Pearl Meyer

Pandemic: Remuneration Committees Take Action

Immediate and future considerations for remuneration committees in responding to the current crisis

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Introduction

- Unlike the 2008 financial crisis, the coronavirus pandemic has created a sudden, exogenous, and far-reaching economic downturn only a few months into 2020.The immediate priority for many companies has been the health and well-being of staff, wherever they are across the globe, along with making arrangements for remote working, moving staff across business units, or repatriation. Sadly, for many this has involved lay-offs and the increasingly common “furloughing” of staff.

- Whilst companies are struggling to cope with the effects of the necessary policies governments are putting in place, or conversely in some cases seeing huge surges in demand for their goods and/or services, boards are also considering what this means in the short and medium term for their people, including remuneration.

- Some organisations have adopted a “wait and see” approach. Others have taken immediate action to conserve cash or to send a message of solidarity and alignment between executives, the wider workforce, investors, and other stakeholders. Actions include pay freezes or in some cases voluntary pay cuts for both executive and non-executive directors. Whichever approach is followed, this is a period of great uncertainty for remuneration committees.

- The areas outlined in this document (see below) are intended to help navigate you through some of the important things to consider in reaching effective decisions. There is no right answer, and some sectors will be affected very differently than others, but noticeable trends *are* now emerging. Above all, it will be important to ensure that any decisions are not only taken in the wider business context but also show the right kind of leadership in the current tough circumstances.

How Should Remuneration Committees Respond?

The challenge remuneration committees are facing is adapting the implementation of their remuneration policy to clearly distinguish between success and failure, while accommodating necessary preservation measures. The right response, and whether it is "wait and see" or "take action now" will depend on the extent to which the business has been affected, both now and in the longer term. Where companies are dealing with lay-offs and furloughing, the response will probably be different to those businesses for whom the pandemic has created an unexpected surge in demand.

Base Pay

- **Cuts and Freezes:** Recent trends have seen a series of pay freezes or cuts. Most companies are limiting solidarity pay cuts to immediate crisis period—for now.
- **Size of the Discount Varies:** It appears related to the pain suffered by the workforce, or the company's dependence on government support; one-tenth seems to be the minimum, others are opting to waive a significant proportion (e.g., Ryanair 50% - for CEO plus all employees)
- **Companies Cutting Base Pay:** Need to consider the impact on any other policies related to base pay, pension, and other insurance benefits.

Adapting Variable Pay Policies

- **Affordability/Workforce Impact:** Not all companies are affected in the same way. However, for those who are hit the hardest, liquidity is the key concern. These companies will take a preservative stance and as a result, become more vigilant about variable pay elements. The approach taken should be aligned with the approach across the organization.
- **Waiver/Deferral of Bonuses already earned:** Several companies are considering the waiver of their annual bonuses or, subject to dilution, payment of earned cash bonuses in shares.
- **Waiver/Delay in grant of Share-Based Awards:** Where it may be considered appropriate, waiving or delaying the grant of share-based awards could be a necessary strategy.
- **Restricted Stock:** Could be advantageous in the context of market uncertainty, using smaller award sizes.
- **Averaging Period:** Investors normally expect at least a reduction in award size where grants are made following a significant share price fall. It's also important to avert from inducing "windfall gains" to executives as a result of the crisis. Some companies are considering the use of a longer averaging period to determine grant size (e.g., 12 months).

How Should Remuneration Committees Respond?

Setting Performance Targets

- This will depend greatly on the severity of the economic impact on each company.
- Companies seeing a windfall revenue growth (such as pharmaceutical and “work from home”-enabling tech companies) could decide to put a heavier weighting on ESG and community actions. Whereas companies on the other side of the spectrum (such as those in hospitality, leisure and retail), will probably be focusing on cash flow, operational efficiency and cost management.
- Performance measures may need to consider how the company has responded, how it has managed the impact on the wider workforce, and how actions may be perceived by investors.
- Consider the impact on, say, earnings per share (EPS) three years out or, if using an average, the impact on more than one cycle, or on relative TSR (e.g., averaging used).
- It may be necessary to set a wider range of performance to allow for the uncertainty of reaching targets.

Use of Discretion at Vesting

- Remuneration committees will need to exercise great care in applying their judgement to ensure that outcomes of incentive plans are proportionate and aligned, as the decisions they take are likely to be scrutinized by investors and the public in a way never seen before.
- Review of outcomes “in the round” at vesting, ensuring they reflect business performance and wider stakeholder impact—investors are likely to consider how the company was performing prior to the crisis.
- Ensure that the ability to use discretion exists in plan documentation.
- Use of positive discretion is likely to be contentious, unless there is evidence of negative discretion having been used in the past to prevent the opposite effect.
- Investors will also want to see clear explanations of any discretion applied, along with any steps that were taken to mitigate the impact of the crisis on the business, and how the wider workforce have been treated.

More than 70% of FTSE 350 companies have experienced a share price fall in excess of 30% from January to March 2020. *(source: Brompton Asset Management)*

Investor Views and Expectations

Financial Institutions:

European Banking Authority (EBA)

Released a statement on the 31 March 2020 urging banks to set variable pay at a conservative level. “To achieve an appropriate alignment with risks stemming from the COVID-19 pandemic a larger part of the variable remuneration could be deferred for a longer period and a larger proportion could be paid out in equity instruments”

Bank Of England (BoE)

Prudential Regulation Authority, the supervisory arm of the BoE, published a statement which included an expectation to refrain from paying any cash bonuses to senior staff and signaled they should stop setting money aside for variable pay during the coming months.

- **PIRC (Pensions & Investment Consultants)**

  On 18 March 2020 PIRC called for suspension of “all payments to executives other than basic salary from 1st April until the end of your financial year.”

- **ISS/IA**

  ISS and Investment Association have indicated that they would not expect to see an adjustment of performance criteria when in-flight LTIP/bonus awards are assessed.

- **High Pay Centre**

  CEO pay cap of ten times the pay of the median worker for large companies bailed out for COVID19 affected performance.

- **BlackRock**

  Have stated that their expectations of companies have not changed, even in light of the new struggles they may face. Michelle Edkins, BlackRock’s Global Head of Investment Stewardship, stated:

  “The concept of long-term sustainability would suggest that companies that come through this crisis and do well would be exactly the kinds of companies you would look to as role models” and that “Companies can still demonstrate that they have effective leadership. In times of crisis that becomes more apparent, not less apparent.”

Investor Views and Expectations (Cont.)

Glass Lewis (26 March 2020)

"The stark reality is that for many workers, including executives, they should not expect to be worth as much as they were before the crisis, because their free market value as human capital has now changed. There is a heavy burden of proof for boards and executives to justify their compensation levels in a drastically different market for talent."

"Trying to make executives whole at even further expense to shareholders and other employees is a certainty for proposals to be rejected and boards to get thrown out—and an open invitation for activists and lawsuits onto a company's back for years to come. Even those companies who project a 'business as usual' approach to executive pay will face opposition if employees and shareholders see their own 'paychecks' cut. Companies would be wise to avoid this."

The UK: What We Are Seeing So Far

Company Name	Executive Remuneration Adjustments
Associated British Foods	CEO and CFO taking 50% pay cuts to base salary. Executive directors will not receive Bonuses for the current financial year. NEDs incur 25% pay cut.
Balfour Beatty	Board and Executive Committee 20% reduction in salary/fees
DFS Furniture	Senior Leaders - Reducing pay and deferring salary reviews
Dunelm Group	Executive Directors reduction in pay and NEDs waived fees for 3 months
Easy Jet	CEO to take 20% pay cut for three month period
First Group	Unspecified range of salary deferrals and sacrifices
Gatwick Airport	Headcount reduction, CEO and senior leadership team are taking a 20% salary cut and waive bonus for current FY
Hammerson	Cancellation of Executive salary and NED fee increase.
Heathrow Airport	It is reported that CEO will waive salary for 3 months, senior team waive salary for 1 month
Informa	CEO & FD 33% other management 25% salary reduction for a period. NEDs 25% cut in fees and paid in shares
InterContinental Hotel Groups	Reduced salary and incentives, including ‘substantial decreases’ for Board and Executive Committee
ITV	Executive directors forgo 2020 annual bonus and will take 20% pay cut until at least 30 June. Board non executive directors will take 20% pay cut.
James Fisher & Sons	Board 20% reduction in salary /fees
Lookers	Board & Senior Management unspecified temporary amendments to remuneration
McCarthy & Stone	Board & leadership team take 20% salary reduction for a period
Primark	CEO 50% pay cut to base pay
Rentokil Initial	Pay cuts for board and senior management, bonus cancelled and LTIP postponed
RPS Group	Deferral of all salary increases and bonus payments for senior leaders
Rugby Football Union	Chief executive, Bill Sweeney, the rest of the executive team and the head coach, Eddie Jones, all agreeing to pay cuts of more than 25%
Ryanair	CEO and airline staff take 50% cut for April and May
Sky	CEO to donate at least 6 months of salary to charities helping people affected by pandemic
Stagecoach Group	50% reduction in all Board salaries/fees for a period. No 2019/20 bonus and no salary increases for the next year
UK & EU Banks	Regulators call for refrain from paying any Cash Bonuses, or setting money aside for Variable pay
Virgin Atlantic	CEO to take 20% pay cut. Executive Leadership pay cut of 15% until end of 2020. Staff asked to take 8 weeks unpaid leave with cost spread over six months’ salary. Voluntary severance packages and sabbatical offered to all employees, reduced pension contributions
WPP	CEO to take 20% pay cut for three month period

The US: CARES Act

The Coronavirus Aid, Relief and Economic Security Act (the "CARES Act") provides $2 trillion in emergency relief to various individuals and businesses impacted by the COVID-19 global pandemic. To receive COVID-19 aid, eligible companies must agree to the following:

Compensation and Severance Limits

- Employees or officers that received between $425,000 and $3M in total compensation in 2019 cannot receive more than what they made in 2019 during any 12-month period.
- Those who received more than $3M in total compensation in 2019 cannot receive total compensation during any 12 months period in excess of $3M + 50% of excess over $3M earned in 2019 (e.g., an executive who received $6M in compensation in 2019 cannot receive more than $4.5M).
- No severance in an amount more than 2x their 2019 total compensation.
- "Total Compensation" broadly includes salary, bonus, awards of stock, and other financial benefits provided.

Duration of Limitations

- Restrictions are in place from time company accepts loan until 1st anniversary of date the loan is no longer outstanding.
- For aircraft carriers and contractors, the restrictions are in place for the two-year period ending on 3/24/2022.

Other Governance and Workforce Restrictions

- There will be no payment of dividends and no stock buybacks until 1 year following loan payoff (or until 9/30/2021 for airline carriers or contractors).
- Air carriers and contractors are prohibited from conducting involuntary furloughs or reducing pay rates and benefits until 9/30/2020

$500 billion will be allotted to provide loans, loan guarantees, and other investments, these will be overseen by a Treasury Department inspector general. These loans will not exceed five years and cannot be forgiven. Airlines will receive $50 billion (of the $500 billion) for passenger air carriers, and $8 billion for cargo air carriers. No payments will be due on the loans for six months, and the interest rate will be 2%.

The US: CARES Act – Recommended Action Steps

Recommended Action Steps

Companies that are considering taking aid should:

1. Identify which employees or officers earned in excess of $425,000 and/or $3M in 2019.
2. Review all employment, change in control, or other contractual commitments with employees who earned over $425,000.
3. Consider whether any employees have already received compensation in 2020 that exceeds limits.
4. Communicate implication of taking aid with those that may be most impacted and consider retention risks of critical talent.

The US: Pearl Meyer Quick Polls

Are companies prepared?

Running period: 10/03/2020 -16 /03/2020

Participants: 233 directors at both public and private companies

82% of compensation committees had not yet started conversations about how the current pandemic will affect incentive pay, while 13% said they have discussed it and 5% were unsure.

Are pay actions being taken?

Running period: 24/3/2020 -27 /3/2020

Participants: 389, including 86 directors and 303 employees.

2020 pay actions

- 50% of respondents indicated that 2020 pay actions have already been made.
- 45% of 2020 pay actions are effective in April or May.
- 55% occurring later in 2020.
- As we approach April 1st, many companies that typically adjust executive pay in April and May are still unsure as to how the pandemic will affect executive salary actions.

Findings

- 25% of respondents indicated that they will freeze executive salaries.
- 3% considered salary freezes but have elected not to and plan to make executive salary adjustments as scheduled, meaning that more than 70% of companies have not finalised plans on this issue.
- For those where pay decisions are made later in the year, more than 60% of respondents indicated that it is too early to tell whether the pandemic will affect executive salary actions.

Doing the Right Thing

Employee Health and Well-being	The most immediate concern for the board, and consequently the remuneration committee will be the health and well-being of all employees. Some may be grappling with illness or struggling to work remotely, or feel exposed to potential harm. These concerns should over-ride all others at the current time.
Demonstrate Leadership	Companies displaying strong and effective leadership will be most likely to weather the crisis, and demonstrate future sustainability. The right leadership responses will include transparent and effective messaging, which inevitably extends to remuneration decisions.
Encourage the Right Behaviours	More than ever, incentive plans should ensure that any performance measures are encouraging the right behaviours, and contributing to the whole workforce, executives and employees, pulling together
Affordability	Cash conservation will be critical if liquidity is to be preserved. Where dividends are being cut or cancelled, there will be an expectation too that executive pay packages will be aligned. In some cases this may involve freezes, suspension or cuts, but could also involve swapping cash for equity where dilution allows.
Fairness and Transparency	Whilst organisations debate broad employee reward actions, this logic should be applied consistently for executives as well. If wider business actions have had a negative impact on staff generally (e.g., redundancies, etc.), investors will scrutinise decisions to treat executives more favourably. Transparency and effective communication are critical.
Reputation Post-Crisis	Although the crisis is immediate and far-reaching, the actions taken now will impact on future reputation. Those companies that have behaved ethically and fairly, regardless of whether the pandemic has had a positive or negative effect on business operations, will be more likely to emerge with reputations intact.

Key Takeaways

Ultimately, remuneration committees will need to take decisions that are within the wider business context, aligned to the wider employee population and other stakeholder interests.

A long-term perspective and sound governance are still required.

As much as ever, it will still be essential to retain and motivate the right behaviours, and provide clarity to the extent possible over incentives at a time of potentially long-term uncertainty.

Communication will be critical to both executives and the wider workforce.

For continually updated resources for the board and remuneration committees, visit www.pearlmeyer.com/coronavirus.

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