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On the 2022 remuneration committee agenda

KPMG Board Leadership Center

Executive compensation has been under increased scrutiny during the pandemic years, with shareholders and society focussing on a "shared burden" approach, tying executive compensation to the experience of other stakeholders such as employees, suppliers and communities. As businesses and economies start to recover and post record profits, remuneration committees will have to carefully review commitments made in previous years to take consistent decisions for 2022, with a continued focus on restraint and impact of pay on the wider workforce.

Based on recent actions within the market, our engagement with board members and members of remuneration committees across different industries as well as responses to the annual SWIPRA Corporate Governance Survey and experience from SWIPRA Services, we have highlighted seven areas to keep in mind as remuneration committees consider and carry out their 2022 agendas.

Prominence of the Environmental and Social (E&S) agenda

E&S topics are now of critical consideration for businesses and continue to be high on the agenda of remuneration committees. As of the 2021 AGM season, only about one out of four of the largest 100 SPI® companies had explicit E&S targets in their compensation system (SWIPRA AGM Analysis 2021). As companies are increasingly asked to tie these non-financial factors to strategy, it is a primary concern for business leaders as to how they will drive dynamic change in this space. Investors, regulators, employees, customers and other stakeholders will therefore hold clear expectations of how management interests are aligned with strategic E&S targets and how management will be incentivized to bring those to fruition.

Linking executive pay and E&S metrics is a continuing conversation, and while only a minority of SPI® companies has implemented an ESG metric in their incentive scheme, there is broad agreement between institutional shareholders (82%) and companies (86%) that ESG incentives should be included in variable pay plans. The question now is, how do you select performance metrics, how do you set targets, and in which compensation element do you anchor them? Below are related talking points for boards and remuneration committees:

- Prioritize. Whilst undoubtedly any board will be looking to achieve all elements of their E&S strategy, it is useful to prioritize which areas will be a key focus in the next 3-5 years. This helps to provide short to medium-term milestones for achievement, particularly where the objectives are very long-term, such as climate-related strategies.
- Materiality. The decision on which E&S metrics to choose should be guided by the measures' materiality for the company's business going forward. Considerations should particularly be given to the fact that what was material yesterday may not be material anymore for the business' future.

- Timeline. Sustainability is long-term by its sheer definition. That does not mean, however, that E&S targets should only be reflected in long-term elements. Indeed, according to the Survey, 77% of investors believe that E&S targets should be built into both long-term short-term incentives. The latter is needed to direct the immediate attention and action of management to E&S topics (opinion shared by 57% of investors and 71% of companies), which again will be relevant on the way to achieve long-term goals.
- Culture. How can the wider workforce also be incentivized? Bringing a collaborative approach and linking together the focus of the executives with that of the wider workforce, will not only reinforce a refreshed corporate culture, but also drive performance.

Shared burden, shared success

The pandemic years required compensation committees to take decisions for or against "shared burden" approaches, i.e., to what extent discretionary changes in compensation arrangements at management level are aligned with changes for the entire workforce. Now that the tide has turned, performance indicators will likely come out at or above target performance levels in many companies. Compensation committees will be watched closely by shareholders and proxy advisors as to whether choices made for the upside are consistent with the decisions taken during the downside period. Widening pay ratio gaps, e.g., the difference between CEO and average worker compensation, will likely be greeted critically by shareholders and proxy advisors.

Remuneration committees and organizations should continue to review the composition of the total reward package and consider if there are constituent parts which may discourage the shared benefit/burden approach. The pay ratio is part of the broader ESG agenda and therefore should become part of the assessment for performance-based executive pay, as discussed above.

Monitoring executive pay levels, determining appropriate bonus outcomes and appropriate basis for LTI grants during this period of economic recovery will continue to be a focus for compensation committee members. However, we are also seeing a growing need to ensure that these decisions are linked to wider workforce pay and people strategies.

Improving transparency around pay decisions

The survey revealed again that a majority of institutional shareholders viewed the pay-for-performance disclosure of Swiss companies very critically. Only 15% stated that they were satisfied with the current disclosure.

This is reflective of many of these shareholders' proxy voting policies that base part of their compensation assessment on the competitiveness of the set KPI targets. Absent this information, which still is often the case in Switzerland, their analysis is incomplete and a reason why Swiss companies' compensation reports are often faced with a notable fraction of "against" votes.

So far, compensation committees often have dodged this shareholder request by referring to a Swiss best-practice approach according to which their disclosure was aligned with the rest of the market and that any additional information would potentially impair their competitiveness. For the large international shareholders and proxy advisors, this argument is increasingly invalidated as companies in the UK and elsewhere have been reporting these actual KPI targets for a while now. Compensation committee members should reconsider the potential costs and benefits of such additional disclosure, bearing in mind that not reacting to this shareholder demand may lead to significantly higher "against" votes in the future.

Potentially aggravating this issues is the broader use of E&S metrics going forward. As the measurement and standards for such metrics are rarely as standardized as for financial metrics, compensation committee members should carefully assess how pay for performance can be explained going forward and how robust the metric is expected to be to changes in and around the company.

Expanded remit of remuneration committees

In the wake of COVID-19, remuneration committees have had to apply sound judgement on executive pay impacted by the pandemic and should continue to do so in terms of exercising restraint and addressing potential windfall gains or losses.

Again, this can be linked to the rise of ESG strategies and the need to have effective change management in terms of corporate culture becoming more focused on a fully inclusive environment and employee engagement and wellbeing.

It is also important in terms of ensuring a strong succession strategy and ensuring that pay policies are encouraging strong career development for a diverse workforce.

Innovative incentive arrangements

The debate around more innovative incentive ideas continues to develop and has only been enhanced by the need for fresh thinking on delivering executive compensation and long-term incentives.

Ideas such as granting only restricted stock with a ten-year blocking period as suggested by Norges Bank Investment Management or by tying part of board compensation to ESG metrics continue to float but have so far only received limited appreciation from investors.

However, with more companies having a renewed purpose and focusing on creating long-term sustainable business models, this will see an increased focus on the need for a more balanced view in terms of performance conditions (i.e., financial vs non-financial) and also a more behavior-focused reward philosophy. For such non-financial performance conditions, this may also entail a shift away from rewarding compliance towards penalizing non-compliance.

Reputational risks and the fairness agenda

According to the SWIPRA 2021 AGM analysis, the median fraction of "against" votes on compensation reports increased to an all-time high since 2013, to 13.2% for SMI and 14.4% for non-SMI companies. The quarter of companies with the highest level of shareholder opposition, the fraction of "against" votes was well above 30%. This increase was also due to many investors taking a harder stance on the fairness of pay.

As we have previously discussed, being in the news for excessive executive pay does not send the right message to potential investors and the public. Whilst the reputational impact of executive pay issues may not be immediately quantified, the remuneration committee and other key officers will spend significant amount of time on issues which are not core to the business itself.

The fairness agenda is not a new topic, but its importance continues to increase and shows the need for continued restraint to be shown in respect of executive pay, but also the growing remit the remuneration committee has to ensure that its pay decisions are reflective of the pay philosophy applied to all employees.

Whilst the majority of companies have frozen executive pay, cancelled or revised bonus payouts and been more conservative in terms of LTIP grants, investors have continued to vote against remuneration reports where they consider executives to have been shielded from the real impact of the pandemic. In many cases, even with the lower pay levels we have seen over the past year, some stakeholders would still consider the level of reward received by executives to be generous given the economic hardships experienced by the population as a whole, but particularly in cases where there has been a level of government support to protect large businesses.

Therefore, again in line with the ESG focus which should be embedded into all areas of a company's operations and outlook, remuneration committees will need to continue to apply a greater focus on social equality and the levelling of pay, with more value being placed on performance across the board and a flatter pay curve effectively 'levelling-up' the wider employee population.

Investor engagement

Engaging with institutional investors on matters around executive pay has always been an important aspect of the ongoing dialog between the company and its shareholders.

However, a very recent statement issued by LGIM has suggested that on the basis that engagement has so infrequently changed the position on executive pay to reflect investor views that this is no longer going to be a key focus of their consultation – with companies instead generally directed to their policy statement (other than in very specific circumstances).

Whilst this is currently only the position of one investment manager, to the extent that this becomes more widespread – as investors increase the range of performance indicators which they assess businesses against – it further serves to illustrate how remuneration committees need to be comfortable in their decisions with reference to the stated policies of their key investors.

This document was prepared in collaboration with SWIPRA Services.

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