Remuneration Committee Chair

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Dear Remuneration Committee Chair,

RE: IA Principles of Remuneration and Shareholder Expectations for 2023

I am writing to highlight the key areas of focus for our members when considering the remuneration practices of companies through the forthcoming AGM Season and to outline the key changes to The Investment Association's (IA) Principles of Remuneration for 2023. For 2023, given the macroeconomic context, IA members think the following issues to be particularly important for Remuneration Committees to consider as they decide on the 2022 outcomes and remuneration approach for 2023.

Cost of Living, Inflation and the Stakeholder Experience

The evolving nature of the macroeconomic challenges impacting the global economy including the impact of the invasion of Ukraine, the resulting impact on energy prices and the wider cost-of-living crisis and inflationary environment has led to significant uncertainty in the global economy. Remuneration Committees will need to delicately navigate the general economic uncertainty when judging 2022 remuneration outcomes and setting remuneration for 2023.

The IA and its members welcomed the restraint and good practice displayed by most FTSE 350 companies in awarding executive pay through the COVID pandemic. Shareholders asked remuneration committees to consider the wider stakeholder experience when setting and agreeing remuneration outcomes to ensure that executives were not isolated from the effects of the pandemic. In the current economic environment, IA members consider that Remuneration Committees will need to sensitively balance the need to continue to incentivise executive performance and ensure the executive experience is commensurate with that of shareholders, employees, and those most impacted by the cost-of-living crisis, including vulnerable customers, suppliers and other major stakeholders. The IA and its members expect companies to continue to factor the shareholder and stakeholder experience into their remuneration decisions and clearly communicate the approach the company has taken to its shareholders.

For several years, the IA and our members have considered that salary increases for executive directors should, in normal circumstances, be limited to the level of inflation or the salary increases given to all employees. Whilst we believe that this principle still holds true, in a period of significantly higher inflation, we consider that additional restraint should be shown for executive director salary increases. The current inflationary impact is disproportionately affecting lower-paid workers, where a greater proportion of their income will be spent on energy or food, which is seeing the greatest levels of inflation. The leveraged nature of executive remuneration packages should also be considered; inflationary salary increases will have a greater impact on the overall remuneration package and quantum, which may not be appropriate in the current circumstances. In addition, the retention and motivation of employees below the executive level will be key for many companies. Boards will have to consider the delicate balance between the need to incentivise executives and employees throughout the organisation, and how this might impact the productivity of the whole workforce. If salary increases are needed, IA members encourage Committees to consider increases below the rate of salary increases given to all employees. All salary increases, and particularly significant salary increases, will have to be carefully justified in the wider stakeholder context for the company.

We expect that in 2023, a majority of companies will seek shareholder approval for their Remuneration Policy. Given the external environment, IA members will expect companies to generally show restraint on the increases to variable pay opportunity in their new Policy. Any increases in opportunity should be carefully explained in the context of the business and delivery of strategy.

The wider economic uncertainties will also impact on the approach that Committees take to judging performance outcomes and setting forthcoming performance targets. The general uncertainty may require wider performance ranges and discretion may be needed to ensure that the appropriate outcomes are achieved. Whilst judging remuneration outcomes, we encourage Remuneration Committees to be clear on disclosing the issues and different performance drivers they have considered when judging the overall performance achieved and as noted above put outcomes in the context of the wider stakeholder experience.

2020 Long Term Incentive Grants & Windfall Gains

The IA's guidance on shareholder expectations during the COVID-19 pandemic noted the potential scenarios in which windfall gains could arise if the level of share grants expressed as a multiple of salary were maintained after a substantial fall in the share price. The guidance stressed the need for Committees to set out in their Remuneration Report the approach and factors they will or have considered when judging if there has been a windfall gain from LTIP grants made in 2020.

In 2023, many Remuneration Committees will be making those vesting decisions, assessing executive's performance against performance measures of long-term incentive grants made in 2020. These 2020 grants were made in the midst of the pandemic following significant share price falls, so a greater number of shares were granted compared to previous years. To ensure that participants do not benefit from being granted significantly more shares, it is important that Remuneration Committees consider if vesting outcomes need to be reduced. Committees should clearly articulate to shareholders how they have considered the impact of any potential windfall gains when determining vesting outcomes and why any reduction is appropriate. If the Committee has decided not to adjust for windfall gains it should explain and disclose its rationale for doing so.

ESG Metrics in Executive Remuneration

In last year's letter to Remuneration Committees, the IA set out the evolving investor expectations on the integration of ESG-linked metrics into executive remuneration structures. Namely, where a company's long-term strategy includes the management of material Environmental, Social and Governance risks and/or opportunities, remuneration committees should consider incorporating these issues into variable remuneration structures.

In response to these emerging investor expectations, there has been a marked increase in the number of companies that have incorporated an ESG metric into their variable remuneration. This is particularly the case where companies have made net-zero commitments or within those sectors where ESG risks are material. Investor expectations have similarly increased, and there are now several IA members that expect all companies to incorporate material ESG risks and opportunities into executive remuneration structures. whilst others emphasise the need for companies to only incorporate ESG metrics where they are material, linked to the business strategy, and can be simply measured and disclosed. As mentioned in last year's letter we recognise that many companies are still considering how to reflect this element of corporate strategy into remuneration. As such it will be increasingly important that companies clearly articulate the journey, they are on to incorporate ESG metrics into variable pay and how they will evolve this approach in future years. As with other performance measures, we would expect ESG metrics to be linked to company strategy, quantifiable and avoid unnecessary complexity. Investors expect companies to explain how progress against the ESG metrics is measured and for performance against these goals to be disclosed.

IA Principles of Remuneration 2023

This year we have decided not to make significant changes to the Principles of Remuneration, as we believe they continue to appropriately set out our member's expectations on executive remuneration. IA members recognise that Non-Executive Director (NED) fees have not always reflected the increased complexity and time commitment expected of their role. We have consequently updated the Principles to set out investor support for NEDs to be paid fees which reflect the reality of the time commitment, complexity and skillset required for their role and expectations of the Board and their shareholders.

Approach to Pensions in 2023

As previously set out in the Principles of Remuneration, IA members consider that pension contributions for executive directors should be aligned with those available to the majority of the company's workforce by the end of 2022. For 2023, IVIS will:

- Red Top any remuneration policy or report where executive pension contributions are not aligned to the majority of the workforce.

If you need any further details on the Principles of Remuneration, please do not hesitate to contact me or one of the IVIS team (www.ivis.co.uk/contact-us).

Yours faithfully,

Andrew Ninian
Director, Stewardship and Corporate Governance