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Remuneration committee briefing

Autumn update

November 2022

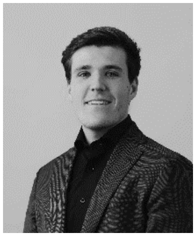
Preparing for the year end & reporting season in a volatile environment

Executive remuneration continues to be a very sensitive topic and will remain under scrutiny as we approach the year end and prepare for the upcoming reporting- and AGM season. On top of the usual executive remuneration challenges, we find ourselves in the aftermath of a global pandemic (including major disruptions to global supply chains and shifts in talent markets), in the middle of a conflict between Russia and Ukraine and ahead of a potential economic slowdown – overturning all 'business-as-usual' plans, projections and strategic roadmaps.

In this challenging, volatile economic environment, remuneration committees ("RemCos") will face heightened scrutiny around executive remuneration decisions and actions taken. Stakeholders will assess quality of decision-making against the backdrop of the deepest squeeze in household living standards in decades, evolving regulation and market standards, and elevated expectations around ESG.

In this briefing, we explore four RemCo hot topics for this autumn based on latest market and investor insights:

- **Salary review and decisions**
- **Incentive payouts**
- **EU remuneration report (draft) guidelines**
- **Key considerations ahead of the 2023 AGM season**

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Salary review and decisions

Remuneration committees will need to carefully consider how executive remuneration decisions relate to the wider workforce experience

Executive remuneration in the context of wider workforce remuneration increases

- While many Dutch companies have linked executives' base salary increases to overall CLA / wider workforce increases, in a high inflation environment we are seeing RemCos take a more considered approach to the annual salary review. We would not be surprised to see executives' base salary increases being *lower* than the wider workforce rate.
- The Dutch National Bank (DNB) has recently come out stating that companies should be able to absorb (wider workforce) wage increases and that current inflation levels are not likely to lead to a wage-price spiral (leading to high inflation levels for a longer time). At the same time, we expect to see elevated political & labour union pressure with CNV and FNV demanding for historically high wage increases (up to 14.3%) to sustain household purchase power.
- In a recent Deloitte poll, over 60% of companies expected to focus salary budgets on lower paid workers and areas of talent premiums (e.g., digital and technology) – of course permitting the CLA provides room for that.
- Approximately one-third of CLAs concluded in 2022 include a one-off payment to sustain purchase power and the quarterly increase of CLA salaries in Q3 2022 was the highest increase since Q1 2009. Outside CLAs, actions being explored to sustain purchase power include (but are not limited to):

One-off payments | **Off-cycle salary increases** | **Financial education** | **Targeting lower-paid workers** | **Expanding benefits offering**

Reviewing impact of executive salary increases on overall quantum

- Given the leverage effect of variable remuneration (typically structured as a multiple of base salary), any potential increases to the level of salary should be considered in tandem with the effect this will have on overall quantum. Small percentage increases to salary may lead to substantial increases in overall remuneration.
- We have seen greater scrutiny by proxy agencies on the multiplier impact of salary increases on the overall package, and this will be a consideration for RemCos when reviewing salary at senior levels.

Expanded narrative in the remuneration report

- As a direct result of the implementation of the Shareholder Rights Directive (SRD II), we have seen the narrative in remuneration reports around executive salary vs. wider workforce remuneration and other cost-of-living/purchasing power actions expand.
- Based on recent engagements with institutional investors this is likely to be a key area of focus during the 2023 AGM season, with shareholders increasingly looking to understand the relationship between remuneration decisions for executives and actions taken to support the wider workforce (/sustaining purchase power).

Incentive payouts

Investors will expect remuneration committees to use judgement and discretion in assessing incentive payouts, ensuring they reflect the wider stakeholder experience

Volatility, disrupted markets and the use of discretion

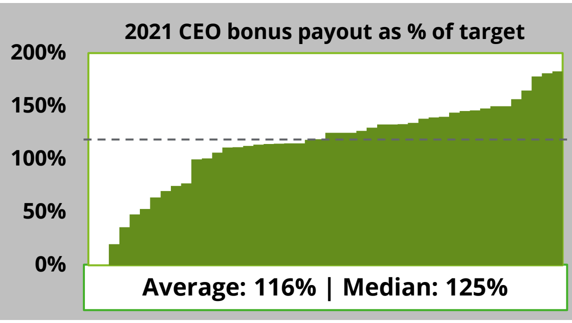
- As companies have continued to set incentive targets in a volatile, post-pandemic environment, investors will expect RemCos to use judgement and discretion in assessing bonus payouts at the year end, ensuring that payouts reflect the wider stakeholder experience.
- The use of (upward) discretion to adjust formulaic incentive payouts has been heavily scrutinized last year, leading to historically low remuneration report support levels (<25% for two companies). Careful consideration is required.
- The Russian invasion of Ukraine continues to present disruption and uncertainty for businesses, and companies are in the process of reviewing any potential changes to incentive plans to reflect their exit from Russian operations.
  - Some investors seem supportive of companies who have divested operations in Russia adjusting targets for in-flight incentive awards in the same way as you would for any M&A activity (provided legal divestment is complete).
  - Adjustments relating to unprecedented or other related Russia/Ukraine costs are likely to be highly sensitive from an investor perspective, and there is not yet a market precedent in this area.

2020 long-term incentive (LTI) awards – assessing windfall gains

- Many companies granted LTI awards in March to May 2020, very close to the 'trough' of the pandemic market volatility, making commitments to review appropriateness at the end of the performance period.
- We see this as an area which requires judgement rather than a 'formulaic answer', and the consideration of a range of reference points and perspectives. The factors that the committee may consider include:
  1. The extent to which the performance conditions have been met;
  2. The value of the award compared to grant;
  3. The relative share price recovery compared to the overall market;
  4. Performance against other key KPIs;
  5. The vesting history in the interim years.
- We expect to see companies articulating the approach they have taken at the year end.

Challenging times ahead

- In our Spring update we saw annual bonus payouts for 2021 on average (well) above target, generally supported by strong recovery in corporate performance. For 2022 and 2023, given significant economic and market volatility and narrowing margins, we expect to see a more challenging period ahead with heightened investor scrutiny of incentive payouts.



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RemCo advisory
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EU remuneration report (draft) guidelines

This is the right moment to review your current remuneration report approach!

Changing landscape

- Since the introduction of the Shareholder Rights Directive II ("SRD II"), we have observed increasing stakeholder expectations and evolving market standards around remuneration report transparency. We expect this trend to continue: the remuneration report is the most important communication tool on executive remuneration decisions.
- To support companies in drafting a remuneration report that is in accordance with SRD II, the European Commission drafted guidelines. Although still in draft and non-binding, many companies are using this guidance to structure their remuneration report.
- The EU has published an update to the draft guidelines end of September, aiming to publish the final guidelines in Q4 2022 or in 2023.

2019

European Commission published draft guidelines

2022

European Commission updated draft guidelines

2023?

Will the guidelines be finalized…?

Areas of change

- Although the updated draft guidelines did not include any fundamental changes to previous guidance, we highlight the following;

1. **Flexibility –** *(subtle) Changes have been made to the tone of voice making the overall document less directive and strict, allowing for more leniency in the application (e.g., changes such as: "should" in "could", "is" into "may").*
2. **Sustainability –** *Features prominently in the updated guidelines, even replacing the broader categorization of 'non-financial' when discussing performance criteria.*
3. **Transparency –** *Non-disclosure of prejudicial information may occur, but should not undermine the overall objective of providing sufficient insight to understand the link between pay and performance.*
4. **Storytelling –** *Providing a narrative along the quantitative information is encouraged (e.g., Chair Letter as introduction to the remuneration report, including a remuneration policy summary in the report).*
5. **Clarification –** *Additional detail provided on addressees, scope- and date of application as well as increased clarity on definitions and overall alignment of wording.*

Key considerations ahead of the 2023 AGM season

Executive remuneration will remain under scrutiny in the upcoming AGM and reporting season – potentially intensified by a challenging and volatile economic environment

Addressing shareholder feedback

Companies are expected to address how shareholder feedback has been taken into account for 2022 executive remuneration decisions. Eumedion has expressed the intention to recommend to vote against re-appointment (or discharge) of the RemCo Chair if failing to do so.

Quiet policy season

Most companies have submitted updated remuneration policies in recent years, as such we expect a relatively quiet policy season (with many companies preparing for submitting an updated remuneration policy to their 2024 AGMs).

Continued focus on ESG

Having an ESG metric is no longer enough as investors will be increasingly challenge quality of KPIs, measurability, rigour of target setting and alignment of KPIs with the most material aspects of the company's ESG strategy – likely putting (even) more emphasis on sustainability.

Key considerations ahead of the 2023 AGM season in The Netherlands

Wider workforce considerations

Executive remuneration decisions will be scrutinized on the fairness of proposals in relationship to wider workforce remuneration, as described on page 3.

Pay for performance

In the current challenging, volatile economic environment, elevated scrutiny on incentive payouts is expected, as described on page 4.

Transparency & simplification

Pressure from shareholders, proxy advisors and wider corporate governance community persists.

The publication of final guidelines could further enhance the level (of expectations) and consistency of disclosure across companies as described on page 5.

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