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Annual Remuneration Strategy Conference 2023

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

Based on our annual conference held on 10 October 2023

We were delighted that over 400 clients and contacts were able to join us for our annual remuneration strategy conference. The event featured a keynote speech from Mark Austin (CMIT member); a debate on the future of the UK executive pay environment; a discussion of hot topics for remuneration committees in the year ahead; live polling questions and a panel debate.

Have you experienced a specific attraction or retention challenge in relation to a 'first choice' candidate, where pay was a contributing factor?

Yes – at both executive director and xecutive committee level	21%
Yes – at executive committee level	20%
Yes – at executive director level	9%
No	41%
Don't know	9%

External context – economic outlook, regulatory reform and shifting ESG landscape

This time last year, the theme of our conference was pay in a volatile environment. Companies were dealing with lots of uncertainty, the aftermath of a mini budget, the post-COVID recovery, soaring inflation and the energy crisis.

Today, inflation looks to have reached its peak but we're still seeing lots of cost pressures in the short term. UK inflation is expected to fall to around 3% by the end of 2024 but that's still higher than the Bank of England's target rate of 2%, and interest rates are likely to stay elevated in the near-term, putting pressure on households. There are also some early signs that the labour market is starting to cool.

Post-Brexit, we are seeing a re-energised debate around the attractiveness of the UK as a place to list. We've heard lots of discussion about regulatory reform and consistency across global markets and in May, the CEO of the London Stock Exchange, Julia Hoggett, called for a 'big tent' conversation on the UK's approach to executive compensation.

In a recent Deloitte Academy poll, leadership succession and talent capability were identified by board members as the top three challenges in the year ahead, along with the macroeconomic and geopolitical outlook.

The discussion in boardrooms around ESG has also become more nuanced. The remit of remuneration committees has got broader, and now covers everything from cost of living and wellbeing to target-setting and workforce salary reviews. Navigating a complex remuneration landscape can also involve a significant time commitment, particularly in a remuneration policy year. The next few pages explore all of this and more.

"Today there is less economic volatility and much more resilience in the system, but we are still dealing with sluggish global growth and continued potential downside risks in terms of macroeconomic and political stability." Juliet Halfhead, Partner, Deloitte

Capital Markets Industry Taskforce update

Mark Austin, member of the Capital Markets Industry Taskforce and Chair of HM Treasury's Secondary Capital Raising Review, provides his views on the capital markets reforms, including in relation to governance and stewardship.

Background

More than three years ago, Jonathan Hill was approached by the then Treasury to conduct a listing review, and he asked me to help. This came out in March 2021, and a lot has already been implemented. I was then asked to do my own review of the UK's secondary capital raising regime, which I did last year. You've also had the Khalifa FinTech review.

In August 2020, there was some scepticism around the call for reform but the conversation has completely moved on and everyone now agrees that the UK needs to adapt to remain competitive as a global capital market. This falls into three main buckets: legal and regulatory reform, market practice and cultural mindset. The latter is the hardest because that's changing hearts and minds. In my view we can achieve a lot without the need for further legal and regulatory reform.

If you think, amongst other things, about Jonathan's review, my review, the Edinburgh reforms, the Financial Services and Markets Act that has just come into force, what Jeremy Hunt said at Mansion House and the Financial Conduct Authority (FCA) consultation paper, which collapses premium and standard down into one single listing regime, we have made incredible progress.

Capital Markets Industry Taskforce (CMIT)

I sit on CMIT, which was set up last year. It's not government-sponsored but it is government-approved. It was the brainchild of Julia Hoggett and has nine members alongside her. We have four workstreams that cover the lifespan of the UK capital markets. We have scale-up capital. We have risk capital. We're joining up public and private markets and the Intermittent Trading Venue, which is something that will allow private companies to go public for three days and then effectively go private again, which will be a first for the UK. Then the final one is governance.

Governance and stewardship regime

We are now at a point where it is widely recognised that our governance and stewardship regimes have become a significant burden for our already listed companies. We know it's a talent drain too. Companies can't remunerate global talent in the way they'd like and we lose them to other markets, which is a listing deterrent. There are some companies that, if we don't see meaningful progress on remuneration and governance in this country by the next AGM season, are considering whether they even want to stay listed in the UK.

That makes all of this very time-critical for two reasons:

- The AGM season for most companies is March to May next year. AGM notice drafting season is December/January, so we've got until then to convince people that we're serious about changing this.
- The Financial Reporting Council closed its Corporate Governance Code consultation on 13 September. It's planning to bring out a new Code by the end of the calendar year, but having another version – with some more exhortations about comply or explain meaning just that, not comply or else – isn't what we need.

There is near unanimous agreement that something needs to be done. CMIT is working hard in this area and we need to have a sensible conversation about what a modernised governance and stewardship regime looks like. We, the market, need to have grown-up discussions and change how we operate. A big part of that is the asset managers, engaging differently with their governance teams, and getting ownership of them again. So, the simple principle should be that you should bring the governance and fund management functions together and always ensure that the views of the two are aligned.

On remuneration, we should have a level playing field with the United States and Europe in terms of how we talk about the subject, because the conversations and guidelines in this country are starkly different. There should also be a level playing field on the part of the asset managers and how they look at companies listed in the UK, Europe and the US.

It's a conversation that needs to happen and I think it's very encouraging that everybody appears to be pulling in the same direction.

> **"We need to take a step back and have a conversation about what a modernised, fit-for-purpose, principles-based, outcome-focused stewardship and governance regime looks like."** Mark Austin

The big debate...

Deloitte Partners Ali Sidat and Mitul Shah discuss the opposing sides of the debate.

"Pay in the UK is uncompetitive in the global talent market"

For: There are plenty of examples where the UK cannot compete for talent. The biggest issue is clearly with the US market, which is our biggest trade corridor. We are linked by lots of different aspects including culture, and if we cannot compete with some of our US peers, that's a huge challenge. And it's a huge commercial market too. So, I would say against the US and other countries and in other areas such as private equity and private companies, we are currently losing this battle.

Against: While this is an issue for a handful of companies, it's not representative of the whole market. The FTSE 350 is made up of a range of companies, including some that are very global and that operate in multiple jurisdictions and have a huge US footprint, all the way down to companies only operating in a handful of countries or just in the UK. Pay in the US is materially higher. But my argument would be that it is the US that is an outlier, not the UK. More than 25% of FTSE 100 CEOs are either US or European nationals. Clearly, companies are able to recruit from those markets in the right circumstances.

"The UK needs to be willing to pay more for top talent"

For: We operate in a market and there is supply and demand. We have to pay the market rate and if we don't, we have challenges. One thing that is obviously not visible is how many companies have not been able to recruit their first, second or even third choice CEO. You may have seen the IMF came out today. The UK GDP forecast has gone down again, less than Russia, and is the lowest of any developed country. I'm not saying pay is the main driver for that but if we need to grow, we need the best people at the top of organisations. At the moment there are too many challenges, which means companies cannot recruit the best talent.

Against: It's not just about absolute pay levels. If we simply changed our approach to governance, if we simplify the way we do things and potentially focus on principles rather than a rules-based approach, could we get into a better position? For example, could we simplify our approach to building executive shareholdings. Do we need to be so granular in terms of how we implement pay and if we move the dial on this point, could we become more competitive as a place of listing? We could probably achieve quite a lot by addressing structure.

"The UK voting regime on pay isn't working. If we get under 80% it is seen as a significant revolt from shareholders."

For: Does that 80% stifle innovation, creativity and the flexibility for Remuneration Committees to do what they think is right? If you've read some of our analysis that 40% of FTSE 100 companies have got less than 80% on either the DRR or Policy in the past five years, you may think that shows you can have creativity and accept a lower vote. But some of my clients have got less than 80% and it creates a huge distraction - just think about the amount of time and effort that the Board and the Remuneration Committee put into pay for two people.

> "Pay and governance is a brilliant barometer for culture." Mitul Shah

Against: I think 51% is bold. Let's look at it from the perspective of a RemCo Chair. Do you want to be in a place where you get your policy approved by 51%? Do CEOs want to be on the front page due to pay? What does the 51% mean for remuneration flexibility in future years? Consensus building does sometimes result in sub-optimal outcomes. But equally there are lots of cases where the tension between companies and shareholders has probably been a good thing. So, 51% probably pushes it too far. Is 80% the right number? The answer is probably in between. If you move that threshold to 70% it would capture around one quarter of the market and potentially allows the flexibility and creativity the market needs.

For: I'd say 70% seems sensible. When you look at the companies that receive less than 80%, the vast majority are companies with sizable US operations. So, there is a correlation with companies trying to push it to try and compete, and you could argue that probably makes sense if that's their biggest market for talent and for commerce as well.

"Pay governance is making the IPO market uncompetitive"

For: Look at our Stock Exchange – we are smaller than the US exchanges, the Asian exchanges and Euronext now too. We have some amazing companies, but are we able to attract the biggest, most complicated technology companies where real growth is going to come? How can we stay relevant? There are lots of good things about our governance rules, but there are some areas, including pay, where we need more flexibility to make the IPO market competitive. For example, we could be more flexible on dilution for tech IPOs.

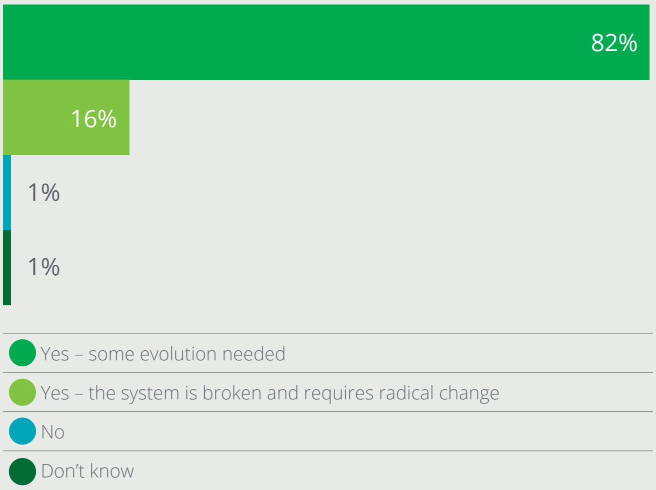
Against: Hard to disagree. I've worked on lots of IPOs and the culture shock when you're moving from private to public is huge. When you're hit with the governance framework, that is the biggest change. I think it raises a fundamental question – what kind of corporate culture do we want to create in the UK?

For: I think that's a great point. What model do we want to be? Pay is a small part of that, but it's a very interesting part because of the signalling it sends. In some smaller countries there is a social democratic model – think of some of the Nordic countries where pay ratios between CEOs and everyone else are much lower. Where do we want to be on this debate?

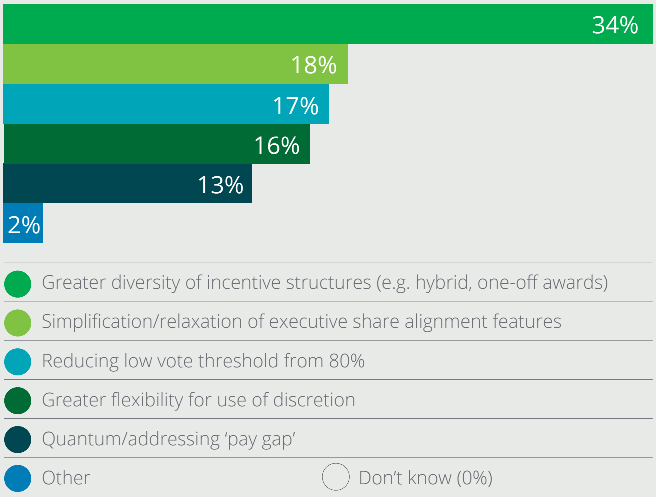
> "We think there is scope for evolution and improvements to the current ecosystem." Ali Sidat

Conference polls: your views

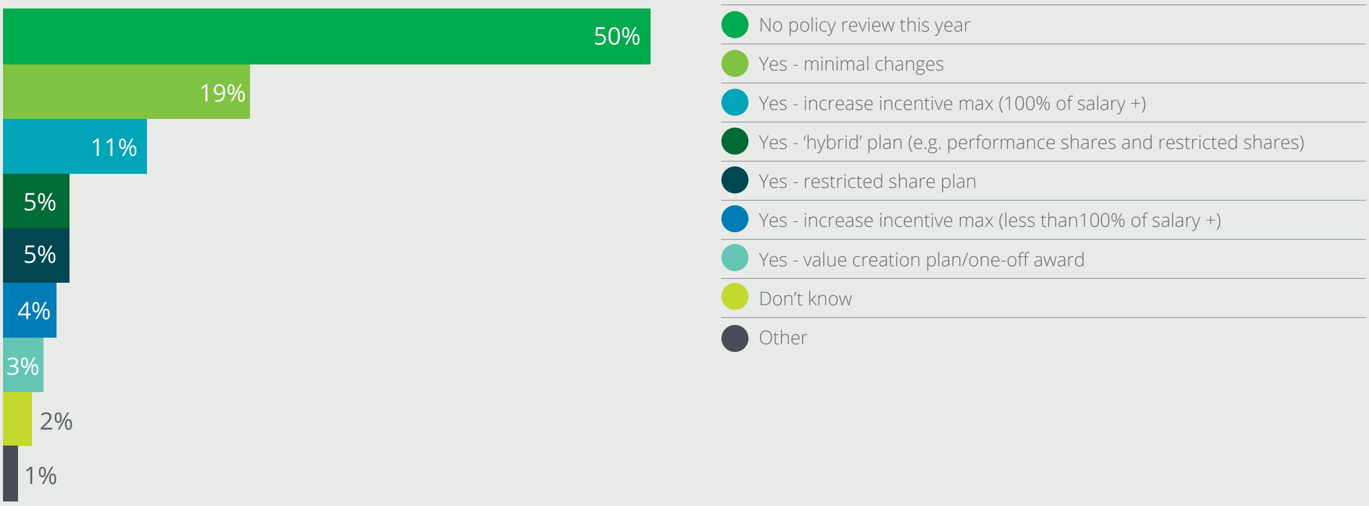
Does the remuneration landscape for UK listed companies require reform?



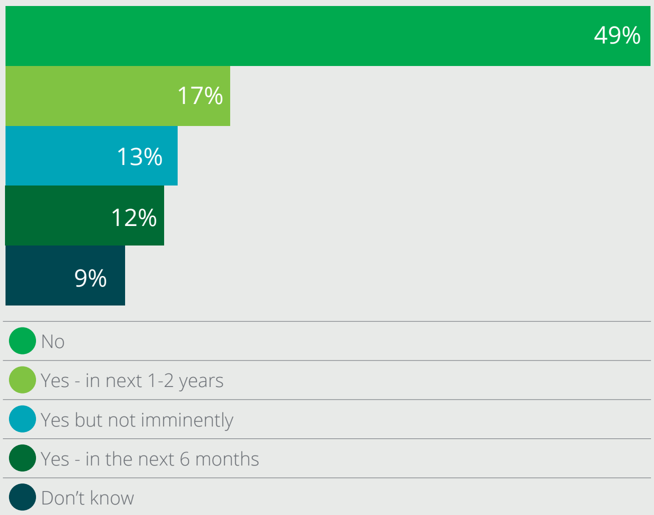
Which areas of reform would have the biggest impact? (select top two that apply)



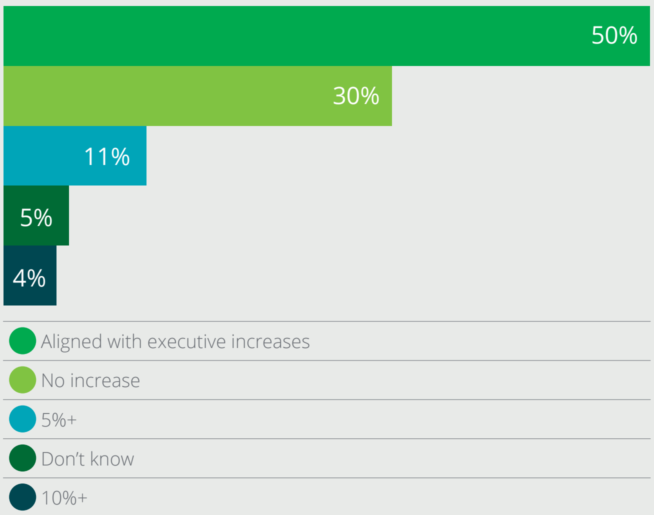
Are you seeking approval for a new remuneration policy in the coming 12 to 18 months and if yes, what changes do you expect to make?



Do you expect to reset non-executive Director fees in the near term?



What is your estimated increase for non-executive Directors in FY2024?



Hot topics

Deloitte partners Katie Kenny and John Cotton discuss some hot topics for remuneration committees in the coming year, including recent developments in the financial services (FS) sector.

1 Annual salary review – executive and workforce increases

For a number of years we saw executive director salary increases at around 2% to 2.5%, which was generally in line with the wider workforce and inflation. Last year there was a break from that trend, and with the heightened inflationary environment, wider workforce budgets were significantly larger. The median wider workforce increase for 2023 was around 6% and in some sectors, it was higher. From an executive director lens, we saw most committees heeding investors' calls for restraint and increases were typically in the 3.5% to 4% range. We expect that gap to narrow this year. From an inflationary perspective, salary budgets are going to be tricky for a number of companies because you're seeking to balance competing factors – talent retention, protecting workers and managing costs appropriately in a constrained economic environment. We think workforce salary budgets are probably going to move in the 4% to 5% range.

FS perspective - Broadly, it is a similar picture within financial services. Those with more customer-facing businesses needed to look at protecting lower-earning employees. Within asset management, who experienced more challenge through the recent macroeconomic volatility, salary budgets were typically slightly lower. Looking forward, that's a picture we expect to see again through this year end. In some firms, there have been low or no Executive Director salary increases over two or three cycles now. They are going to think very carefully about whether that's the right choice for this year.

Another consideration for companies is changes to the National Living Wage from April 2024. The announcement so far is that it will be above £11, which is around 5.5% above where it is. Most people think that it will be higher, probably at the £11.20 range. That is quite a significant increase to protect the lowest-paid workers in society. But, for businesses struggling in the retail or services sectors where they have a lot of lower-paid workers, it will mean they will need to be budgeting to take that into account.

2 Variable pay year-end outcomes

In terms of annual bonus outcomes for 2022, there was a reversion towards what we'd see as the norm over the long run, following very elevated outcomes in 2021 and much lower outcomes in 2020. We expect that trend to be broadly similar for 2023.

For LTIPs vesting at the end of last year (awards granted in 2020), the big topic was windfall gains. Shareholders were looking for companies to potentially adjust awards granted after COVID where there was a material dip in share price. When you look at vesting of those awards, there was only a small minority of companies that were subject to that classic windfall gains profile. Of those, most either made a cut at grant on the way in or at vesting. There were only relatively few that didn't do anything and some got pushback from shareholders. In terms of 2021 awards, windfall gains are much less likely to be an issue because the share price had largely re-calibrated by the time those awards were granted. But this year we are expecting to see much higher levels of vesting outcomes. When we look at March to June year-ends, the median outcome was 81% of maximum and one third of awards vested in full. Remuneration committees will be thinking about whether those vesting levels are appropriate in the context of the broader shareholder and stakeholder experience – it might be that while this year is slightly higher, it follows a couple of years of nil or very low vesting. It's going to be critical to get the narrative in the DRR right around why you've made the decisions and why you think those outcomes are appropriate.

3 Removal of the banking bonus cap

FS perspective - Assuming the rules are finalised as published, firms subject to the bonus cap are welcoming having a different pay mix or more flexibility around variable pay. However, taking away fixed pay is not easy. In conversations with shareholders, this isn't seen as a burning platform and investors generally don't want to see a move back to the days of the pre-financial crash in 2008, where there was very different leverage in terms of remuneration packages. The flexibility is very welcome, but let's wait and see what the final rules say.

4 Workforce pay and policies - enhanced disclosure

Investors and wider stakeholders increasingly want to understand how the workforce is being treated in terms of reward policies, and financial services is one of the sectors that leads the way in this. Here we see very detailed fair pay reporting at a number of different companies and there are new regulations in relation to diversity and inclusion reporting.

FS perspective - Financial services is leading the way partly due to regulations but also because it wants to be viewed as such. We see some fantastic fair pay reports, which are voluntary from certain firms. You also see them in some firms outside financial services. Diversity and inclusion reporting is coming through, including gender pay gap reporting, and not only in the UK – new requirements are

> **"If your workforce are happy, feel psychologically safe and are motivated to do their jobs, you're probably, as an organisation, going to perform better."** Katie Kenny

Hot topics continued

coming in across Europe, as well as for different types of firms. We've seen the Financial Conduct Authority and Prudential Regulation Authority put out their discussion papers on this too.

5 EU Pay Transparency Directive

Many firms are also now focusing on the EU Pay Transparency Directive. This is due in 2026 but that will come around quickly and for some firms, this is going to be quite a challenging transition. The younger generation generally is looking for more transparency around pay. So, there is an employee experience angle to this, as much as there is a legal one as well. So that's the topic that's taking up a huge amount of time and is likely to only increase over the coming year or so.

This is leading to many companies look at their bonus frameworks. We're working with some clients who, for example, have had fully discretionary bonus models and are looking to put some more structure around that - so an on-target bonus, and perhaps being clearer about the factors that would lead it to go up or down, linked to performance. So, the market could potentially change quite quickly.

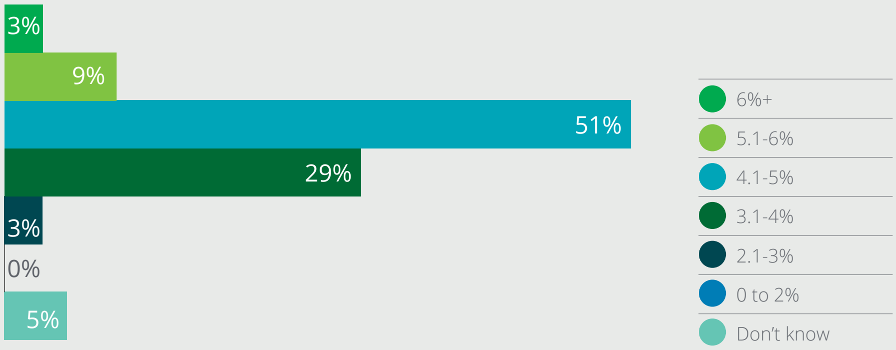
We have had some clients that took away performance ratings and are now bringing them back because they want to see that level of accountability.

6 Wellbeing

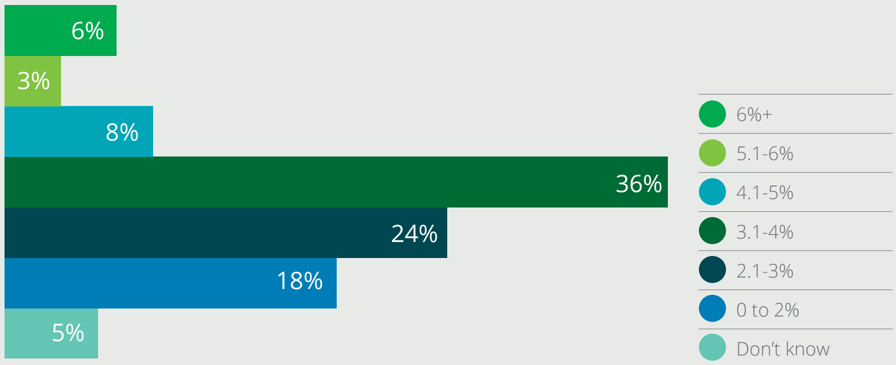
The focus on employee wellbeing has gone from something we saw rise up during COVID to a kind of employee resource. It will be really interesting to see how this evolves over the next few years as more and more companies build a holistic wellbeing strategy.

"Financial services firms are really focusing on the EU Pay Transparency Directive and honing in on what it will mean." John Cotton

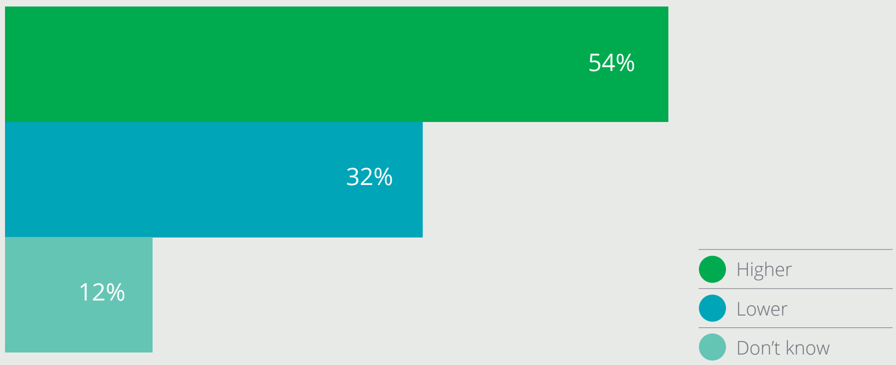
What average salary increase are you expecting for the wider workforce in 2024?



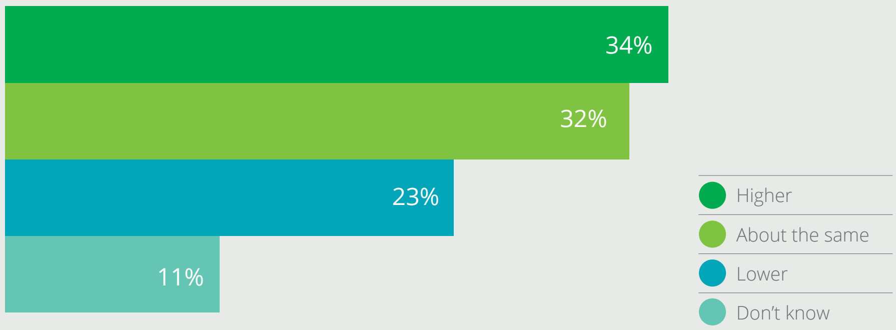
What average salary increase are you expecting for the CEO in 2024?



Do you expect CEO bonus out-turns to be higher or lower than last year?



Do you expect long-term incentive vesting to be higher or lower than last year?



Perspectives from the conference panel

Deloitte partner Sally Cooper chairs our panel debate, looking at different perspectives on the 'big tent' debate, from voting thresholds to the power of proxy agencies.

Panel guests

Mark Austin,
Member of the Capital Markets Industry Taskforce

Tracy Clarke,
Remuneration Committee Chair, Haleon plc; TP ICAP plc, Starling Bank

Helen Thomas,
Journalist, Financial Times

Q Sally: Is the UK corporate governance framework completely broken?

Tracy: I don't think it's completely broken but there are parts of our corporate governance framework on pay that need to change. We spend too much time ensuring that we're compliant with this and that, and not enough time focusing on what is right for the business.

Mark: I think it's a talent drain. I also think it is a deterrent to the competitiveness of our markets. It's a perception problem as much as anything, and perception matters because it becomes reality. There is a perception that the remuneration regime in this country is too restrictive, and there is some truth in that. It's very hard to say, particularly in the cost-of-living crisis, that some of the best paid people in the country should get more.

Helen: There's definitely an issue, but I think the perception is greater than the underlying issue. I'm not sure pushing the big red button that's marked higher pay is the thing that's going to improve the competitiveness of London overall. There are probably some easy wins around flexibility and structure that aren't going to provoke outrage around giving big pay rises to people who already earn a lot of money.

Q Sally: Should everyone be getting ready for something new and different? What's the plan here?

Mark: I think it's a conversation that needs to happen now. Nobody disagrees that there's something we've got to do, but it's down to the investors and the issuers. Things have got to a point with our capital markets and our financial services sector that people recognise we have to make progress. I am optimistic that we can change the narrative on this discussion in the next eight months.

Q Sally: Should we be levelling the playing field with the US?

Mark: It's a bit more subtle than that. It's saying that, regarding the ability for us to remunerate people, the principle should be the same. The way that asset managers talk about it should be the same. It's not saying everyone should have higher pay, it's just the framework should change.

Helen: One thing I want to see in the US discussion is better data. The other thing that always slightly frustrates is that the US is a much bigger, richer country. Average living standards are two-thirds higher than in the UK and that gets slightly lost here.

Q Sally: Are you talking about flexibility and structures?

Mark: It's about having the same framework that the asset managers apply. At the moment you can have a UK company listed in New York and a UK company listed in London and the same asset manager will take a completely different view and vote completely differently. That cannot be right.

Tracy: It's counterintuitive. Is there also a cultural difference? Many of the Boards that I'm on have big businesses in the US. There's a general pride in success there. You're an entrepreneur and you're running this fabulous business and you're going to generate wealth. That isn't the culture here at the moment.

Q Sally: Do you think that there is something in the UK psyche? Is the media more focused on pay?

Helen: Find me the pay stories that don't refer to a red top alert or an ISS or a Glass Lewis. That's broadly where the reporting on pay stems from. I have worked in the media in both the UK and the US and I don't see a huge difference in the way they approach any of these issues.

Q Sally: If we agree there should be some evolution, how do you feel about the voting threshold?

Tracy: I think 80% is too high. If you've got 80% you've ticked all

> **"I don't think it's completely broken but there are parts of our corporate governance framework on pay that need to change."** Tracy Clarke

Perspectives from the conference panel

"I would argue that, to the extent that there is a sort of cultural or psyche problem, the media reflects that rather than creates it." Helen Thomas

the boxes with some outliers and you've potentially compromised doing something that's really strategically on point for your business. As Board members, we are appointed by our investors, they get the vote, so that's fine. Trust us to do the job and if we're not doing the job, we should step down or you vote against us. The system adds up to a lack of trust and an unnecessary level of control that leads to poor outcomes.

Helen: I'm amazed how much it bothers some Boards and non-execs that they're not getting 95% approval. I do think the market has changed and it makes it harder to get that level of approval for starters. I think Boards need to be a bit thicker-skinned about these votes against, and a bit more willing to take the case to their investors on things like restricted stock or making changes that they genuinely believe are in the interests of the company. I think that's the only way you're going to make progress on flexibility.

Mark: Get rid of the public register. Just don't have it anymore because it's an outdated concept. There should be an obligation that you create a forum for effective engagement between companies and their shareholders, and an obligation on proxy agencies and asset manages to interact properly.

Q Sally: What can the governance framework do around proxy agencies and the power they have?

Mark: I'm told a lot of it will get solved by bringing the fund management, governance functions and the asset managers back together. Then the message that goes out to the proxy agencies will be more informed and not as restrictive as it is at the moment.

Tracy: There has to be a two-way role for the proxy agencies. At the moment it's just perceived to be representative of the views of the asset managers, but if the asset managers are not talking to the companies they've invested in, what information are they getting back?

Mark: When you talk about proxy agencies the conversation seems to quickly shade into, 'they should be regulated,' which I just don't agree with. I think it is about reframing the debate.

Q Sally: Will we always be talking about pay?

Tracy: We're only having the debate because we haven't seen enough change or progress.

Helen: I do wonder whether some of this is correlated with performance. There are certainly pay votes that I see and think they are not really about pay.

Mark: I totally agree. It always comes back to this issuer/investor re-establishment of trust and a proper ability to engage. I think there's the British psyche as well. We're less comfortable with people doing well and earning lots of money.

Q Sally: In terms of that UK governance framework, what would you keep? What do you like about it?

Tracy: Policy votes should be every five years – three years is too short.

Mark: I'd keep most of it. What would I change? I agree with Tracy's suggestion, but that's not realistic right now. I would deal with dilution. I think that's a massive issue, particularly for fast growing companies.

"We should ask the big asset managers to be jurisdiction agnostic." Mark Austin