SECTION 5: REMUNERATION

The UK is still in the depths of a severe cost-of-living in crisis, which is likely to be impacting the vast majority of those employed in investee companies as well as pension scheme savers.

This is an area of particular focus amongst investors, especially after the introduction of new disclosure requirements by the Companies (Miscellaneous Reporting) Regulations 2018.[32] The legislation established mandatory reporting for some companies on employee and stakeholder engagement, and disclosure of information on the ratios between CEO and average staff pay, among other demands.

According to Minerva Analytics, in the 2023 voting season, 143 companies put forward remuneration policy votes, of which 18 received high dissent, a fall from the 20 of 111 resolutions in 2022. In 2023, 44 remuneration report approvals received high dissent, an identical number to 2022.[33]

Executive Pay

The PLSA has always recognised the importance of appropriate remuneration policies as a litmus test for wider corporate governance practices. We are particularly concerned at some of the executive awards being made, which have historically been significantly out of step with those made to the wider workforce. This was especially concerning in 2023, with inflation only dropping below 5% in October[34], resulting in financial difficulties for many UK households, including in accessing electricity and gas. The PLSA also believes there is limited evidence that the increase in executive pay over the years has genuinely been in response to performance.

While there is limited data on shareholder dissent on this issue, it remains the case that 'Say on Pay' votes are advisory only. The say on pay legislation was introduced in 2002 and requires publicly traded firms to submit an executive Remuneration Report to a non-binding shareholder vote. According to research from Harvard Business School, there has been no evidence of a change in the level and growth rate of CEO pay after the adoption of the new rules.[35] A second stage in the evolution of the regime began in 2013, when shareholders were granted a binding vote on remuneration policy. Another study stated that in light of the continuing presence of significant levels of excess pay, say on pay has to date had limited success as a regulatory strategy.[36]

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[32] The Companies (Miscellaneous Reporting) Regulations 2018, The Stationary Office <https://www.legislation.gov.uk/uksi/2018/860/contents/made>.

[33] Minerva Analytics, 'Minerva Briefing 2023 Proxy Season Review' Minerva Analytics (2023).

[34] Office for National Statistics 'Consumer price inflation, UK: October 2023', Office for National Statistics (2023) <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/october2023>.

[35] Fabrizio Ferri and David Maber 'Say on Pay Vote and CEO Compensation: Evidence from the UK', Harvard Business School (2007) <https://www.hbs.edu/faculty/Pages/item.aspx?num=30651>.

[36] B. Wu, Iain MacNeil, Katarzyna Chalaczkiewicz-Ladna "Say on pay' regulations and director remuneration: evidence from the UK in the past two decades', Journal of Corporate Law Studies (2020) <http://eprints.gla.ac.uk/210140/7/210140.pdf>.

The PLSA calls on companies to exercise restraint in executive pay, especially during the cost-of-living crisis. The PLSA also encourages investors to evaluate all aspects of a company's remuneration policy, with a view towards ensuring that it is closely aligned with investors' interests, driving long-term strategic success and is in line with wider workforce policies.

Investors should be aware that there is a significant and growing reputational risk from the issue of poorly managed executive remuneration, including for investors themselves and how well they are holding companies to account on this issue.

We also believe there is growing demand for alignment between remuneration and wider sustainability targets, and we now expect to see this reflected in voting policies.

Gender and Ethnicity Pay Gaps

Companies with over 250 employees are mandated to report on gender pay gap, which is normally included in a separate document alongside their Annual Report.[37] Ethnicity pay gap reporting, however, is not yet compulsory. A 2021 recommendation from the UK Government's Commission on Race and Ethnic Disparities detailed that companies that choose to publish pay gaps between ethnic groups should also publish a diagnosis and action plan to address them.[38] In December, a group of 10 major UK investors, coordinated by ShareAction, called on the FCA to introduce mandatory ethnicity pay gap reporting for financial institutions.[39] More information on the topic of diversity and inclusion can be found in Section 3: Composition, Succession, and Evaluation.

EVIDENCE BASE

There are often several pages dedicated to executive remuneration in the Annual Report. However, it is vital that companies and shareholders also have regular discussions on strategy and long-term performance; investors must be sure to then use these engagements as an opportunity to encourage firms to directly link remuneration and corporate performance objectives.

Remuneration metrics should be considered in the context of the sector in which the company operates, the wider workforce and what similar companies are doing in terms of their pay arrangements. There should be evidence of a range of long-term remuneration structures considered, with a robust, long-term business rationale as to why a particular approach – such as a Long Term Incentive Plan (LTIP) – was chosen over other approaches such as deferred stock options.

[37] Government Equalities Office, 'Who needs to report their gender pay gap' Government Equalities Office (2020) <https://www.gov.uk/guidance/who-needs-to-report-their-gender-pay-gap>.

[38] Commission on Race and Ethnic Disparities, 'Commission on Race and Ethnic Disparities: The Report' (2021) <Commission on Race and Ethnic Disparities – Commission on Race and Ethnic Disparities: The Report – March 2021 (publishing.service.gov.uk)>.

[39] ShareAction 'Investor Letter to the Financial Conduct Authority on Diversity & Inclusion', ShareAction (2023) <https://cdn2.assets-servd.host/shareaction-api/production/resources/reports/FCA-Investor-Letter-press-2023.pdf>.

Investors should also ensure that there is a discussion of the remuneration quantum and not just the approach, bearing in mind the increased scrutiny from public and policymakers regarding big pay packages in an era where we are likely to face greater economic and market uncertainty.

WHAT DOES GOOD COMPANY BEHAVIOUR LOOK LIKE?

- Remuneration structures and incentives for Executive Directors should cascade down to all employees in order to allow staff to also share in the success of the business. For example, companies should seek to offer employees share awards in the most cost effective and simple manner. This should also include Executive pension contributions – rates for Executive Directors should be in line with those available to the workforce. This should be the case for new Directors and investors should engage as much as possible to ensure that this is the case for existing Directors too.
    - Maximum pay-outs must remain in line with the expectations of shareholders and other stakeholders, including workers and the wider society.
    - The pay policy should not enable any pay award larger than what is necessary to successfully execute the company's wider strategy and to incentivise and reward appropriately.
    - There are clear time frames for bringing Executive pension contribution rates for existing Directors in line with those of the wider workforce. No compensation should be awarded for this change.
    - New Executive Directors or any Director changing role are appointed at the same level of pension contribution as for the overall workforce.
- The remuneration policy is clearly linked to incentivising behaviours which are consistent with the company's purpose and values. This should include performance on environmental and social issues and should demonstrate some recognition of wider societal expectations, the general economic environment and the returns to long-term shareholders.
    - Remuneration Committees should take into consideration (as a starting point) the company's strategic plan and KPIs to ensure there is a strong explanation for the drivers of executive remuneration given the company's overall strategy.
    - This should include a plan in the near-term, if not already undertaken, to tie remuneration to company performance on relevant and material environment and social metrics. Please note that this should be done in a way which does not incentivise the pursuit of sustainability at any cost and should be appropriate to the company context.
    - Where LTIPs are used, these should be linked to several different performance metrics, perhaps including a combination of growth, earnings and a mix of top-line and bottom-line contributions, in order to avoid incentivising short-term behaviour by executives.
- Pay schemes are clear and understandable for both investors and executives. Firms should not be operating multiple long-term schemes – a multiplicity of awards, with varying performance conditions is rarely successful in motivating company executives.

- The Remuneration Committee designs rewards that drive long-term success. Remuneration Committees should take ownership of, and be accountable for, both the remuneration policy and its outcomes. Companies should consider how they might align pay more closely with the interests and expectations of their long-term owners in order to position themselves well for future success.
- The Remuneration Committee exercises its judgement, taking a critical and challenging approach to pay increases. Shareholders allow remuneration Committees' significant discretion and room to exercise judgement about the overall performance of the company when determining awards.
    - Even when Remuneration Committees are thinking about making executive salary increases that are in line with the average employee increase, consideration should be made to how competitive pay is already and to the extent to which this will increase all other areas of remuneration (typically already much higher than that available for employees).
    - Remuneration Committees should demonstrate that they are prepared to exert downward pressure on executive pay where necessary and that they have used their discretion to ensure that awards properly reflect business performance. This should include a willingness to scale back on account of wider factors relating to the company, as well as its conduct, reputation and relationship with key stakeholders.
    - Where Remuneration Committees have used their discretion in an upwards direction, they should explain appropriately.
    - Remuneration Committees should consider how the results have been achieved, not just what was achieved including the creation of meaningful value and not just temporary stock price increases.
- Executive management makes a material long-term investment in shares of the businesses they manage. Senior Executives should have significant "skin in the game" of the companies they manage. Importantly, this should not just arise owing to share awards, but be as a result of active purchase of shares by Executives in the open market.
    - The bulk of variable rewards should flow over time from the benefits of being an equity owner.
    - Companies should also consider ensuring that Executives are exposed to some tail risk for an appropriate length of time once they leave a company.
- There is a cap on variable pay and clear Remuneration Committee consideration of the overall quantum. There is no need for there to be a cap on fixed pay, but Remuneration Committees should ensure there are set limits for variable pay (typically as a percentage of salary). They should also consider whether an overall pay cap (i.e. the value of awards actually paid) may be appropriate in certain circumstances to ensure executives are not benefiting from windfall gains, particularly as a result of external factors which are outside of management's control.
- There is a clear narrative to support the gender pay gap figures. This should include a well-targeted action plan for any improvement, including anticipated outcomes and how it links back to the company's strategy. The best companies will also be disclosing – in advance of likely

future mandatory reporting requirements – their ethnicity pay gap and any supporting narrative.
- The company initiates appropriately regular discussions with investors on strategy and long-term performance. Any discussions on remuneration should be initiated at a sufficiently early stage and include long-term investors who are committed to stewardship.
- The company includes in its annual report a description of its malus (reducing bonuses before payment and clawback (recovering bonus after payment) provisions, which can be applied in certain circumstances such as payments based on erroneous or misleading data, misconduct, misstatement of accounts, serious reputational damage and corporate failure[40].

HOW INVESTORS SHOULD CONSIDER VOTING

It is important that investors note the difference between a remuneration policy and a Remuneration Report when it comes to choosing the right resolution on which to express a view. While one does impact the other, a vote for or against one does not necessarily require a vote for or against the other. Shareholders should view the separate resolutions independently.

On the Remuneration Report resolution specifically: given that this is advisory and that many companies remain too slow to heed the message on remuneration, the PLSA believes it is more appropriate for investors to vote against any Remuneration Report that they feel unable to support, rather than abstain.

Investors should consider voting against the remuneration policy if:

- The company's remuneration policy fails to meet the standards outlined above.
- Pay policies may result in pay awards that could bring the company into public disrepute or foster internal resentment.
- The pay policy awards 'sign-on' bonuses without the inclusion of any conditionality, or allows for the payment of awards not already vested at the previous employer.
- The process of engagement prior to the AGM vote fails to produce a remuneration policy that shareholders can support. This represents a serious failure on the part of the Chair of the remuneration committee in what is the most fundamental aspect of their role.
- There is no provision to enable the company to claw back sums paid or scale back unvested awards. Such provisions should not be restricted solely to material misstatements of the financial statements.
- The pension payments or payments in lieu of pension (as a percentage of salary) for new appointments are not in line with the proportion paid to the rest of the workforce.
- There is no plan to bring pension payments to incumbent Directors in line with the proportion paid to the rest of the workforce over the next few years.
- There is an excessive amount of flexibility being provided for 'exceptional circumstances'.

[40] Financial Reporting Council 'Corporate Governance Code Guidance', Financial Reporting Council (2024) <https://www.frc.org.uk/library/standards-codes-policy/corporate-governance/corporate-governance-code-guidance/>.

- The recruitment policy is vague and unlimited or substantial headroom is given and not accompanied by substantial additional hurdles.
- There are guaranteed pensionable, discretionary or 'one-off' annual bonuses or termination payments.
- There is any re-testing of performance conditions to enable awards to be made.
- New share award schemes are layered on top of existing schemes.

Investors should consider voting against the Remuneration Report if:

- There is insufficient evidence of alignment with shareholders' interests and company long-term strategy. This could include, but is not limited to, a shareholding requirement for which the level is set at less than 2x salary.
- The metrics used are inappropriate or there are insufficiently stretching targets for annual bonus or LTIP.
- There are annual pay increases in excess of those awarded to the rest of the workforce and an absence of a convincing rationale.
- Pension payments to incumbent Directors (as a percentage of salary) are higher than the rest of the workforce and there is no evidence that this will be reduced.
- The pension payments, or payments in lieu of pension (as a percentage of salary) for new appointments, are not in line with the proportion paid to the rest of the workforce.
- There is a failure to disclose (or to have a retrospective disclosure of) variable pay performance conditions for annual bonuses or ex-gratia and other non-contractual payments.
- There is a change in control provisions which trigger earlier and/or larger payments and rewards and there is an absence of service contracts for executive Directors.
- The process of engagement prior to the AGM vote fails to produce a remuneration policy that shareholders can support – this represents a serious failure on the part of the Chair of the remuneration committee in what is the most fundamental aspect of their role.

Investors should consider voting against the Remuneration Committee Chair (Director's election) if they have been in post for more than one year and:

- The company has repeatedly failed to take investors' concerns into account and fail to respond in what investors consider to be an appropriate fashion.
- The process of engagement pre-AGM has failed to result in a remuneration policy that shareholders can support, or shareholders feel that the Chair has failed to take on board their concerns about the Remuneration Report.
- Any revised policy continues, on a repeat basis, to fail to meet the principles outlined above.