ESG Viewpoint

October 2020

The ESG implications of COVID-19: **Executive Pay**

The COVID-19 pandemic is resulting in an economic crisis mired in uncertainty. Industry and governments have been forced to react to previously unseen and almost unimaginable threats to the global economy.

After all, how many companies had 'global pandemic' listed as a principal risk in 2019? The severe impact of the pandemic on jobs has further heightened investor and public scrutiny of executive pay levels.

We've tracked the actions of the UK's top 350 companies, and analysed how these compare with the reaction to the global financial crisis.

Key takeaway: Boards are more willing to accept that cutting executive pay may sometimes be necessary – something rarely seen as acceptable in the past. We hope this signals a move towards fairer and more performance-driven pay levels.

Want to learn more? Read on or click the links to explore:

- COVID-19 with the global financial crisis: compare and contrast
- Executive pay under scrutiny
- How UK companies responded to the pressure
- Recent pay-related actions by FTSE 350 companies
- Details of banks cutting dividend payments

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Let's talk about risk

The value of investments and any income derived from them can go down as well as up and investors may not get back the original amount invested.

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COVID-19 and the 2008 global financial crisis

In the UK and many other countries, governments have stepped in to pay employees, reducing the short-term need for redundancies. Such job support schemes have been widely embraced by industry and represent an unparalleled intervention by government into the labour market.

Thinking back a decade to May 2010, as the global financial crisis (GFC) continued to bite, we saw the reduction of the UK debt rating and the bailout of Greece. Comparing this crisis with the COVID-19 pandemic, significant similarities and differences exist. One of the starkest similarities is the pain felt through the economy – albeit the shutdown of whole industries this year is unprecedented and has resulted in furloughed staff, pay freezes or reductions, and redundancies, with more on the way.

From a corporate governance perspective, a significant difference with the GFC is how remuneration committees and executives have reacted by adjusting their pay arrangements. The GFC saw a large number of companies around the world freeze pay and limit incentive payouts. Very few companies outside the banking sector, however, actually reduced pay at executive or senior management levels. There were exceptions: Ireland did see significant reductions to executive pay, but in the UK payouts largely remained flat. During the current crisis, we have seen a significant number of companies cut executive and senior management pay levels. Whilst these cuts are of a temporary nature aligning with the rest of the workforce that have been furloughed or let go, the change of approach in comparison to the GFC is notable.

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Executive pay under scrutiny

The level of executive pay over the past 30 years has grown exponentially. What has also increased significantly is the focus on executive pay levels in the context of the wider workforce. CEO pay ratios are now widely published (for example in the UK and US) and the level of stakeholder scrutiny of these figures has increased. Negative publicity is not only widely viewed and acted upon by customers, but also employees and others related to the business.

Since the GFC, the role and responsibilities of a remuneration committee in the UK have become deeper. Committees are now required to demonstrate that executive pay outcomes are fair and that they have taken serious account of wider workforce pay and conditions when setting directors'pay. Moreover, society as a whole expects directors to understand the wider workforce and be clear on how pay links to corporate culture.

> Management teams are being asked to demonstrate significant leadership and resilience and ensure the executive experience is commensurate with that of shareholders, employees and other stakeholders.
>
> **Investment Association, April 2020**

The focus on pay, along with other topics such as corporate tax and the treatment of employees during this crisis, will continue through the subsequent economic fallout.

Examples of UK companies that seriously misread the mood music during the pandemic:

Sports Direct tried to keep stores open as an 'essential' service.

Wetherspoons' boss Tim Martin had announced that workers would only be paid up until the date pubs were last open and further suggested employees should apply for jobs in food retail.

A company's social licence to operate is becoming increasingly important.

Within days of lockdown beginning, as the potential labour force impacts became apparent, industry bodies and investors began releasing guidance proposing that companies should be 'sharing the pain' at executive level. This did not fall on deaf ears. Soon after lockdown, many companies began to announce pay cuts to senior management as part of the drive to preserve cash. Many of the cuts were management-led, which shows particularly strong empathy for the wider workforce.

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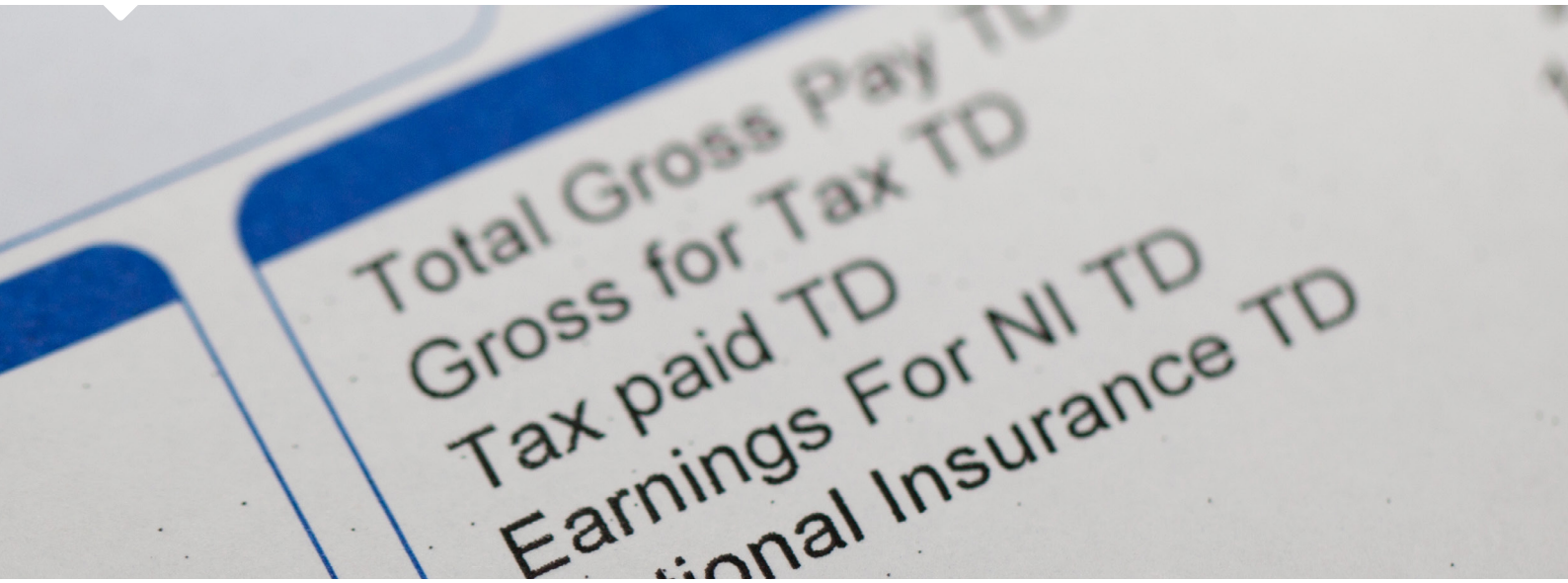


UK companies respond to the pressure

Following the GFC, shareholders in the UK were given a forward-looking remuneration policy vote that takes place for each company at least every three years. The first of these votes generally took place in 2014. Given the triennial nature of the policy, 2020 was set to be an important year, with the majority of UK companies needing to renew shareholder approval.

As a result of the pressures on executive pay as the pandemic hit, we witnessed companies deferring any proposed increase to pay for at least a year. A common practice seen was to defer implementation of any pay rises until more certainty returns to the economy. This approach is justified given the potential reputational impact of executive pay increasing whilst employees may be furloughed.

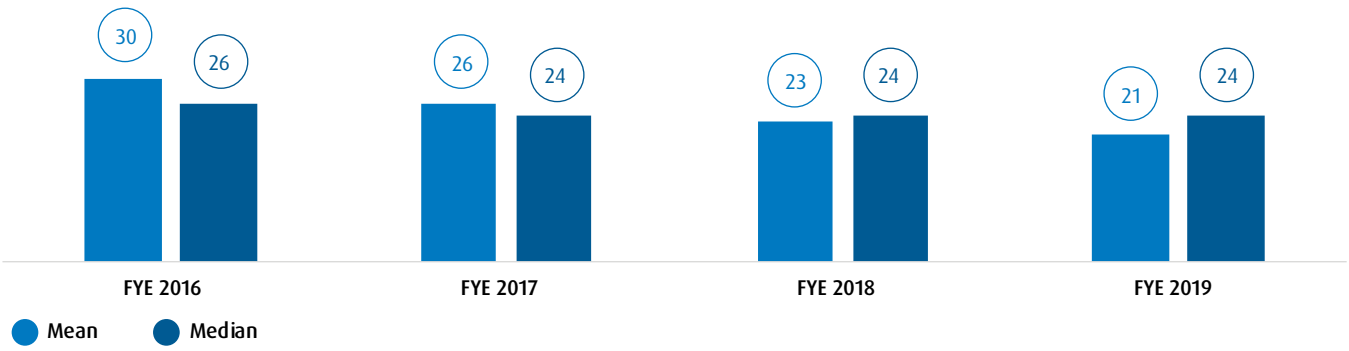
Additionally, companies have also been under significant pressure in recent years to reduce the levels of pension contribution received by senior management, in order to bring them in line with those received by the rest of the workforce.

Important changes we have seen this year:

- A majority of companies reducing pension contributions for new executives formally in the remuneration policy – changes that on the whole were planned well before the pandemic struck
- Many have also implemented actual decreases in pension contributions to serving directors, while a decade ago a cut to an individual director's pay package was almost unimaginable

This has been a great example of investors and industry bodies all giving a clear message on a topic and companies responding.

Pension contribution, or equivalent, as a proportion of FTSE base salary (%)



Source: Chartered Institute of Personnel and Development, as at August 2020

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Actions

by FTSE-350 companies

Throughout the lockdown period, until the end of May, we monitored announcements by the UK's largest 350 companies regarding the COVID-19 pandemic. These normally took the form of trading updates, providing investors with information on how the company was reacting to the crisis. But many of the announcements also included information on changes to executive pay. Once we had seen a handful of these announcement including pay reduction information, we started to systematically record the information. Below is a summary of what we found:

FTSE 100		FTSE 250
38	companies disclosed some form of temporary pay reduction	84
32	disclosed salary reductions	76
5	announced incentive cuts or incentive deferrals without a corresponding salary decrease	8
13	companies announced either incentive deferrals or reductions for the prior financial year that were yet to be paid, or bonus waivers for the current financial year	26
20%	salary reduction was the most common response to the crisis	20%
✓	The **consumer discretionary**, **financial** and **construction sectors** saw the majority of reductions	✓

It's also worth noting that a number of companies made annual share incentive awards to executives during the lockdown period. This resulted in a larger than normal number of shares being awarded due to the lower share price. Remuneration committees will have to ensure that these large grants of shares do not result in unacceptable payouts at the end of the performance period. Investors will also need to keep a close watch on how remuneration committees handle awards and payouts at companies that have needed to raise emergency capital or that have cancelled dividends as a result of the current crisis.

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Banks cut pay as dividends take a hit

Given the impact of COVID-19 on the real economy, regulators acted to preserve healthy balance sheets in key industries. The government also asked UK banks to suspend dividend payments for 2019. Elsewhere in Europe:

- The European Central Bank issued guidance for banks not to pay dividends for financial years 2019 and 2020 until at least 1 January 2021.
- The Swiss Financial Market Authority FINMA urged Swiss-domiciled companies to drop dividend proposals. These moves were intended to boost banks' capacity to absorb losses and to support lending.

In this context, it was encouraging – and unprecedented – to see a large number of major banks announcing various actions to reduce executive pay, including salary cuts, cuts or waiving of bonuses, or agreements to postpone planned compensation increases. Announced pay reductions by some major banks are set out below, although so far many of the commitments have been in form of charitable contributors volunteered by top management. Given dividend cuts, we expect the remuneration committees of banks to clearly communicate with investors their approach for reflecting the impact of COVID-19 in executive pay for 2020. Boards will need to take into account not only the impact on investors but also on staff in the new economic environment, including where layoffs may have been planned pre-coronavirus.

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Selected Banks	Salary, Fees & Pension (top executives and Board directors)	Bonus	Long-term incentive
UK			
HSBC	• Company pension contributions reduced from 30% to 10% of salary (not COVID-related)		
Barclays	• Fixed Pay increase for the CEO and FD postponed until at least 2021 • CEO, FD and Chair to contribute one-third of their Fixed Pay for six months to charitable causes to support vulnerable people impacted by COVID-19 • Company pension contributions reduced to 10% (not COVID-related)		Delayed release of part of 2017 long-term incentive plan due to vest in June 2020
Lloyds Banking Group	• Company pension contributions reduced to 15%. (not COVID-related)	CEO waived 2019 bonus	
Rest of Europe			
Banco Santander	• 50% reduction of salary and bonus for 2020		
Deutsche Bank	• Top managers to waive one month's pay		
Unicredit		Top managers waived 2020 bonus pay and donated equivalent to the UniCredit Foundation to support social initiatives	
UBS	• Top managers to contribute the equivalent of three months' salary to fight coronavirus • From 2020 AGM onward, Board director fees will be reduced (not COVID-related)		

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Final thoughts

Executive pay levels continue to receive media and public attention year after year. The huge increases in pay seen over the past 30 years have not reflected corresponding improvements in market or economic performance, and have become increasingly hard to justify.

However, comparing and contrasting two economic crisis – the global financial crisis in 2008-2010 and the more recent COVID-19 pandemic and subsequent lockdown – we are able to see a notable change of tack between how Boards responded in terms of executive pay.

With payouts running into several million pounds per year for many CEOs, there is clearly a long way to go before a level of pay is reached that society considers fair. However, the fact that a third of companies reduced pay in the lockdown shows significant shift and an improvement when compared to the GFC. The reasonably widespread response to the lockdown, coupled with the reductions in pension contribution also seen in recent years may not be the end of the journey for investors who wish to see executive incentives structured to drive sustainable long-term value creation. It may, however, be the start of an era where remuneration committees feel more comfortable with reducing salary levels if performance is hit. We may also be seeing the first benefits of the remuneration committee being formally required to account of wider workforce pay and conditions.

Certainly, the role of investors has never been as important in delivering a clear message to Boards on pay as it is today. We will continue to engage companies to ensure pay is fair and appropriate in the circumstances. Whilst the current circumstances are, we hope, time-limited, we can try and use this year and the temporary reductions seen as a catalyst for longer-term change.

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Responsible Investment – **a glossary of terms**

Its wide-ranging nature means that responsible investment involves a host of associated language and jargon. Here we explain some of the most commonly used terms.

Active ownership

Discharging responsibilities as investors and owners in a company through engagement and voting to influence the management of environmental, social and governance (ESG) issues.

Stewardship

The responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.*

Environmental, Social and Governance (ESG)

A framework that breaks the broad concept of sustainability down into these 3 key issues.

Engagement

Entering dialogue with companies after investment, to support and encourage positive change in the management of key ESG issues.

Proxy voting

Exercising the right to vote on resolutions at company shareholder meetings. It compliments engagement as a key tool for influencing change.

Sustainable Development Goals (SDGs)

The 17 goals set by the United Nations in 2015 are a global framework for achieving a better and more sustainable future. They address the global challenges we face, including those related to poverty, inequality, climate, environmental degradation, prosperity and peace and justice. The UN is targeting completion of all 17 interconnecting goals by 2030.

* https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship Code_Final2.pdf, p. 4. The Investment Association reserves the right to review its alignment with the FRC definition at any time.

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