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Unlocking growth in UK capital markets...the role of pay and governance

Observations and recommendations for the ‘big tent’ conversation on executive remuneration

September 2023

MAKING AN IMPACT THAT MATTERS since 1845

‘Big tent’ conversation…a welcome debate

We support a healthy ecosystem for governance of executive remuneration in the UK listed environment, but have seen growing frustration around the gradual emergence of a wide range of complex requirements and often divergent investor views in recent years. This has led to a position where pay constraints – in particular around pay structures - are substantially more onerous than those seen in other markets.

While the fundamentals aren’t broken, in order for the UK to maintain a competitive position, we would argue for a move away from the rules-based mindset that often prevails.

In our view, structural constraints are often more of a barrier than quantum, and a sole focus on the US oversimplifies the challenge. To support an environment of greater innovation and growth, remuneration committees need greater flexibility to develop remuneration policies and incentive structures that suit a diverse range of companies with different global footprints, talent markets and business lifecycles.

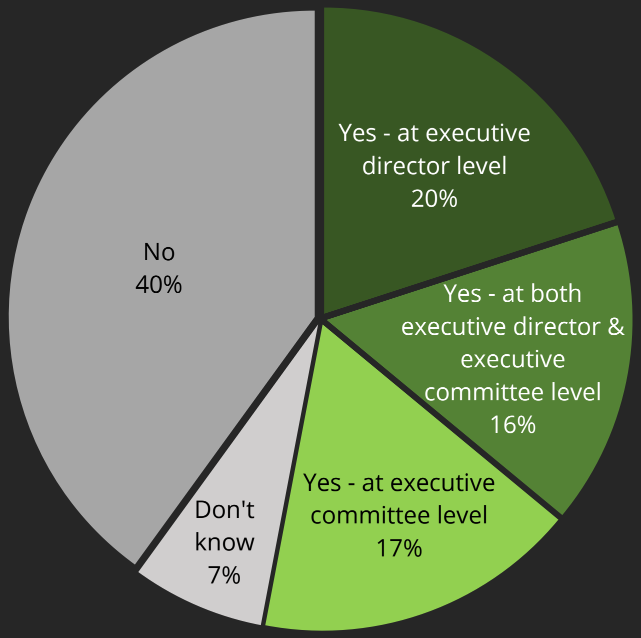
Pay is a small but emotive part of the debate around the attractiveness of the UK as a place to list. Rightly, there is also sensitivity to the wider economic context including the cost of living challenges across society. However, signalling that the UK is a more agile environment – balancing greater flexibility and trust in boards while maintaining strong corporate governance around executive pay – could be a factor in making it a vibrant place to list and grow.

This document identifies **six observations** and **potential interventions for change** for all stakeholders in the current ecosystem.

Deloitte Academy polling result

Remuneration Committee webinar - June 2023 (c.300 attendees)

Based on a recent Deloitte survey, over 50% of UK companies have experienced a specific attraction or retention challenge in relation to a ‘first choice’ executive candidate where pay was a contributing factor.



Summary observations

01 The FTSE index includes companies with a diverse range of international footprints, competing in different talent markets. While an overfocus on the US market paints a simplified picture – and will not be relevant to all listed businesses – remuneration committees need flexibility to develop pay policies that reflect a range of global profiles, talent markets and business lifecycles.

02 The majority of FTSE 100 'low votes' on remuneration policies relate to companies with a significant US footprint. Companies in high innovation sectors such as technology or pharmaceuticals have also experienced investor 'revolts' on pay. These companies have often outperformed the wider index.

03 UK CEO pay levels fall significantly behind the US, but are broadly competitive against other global markets. However, a range of more stringent governance requirements have led to UK packages being less attractive than many international peers.

04 There is intense media scrutiny around executive remuneration in the UK, and debunking some of the 'myths' is an important part of the debate – median CEO total pay has remained relatively stagnant in recent years.

05 The UK Corporate Governance Code includes some important principles of remuneration governance, including the promotion of executive share ownership and the use of remuneration committee discretion. However, we have seen an increasingly prescriptive or 'tick box' approach in assessing how these remuneration principles should be met.

06 The UK remuneration voting regime provides an effective framework that has influenced other jurisdictions in Europe and Asia. Pay governance can also be a useful barometer of wider company culture. However, in our view the current 'low vote' threshold of 80% casts the net too wide, capturing c.40% of FTSE 100 companies in the last five years.

Interventions for change

Simplification of executive share ownership requirements

- We support the principle of promoting long-term executive shareholdings – however, the existing requirements in this area could be simplified. Remuneration committees should be empowered to develop and explain how the remuneration framework supports this principle, which may include some, but not all, of existing 'best practice' features. In all cases, appropriate malus and clawback provisions should be in place.
- For example, **where a significant in-post shareholding guideline has been met, the use of an additional two-year holding period for vested long-term incentive awards could be removed and bonus deferral reduced/removed.** A less prescriptive or 'tick box' approach could also be taken to policies in place to maintain post-employment shareholdings.
- In our view, **a greater acceptance and use of the comply or explain nature of the Code** and related best practice guidance would enable boards to make informed decisions around pay frameworks that are appropriate for the talent market in which they operate.

Greater recognition of exposure to US talent markets and/or high growth sectors, including acceptance of alternative incentive structures (e.g. hybrid structures, one-off awards or higher risk/reward plans) and incentive increases where supported by a rationale of growth and/or specific talent markets

- We welcome recent case studies of proxy and investor support for more significant increases to incentive opportunities where there is a particular exposure and growth trajectory in the US, and support **a continued move away from a rules-based mindset, with greater case-by-case consideration of proposals in the following areas:**
  - **Hybrid structures** - To date, hybrid structures of performance shares and restricted shares have been a red-line issue in the UK environment at executive director level. In sectors with high exposure to the US talent market, or in volatile sectors where target setting can be particularly challenging, they could provide an effective and pragmatic tool in attracting and incentivising talent, where discounts and appropriate safeguards are applied.
  - **One-off strategic awards or high risk/reward plans** - In sectors such as technology or in turnaround scenarios, high risk / reward plans or one-off incentive grants can provide an effective tool in driving strategic growth ambitions and provide direct shareholder alignment (with significantly higher prevalence of zero pay-outs than typical performance share plan awards). Important safeguards and extended time horizons should apply to ensure long-term stewardship and sustainable value creation.
  - **Incentive maximum increases** – In the UK listed market, incentive increases of 100% of salary or more have historically received an ISS against recommendation and 'low vote', including in high growth scenarios or where companies are looking to partially close (but not meet) a quantum gap where there is particular exposure to the US talent market.

Interventions for change contd.

Reduce the 'low vote' threshold on remuneration resolutions from 80% to 70%

- Under the UK Corporate Governance Code, companies are required to further engage with investors where 20% or more of votes have been cast against a board recommended resolution, with an update statement provided within six months of the shareholder meeting, and final summary in the annual report. They are also included on the Investment Association Public Register tracking shareholder dissent at listed companies.
- c.40% of FTSE 100 companies have been subject to a 'low vote' on the remuneration report and/or policy in the last five years. This can capture companies that have gained the support of their largest shareholders during extensive consultation, but who receive an 'against' from a proxy agency with a strong swing of investors automatically voting in line with recommendations. Too many of these can reflect examples where there are differences of opinion rather than widespread unease with pay practices.
- In our view, **the 'low vote' threshold of 80% should be reduced to 70% to provide more meaningful focus where there is greater investor consensus on areas of concern. Historically, this would have captured c.25%, rather than c.40%, of the FTSE 100 market.**

Evolving the 'checks and balances' on remuneration

- **Move away from 'single issue' focus areas** - We have seen an increase in the number of single-issue focus areas dominating proxy and investor voting policies - for example, post-employment shareholding requirements; executive and workforce pension alignment; windfall gains and executive salary increases below workforce levels. This has led to a 'tick box' approach to remuneration, as opposed to consideration of pay practices in the round.
- **Extend timing for response to draft proxy reports** - Companies often have a 24 - 48 hour period to consider and respond to draft proxy recommendations. This should be increased to enable greater dialogue between proxy agencies and companies – taking into account the significant impact that recommendations can have on voting out-turns.
- **Greater use of voting abstentions –** The increased complexity of pay disclosure and investor guidance/voting policies requires significant resource from investors and proxy agencies in making an informed assessment of pay proposals. We would support greater use of voting abstentions where the assessment is more nuanced and/or where there is insufficient resource to fully consider the issues. Boards are attuned to all investor concerns - whether voiced via a negative vote or abstention.

Discretion...a two way street?

- The use of positive discretion remains extremely challenging - including for companies with a track record of the use of negative discretion – and significant investor consultation is required in respect of any adjustments to out-turns. The recent focus on windfall gains demonstrates the 'one way street' nature of discretion in the current environment. In our view, **a greater sense of proportionality should exist to enable committees to exercise reasonable positive discretion where considered appropriate, taking into account wider company performance and stakeholder experience.**

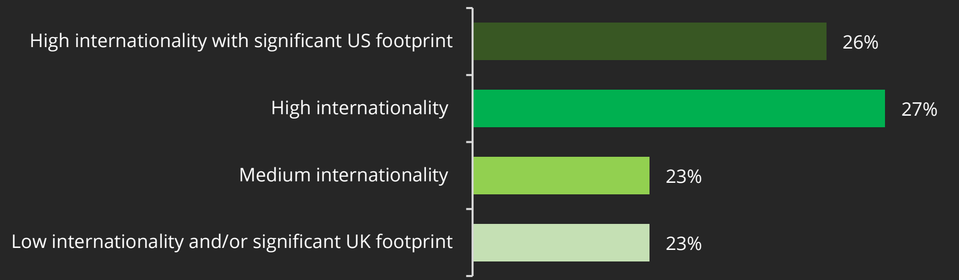
Observations on the UK executive remuneration landscape – supplementary analysis

01 The FTSE index includes companies with a diverse range of international footprints, competing in different talent markets. While an overfocus on the US market paints a simplified picture – and will not be relevant to all listed businesses – remuneration committees need flexibility to develop pay policies that reflect a range of global profiles, talent markets and business lifecycles.

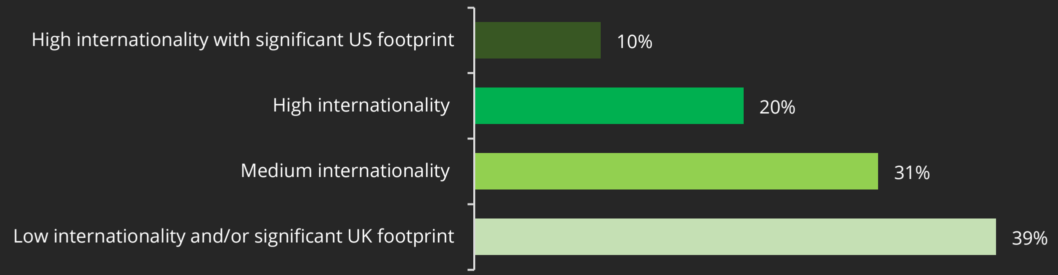
FTSE 350 – mix of global footprint

The UK's listed landscape includes companies with a range of global footprints. Around 55% of FTSE 100 and 30% of FTSE 250 have a high level of internationality. This includes c.25% of FTSE 100 companies and c.10% of FTSE 250 companies with a significant US footprint.*

FTSE 100



FTSE 250



Internationality ratings broadly based on the following categories:

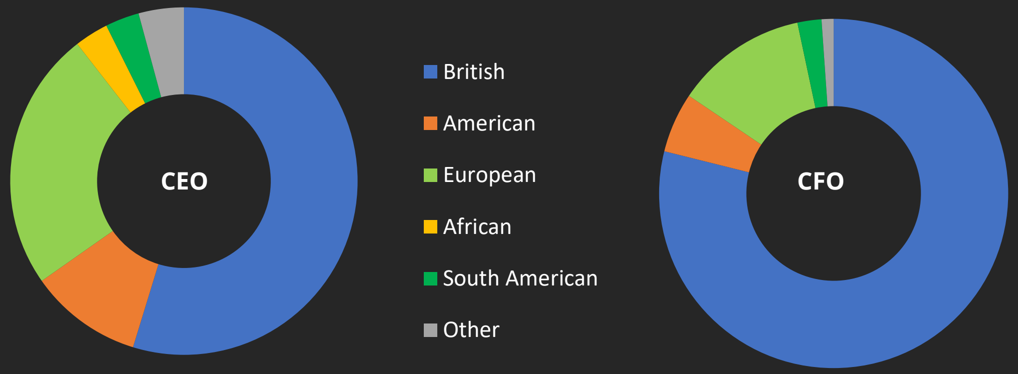
- *High internationality with significant US footprint = > 50% revenues from the US and/or more than £5bn US revenue.*
- *High internationality = revenues from c.4-5+ geographical segments*
- *Medium internationality = revenues from c 3+ geographical segments*
- *Low internationality = revenues from less than 3 geographical segments and/or more than 70% revenues from UK*

Revenue data source: Refinitiv Eikon Datastream

FTSE 350 – nationality of executive directors (CEO and CFO)

Nearly 50% of FTSE 100 CEOs, and c.one-third of FTSE 250 CEOs, are of non-British nationality.

FTSE 100



FTSE 250

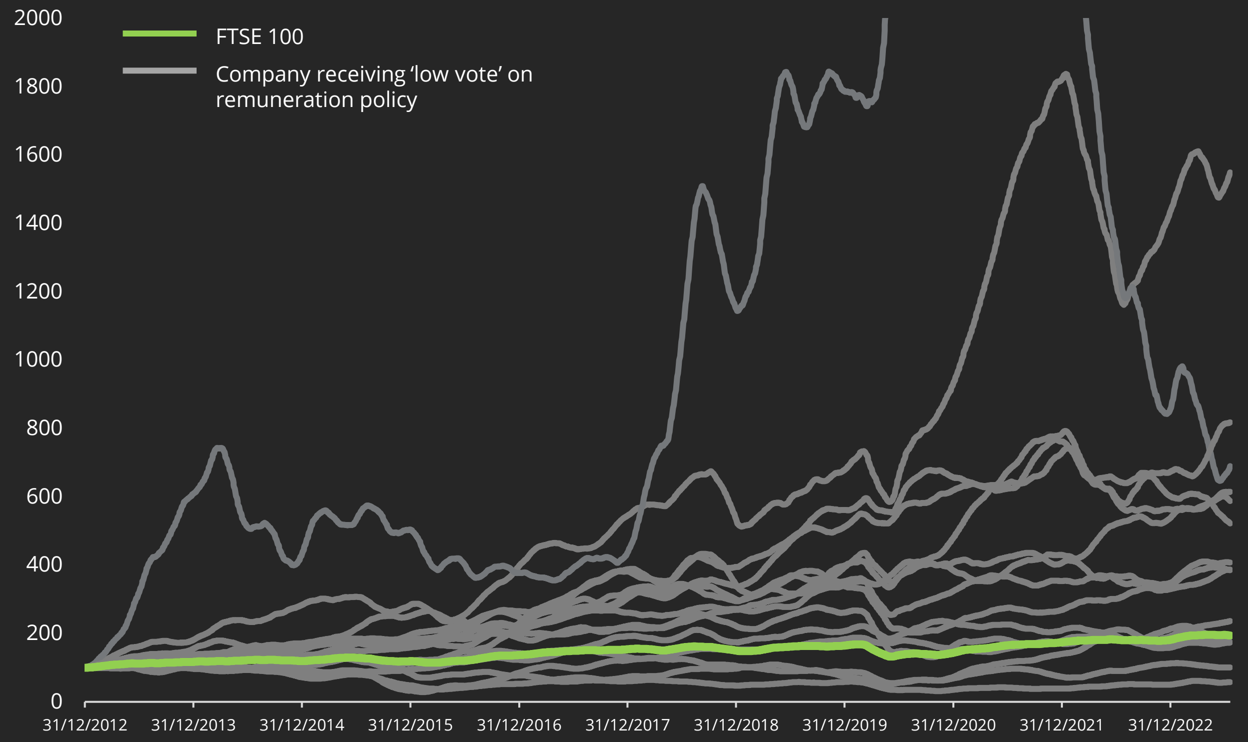
Data source: BoardEx (where nationality disclosed).

02 The majority of FTSE 100 'low votes' on remuneration policies relate to companies with a significant US footprint. Companies in high innovation sectors such as technology or pharmaceuticals have also experienced investor 'revolts' on pay. These companies have often outperformed the wider index.

A recent statement by the CEO of the London Stock Exchange called for a 'big tent' conversation around the UK's approach to executive compensation, to better enable companies to compete for global talent and support the creation of '*globally consequential companies in the UK to drive innovation, jobs and growth in the economy*'. A review of the current landscape shows that the FTSE market has generally lagged global peers in both representation of high-innovation sectors (e.g. technology, life sciences) and total shareholder returns, with the 2021 UK Listings Review identifying a 40% fall in the number of UK listings since its peak in 2008.

Total Shareholder Return (TSR) of FTSE 100 companies receiving 'low vote' on policy in last three years

FTSE 100 companies receiving 'low votes' on remuneration policy have often outperformed the wider index

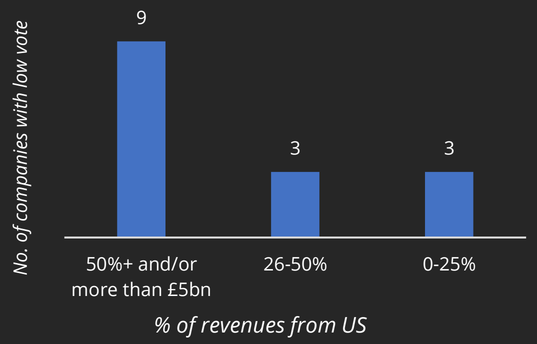


Data source: Refinitiv Eikon Datastream

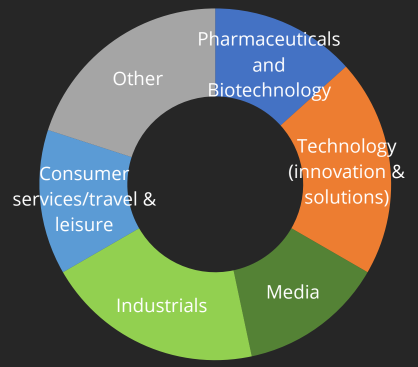
FTSE 100 'low votes' on remuneration policy in last three years – by global footprint / sector

The majority of FTSE 100 'low votes' on remuneration policies relate to companies with a significant US footprint. Companies in high innovation sectors such as technology or pharmaceuticals have also experienced investor 'revolts' on pay.

By US footprint (revenues from US)

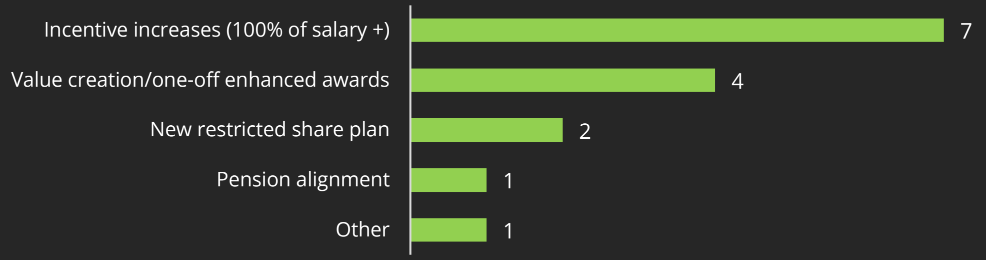


By sector



FTSE 100 'low votes' on remuneration policy in last three years – by primary issue

Low votes have typically related to 'red line' issues that look to partially close the gap – but not meet – relevant global or sector practices



03 UK CEO pay levels fall significantly behind the US, but are broadly competitive against other global markets. However, a range of more stringent governance requirements have led to UK packages being less attractive than many international peers.

CEO target compensation – UK v global markets

UK CEO pay levels fall significantly behind US market practice but are broadly competitive against other listed global markets.

** Based on data analysis for c. 500 global listed companies. Source: Annual Report & Accounts; European data (excluding UK) – Diligent.*

Global pay practice overview

A range of more stringent governance requirements in the UK have led to a framework which is out of line with global market practice.

Typical practices	UK	Continental Europe	United States	Hong Kong/ Singapore	Australia	South Africa
Bonus deferral	●	●	●	●	●	●
LTI time horizon (years)	**5**	**3+** *Examples of holding periods in some countries*	**3+**	**3 – 4**	**3 – 4**	**3 - 5**
Shareholding requirement	●	●	●	●	●	●
Post-employment shareholding requirement	●	●	●	●	●	●
Pension-workforce alignment	●	●	●	●	●	●
LTI structure	Generally PSP, some RSP	Primarily PSP with some examples of alternative or hybrid plans	Hybrid of PSP and RSP and/or share options	Mixed practice - increasing prevalence of long-term incentives, including hybrid plans	Generally PSP	Primarily PSP with some examples of hybrid plans

● *Expected and/or majority market practice*

● *Mixed / minority market practice*

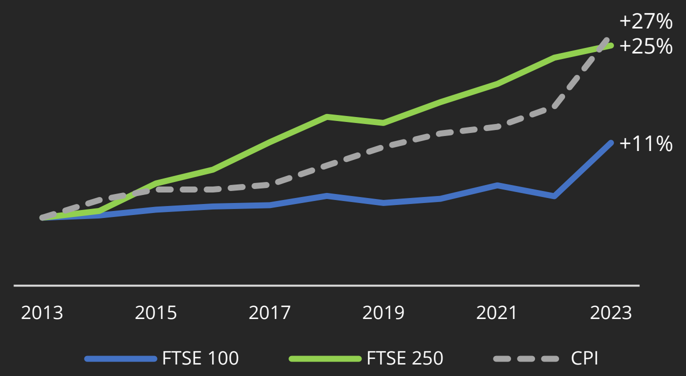
● *Unusual practice / not required*

Note - excludes regulatory requirements applicable to FS companies (e.g. deferral and incentive time horizons).

04 There is intense media scrutiny around executive remuneration in the UK, and debunking some of the 'myths' is an important part of the debate – median CEO total pay has remained relatively stagnant in recent years.

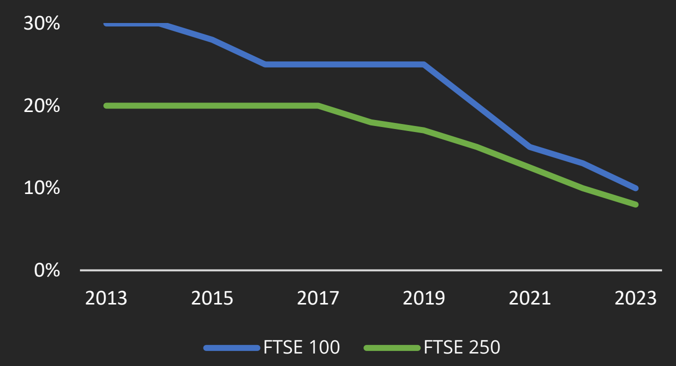
The UK is subject to the highest levels of media scrutiny around executive remuneration, and debunking some of the 'myths' is an important part of the debate. Despite frequent media headlines, median CEO total pay in the UK listed environment has remained relatively stagnant in the last five years. FTSE 100 CEO salary increases have lagged inflation, and pension contributions have fallen following investor pressure in this area. While incremental increases to long-term incentive awards have generally gained investor support - with maximum performance share plan opportunities showing an upward trend in the last ten years - a growing expectation around the use of downward discretion (including a recent focus on 'windfall gains') has led to overall total remuneration levels remaining flat.

Median CEO FTSE 100 and 250 salary increases v CPI (2013 to date)

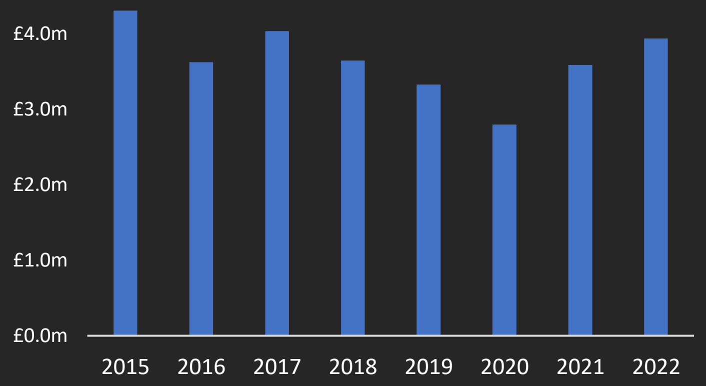


Source (CPI): ONS

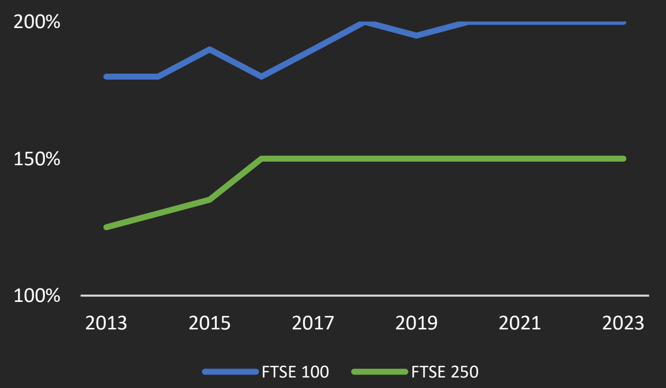
Median FTSE 100 and 250 CEO actual pension contribution (2013 to date) % of salary



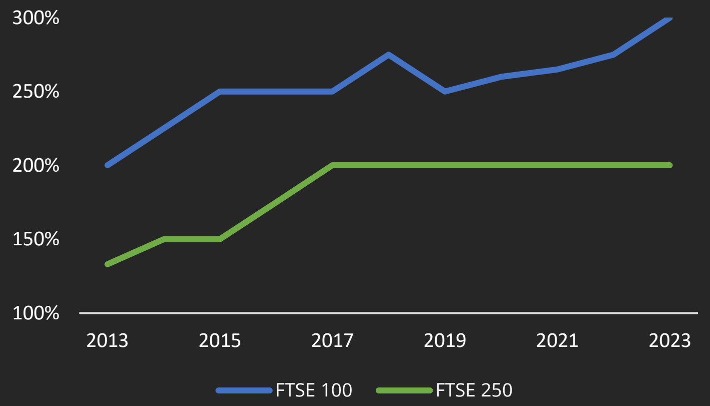
Median CEO 'single figure' remuneration – FTSE 100 (2015 to date)



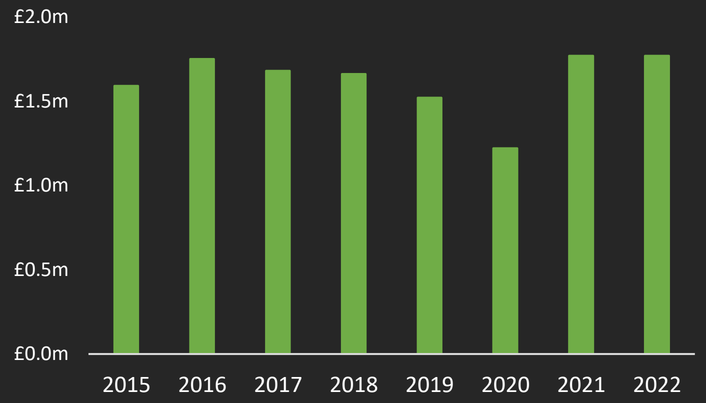
Median FTSE 100 and 250 CEO annual bonus maximum (2013 to date) % of salary



Median FTSE 100 and 250 CEO performance share plan maximum (2013 to date) % of salary



Median CEO 'single figure' remuneration – FTSE 250 (2015 to date)



05 The UK Corporate Governance Code includes some important principles of remuneration governance, including the promotion of executive share ownership and the use of remuneration committee discretion. However, we have seen an increasingly prescriptive or 'tick box' approach in assessing how these remuneration principles should be met.

'Cornerstones' / principles of UK executive remuneration

Set out in UK Corporate Governance Code

'Rules of the road'

Evolved from range of investor and proxy voting policies, Code changes and market practice

Alignment to workforce pay and policies

- *Salary increases generally below workforce rate*
- *Salary on appointment no higher than predecessor*
- *Pension aligned with rate available to majority of the workforce*
- *No compensation for pension reduction*

Remuneration policy should promote long-term shareholdings

Policy for post-employment shareholding requirements

- *'Substantial' shareholding requirements*
- *Bonus deferral 'expected'*
- *Five year time horizon for LTIP – two year holding period*
- *Post-employment shareholding – full requirement for two years*
- *Dividends accrued in shares only (no cash)*

Incentives aligned to business strategy and sustainable business performance

- *No hybrid incentive structures (PSP or RSU)*
- *High risk/reward incentive plans (value creation plans) or one-off awards generally not supported*
- *Threshold vesting no more than 25% of maximum*
- *No vesting for less than median relative TSR performance*
- *No 'multipliers' / TSR kickers*

Discretion to override formulaic outcomes, taking into account wider circumstances

- *Upward discretion – very challenging*
- *No 'windfall gains' / scale back at grant where share price fall*
- *No amendment to in-flight performance targets*
- *No re-testing*

No reward for failure - ability to recover/withhold 'in extremis'

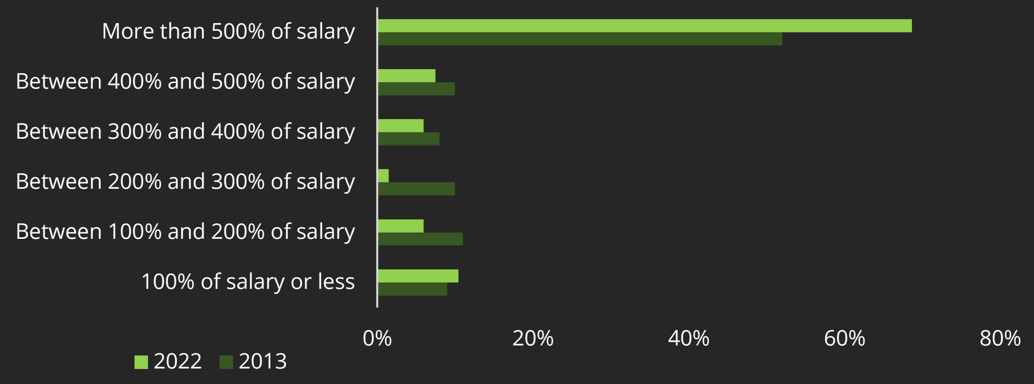
- *No retention or recruitment awards (excluding buyouts)*
- *Malus and clawback – 'more expansive' than gross misconduct and misstatement*

We support the key 'cornerstones' of pay governance in the UK, however the gradual layering of additional requirements in recent years has led to an increasingly rules-based mindset in how these should be met.

Market practice

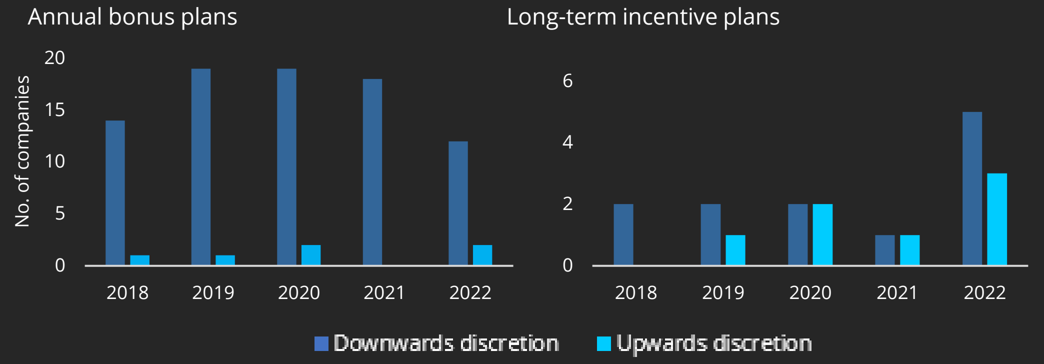
CEO share ownership – 2013 to 2022 (value of shareholding, % of FTSE 100 CEOs)

In practice, the layering of additional shareholding requirements has not significantly moved the dial in executive share ownership, and chief executives rarely sell shares while in role. In 2013, over 50% of CEO's held shares worth at least 500% of salary, increasing to over 60% in 2022.



Remuneration committee discretion – FTSE 100 market practice 2018 to 2022

Remuneration committee discretion has typically been a 'one way street' for companies in recent years, since its introduction as a Code principle in 2018. The use of upwards discretion remains extremely challenging from a proxy and investor perspective.

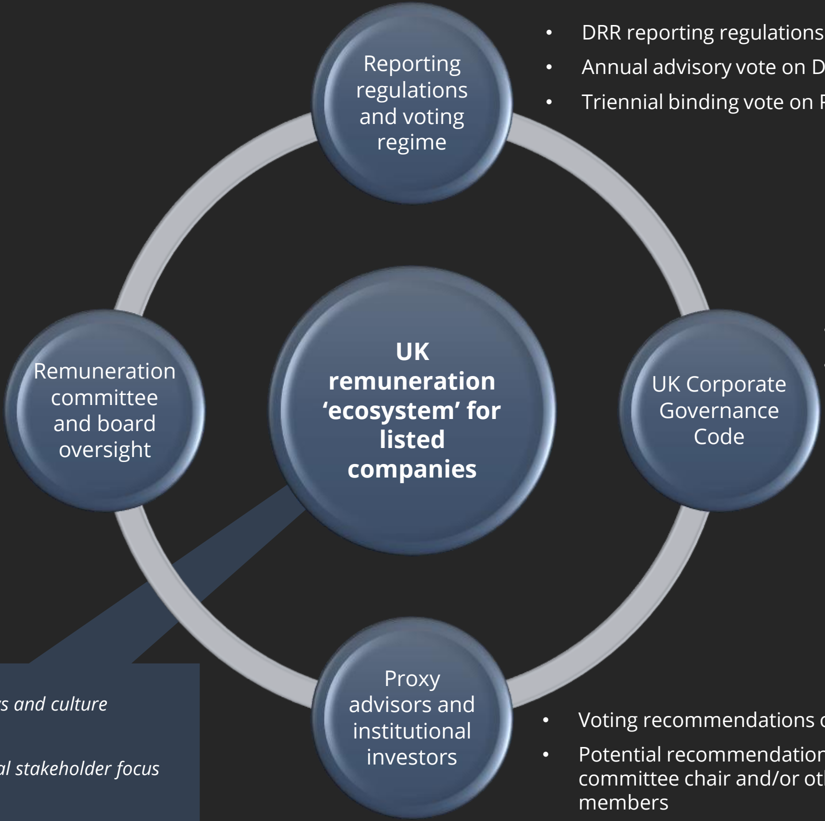


06

The UK remuneration voting regime provides an effective framework that has influenced other jurisdictions in Europe and Asia. Pay governance can also be a useful barometer of wider company culture. However, in our view the current 'low vote' threshold of 80% casts the net too wide, capturing c.40% of FTSE 100 companies in the last five years.

UK listed environment – remuneration 'checks and balances'

The UK remuneration voting regime provides an effective framework that has influenced other jurisdictions in Europe and Asia.



- DRR reporting regulations
- Annual advisory vote on DRR
- Triennial binding vote on Policy

- Remuneration committee oversight and risk appetite
- Review workforce pay and policies and wider 'success sharing'
- Engagement with workforce

- 'Comply or explain'
- Requirement to consult with shareholders where less than 80% support

- Voting recommendations on DRR / Policy
- Potential recommendation 'against' remuneration committee chair and/or other committee members
- IA Register (vote less than 80%)
- Proxy and individual institutional voting policies and guidance updates

Workforce views and culture

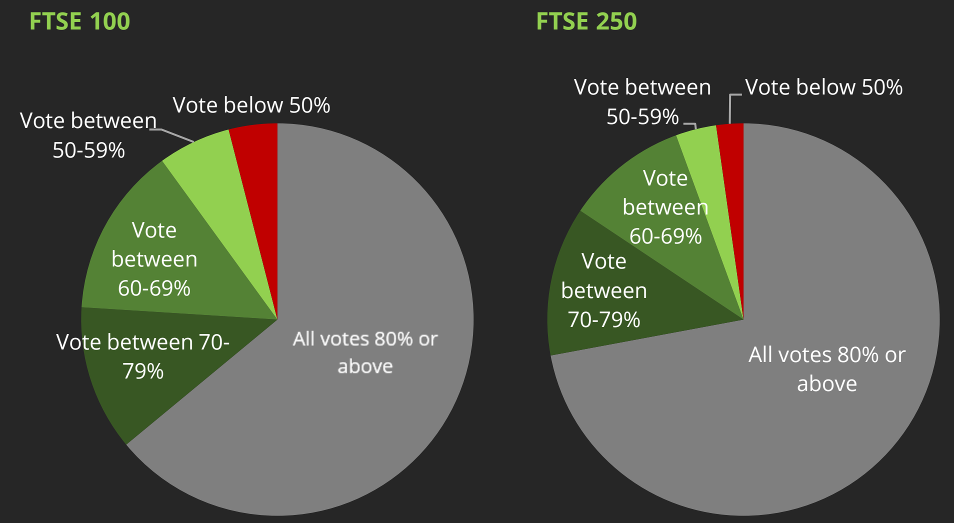
Media / external stakeholder focus

Government select committees

The UK has a highly evolved executive remuneration ecosystem with a wide range of checks and balances. While we support a healthy ecosystem of governance, we would encourage a move away from the rules-based mindset that often prevails, and a greater acceptance and use of the 'comply or explain' nature of the Code.

FTSE 100 and FTSE 250 - voting on annual remuneration report and/or remuneration policy (2018 – 2023)

c.40% of FTSE 100 have been subject to a 'low vote' (below the current 80% threshold) on the remuneration report and/or policy in the last five years. Reducing the low vote threshold to 70% would historically have captured c.20-25% of the market.



To support an environment of greater innovation and growth, remuneration committees need flexibility to develop and implement remuneration policies that support a diverse range of companies with different global footprints, talent markets and business lifecycles. In some cases, this may mean that divergent investor and proxy views are not all met, with committees accepting a 'lower vote' outcome where appropriate.

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Deloitte Annual Remuneration Strategy Conference 2023

Unlocking growth in UK markets – the role of pay and governance

10th October 2023, 2pm – 5pm BST

Deloitte Auditorium, 2 New Street Square,
London, EC4A 3BZ

Register here

Please join us for our Annual Remuneration Strategy Conference on Tuesday 10th October 2023. This year we will be focusing on the growing debate around the role of pay and governance in unlocking growth in UK capital markets, exploring the following areas:

- Is the UK's 'gold standard' pay governance framework hampering the competitiveness of UK capital markets?
- How can the UK remuneration landscape enable global talent attraction while promoting responsible business and fair pay?
- Is there scope for greater flexibility around pay structures and alignment features?
- A pivotal moment…? Considering potential reforms in the current regulatory and political landscape.

For more information please visit our website here