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Three Ways Long-Term Incentives are Changing in the UK

Boards continue to make changes to executive pay design in the face of the challenges from the COVID-19 pandemic, in addition to evolving views of investors and broader stakeholders on what elements of performance should determine how senior executives are rewarded.

There are several trends occurring in the design of executive pay plans in the United Kingdom (UK) in recent years — and the business disruption caused by the COVID-19 pandemic has accelerated these trends and how boards are communicating pay design to shareholders. In this article, we provide our views and observations on the top three ways we see long-term incentive plan (LTIP) design changing in the past couple of years in the UK market.

#1. Stakeholders say payouts should reflect company performance, regardless of economic uncertainty.

Initially, shareholders were sympathetic to companies navigating business uncertainty during the pandemic, but there are signs of increasing expectations that businesses should plan for recovery and reshape their businesses. Many of the UK's most influential shareholders and proxy advisers, including the Investment Association (the IA), ISS, Glass Lewis and Legal and General Investment Management, have called for listed companies to ensure executive pay packages reflect the experience of other stakeholders in the wake of the pandemic (e.g., lost jobs, employee pay cuts, lower shareholder returns).

In April 2020, the IA stated (and reiterated in November of that year), that it did not expect remuneration committees to adjust performance conditions for in-flight bonuses and LTIP awards. Some remuneration committees have chosen to apply discretion when performance goals aren't met. In some cases, there has been substantial shareholder dissent when boards have applied positive discretion in situations where underperformance has been blamed on the pandemic.

The IA has also said that where a company has taken government support, such as furlough compensation or additional capital from shareholders, remuneration committees should be mindful of the wider employee and social context when determining pay for executive directors.

The criticism isn't just aimed at pay delivered. Expectations for remuneration committees to hold management accountable for underperformance are increasing also. Companies lagging industry peers and/or paying excessively compared to shareholder returns are likely to face an increased risk of a negative outcome on the advisory vote on remuneration policy implementation. Based on data

from Proxy Insight, the average vote against remuneration reports across all UK companies stood at 7.3% as of May 2021, the highest level of dissent since 2014[1].

Remuneration committees need to be more mindful then ever in striking an appropriate balance between rewarding executive management fairly based on performance and shareholder returns, as well as within the wider prevailing social and economic context.

#2. The definition of performance is evolving, with ESG issues gaining prominence.

Increasingly, investors and other stakeholders are taking a broader perspective around how company performance is assessed. Whilst there are no formal views or guidance, there is an increasing recognition that company performance includes factors other than traditional financial or accounting measures. In particular, interest from stakeholders has centred on the environmental, social and governance (ESG) agenda.

The areas of focus on ESG will vary by sector — for example, hospitality firms will be more focused on employee engagement and customer satisfaction while oil and gas companies will monitor environmental impacts and policy. No matter the focus, companies are increasingly incorporating ESG metrics into short-term incentive plans. In one study of major UK and European Union (EU) companies, 89% were using ESG metrics in their annual incentive plans[2]. Metrics tend to cover social issues, including diversity, equity and inclusion targets, employee engagement and customer satisfaction measurements. However, some ESG performance areas are not well suited to assessing performance over a single financial year (e.g., CO2 emission reduction targets and reduction of reliance on carbon fuels). As companies look beyond short-term targets, there is growing momentum for UK companies to include ESG metrics in long-term incentives as well. In the same study of major UK and European Union companies, 41% were using ESG metrics for long-term incentives.

Whether covered under annual or longer-term incentives, ESG measures tend to have relatively modest weighting in plan design, usually 10% to 20% of the overall performance assessment. This is likely for two main reasons. First, investors still expect most of the performance assessment will be weighted towards quantifiable financial metrics. Second, ESG measures are inherently not as quantifiable, causing remuneration committees to exercise more discretion or objectivity in the assessment of performance. Some companies have chosen to employ ESG measures as a modifier to financial performance.

Companies will need to determine what state of readiness they are at in order to be able to select the appropriate metrics, define performance standards and to monitor their outcomes for pay purposes. Additionally, boards will need to be confident that the metrics used and the performance standards set will be justifiable and defensible to stakeholders, keeping in mind that public companies need to provide detailed information on the selection, calibration and assessment of non-financial performance in the Directors' Remuneration Report.

The use of ESG metrics in executive compensation is still at an early stage and companies are continuing to learn, develop and adapt in how they are used. To learn more about our approach to incorporating ESG into executive compensation plans, please see our recent articles: *A Framework for Tying ESG Metrics to Executive Compensation Plans* and *As More Firms Add ESG Metrics to Executive Pay, Best Practices are Emerging*.

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[1] https://www.ft.com/content/62d4fd7c-aa73-43a5-9fb9-5962c1a0baed

[2] https://assets.website-files.com/5980b84b2dea980001263e02/60d0ad94c8ae4605a5efc9aa_do%20uk%20and%20eu%20companies%20lead%20us%20companies%20in%20esg%20measurements.pdf

#3. Alternative equity vehicles are becoming more prevalent

Driven in part by the difficulties of determining links between pay and performance in the light of business uncertainty, there has been a rise in restricted share plans (RSP) in place of performance share plans (PSP). These are long-term incentives requiring continued service but without performance conditions. Most notably, RSPs have recently been approved at BT, Burberry and Lloyds Banking Group.

The advocacy group Purposeful Company reported that at the end of 2020 nearly 1 in 10 companies in the FTSE 350 (excluding investment trusts) operate an RSP in place of a PSP[3]. However, the plans still need to show accountability to shareholders. To gain shareholder support, plans are expected to be aligned to company strategy, have a maximum award level discounted by at least 50% to the previous performance share plan, alongside meaningful financial underpins and a greater focus on increasing shareholding requirements.

There are several reasons for the growth of RSPs in the market. As we mentioned, the impact of COVID-19 on financial results to-date, as well as the setting of forward-looking performance standards, has dampened the appeal of vehicles like performance shares. By contrast, restricted shares offer a simpler way of aligning executives with share price performance. RSPs may also help companies address any retention concerns that may arise if in-flight LTIPs seem unlikely to vest.

With active shareholder engagement, institutional investors can be sympathetic to well-considered and well-balanced proposals that simplify and de-leverage current arrangements. However, boards should be mindful that plans that appear to be designed to reward executives in lieu of legacy non-vesting performance-based arrangements will not be acceptable.

Next Steps

A well-designed LTIP can help companies navigate uncertainty, volatility and change by incentivising performance linked to key corporate goals and strategy over the long term, while at the same time aligning participants to the shareholder experience. As best practices and market conditions change, remuneration committees must to stay on top of evolving best practices.

Our consultants have experience to help you determine the right approach, from initial review and diagnosis to design and stakeholder engagement to approval and implementation. If you want to speak to one of our consultants about long-term plan design, please contact one of the authors below or write to rewards-solutions@aon.com.

[3]The Purposeful Company Study on Deferred Shares Progress Review, The Purposeful Company Steering Group, September 2020 https://thepurposefulcompany.org/wp-content/uploads/2021/01/tpc-deferred-shares-progress-review-2020-200930-2.pdf

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