LGIM's UK Principles of Executive Pay

October 2020

UK Principles of Executive Pay

As a long-term engaged investor, we entrust the board to oversee the company and its management on our behalf. This applies equally to the setting and awarding of management remuneration.

We take our voting rights 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:

https://www.lgim.com/api/epi/documentlibrary/view?id=86336ca33aee4900999635000e123bad&old=literature

Additional publications on this topic can be found on our website, here:

https://www.lgim.com/uk/en/capabilities/corporate-governance/influencing-the-debate/

Structure and operation of the remuneration committee

The chair of the remuneration committee should have appropriate knowledge of the business to align remuneration with the strategy of the company. In addition, we would expect the chair to have a good working knowledge of the key people for whom they are setting pay structures and the pay and benefits offered throughout the company. For this reason, the person appointed to the role of remuneration committee chair 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 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 judgement 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, gender pay gap and pay ratio 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 chair's statement in the next annual report.

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.

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

Transparency in the annual report

Executive remuneration is a board decision, supported by the remuneration committee. The chair 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 on how this is achieved and how pay structures aid in driving company strategy and shareholder value creation.

The remuneration committee chair's statement should explain:

- Why the total single figure is appropriate, taking into account the delivery of key performance indicators (KPIs), 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:
    - Engagement that has taken place with the workforce to explain how executive remuneration aligns with the wider company pay policy.
    - 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 judgement on the level of fairness.

Other disclosures we would expect to find or signposted in the remuneration report include:

- How the chosen performance criteria and targets align with the long-term strategy of the company, thus providing a clear linkage between the front end of the annual report, including company strategy and KPIs, agreed pay structures and targets, and financial performance outcomes.
- COVID-19. How the committee has taken into account the impact of the pandemic on its operations including stakeholders when deciding pay outcomes. LGIM has specific expectations (see section on the annual bonus).
- 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.
- Gender pay gap reporting as required by the Equality Act 2010 (Gender Pay Information) Regulations 2017. We note that this has been suspended for the 2019/20 period due to COVID; however, we would encourage those that can report to continue reporting.
- 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 prefers the use of option A when calculating these ratios. If a company adopts options B or C to calculate their ratios; we would expect a full explanation of why it was not feasible to use option A.

- 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.
- We believe calculating this ratio is an important step in addressing fairness in pay at different levels of the organisation.

Quantum

As the executive remuneration landscape continues to evolve to meet the needs of modern corporations, companies must take account of 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, given the size, complexity of the business and preferably without solely relying on benchmark data.
- Boards are expected to consider whether their 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 corporate 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 taking into account their continued performance. LGIM expects the committee to use the opportunity when a new director is appointed to reset executive pay and consider the current circumstances of the business as well as the previous experience of the individual. Salaries for new directors should be phased over time based on their level of experience. When reviewing an individual's base salary, consideration should be given to the impact of any change on the total package.
- **Pensions**. LGIM expects companies to ensure that the pension provisions for a new board director and others for whom contracts are being re-negotiated are aligned with what is being offered to a majority of the workforce. In addition, and in line with developing market practice in this area, LGIM expects incumbent directors' pension provisions to be aligned with what is offered to a majority of the workforce by 2023. LGIM will vote against the remuneration policy where there have been no changes proposed to address the disparity in pension provisions.
- **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.
    - COVID-19. For the 2020 financial year, for those companies that have been impacted by the coronavirus pandemic to the extent that support from government or shareholders (via additional capital or suspended dividend) and staff redundancies were necessary, LGIM would not expect to find a bonus being paid. The payment of a bonus may result in a vote against the remuneration report. However, LGIM will look at the reasons for payment on a case by case basis.
- **Long Term Incentives**. 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.
    - Where a company has experienced a significant fall in the share price (>20%) since the last award was made and any new award would result in a greater number of shares being granted, companies are expected to reduce the size of the new award to ensure there is no prospect of a

reward for failure. Where this has not happened and the committee has not provided an undertaking to reduce awards when they vest, LGIM will vote against the remuneration report.

    - COVID-19 measures. Some companies informed shareholders that they would adjust vesting outcomes rather than reduce the initial award. This is not LGIM's preferred solution as it is more complex; however, to ensure that this action does not inadvertently result in a negative vote in proceeding years, we would ask that a clear explanation is provided in the Annual Report of this intention until the awards have vested. At the point of vesting, LGIM will expect a detailed explanation on how the remuneration committee has applied discretion to ensure appropriate adjustments were made to avoid windfall gains.
    - LGIM does not generally support retrospective changes to LTIP awards, therefore any proposed discretion to in-flight awards that are material – i.e. affect the outcome to the benefit of directors, should be subject to shareholder consultation and support. LGIM can be taken off-side regarding these conversations.

- **Benchmarks**. 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 encourages companies to consider the appropriateness of their salary benchmark, in conjunction with comparators used across its performance pay disclosures. LGIM believes that performance relative to the chosen peer group should play an important part in determining pay levels.

Malus & clawback

These should apply to all elements of variable remuneration:

- Employment contracts should be designed to enable malus and clawback to be applied to awards.
- 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.

Performance metrics and targets

The board should determine what the right metrics (e.g. published KPIs) 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.
- Companies should consider a basket of criteria in achieving their strategy and to ensure that the same performance achievement does not lead to 'double-dipping' under various pay schemes.
- Financial 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.
- Bonus Targets. To highlight the integrity of the target-setting process, companies should disclose as many components of the bonus targets as possible. Any 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.
- Achieving a threshold level of financial performance should be a pre-requisite for the delivery of any bonus including the delivery of personal/strategic performance objectives. The exception being in a turnaround situation when changes to non-financial strategic targets may take priority for a few years. However; these circumstances should be clearly explained within the remuneration report.
- Personal Performance. LGIM's current view is that for board directors, personal performance amounts to delivering the strategy. We therefore expect strategic targets to be meaningful and quantifiable. We are conscious that the weighting for personal/strategic target continues to grow. LGIM may vote against if the weighting is high and the measures are not meaningful/quantifiable or sufficiently explained. LGIM expects a threshold level of corporate financial measures to be met before any element under this section is triggered.
- As a general rule, long-term incentive performance targets should be disclosed in advance and should not be adjusted retrospectively. However, due to COVID, LGIM is supportive of those companies that need to delay target setting by 6 months, in addition please see the flexibility provided for retrospective changes on page 8. LGIM does not generally support the setting of targets at a level that is below the previous year's out-turn. However, if due to exceptional circumstances the remuneration committee believe it is appropriate to set lower targets, we would expect to learn why they consider the new targets to be equally stretching. Without such an explanation we would expect a reduction to the award size to reflect the reduction in targets.
- Any accrued dividends on share awards should only be paid on those shares that ultimately vest.

ESG metrics in executive remuneration

- Companies that are exposed to high levels of environmental, social or reputational risk should include relevant and clearly measurable targets that focus management in mitigating these risks.
- LGIM expects ESG to be incorporated into the strategy of the business, the delivery of which should form how the business operates and its purpose. We therefore believe ESG performance targets lend themselves to act as a modifier to financial outcomes rather than to provide additional reward. For example, ensuring the health & safety of employees should be embedded in the philosophy and values of the company and a normal expectation of running a successful business. However, for a company that

has specific ESG performance objectives that go beyond the company's purpose, or are linked to growth opportunities, e.g. green revenue, we would encourage the setting of specific targets that are linked to this strategy.

- Targets for oil & gas companies. Remuneration should prioritise financial value over production volumes. The use of measures which directly encourage volume growth (such as reserve replacement ratios or production targets) risks incentivising overinvestment at a time when growth in demand seems increasingly uncertain and should therefore be avoided. Financial measures (relating to total shareholder return, balance sheet strength) or other strategic metrics would be preferred. The use of volume growth targets may result in a negative vote.

Alternative Incentive Structures

Restricted share plan

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.
- In keeping with our policy for other long-term incentive plans, LGIM expects substantial share price falls over the year to be captured in the grant size of restricted share awards.
- The plan should continue to operate 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-year period 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 prorated for time and subject to the same vesting time frame and holding requirements as set out above.
- Targets under any annual bonus plan targets should be disclosed in full, retrospectively.
- A shareholding guideline must be in place that is material whilst in employment as well as post-exit (see below).

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 their departure from the company.

- LGIM expects 100% of vested LTIP and deferred bonus shares to be retained (except those sold for tax purposes) until the shareholding requirement is achieved.
- Directors should be encouraged to buy shares in their company. These purchased shares do not need to be included in the post-exit holding requirement discussed below. If purchased shares are used to make up the in-post shareholding requirement these should be replaced when shares vest from incentive arrangements.
- As a minimum, the shareholding requirement should be linked to the value of annual share based variable pay.
- Aspirational shareholding targets. LGIM has set out below the levels of shareholding it would encourage companies to achieve over a five-year period:

Company	Aspirational Shareholding
FTSE 1-30	5 x salary
FTSE 31-50	4.5 x salary
FTSE 51-100	4 x salary

Post-exit shareholding requirement

LGIM expects a meaningful number of shares to be held by board directors post their departure from office. These should be held for two years. As a guide, for FTSE 100 companies this should be not less than three times' salary.

- Post-exit shareholding guidelines should reflect a significant proportion of the prevailing minimum shareholding requirement (no less than 80% of the in-post requirement).
- Vested shares, deferred bonus shares and shares subject to a holding period can count towards meeting shareholding guidelines.
- Any shares purchased by the director can be excluded from this requirement.
- LGIM will vote against the remuneration policy where a post-exit shareholding requirement that meets our guidance is not included.

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 until all recruitment-related increases are completed.
- New recruits should be encouraged to purchase shares in the company.
- The use of golden hellos is not supported and should be avoided.
- Any buy-out awards considered necessary, in exceptional circumstances, should be explained and awarded predominantly in shares and subject to performance.
- 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.
- The use of golden goodbyes is not supported. Any gifts with a material value should be fully disclosed.

Important information