Remuneration Committee update

Pay in a volatile environment – Approaching the year end

October 2022

In a challenging economic environment, boards will face heightened scrutiny in the coming year around executive pay decisions and actions taken to support the workforce in light of the deepest squeeze in household living standards in decades.

We explore five Remuneration Committee hot topics based on latest market and investor insights.

1. **Salary review (executive and workforce)**
2. **Response to cost-of-living crisis and workforce pay**
3. **Incentive out-turns at the year end**
4. **Remuneration Policy review – incentivising leadership**
5. **Continued focus on ESG, sustainable business and innovation**

Salary review (executive and workforce)

1

Emerging themes:

Salary budgets focused on lower income workers

- While executive salary increases have typically tracked a workforce inflation rate of c.2% in recent years, in a high inflation environment we are seeing remuneration committees take a more considered approach to the annual salary review. For March to June financial year ends, we have seen a trend towards executive director increases being *lower* than the workforce rate, in particular where average workforce salary increases were at or above 4%.
- A recent study by the UK Institute for Fiscal Studies showed that inflation for the lowest income households is expected to be double that of the highest income households by October 2022. Notwithstanding the recent Energy Price Guarantee announcement, economic volatility and interest rate rises are likely to put continued pressure on household living standards in the coming year.
- In a recent Deloitte Academy webinar poll, over 60% of companies expected to focus salary budgets on lower paid workers and areas of talent premiums (e.g. digital and technology), and we expect to see ongoing trade union pressure in a number of sectors.

Reviewing impact of executive salary increases on overall quantum

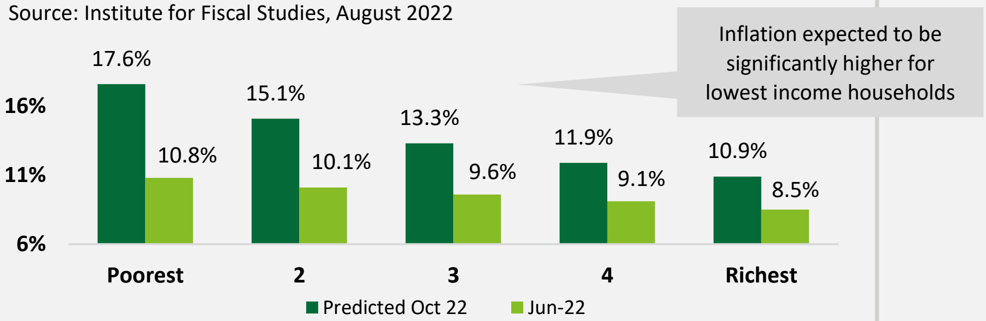
- The Investment Association guidance states "any potential increases to the level of salary should be considered in tandem with the effect this will have on overall quantum. Small percentage increases to salary may lead to substantial increases in overall remuneration". We have seen greater scrutiny by proxy agencies on the multiplier impact of salary increases on the overall package, and this will be a consideration for remuneration committees when reviewing salary at senior levels.

Expanded narrative in directors' remuneration report

- In recent months we have seen expanded narrative in directors' remuneration reports around executive salary reviews, with additional context provided around wider workforce pay increases and other cost-of-living actions. Based on recent engagement 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 pay decisions for executives and the workforce.

Expected UK inflation by income in October 2022 (by income quintile)

Source: Institute for Fiscal Studies, August 2022



In a rapidly changing external landscape, remuneration committees will be keeping a watching brief on evolving market practice and expectations in the coming months.

Executive and workforce salary increases - March to June year ends

	FTSE 100 (26 companies)			**FTSE 250** (36 companies)		
	CEO	**CFO**	**Wider workforce** (average)*	**CEO**	**CFO**	**Wider workforce** (average)*
Upper quartile	3.9%	4%	5.1%	4.8%	5.5%	5.4%
Median	**3%**	**3%**	**4%**	**3.5%**	**3.6%**	**4.9%**
Lower quartile	3%	2.8%	3%	2.8%	3%	3.1%

*As disclosed in the Directors' Remuneration Report

Investor insights

Based on recent engagement 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 pay decisions for executives and the workforce.

Response to cost-of-living crisis and workforce pay

2

Emerging themes:

Actions in response to cost-of-living crisis

- Over 70 companies have published details of their response to the cost-of-living crisis, including c.25% of FTSE 100 companies, and the majority of companies are considering their response in this area. For global companies, the impact and potential response is likely to vary by region. Many companies have reported increased employee engagement activities as they seek to monitor and assess workforce impact and views as the economic position evolves, as well as a review of benefits and discount offerings.
- To date, published actions have been most common in sectors with significant populations of front-line workers (e.g. consumer goods and retail), as well as banks, insurance and financial services sectors.
- We are also seeing increased remuneration committee discussion around the wider employee proposition, in the context of return to office/hybrid working and the ‘war for talent’.

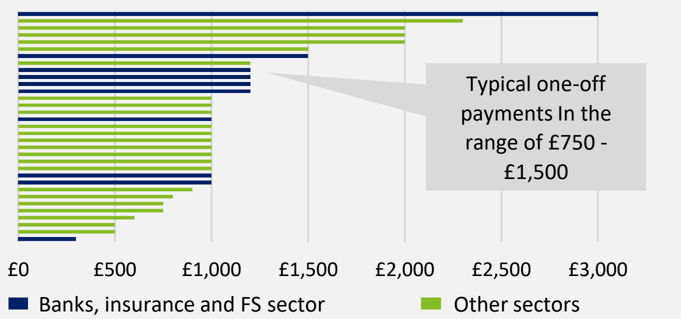
Expanded narrative and disclosure in directors’ remuneration report

- Based on recent engagement with institutional investors this is likely to be key area of focus during the 2023 AGM season, with shareholders increasingly looking to understand actions taken by companies to support their workforce during this period.

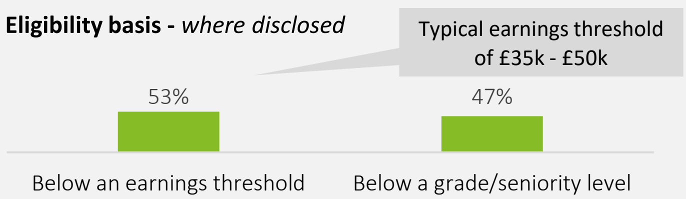
c.25% of FTSE 100 companies have published details of their response to the cost-of-living crisis for the workforce, and many companies are in the process of considering their response in this area.

One-off cost-of-living payments

Payment value (£) – *where disclosed*



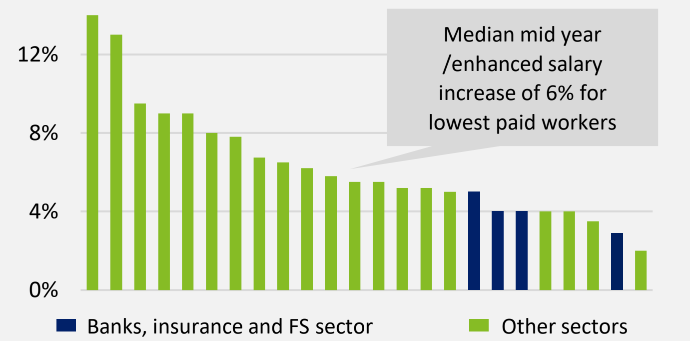
Eligibility basis - *where disclosed*



- 33 companies have announced one-off cost-of-living payments. Typically made to individuals below a specified earnings level (most commonly £35,000 - £50,000) or employees **excluding** senior management.
- May be structured as one-off awards or payments made in tranches over a period (e.g. six months).
- Most common in **banks, financial services, insurance and housebuilder/construction sector.**

Mid year/enhanced salary increases for lowest paid workers

Mid-year salary increase (%) – *where disclosed*



- 33 companies have announced mid year/enhanced salary increases for their lowest paid workers, in the range of 4% - 10% (median 6%).
- To date, these have been most common in retail, industrial and construction sectors with a significant population of front- line workers.

Other actions (where published)

- Additional benefits including financial planning assistance
- Free meals
- Accelerated bonus payment date
- Free share awards
- Increased employer pension contributions
- Enhanced healthcare

Incentive out-turns in a volatile environment

3

Emerging themes:

In 2021 we saw annual bonus out-turns return to above pre-COVID levels in the majority of sectors, with a median FTSE 100 bonus out-turn of 85% of maximum, generally supported by strong recovery in corporate performance. For 2022 and 2023, given significant economic and market volatility and narrowing corporate margins, we expect to see a more challenging period ahead with heightened investor scrutiny of incentive out-turns.

Use of discretion

- As companies have continued to set incentive targets in a volatile, post-pandemic environment, investors will expect remuneration committees to use judgement and discretion in assessing bonus out-turns at the year end, ensuring that out-turns reflect the wider stakeholder experience.
- The use of discretion to adjust formulaic annual bonus out-turns at the year end has become more common in recent years, following changes to the UK Corporate Governance Code. c.20% of FTSE 100 companies used downward discretion to adjust 2021 annual bonus out-turns (typically a downward adjustment of c.5-10%).

Impact of Russian invasion of Ukraine

- The Russian invasion of Ukraine continues to present disruption and uncertainty for businesses, and a number of global companies are in the process of reviewing any potential changes to incentive plans to reflect their exit from Russian operations.
- In our engagement with a range of investors, some have been 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 the legal divestment is complete. In general, investors are not supportive of discretionary adjustments to reflect any broader deviation of the global economy from its expected trajectory, or adjustments which may insulate executives from the wider stakeholder experience.
- 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. As noted in the IA Principles of Remuneration, "any adjustments to reported metrics should be clearly explained and the impact on the outcome detailed."

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

- Many December year end companies granted LTI awards in March to May 2020, very close to the 'trough' of the pandemic market volatility, making commitments to review the out-turn at the end of the performance period and assess whether a windfall gain occurred. This reflects that shareholders have concerns around the potential for perceived 'windfall gains' where there is market volatility around the time of grant of long-term share awards.
- 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: the extent to which the performance conditions have been met; the value of the award compared to grant; the relative share price recovery compared to the overall market; performance against other key KPIs and the vesting history in the interim years. We expect to see companies articulating the approach they have taken at the year end.

Investor insights

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In general, investors are not supportive of discretionary adjustments to reflect any broader deviation of the global economy from its expected trajectory, or adjustments which may insulate executives from the wider stakeholder experience.

As set out in the IA Principles of Remuneration, "any adjustments to reported metrics should be clearly explained and the impact on the outcome detailed."

While annual bonus out-turns returned to above pre-COVID levels in the majority of sectors in 2021, we expect to see a more challenging environment and heightened scrutiny of incentive out-turns in the coming year.

Policy review – Incentivising leadership

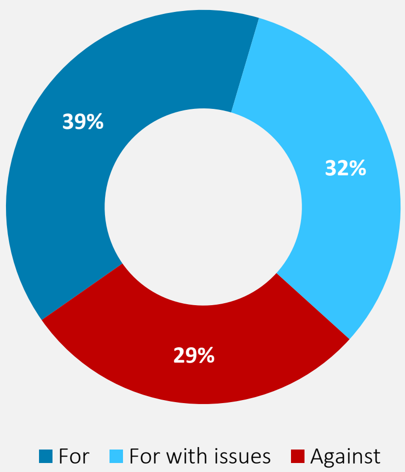
4

Emerging themes:

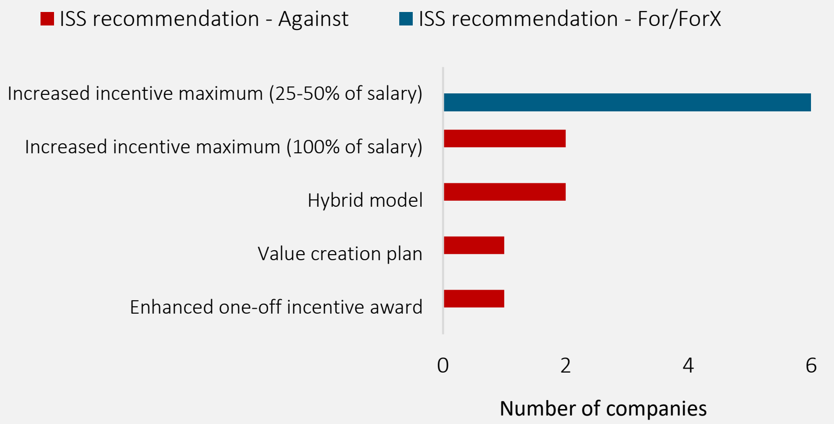
- Around one-third of FTSE 100 companies have appointed a new chief executive since 2020, as we continue to see a high turnover of senior executive talent in the UK listed environment.
- In 2023, the majority of listed companies are expected to seek a triannual binding vote on the Remuneration Policy for executive directors, including large multinationals looking to remain competitive in a global talent market. We are seeing a number of companies explore alternative incentive structures such as 'hybrid' models (combining restricted shares and performance shares).
- The UK governance landscape remains challenging in this area. In the 2022 AGM season, Institutional Shareholder Services (ISS) recommended a vote 'Against' nearly one-third of new remuneration policies in the FTSE 100, primarily relating to increases to incentive opportunities or alternative arrangements such as one-off incentive awards, with typical voting out-turns of 60-70% in those cases.
- In the last three months, we have also seen ISS issue recommendations to vote against two FTSE 100 remuneration committee chair re-elections, reflecting a potentially hardening stance in this area.
- While the recent government announcement of a lifting of the banking bonus cap potentially indicates a more pro-business approach to executive pay, there is not yet evidence that the mood of wider stakeholders, such as investors and employees, will follow.

Around one-third of FTSE 100 companies have appointed a new CEO since 2020, as we continue to see high turnover of senior executives in a competitive talent market.

2022 AGM season – ISS voting recommendations on FTSE 100 Remuneration Policy



Incentive structure changes and ISS voting recommendations (FTSE 100 - 2022 AGM season)



We continue to see a challenging environment for large, multinational companies looking to remain competitive in a global talent market, with nearly one-third of FTSE 100 remuneration policies receiving an ISS recommendation to vote 'Against' in the 2022 AGM season.

Continued focus on ESG, sustainable business and innovation

5

Emerging themes:

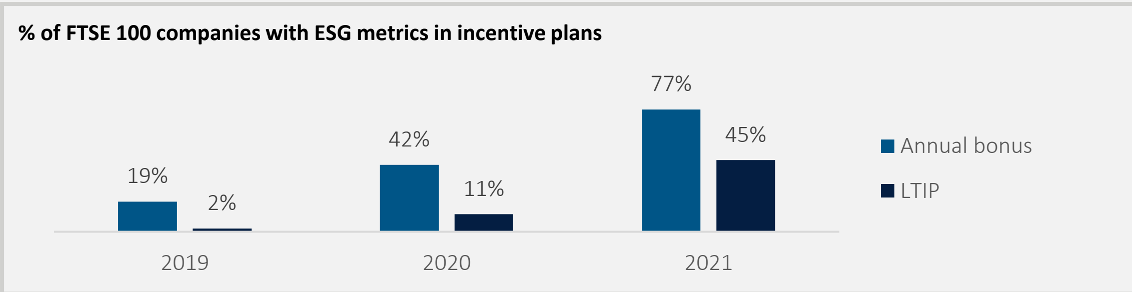
ESG, sustainable business and innovation?

- Over 90% of FTSE 100 companies now include ESG metrics in annual or long-term incentive plans as investors continue to focus on the alignment of remuneration frameworks with a company's ESG strategy.
- In the last year we have seen a notable increase in companies including Scope 1 and 2 emissions reduction metrics in their incentive plans (c. 40% of FTSE 100 companies), as companies develop and improve their ability to measure performance outputs and seek a qualitative approach to ESG performance. We are also seeing examples of companies introducing metrics directly linked to ESG-related business activity such as net revenue from sustainable products, or the output of investment in innovation to drive long-term growth.
- We continue to see a wide range of ESG metrics being adopted in line with key strategic areas, including gender and ethnic diversity, workforce safety and biodiversity impact.

Use of external ESG rating agencies?

- To date, the use of external ESG Rating Agencies such as Sustainalytics, MSCI and FTSE ESG has been relatively uncommon in UK incentive plans and we have seen mixed investor views on this approach. Two FTSE 100 companies have recently incorporated external ESG rating performance in their incentive plans as a relative performance benchmark alongside specific ESG goals, as businesses look to measure ESG performance on a quantifiable and independent basis.

Over 90% of FTSE 100 companies now include ESG metrics in annual or long-term incentive plans.



Upcoming events

Annual Remuneration Strategy Conference 2022

Tuesday 11 October 2022 (**14.00 – 17.00 BST**)

Pay in a volatile environment

Join us on Tuesday 11 October 2022 for our Annual Remuneration Strategy Conference in London. This year, the conference will focus on considerations for remuneration committees and HR teams in setting pay and incentives in the current economic and geopolitical environment. We are delighted to confirm a host of outstanding speakers, including **Ian Tyler** (Senior Independent Director and Remuneration Committee Chair, Anglo American plc), **Annemarie Durbin** (Remuneration Committee Chair, Persimmon plc and Santander UK plc), **Alex Edmans** (Professor of Finance, London Business School), **Vineet Chhibber** (Director, Blackrock) and **Ian Stewart** (Chief Economist, Deloitte).

We hope that many of our clients and contacts will be able to join us in person to celebrate the opportunity to network once again. If you are not able to attend in person, there is also an opportunity to access the event via our virtual conference platform.

For more information and to register here: https://ukpages.deloitte.com/Annual-Remuneration-Conference-Oct-2022-Self-Registration.html

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