# LGIM's Principles on executive remuneration

Legal & General
INVESTMENT MANAGEMENT

As a long-term engaged investor we entrust the board to oversee the company and its management on our behalf. This equally applies to the setting and awarding of management remuneration. We take our voting rights extremely seriously and want to be able to support both the remuneration proposals and the board at your future shareholder meetings. To assist the board in this regard we have developed this summary document of the main principles that support our corporate governance and voting policy on executive remuneration.

Detailed policy and guidance on executive remuneration is contained within our UK policy on Corporate Governance. http://www.lgim.com/files/_document-library/capabilities/uk-policy-2018.pdf

# Structure and operation of the Remuneration Committee

The chairman of the Remuneration Committee should have appropriate knowledge of the business to align remuneration with the strategy of the company. For this reason the person appointed to the role of Remuneration Committee chairman should have served on the board for at least a year prior to their appointment.

We expect the Remuneration Committee to:

- Set the remuneration policy for the executive directors, the chair and senior management
- Seek independent advice. External advisors, consultants and internal employees advising the committee should be fully accountable to the committee. The committee should exercise its own independent judgment when considering any advice provided by third parties
- Consider carefully and be able to demonstrate how they have reviewed the pay and related policies of the workforce when setting pay for the executive team and be able to demonstrate how this is aligned with the culture of the company
- Take into account the views of their largest shareholders, whose pay policies are generally on their corporate website

LGIM's pay policies are on our website and we communicate these policies with remuneration consultants annually, so that they can provide better advice to companies.

LGIM will vote against the election of individual board directors where we do not support remuneration for the second consecutive year. LGIM may also vote against individual directors where there are particularly contentious issues.

A large voting opposition (>20%) to the remuneration proposals should not be ignored. The Remuneration Committee should:

- Hold themselves accountable for the decisions taken that led to the high vote against
- Publish an explanation for the dissent when disclosing the voting outcomes including what the board is doing to address concerns. This should be sent to the Investment Association for inclusion in the Public Register. An explanation should also be included in the chairman's statement in the next annual report
- Consider re-tendering the remuneration consultant contracts if the decisions of the Remuneration Committee were based on the advice of the consultant

# Pay principles

We apply a set of simple pay principles when looking at remuneration structures:

- The remuneration structure and the payments awarded should be fair, balanced and understandable. This means: fair in terms of what the company has achieved; balanced in terms of total pay to the executive when compared with employees and the shareholder experience; and understandable for the recipient, the board and its shareholders

- Awards should promote long-term decision making and be aligned to and support the company's values and achievement of the business strategy

- Executives should have meaningful direct equity holdings while employed and thereafter; buying shares is one of the best ways of aligning management and shareholders

- Significant changes to existing remuneration strategy should be subject to a two-way consultation with shareholders prior to the company seeking specific approval via votes

- Boards should retain ultimate flexibility to apply discretion and 'sense-check' the final payments to ensure that they align with the underlying long-term performance of the business

### Transparency in the annual report

Executive remuneration is a board decision, supported by the Remuneration Committee. The chairman should support the process of setting pay and this should come through in the annual report.

Companies can build trust with shareholders if they can demonstrate historic restraint, consistency and alignment with shareholders. The board should provide an explanation in the annual report:

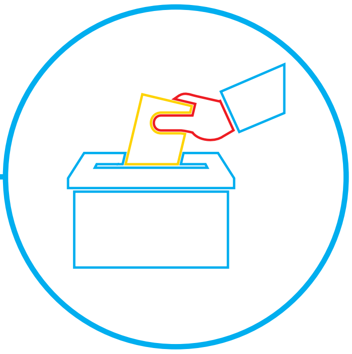
The Remuneration Committee chairman's statement should explain:

- Why the total single figure is appropriate, taking into account the delivery of key performance measures, employee pay and shareholder experience in terms of value created

- Why the chosen remuneration award level is appropriate for the company. Any explanation should avoid as its main argument comparisons with peer median pay

- Details of engagement undertaken with all stakeholders. In particular, engagement that has taken place with the workforce to explain how executive remuneration aligns with the wider company pay policy. Any engagement with shareholders should be outlined, as well as the impact this has had on remuneration policy and the outcomes

- Evidence of the exercise of discretion (in revising pay up or down) during the year. We would define discretion as anything that alters the monetary outcome. Where pay has been revised upwards, we would expect to be reminded of when pay was revised downward. When discretion is applied, and pay moves up or down, we would also expect to understand what the monetary outcome would have been had this change not been applied. This will help us in applying our own judgment on the level of fairness



Other disclosure we would expect to find in the remuneration report includes:

- A breakdown of fees paid to remuneration consultants, broken down as fees paid for services carried out for the Remuneration Committee and other HR related fees

- The pay ratios – the Companies (Miscellaneous Reporting) Regulations 2018 was published in August 2018, requiring companies with an average number of UK employees of 250 or more to provide a set of pay ratios based on the CEO total single figure remuneration vs, the 25th, 50th and 75th percentile employee.

LGIM expects all companies to provide a pay ratio regardless of whether they have 250 full time equivalent UK employees or not. Where they do not have 250 UK employees a statement to this effect can explain the basis on which the ratio was calculated

LGIM is mindful that the Department for Business, Energy & Industrial Strategy offered three options on how to calculate these ratios. To ensure meaningful comparability, we would expect companies to adopt methodology option A – which requires the company to calculate the pay and benefits of all its UK employees for the relevant financial year in order to identify the 25th, 50th and 75th percentile employee and use these numbers when calculating these ratios. Where another option is adopted, we would expect a full explanation of why the adoption of methodology A was not possible.

**Quantum**

As the executive remuneration landscape continues to evolve to meet the needs of modern corporations, companies must take into account the current social sensitivities around pay inequality.

We entrust the current board to ensure that executive pay is set at an appropriate level to drive positive corporate behaviour and performance. In doing so, the board should consider the wider impact of executive pay, e.g. upon the general workforce, public perception, the economic climate, and government bodies.

Boards should not consider increases to individual elements of remuneration in isolation and should consider the effect that an increase in each component will have on total remuneration. The board should consider whether the total package is appropriate for a role of this nature, preferably without solely relying on benchmark data; i.e. the board should perform a sense check.

- Boards are expected to consider the pay ratios between the CEO's total single figure to employees at each of the key percentiles, i.e. 25th 50th and 75th. Boards should question whether their own company's pay ratio is appropriate in light of the industry in which it operates. Are the 'year on year' changes in the ratio appropriate in light of performance?

- Salary increases should be in line with the general workforce unless there has been a genuine change to the role with increased responsibilities in which case a phased increase is expected. Phasing ensures that the individual is rewarded as they grow into the role and performs well. When reviewing an individual's base salary, consideration should be given to the impact of any change on the total package

- Pension arrangements should be reduced over time so that they are more closely aligned with the general workforce. At the next remuneration policy review, LGIM expects companies to introduce a pension provision for new board directors that is aligned with what is being offered to the general workforce. In addition, where contracts are being re-negotiated for existing directors we expect pension provisions to be lowered. LGIM will be voting against the remuneration policy from 2020 where there has not been any changes to address the disparity in pension provisions unless the company can demonstrate that similar arrangements are available to the workforce

- Bonus – LGIM would encourage the reduction of short-term annual bonus levels. A bonus of 200% of salary should be reserved for the largest global companies. LGIM will not support any increases to the annual bonus going forward

- Where a company has experienced a significant fall in the value of their shares, companies are expected to reduce the size of a new award to ensure there is no prospect of reward for failure.

LGIM expects all variable remuneration schemes to be capped. Regardless of an award cap (as a % of salary or fixed number of shares), the Remuneration Committee should ensure that scheme rules permit the application of downward discretion to reduce the value of vested awards if they reach a value that goes beyond the committee's expectation and could result in reputational damage to the company.

The focus on median pay has contributed to the general increase in executive remuneration for all companies with less focus being given to the actual performance of the individual company and absolute pay. For this reason, LGIM discourages the over-reliance and over-use of benchmark data as pay and performance can vary considerably between companies. The use of benchmarks should only happen at specified intervals, e.g. once in three years or when considering new appointments.

When considering the constituents of the benchmark, companies usually select constituents based on revenue or market cap. LGIM believes that performance relative to this peer group should play a part in determining pay levels.

## Simple and understandable

The remuneration policy should be understandable for all stakeholders and clearly explained in the annual report. LGIM:

- Will not support a new incentive scheme if it complicates the remuneration structure

- Advocate the use of only one Long Term Incentive Plan with no more than four performance measures. Long-term is defined as a minimum of three years of performance

- Will oppose any new matching plan or renewal of existing matching scheme

- Will not support performance on grant schemes, bonus banking schemes. One-off schemes are generally not supported.

## Performance metrics and targets

The board should determine what the right metrics are to deliver the strategy, and what level of stretch in the target is appropriate to deliver the right outcomes for all stakeholders.

- Metrics should be linked to long-term strategy, stretching but achievable without undue risk taking

- Performance targets should use the reported numbers without further adjustments, save for share buy-backs and other capital changes. Any adjustments should be consistent, explained and reconciled with reported numbers

- Long term incentive performance targets should be disclosed in advance and short-term annual bonus targets retrospectively and where possible prospectively

- To highlight the integrity of the target-setting process, companies should disclose as many components of the bonus targets as possible. Where possible, this should be on a prospective basis; otherwise, retrospectively

- Strategic/qualitative and personal targets should be fully explained and the degree to which they were achieved should be demonstrated. LGIM expects this proportion of the award to be limited to 25% of salary or less

- Targets that are commercially sensitive to the business should be disclosed retrospectively, within a year after payment; if this is not possible, an explanation of why the target continues to be commercially sensitive is expected

- Targets should not be adjusted retrospectively

- LGIM does not generally support the setting of targets at a level that is below the previous year's out-turn. However, in exceptional circumstances where this is felt necessary. LGIM will expect a detailed explanation which should cover any reason for not reducing the size of the award to reflect the lower expectations

- Any accrued dividends on share awards should only be paid on those shares that ultimately vest

### Restricted schemes

For those companies considering adopting a restricted scheme, here is further guidance as to what would be acceptable to LGIM as a shareholder in your company.

- Companies will have to justify why this type of arrangement is appropriate and why the existing arrangement is no longer suitable

- Award levels should be reduced to 50% or less than the normal long-term incentive grant to take into account the greater level of certainty

- Restricted schemes should be a long-term scheme that is applied through different business cycles

- Shares should be held for a minimum of five years prior to release

- The release of shares should be subject to an underpin that requires the Remuneration Committee to be satisfied that over the five years since the grant was awarded, the company's overall performance and individual's leadership is such that the release of shares is warranted

- Discretion should be applied to reduce awards if at the end of the holding period the performance of the company and the shareholder experience is not aligned. (See: p23, para. 2 of the Executive Remuneration Working Group report.)

- For leavers unvested restricted shares should be pro-rated for time and subject to the same vesting time frame and holding requirements as set out above

- Annual bonus targets should be disclosed in full, retrospectively, if not in advance

- A shareholding guideline must be in place that is material whilst in employment and post-exit (see below)

### Malus & clawback

Both of these should apply to all elements of variable remuneration

- Employment contracts should be designed so as to provide the ability to apply malus and clawback

- To provide clarity for all stakeholders, the Remuneration Committee should set out the circumstances under which malus and clawback will be applied. These circumstances should not be too narrowly defined

### Director alignment – shareholding guidelines

LGIM expects directors to build up and maintain a significant equity holding in the Company they are leading. To promote long-term strategic decisions and shareholder alignment, directors should continue to hold a meaningful number of shares even after departure from the company.

- The shareholding requirement should be linked to the value of total variable pay. As a guide, in terms of size on the FTSE 100 index:

**FTSE 1 – 30 – 5 x salary**
**FTSE 31 – 50 – 4.5 x salary**
**FTSE 51 – 100 – 4 x salary**

- Directors should be encouraged to buy shares to meet the shareholding guideline

- A post exit shareholding requirement of vested shares should be set that is meaningful and held for two years post exit. As a guide, for FTSE 100 companies this should be not less than three times salary

- Vested shares, deferred bonus shares and shares subject to a holding period can count towards meeting shareholding guidelines

### Recruitment and Departures

- Recruitment

  - A new executive director's remuneration should be set by taking into account their level of experience in the role with a view to reaching a market rate over time, subject to performance. It would be prudent to state this intention in the annual report at the time of appointment and repeated annually

  - New recruits should be encouraged to purchase shares in the company

  - The use of golden hellos and goodbyes is not supported and should be avoided

  - The use of buy-out awards is discouraged

  - Any buy-out awards considered necessary, in exceptional circumstances, should be explained and awarded predominantly in shares

  - Additional employee benefits of moving residence should mirror what is being offered to employees at all levels and have a time limit of two years

  - Employment contracts should be for a maximum of 12 months. LGIM would expect the notice period to be the same for employer and employee

- Departures

  - Except in cases of dismissal for conduct or to avoid payment for failure, share-based awards outstanding should be time pro-rated and subject to the same vesting conditions that applied at grant

## CONTACT US

**For further information on anything you have read here or to provide feedback, please contact us at:**

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