Part 1: Executive Pay: reframing for the long-term
18 June 2020

This Webinar discussed short-term executive pay and bonus cuts in response to COVID and whether this was the start of fundamental structural change or pure symbolism. Speakers also discussed the importance of ESG measures to promote long term resilience.

ICGN is grateful to our Speakers as follows:

- Mirza Baig, Global Head of Governance and Stewardship, Aviva Investors
- Rick Bennett, President and CEO, ValueEdge Advisors
- Georgina Marshall, Head of Global Research, ISS
- Charlotte Valeur, Chairman, UK IoD

Global trends: 2020 and beyond

- Many companies have imposed temporary executive-level salary reductions, bonus reductions or bonus cancellations, particularly in sectors where they have been heavily impacted by the pandemic resulting in staff losses. However, there are some opportunistic (or possibly just badly timed) stock option awards being paid out which have the potential to dwarf any short term 2020 salary and bonus cuts.

- Where companies have received state assistance to furlough staff with some form of pay, some Government have imposed restrictions. For example, variable pay may not be paid out in the Netherlands if companies have received assistance or, in France, executive pay levels must be reduced.

- In terms of shareholder voting on pay across North America and Europe, dissent levels are similar to last year, i.e. no change to the status quo whether pay is high or low. However, shareholders are voting on last year’s pay and performance which does not necessarily factor in the impact of the Covid crisis. Some markets have not had their main AGM seasons yet such as Australia, Israel and India which are held later in the calendar year - these markets will be the first to show any direct impact of Covid on executive pay.

- One thing that has not changed despite the pandemic is that the implementation of the shareholder rights directive in Europe remains in progress. This is driving the widespread introduction of pay votes across all EU states, including Germany this year.

- Next year, the extent to which companies have acted and managed their executive pay in response to Covid will become clearer. Investors are likely to scrutinize any special awards, one-time pay reductions, bonus cuts, one-time adjustments of pay and performance targets, and whether any remuneration committee discretion has been used appropriately.

Data was also provided around how environmental and social metrics are being used to align pay with performance:
• Around 19% of companies in Europe, USA and Canada use some form of environmental and social measure as part of their executive incentive awards. This is up from just 5% in 2012. Adoption is increasing and at a faster rate.

• There are five times as many social related metrics (including human capital management) being used compared to environmental metrics.

• In terms of short-term incentives, staff related incentives (health and safety, staff relations) are used most frequently as E and S measures, while diversity, human rights and labour conditions in the supply chain were ranked lower in usage.

• In terms of long-term incentives, (stock options and stock awards) corporate social responsibility was the most popular measure, followed by climate change and energy use. Again, diversity human rights and labour was at the lower end of usage.

• The utilities industry is the highest user of ESG metrics followed by energy and materials production, while the health-care industry lags at the bottom.

• France and Canada top of the ranking of countries with the largest number of companies adopting ESG metrics, followed closely by Spain and Australia and the Netherlands. The UK, Germany and Italy follow, with the USA at the bottom of the ranking.

(This data is provided by ISS, see Annex)

Recruit, retain, align

The fundamental objectives of pay are around ‘recruit’, ‘retain’ and ‘align’. The fact that remuneration still dominates as a key subject for company engagement and is still a primary driver for shareholder rebellions at AGMs means that a lot of the issues that investors wrestled with 20 years ago persist today. Now is an opportune moment for us to evaluate the fundamentals of executive pay and challenge conventional wisdom.

• **Recruit**: If we consider the paradigm of ‘recruit’, the problem that we are trying to solve is predicated on an assumption of a highly limited talent pool of executive directors. To what extent have we artificially created barriers that have given rise to this problem? This could be due to misplaced notions of the profile of an individual required for a CEO. So how many of us have inadvertently put expectations on nomination committees to restrict themselves to individuals that look as close as possible to the incumbent CEO. Or, when we are evaluating candidates, do we evaluate them purely on the basis of past performance in similar roles or do we take a view on the skills and experience acquired by the individual to get to that role?

• **Retain**: If companies pay less, are we going to get lower quality or less motivated CEOs? Where do we get the idea that the primary driver of an individual taking up a CEO role simply boils down to pay? If we look at it within the context of Maslow’s pyramid of needs at what point does a CEO move from the safety needs of gathering material wealth to valuing the esteem associated with the role whether that is being in the public eye or the status of leading a multinational corporation, or the new network of contacts that they would make. Why does the appeal of the role always
boil down to pay when there is so much more about the role that is attractive? When it comes to motivation, surely the reputation and legacy are equally - or of even greater importance - to a CEO to successfully deliver on strategy rather than simply the promise of a payday at the end.

- **Alignment:** Similar questions can be asked around the fundamental alignment objective. What exactly are the shareholder interests that we are seeking to align management to? Traditionally this has been viewed very narrowly through the prism of long-term financial returns. As a result, financial performance conditions have tended to coalesce around earnings growth and returns on capital and total shareholder return.

- **Value:** Another area to reflect on is the pedestal that we sometimes place CEOs on. Executive leadership is important but is it really the sole determinant of the success of a company? The Covid crisis has highlighted the fallacy of this thinking and has shone a spotlight on the value that is added by employees, suppliers, and others. How do you monitor, measure and attribute value creation throughout the business and then subsequently design a pay structure that is fair and reflects that i.e. how much of the pie do we justifiably allocate to a Chief Executive versus other parts of the business?

**Social contract and diversity**

The social contract is a very real discussion in corporate board rooms. A company’s impact on society, for good or for bad, should be measured in a way that aligns with executive incentives. This should be published so that companies can be accountable. Executive pay should engender a sense of solidarity with other stakeholders and wider society – we are all in this together!

Stakeholder governance rather than shareholder governance is where boards should focus. Executives should not seek to benefit excessively or opportunistically to manipulate performance metrics.

Remuneration committees should be aware of the compatibility of their pay policies particularly when accepting government support. Remuneration policy should be focused on long-term performance as well performance through the immediate crisis. Pay should be subject to claw-backs taking account any non-financial performance metrics.

Companies have normally satisfied themselves with the mantra of ‘do no harm’ so as long as they are not explicitly supporting discriminatory actions, they are content with that. When we are trying to tackle fundamental institutionalised inequalities, that position is not good enough. We need companies to embrace a responsibility to be agents of change and to look at all of the touch points that they have in society with their suppliers, local communities and customers and proactively try to rebalance some of these inequalities that we have in society. Documenting that social contract explicitly will be an important catalyst for that.

Diversity is likely to rise in the ranks of importance in terms of an ESG indicator in the wake of the unrest around racial discrimination emanating from the USA and now around the world. Often diversity metrics are focused narrowly on ‘gender’ but diversity should be considered in all its forms and across the company as a whole including its management and workforce. This can make a difference to the long-term success of the company.
Diversity is very close to equality. It is time for proper change and for actions not just words. There are very clear things that companies can do to change. Many companies are publishing statements around diversity but before they do that they need to look inwardly to see how they are fair themselves on the subject. There is acknowledgement that diversity does bring about better performing companies and there is an acceptance that things must change in corporate boardrooms. We need clear policies around discrimination and diversity within the workforce and externally. There should be clear disclosure around pay inequalities and diversity KPIs for the executive management team.

In terms of ethnic diversity, we normally try to put people into silos, however we rarely address the importance of multiculturalism as opposed to monoculturalism. To what extent are we recruiting people from diverse backgrounds and then making them fit within a company’s monoculture? It is not enough to just consider your employee’s different ethnic backgrounds we must encourage diverse thinking within an inclusive multicultural environment to benefit from a diverse workforce for longer term value creation.

In terms of employees on boards, we need to make sure that the employee representatives have a very clear mandate, they are empowered to participate fully in a full spectrum of board deliberations and there should be robust controls to mitigate against any potential conflicts of interest that might arise.

**Sustainability**

There is momentum for sustainability metrics to be included in pay decisions, but it is still very much on the margins if you look at it in the context of total pay potential. We are all aware of the debate around the topic of corporate purpose, reframing investor objectives and broadening the outcomes that we expect of companies. It is essential that we tie these two conversations closer together.

The conversations around pay and the selection of performance conditions becomes a derivative subject and grounded within the broader context of corporate purpose. That is the only way that stakeholder welfare or climate transition will move from the margins to become a more meaningful part of executive pay going forward.

One of the problems with the oil and gas industry is that despite companies publishing net-zero emissions with 10 or 20 year targets, there is very little understanding of how current day capital allocation relates to these long-term ambitions. If we want to change behaviour particularly within the executive team, we need to see standalone transition objectives fully included in a material part of executive incentive arrangements.

**Quantum**

We are driven by more than money so there will be a natural flattening out of executive pay and a more equal way of running organisations. There have been a lot of symbolic gestures whether that be temporary salary cuts or executives donating some of the money towards national health services. A lot of those companies now are restating pay back to the levels that they were prior to the crisis. So, it is more of a symbolic gesture rather than a structural rethink.
ANNEX:
Slides presented by Georgina Marshall, Head of Global Research, ISS

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**2020 Global Executive Pay Trends**
Crisis Responses from Companies Alongside Long-term Investor Concerns Over Pay, Sustainability and Fairness

- Widespread Voluntary Pay Cuts at Companies Impacted by COVID-19 Pandemic
  - Many CEOs in North America and Europe take salary and/or bonus cuts in sectors with heavy layoffs
  - **BUT...** concerns over stock and option grant "bubbles"
- Governmental Restrictions on Pay for Companies Receiving Assistance
  - Purse strings closed for some businesses that received loans or enhanced worker offsets/benefits
- Opposition on Say-on-Pay Votes Remains Steady
  - Shareholder dissent remains high in some European markets; Americas markets hold course
- SR & R Remuneration Requirements Remain on Schedule Despite Coronavirus
  - Extended votes on pay policies and practices continue implementation across Europe
- Outlook for 2021
  - All eyes on boardrooms as investors are expected to scrutinize longer-term responses to crisis and recovery
  - Focus on level of discretion used, one-time adjustments, repricings/exchanges, changes in in-flight awards, retention payments, mix of short- and long-term incentive programs and metrics
  - Will ESG-related pay metrics move more to front burner to promote corporate resilience and keep social contract?

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**E&S Performance Metrics Adoption Rates**
More Executives are Being Incentivized for E&S Performance

19% now use E&S metrics as some part of CEO incentives *

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<th>% of companies with 1 or more E&amp;S metrics in STI or LTI</th>
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* Most recent disclosures for companies in Europe, USA, and Canada as of 6/15/2020 for fiscal year-end dates between 7/1/2019 and 6/30/2020

Source: ISS ESG Executive Compensation Analytics database
E&S Metrics – who and where?
% of Companies Adopting at Least One E&S Incentive

By Industry
- Utilities (66) 48.5%
- Energy (67) 32.4%
- Materials (93) 25.4%
- Industrials (57) 7.6%
- Real Estate (29) 6.5%
- Consumer Staples (12) 6.2%
- Communication Services... 4.8%
- Financials (29) 4.0%
- Consumer Discretionary... 3.7%
- Health Care (12) 1.9%
- Information Technology (7) 1.5%

By Country
- France (19) 27.2%
- Canada (117) 25.8%
- Spain (8) 17.8%
- Australia (17) 17.1%
- Netherlands (12) 16.4%
- United Kingdom (31) 9.9%
- Germany (14) 5.3%
- Italy (8) 8.4%
- USA (147) 5.6%

Source: ICAP ESG Benchmarking Analysis Platform database for companies with fiscal year end between 1/1/2019 and 12/31/2020

E&S Metrics – what and when?

Short-term incentives
- Staff Health and Safety
- Corporate Social Responsibility
- Staff Relations/Engagement/Training
- Environmental Protection
- Customer and Product Responsibility
- Climate Change and Energy Use
- Diversity
- Diversity
- Human Rights
- Investor Use
- Labor Conditions in Supply Chain
- Long-term incentives
- Corporate Social Responsibility
- Climate Change and Energy Use
- Staff Relations/Engagement/Training
- Staff Health and Safety
- Environmental Protection
- Customer and Product Responsibility
- Diversity
- Diversity
- Human Rights
- Investor Use
- Labor Conditions in Supply Chain

Source: ICAP ESG Benchmarking Analysis Platform database for companies with fiscal year end between 1/1/2019 and 12/31/2020