

UK Financial Services Regulations

On 26 November 2024, the Regulators issued a Consultation Paper which included substantial proposed changes to the remuneration regime. The proposed changes are relevant to banks, building societies, and PRA-designated investment firms – and are designed to support more "balanced and competitive outcomes for consumers and markets". With these changes, the Regulators intend to make the UK remuneration regime more "effective, simple and proportionate. The proposals complement previous remuneration regime changes enhancing proportionality for small firms, and removing the bonus cap."

The global financial crisis was a trigger for the introduction of a strict remuneration regime under the EU Capital Requirement Directives. In recent years, however, these rules have increasingly been criticised as excessively punitive and a deterrent to attracting global talent to the UK. The regulators and the government recognise that the current regulations have made the UK a less attractive location for global companies and talent.

The first response to this was the removal of the "bonus cap" in October 2023, allowing firms to set their own ratio of variable to fixed remuneration. The "bonus cap" also led to increased base salaries which were harder to adjust in response to economic uncertainties. We see that a significant number of UK headquartered banks have changed their bonus cap with the balance continuing to review their position.

The proposed changes retain the core foundations of the existing remuneration regime but seek to address some of the most complex and burdensome areas of the remuneration requirements. The key proposals are:

Identifying Material Risk Takers (MRTs)

The remuneration rules primarily apply to MRTs, whose activities are considered to have a potentially material impact on a company's risk profile. MRTs are identified through a continuous identification process based on both quantitative and qualitative criteria. The quantitative criteria are not considered to be fit for purpose for the UK.

The Regulators are proposing to replace these with a single criterium based on an employee's total remuneration. The Regulators also propose to remove the concepts of "higher paid material risk taker" and "significant firm". This is a further simplification as firms would only need to consider whether an MRT is above or below a single proportionality threshold.

Deferral periods and vesting

The Regulators are proposing the following key changes:

— To reduce the vesting period from 7 years to 5 years for the most senior executives in a firm

— To reduce the vesting period to 4 years in all other cases

— Where previously the portion subject to a deferred vesting schedule rose from 40% to 60% where variable remuneration was above £500,000, this threshold has now been raised to £660,000 (adjusting for inflation).

The Consultation also proposes to allow vesting to start immediately, rather than three years from the point at which the award is made. This is a simpler approach which will allow bonuses to be received faster. The requirement for a proportion of an award to be made in financial instruments will remain but "holding periods" will be removed, also allowing non-cash elements to be received faster.

The prohibition on payment of interest or dividends on deferred instruments is also proposed to be removed.

Increased accountability for senior managers

The 2016 Senior Managers and Certification Regime (SMCR) resulted in many senior executives becoming personally accountable for breaches of law and regulation and this trend continues in the Consultation. The proposals aim to ensure that variable remuneration better reflects risk-taking outcomes and individual responsibilities with better links between the SMCR and remuneration regimes. SMCR is currently under separate review by the Regulators.

Handbook simplification

The Regulators are proposing to consolidate rules which are currently duplicated in the FCA Handbook and the PRA Rulebook. This will remove the need for the FCA to maintain its own set of parallel remuneration rules.

The change in the quantitative criteria for identifying MRTs could potentially result in a material reduction of identified MRTs. This is likely to be a key area of focus for many banks. Firms are also likely to focus on preparing cashflow projections, particularly for their most senior executives given the change in deferral requirements. More generally the proposed changes represent an added complexity to the global landscape with the UK regime potentially being very different to that of EU member states which brings added complexity in terms of tax, social security and accounting.

Whilst the potential increased flexibility will allow companies to review their compensation arrangements, there will also be a need to ensure that robust consequence management frameworks and policies are in place. In addition, employee consents to the malus and clawback policy should be included in all relevant bonus and share plan documentation.

The KPMG Board Leadership Centre

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