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PAY IN UK LISTED COMPANIES: INVESTMENT ASSOCIATION PAY EXPECTATIONS FOR 2021

Summary

The Investment Association ('IA') has published an update of its "Principles of Remuneration" for 2021 along with an updated version of its April 2020 guidance on the impact of Covid-19 on executive pay. Here's a summary of the key areas for UK listed companies for 2021 (detail can be accessed here and here).

The impact of COVID-19 remains a focus, with the IA acknowledging the significant challenges that companies are still facing. The IA expects that RemCos will want to 'sensitively balance' incentivising executive performance at a time where management is being asked to demonstrate significant leadership and resilience. RemCos are reminded that executives should not however be 'isolated' from the impact of COVID-19 in a way that is not consistent with the approach taken for the general workforce and should also be aware of the pandemic's impact on society.

Outside of COVID-19, the reduction of executive directors' pensions contributions to align with the majority of the workforce also remains an area of focus for the IA.

Updated Shareholder Expectations on pay during the COVID-19 pandemic

In April 2020, the IA provided additional guidance on shareholder expectations during the COVID-19 pandemic, this has now been updated. Key points to note are:

- ***Government aid and loans*** - Confirmation that investors do not expect companies taking government loans or other forms of aid to pay any annual bonuses for either FY2020 or FY2020/21, unless there are 'truly exceptional circumstances'. RemCos should also disclose how they have taken into account the impact of any indirect support measures (such as business rate relief) on remuneration outcomes.

- ***Dividend payments for FY 2019 or FY 2019/20*** – Expectation that RemCos clearly disclose how the cancellation of an intended dividend has been reflected in 2019 or 2020 remuneration outcomes.
- ***Performance measures and LTIPs*** – Adjusting performance for 'inflight' LTIP awards is discouraged and confirmation in the annual report will be needed that companies have not adjusted performance targets. Shareholders would not expect LTIP grants to be cancelled and replaced with another grant, because of COVID-19. Shareholders also do not expect RemCos to compensate executives with a higher variable pay opportunity in 2021 for any lower remuneration received in 2020 due to the pandemic. For future LTIP grants, performance targets must remain sufficiently stretching and should not be adjusted to compensate for reduced remuneration outcomes due to COVID-19 (with enhanced disclosure needed on setting the targets).
- ***Salaries*** – Expectation that companies show 'continued restraint' on salary increases and on overall quantum of pay (with any increases, if necessary, in line with changes to the wider workforce). Investors will continue to look closely at how any increases to basic salary or variable pay opportunity are justified.
- ***Bonuses*** – Where RemCos' discretionary powers are used this should be matched with increased disclosure on rationale and outcomes. This includes disclosure on how RemCos have determined financial targets and why any pay-outs have been made under non-financial elements only. Companies may also consider whether a higher portion of bonus should be deferred into shares.
- ***Windfall gains*** – Confirmation that disclosure is needed of the approach taken and factors considered when judging if there has been a windfall gain from any LTIP grant made in 2020. For those that reduced the size of the grant of a new award, this should also be stated.
- ***Alternative Remuneration Structures*** - Shareholders will still consider the strategic rationale for the implementation of any restricted share plans (RSP), noting that the inability to set meaningful performance targets is not a reason in itself for this move. Where companies introduce a RSP, a RemCo should consider share price factors in addition to the usual discount rate of at least 50% from the LTIP grant level that is expected by the IA.
- ***Impact on Directors' Remuneration Policy (DRP) and shareholder vote*** - For companies significantly impacted by the pandemic, it may be appropriate to adopt a 'wait and see' approach before making significant changes to their DRP. Minor changes should still be made to reflect best practice and UK Corporate Governance Code requirements.

CC Comment: The emphasis remains on appropriate use of RemCo discretion to help navigate a company's response to Covid-19. The IA has now placed an increased emphasis on transparency through shareholder engagement and in many instances expects a heightened level of disclosure in the annual report. In terms of response to the pandemic, the IA appears to continue to advocate, in many areas, taking a medium to long-term approach on pay decisions. RemCos will want to review pay arrangements and practices well before year-end, to consider the parameters of flexibility and discretions in bonus and LTIP awards.

Minor changes to the Principles of Remuneration for 2021

Minor amendments have been made to the Principles this year, to reflect developments in market practice, these include:

- ***Use of Non-Financial Performance Measures*** – Further clarity on shareholder expectations on the range of non-financial performance metrics for variable pay (strategic, personal and Environmental, Social and Governance). Shareholders continue to expect financial metrics to comprise the significant majority of the overall bonus. Where personal objectives are used companies should demonstrate how they link to long term value creation and they should not be for "doing the day job." For any personal or strategic objectives, the IA expect a detailed rationale for and disclosure of achievements that have led to payment of these elements.
- ***Post-Employment Shareholding*** – Further detail to be disclosed in the annual report on the enforcement mechanisms which a RemCo has at its disposal to ensure that policies are enforced.
- ***Deferrals*** – Expectation that a proportion of the entire bonus should be deferred when the bonus opportunity is greater than 100% of salary.
- ***Leavers*** – Expectation that bad leavers would not receive bonus.

Approach to Executive Directors' Pension Contributions for 2021

The IA continues its focus on ensuring that pension contributions for executive directors are aligned with those available to the majority of the company's workforce. The approach for 2021 is that:

- ***Pension contributions for new directors*** – Position remains unchanged. Any new director (or director changing role) and any new DRP should have pension contributions in line with the majority of the workforce, or result in a Red Top from IVIS on the report or DRP.
- ***Incumbent directors' pensions contributions*** - Position remains that a RemCo is expected to set out a 'credible action plan' to align the contributions of incumbent directors to the majority of the workforce by the end of 2022. Where the RemCo has not disclosed a credible plan, IVIS will now Red Top the report if the pension contribution is 15% or more (previously 25%).

CC Comment:
As was the case for 2019-20, pension contributions and salary increases will remain an area of focus for the 2020-21 pay-round, with the added complexity and uncertainty of Covid-19. The clear expectation is that shareholders and wider stakeholders will be looking even more closely at disclosures and how any increases to executive director salary, pension contributions or variable remuneration are justified by a RemCo with any deviations from the IA's guidance open to public censure.

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