Executive pay: Insights into the 2019 AGM reporting season – FTSE 350

June 2019
AGM season review 2019

With approximately half of the FTSE 350 having published their directors’ remuneration report, we take a look at the key themes emerging from the 2019 AGM season:

35% of the FTSE 350 have published their CEO pay ratio, employing a variety of methodologies. Most companies that stated their methodology used Option A to calculate the ratio.

The pay ratio in practice

For the majority of companies, fully conforming with Option A (the Government and investors preferred approach to calculating the ratio) has presented many data challenges. Companies are having internal discussions on whether to exclude populations that may have a distortive effect on the ratio (for example, those on maternity and sick leave) or whether they should use estimates or exclude certain pay elements to allow time for validation, narrative building and approval of the ratio. Given the exclusions and assumptions that many companies are making, there may be an argument to suggest that companies are actually employing Option C when intending to conform with Option A. More importantly, it may mean that direct cross-company comparisons are not straightforward.

Whilst disclosure of the methodology is important, investors have stated that they will pay the most attention to the narrative that sits alongside the ratio. Whilst investors and proxy voting agencies have welcomed early disclosure of the ratio, none have made specific comment on the size of a company’s pay ratio or accompanying narrative. Practice in relation to the pay ratio narrative is mixed, with those providing a more comprehensive narrative typically explaining the ratio with reference to their lowest paid employees. This includes, for example: referencing how salary progression is structured for those at the lowest pay bands; stating that no employees are paid below the real living wage; and referencing fair pay principles that form the backbone of a remuneration framework that is intended to be fair and free from discrimination. We expect that best practice in narrative building will continue to evolve and this will need to include explaining the inevitable variability in the ratio on a year on year basis.

1 Analysis based on 171 FTSE 350 companies who have published their annual report and accounts
Alignment to the wider workforce

The Investment Association (IA) has stated that companies should disclose the pension available to the wider workforce and they expect companies to exercise judgement in determining a pension figure that is representative of this group. For a UK based executive, the IA has stated that it is generally acceptable to use the UK workforce as a proxy for the wider workforce, and that disclosing maximum opportunity available would generally be acceptable provided employees are actually contributing at these levels.

Although companies across the FTSE 350 are lowering pension contributions for both new and existing directors only a small number have disclosed the pension contribution levels available to the wider workforce – this is typically between 5-15%. One company included a table outlining the maximum employer pension contribution available to each grade. We expect additional disclosure on this point next year.

33% of FTSE 350 companies have reduced executive director pension contributions. Of these, around a third lowered contributions for existing incumbents.

21% of FTSE 350 companies now have post-cessation shareholding guidelines. These are typically 100% of the shareholding requirement held for one or two years.

13% of FTSE 350 companies exercised discretion on annual bonus and/or LTIP vesting. Of these, the majority (86%) reduced rather than increased vesting.
### Aligning pay with culture

As part of the changes to the 2018 UK Corporate Governance Code, remuneration committees are being asked to review the alignment between executive incentives and rewards, and the organisation’s culture. It’s difficult to define what culture means and it will inevitably be very company-specific. From a remuneration committee perspective, the EY view is that the following elements should be considered:

#### Metrics

- It may be appropriate to include metrics in incentive plans that are cultural indicators for the organisation, for example:
  - Net promotor score
  - Environmental social and governance metrics
  - Employee engagement

As a minimum the committee should ensure that metrics are not driving or over-emphasising behaviour which is counter-cultural.

#### Governance

The remuneration committee needs to be satisfied they are taking the right steps to ensure executive director and senior manager pay is appropriate from a cultural context, including, but not limited to:

- Use of discretion and consideration of a broad view of performance, not just formulaic metrics specified in incentive plans
- Exercising malus and clawback

#### Engagement

The remuneration committee needs to understand what is going on in the rest of the organisation, and ensure pay decisions are aligned, including:

- CEO and senior management pay ratios
- Minimum wage
- Pension contributions
- Relationships with wider stakeholders

### How have companies responded this AGM season?

**Metrics:** Overall we have seen a slight growth in the number of companies employing environmental, social, and governance metrics across their incentive plans. Companies are increasingly focusing on their carbon footprint, health and safety, and workforce diversity and incorporating these as metrics into incentive plans.

**Governance:** Given the widespread use of discretion throughout the FTSE 350, it appears that remuneration committees are becoming increasingly aware of wider company culture and performance in reaching decisions on executive pay. One company exercised malus in respect of the annual bonus, although proxy voting agencies deemed that this was an inadequate response given the impact the event had on the organisation. In their updated principles of remuneration, the IA has advised that remuneration committees should establish a more substantial list of agreed trigger events for the application of malus and clawback. This is in recognition that the current standard trigger events (gross misconduct or misstatement of results) are likely to be both rare and challenging to prove the individual culpable.

**Engagement:** A number of FTSE 350 companies have stated that they use or are developing pay dashboards to aid remuneration committee understanding of pay across the wider workforce. We expect practice in this area to continue to evolve alongside broader employee engagement mechanisms.
Shareholder reaction

Proxy voting agencies are continuing to flag the same issues raised in recent years. These are: incentive quantum; inadequate bonus target disclosure, particularly in relation to non-financial metrics; use of upwards discretion; lack of target stretch; and base salary increases above inflation.

The 2019 AGM season marks the second full year that the IA shareholders register has been in operation, publicly naming companies with less than 80% shareholder support. At the time of writing, just four FTSE 350 companies have been named on the register, a significant reduction in the number named by this point in 2018. This is partly due to significantly less remuneration policies being put to vote across the FTSE 350 this year compared to last (36 in 2019 compared with 69 in 2018). So far this year the average vote in favour of the implementation report is 92.05% which is a drop of approximately 1% compared with 2018.

So what did shareholders object to in these four instances?

**Company A – Policy and report**

Due to wider discontent with the directors, a major shareholder voted against both the remuneration policy and remuneration report.

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**Company B – Report**

Noted concerns around the 2017 LTIP, issued as a block award, delivering up to 1.6% of share capital.

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**Company C – Report**

Scope for bonus target setting to be more robust and quantum appears high relative to peers.

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**Company D – Report**

Company nearly doubled variable pay opportunity following acquisition, not supported by compelling rationale.

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Conclusions

It comes as no surprise that companies making structural changes to executive remuneration are doing so in order to align their pay structures with the updated requirements of the Corporate Governance Code. These changes include the gradual adoption of post-cessation shareholding guidelines and the reduction in executive pension contributions, albeit primarily for new hires. Given that companies will be required to disclose the pension contributions available to that of the wider workforce we expect the heightened focus on executive pensions to continue.

Answering investor calls for early publication, a significant proportion of the FTSE 350 have published their CEO to worker pay ratio. Early disclosure is seen by many as a practice run and as such, the focus has been primarily on successfully producing the ratio rather than developing a compelling narrative. As best practice continues to develop, organisations will need to ensure that any pay ratio narrative is consistent with wider internal and external pay messaging and ‘own’ their pay story in the process.

The prevalence of the use of downward discretion across the FTSE 350 is a sign that remuneration committees are in the process of taking a holistic view of business performance when determining incentive vesting. Given that executive pay must be justified with reference to the wider workforce, remuneration committees will need to ensure they have the tools to fully understand pay across the business and be prepared to make some tough decisions to ensure pay alignment with the wider workforce.

How we can help

We advise employers on all aspects of executive and broader reward, strategic reward design, governance, and disclosure including:

- Navigating the evolving corporate governance landscape in line with a best practice approach
- Assisting in developing fair pay principles that combine disclosures to articulate a compelling fair pay story
- Developing a pay dashboard to aid remuneration committee understanding of pay across the workforce

Contact

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