Empower Results®

Aon McLagan client briefing
Considerations for 2020 Remuneration Committee year-end decision-making
17 September 2020

Introduction
Each year the agenda for Remuneration Committees is challenging. But, this will not be a normal year-end. Not only has Covid-19 had a real impact on the economy to date but as we approach the end of the third quarter, there is still considerable uncertainty on the economic impact of Covid-19 on year-end results. Of course, some financial services business lines have come through the year unscathed or even benefiting from market volatility while other sectors such as retail and commercial banking have been particularly hard-hit. While no two firms have been impacted in precisely the same way, or to the same extent, we are seeing a number of common issues making their way to the top of Remuneration Committee agendas.

Outside of year-end decision-making, implementation of CRD V and the Investment Firms Directive (IFD) together with resulting changes required to company remuneration policy, remuneration structure and the likely increase to the Material Risk Taker (MRT) population are also important areas for the Remuneration Committee, leading to crowded agendas. These have been covered in separate Aon Client Briefings which can be provided on request.

Bonus pool funding
Firstly, what does the bonus pool look like for the year? We are not seeing fundamental changes to the approach in setting the bonus pool. However, we are hearing some really important questions being raised. Probably, highest profile, is the question of which profit measure to use. Firms generally use some form of adjusted profit and, in most years, there is discussion as to what adjustments are appropriate. This year, some businesses have seen a high level of impairments and write-off of loans. These do not impact cash-flow but they do impact statutory profit which is the bottom line for shareholders. Also, from a prudential and hence a regulatory perspective, the impairments and write-off of loans do impact the strength of the balance sheet and the capital position. So, this will be a tough decision for the Remuneration Committee and they will need to be able to justify their decisions.

Bonus pool allocation
I mentioned earlier that performance has varied across different business lines this year. Many companies have seen very different results in different parts of their business and also in different locations. So, how does this translate into allocation of the bonus pool across the Group and any cross-subsidisation? For larger organisations in particular some form of cross-subsidisation is inevitable and the key will be to strike the balance between adequately rewarding exceptional performance and providing some protection to areas where performance has suffered. Many factors will come into play in the outcome. Firstly, across the different areas of the business and the different locations there may be contractual commitments or collective bargaining requirements. Secondly, in some areas there continue to be real market pressures in the profitable parts of the business and, finally, to what extent can 'out performance' (disaggregated from market opportunity presented by volatility) be demonstrated - so it is important to check that this is supported by robust data and that both the overall compensation cost and the allocation can be justified in relation to performance. Thirdly, some parts

Empower Results®

of the business will inevitably flex their muscles in the year-end process. Finally, the company culture on recognising successful business lines versus a collaborative one Group approach will be a key factor.

Headcount decisions

One of the tools used by companies to date to manage allocation of the bonus pool at year-end is headcount with headcount reduction exercises often having happened around year-end. This year, some companies have held back on restructuring plans to look after their workforce through the Covid-19 pandemic with commitments not to reduce headcount as a result of Covid-19 in 2020. But, what will companies decide to do at the end of this year? Will job security continue to be prioritised into 2021? This is one of the tools in the toolkit as Remuneration Committees look at their options for year-end remuneration decision-making.

Regulatory interventions

We have seen specific communication from the EBA, ECB and the UK PRA on variable pay covering Material Risk Takers (MRTs) in 2020. The PRA has advised that it is not expecting cash bonuses to be paid to senior staff this year and the ECB expects firms to adopt "extreme moderation" on variable pay until 1 January 2021, especially for MRTs. The regulators have also been looking for increased deferral, a longer deferral period and increased use of equity, at least for MRTs. Furthermore, the ECB has set out a requirement for firms to keep their Joint Supervisory Team regularly informed of any changes to a firm's remuneration policy.

This is also a year when it will be particularly important for Remuneration Committees to consider the position on malus. Of specific note, one of the regulatory triggers for malus is where firms suffer a material downturn in financial performance - so it will be particularly important for this to be brought to the Remuneration Committee's attention for their consideration. Discussions with our clients indicate that this will be a particularly tough decision where there have been no misconduct issues and the market downturn is due solely to market movement in a year when many staff may have demonstrated real resilience and commitment to maintain client service. If deferral is going to be increased and/or additional use made of equity, now is the time to do the preparation, consider the scenarios and look into the knock-on effects on the P&L charge, shareholder dilution, policies and employee communication.

Changes to regulation which limit flexibility on 2020 bonuses to be paid early in 2021 may be the curveball at year-end and an area to keep a watching brief. Will further regulation be sector specific? We can expect banks to be targeted given their prudential importance but what about the insurance sector and financial services more broadly? Will regulators look at firms collectively or will their focus be on the major systemically important companies?

Shareholders and other stakeholders

Since the financial crisis we have seen a divergence in the approach taken by regulators and shareholders on pay. Not surprising, since regulators are focused on macro-prudential stability and shareholders are focused on shareholder returns. With many shareholders likely to be disappointed on dividends this year, at least in the banking sector, as a minimum they will expect executive pay to be aligned to the shareholder experience. They will also look for executive pay to be aligned with the approach taken on employee pay and consistent with outcomes for other stakeholders.

Although our feedback is that hardly any financial services firms have taken direct government assistance, some of the government financial assistance has benefited their clients, for example, the

Business Interruption Loan Scheme and the Corporate Finance Facility - and there will be an expectation that this be taken into consideration when assessing the performance underpinning pay decisions.

Last year we saw UK Corporate Governance Code changes requiring Remuneration Committees to consider workforce pay alongside executive pay. They will need to weigh decisions on executive compensation in the overall context of firm performance and impact on all employees and consider how this will be articulated in the Directors' Remuneration Report. In the last few months there has been mounting interest in the Environmental, Social and Corporate Governance, the ESG agenda. 2020 has highlighted that health, economic activity, diversity and inclusion need to be included in the balance. This can be expected to feed through to how the proxy agencies set recommendations and the institutional shareholders vote this year. Pay disclosures will attract attention and be seen against the backdrop of what the company has achieved on the ESG agenda. This is in a year when the contribution of key workers in the fight against Covid-19 has been very visible and the media and politicians will have this front of mind when they look at pay disclosures for executives and at the incentive compensation spend in financial services.

The role of Remuneration Committees this year

All of this amounts to a high profile and thorny agenda for Remuneration Committees this year. It is important for the management team to be aligned with its Remuneration Committee thinking on how to approach the year-end. We are working with our clients on scenario planning, to frame the issues for their Remuneration Committees and help guide them through the considerations that will be paramount this year, the curveballs which need to be anticipated and the discussions with stakeholders which need to be put in diaries and for which preparation is required.

This is a year when Remuneration Committees will need to use their judgement within existing policy and their discretion to take broader factors into account. We are working with clients on setting up a framework to support Remuneration Committees in exercising discretion. When we speak to Remuneration Committee Chairs they are highly conscious that more than any other year, executive pay decisions and the overall P&L charge for compensation will be reputationally important for the company – and, also, will reflect on the Remuneration Committee.

Implementation of CRD V and the Investment Firms Directive (IFD) are additional big-ticket items on the Remuneration Committee agenda. These have been covered by separate Aon Client Briefings which can be provided on request.

For further information please contact me, my colleagues below or your Aon McLagan Relationship Manager.

Claire Morland - Associate Partner
Executive Compensation Financial Services Lead
Email: claire.morland@aon.com

Joel Davies - Partner
Head of Executive Compensation
Email: joel.davies@mclagan.com

Oliver Maslin - Senior Manager
McLagan
Email: oliver.maslin@mclagan.com

The information in this Client Briefing should not be construed as legal advice.