Executive Director Salary Increases: To Align or Not to Align?

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That is the question. At least it is for remuneration committees considering their approach to executive director salary increases for next year. For many years, it has been established practice for executive director salary increases to align with the average increase for the company's broader employee population. This year, where increases for the employee population are expected to be higher than normal given ongoing inflationary pressures, we expect more companies to reconsider whether aligning executive director increases to this level remains appropriate, particularly in light of the latest updates to shareholder guidance which call into question the conventional approach. Our analysis of developments in market data, over the course of the year to date suggests that a trend towards a "discounted" approach is already emerging in this high inflation environment, where executive director increases are at a discount to the workforce average. The analysis also provides an insight into the level of discount we are seeing, suggesting that the higher the level of all-employee increase, the larger the discount for executives might be. While there is a logic for a discounted approach, it may not be right for all companies and careful consideration is required.

ESTABLISHED PRACTICE HAS BEEN TO ALIGN SALARY INCREASES

For those of us who have been practising in the field for some time, we can well remember the days where annual salary increases for executive directors were consistently in excess of 5%, and therefore often significantly above the average level of increase within their broader employee population. In the wake of the financial crisis, shareholder scrutiny in this area increased and an expectation emerged that salary increases for executive directors should align to the employee average, or at least be no higher without an appropriate rationale. Since that time, it has become well established practice across the market that increases normally align to the average employee rate (with divergence typically only in certain circumstances).

Over the last ten years or so, the typical level of salary increase to employee populations has consistently been in the c.2-3% range (in the UK), reflecting a sustained period of low inflation and limited labour market pressures. In these circumstances, awarding executive directors a similar level is not unreasonable.

WHAT IF THE ALL-EMPLOYEE INCREASE IS MUCH HIGHER THAN NORMAL, AS A RESULT OF THE CURRENT INFLATIONARY ENVIRONMENT - DOES THIS CHANGE THE DYNAMIC?

As an example, if the employee average increase is, say, 10%, should executive directors align with this and also receive a 10% increase? There is clearly an argument that the rationale for providing higher levels of increase to lower paid employees this year, necessary to help address current cost-of-living challenges which disproportionately impact these employees, is not as compelling for those on much higher incomes. As a stark example, a 10% increase for an employee on £30,000 may not provide sufficient incremental net income to cover the expected increase in average domestic fuel bills this year. For an executive on a salary of, say, £500,000, an incremental c.£25,000 net from a 10% increase would be expected to more than cover the increased domestic fuel costs for all but the most lavish of residences! And this value understates the incremental impact on likely total package value as a result of the "multiplier" effect through incentive participation.

LATEST SHAREHOLDER PERSPECTIVES URGE CONSIDERATION OF LOWER INCREASES FOR EXECUTIVE DIRECTORS

Guidance updates released by a number of prominent UK institutions in recent weeks indicate an emerging preference for salary increases for executive directors to be lower than the average rate for the workforce:

Investment Association	ISS	LGIM
In their letter to remuneration committee chairs, the IA discusses the need to "delicately" navigate the current cost-of-living / inflationary environment, and state: *"For several years, the IA and our members have considered that salary increases for executive directors should, in normal circumstances, be limited to the level of inflation or the salary increases given to all employees. Whilst we believe that this principle still holds true, in a period of significantly higher inflation, we consider that additional restraint should be shown for executive director salary increases….If salary increases are needed, IA members encourage Committees to consider increases below the rate of salary increases given to all employees"*	In its consultation on proposed policy changes for 2023, the guidance on salary increase will be updated to state: *"Annual increases in salary are expected to be low and ideally lower proportionally than general increases across the broader workforce"* (Updated from the current guidelines which state "expected to be low and in line with general increases across the broader workforce")	In its updated "UK principles on executive pay", LGIM states: *"The remuneration committees of those companies that have decided to give employees on low salaries a significant pay increase to help them navigate the current crisis should exercise caution if they plan to use the average workforce salary increase rate when setting executive salaries"*

MARKET PRACTICE DURING 2022 SUGGESTS A TREND TO "DISCOUNTING" IS ALREADY EMERGING

We believe that many companies have already recognised this issue and have already adopted a "discounted" approach for their executive directors this year (i.e. in the example above, executive directors would not receive 10%, but some lower percentage). Indeed, looking at the development of market data over the last year provides the initial evidence of this emerging trend.

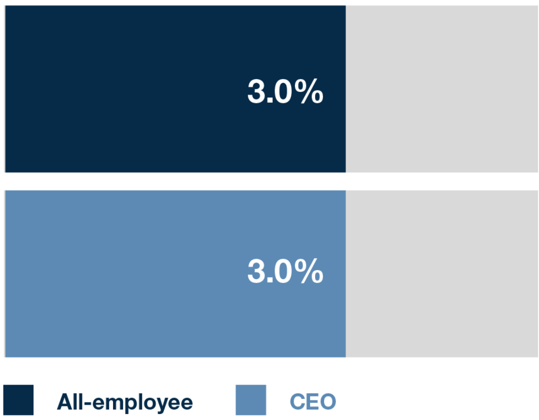
The charts below illustrate the progression of market practice on salaries over the course of 2022. Data are shown for FTSE 350 companies (where the CEO received a salary increase). Practice has been grouped into three samples of companies with year-ends around December, March and June, to illustrate how practice has evolved over the year as expectations for inflation and cost-of-living pressures have become more acute.

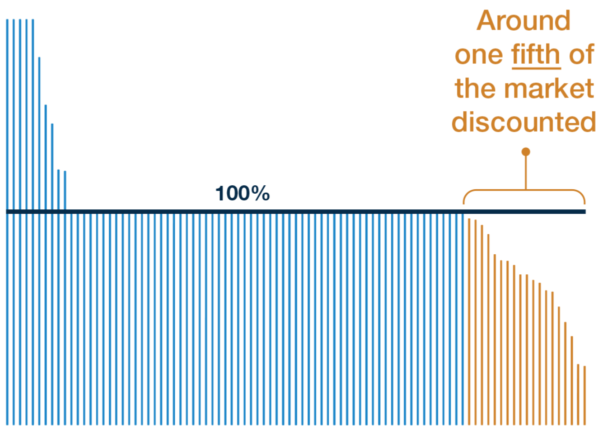
Charts on the left hand-side show the median CEO and all-employee salary increase in each sample. The right-hand side then shows the relativity of the CEO increase to the all-employee increase (i.e. where the CEO increase was aligned to the average employee increase, the value is 100%. Whereas, if, say, the CEO increase was 3% and the all-employee increase was 6%, the value shown would be 50%). Each bar represents one company.

In the December 2021 year-end sample, where salary increases would have been agreed around the start of 2022 when inflation (UK CPI) was running at around 5%, the median CEO increase was aligned to the median employee increase (both 3%), reflecting that a substantial portion of the market was retaining an aligned approach, in line with common practice in previous years. For the March 2022 year-ends, by which time UK inflation had risen to c.7%, the median employee increase was 4% but the median CEO increase had begun to lag this (at 3.3%), reflecting an increase in the proportion of the market adopting a discounted approach. By the time of the June year-ends, UK inflation had reached c.10%, feeding through into a further increase to the median all-employee rate (5%), and a further divergence to the median CEO rate (4%) with over half of this sample now adopting a discounted approach.

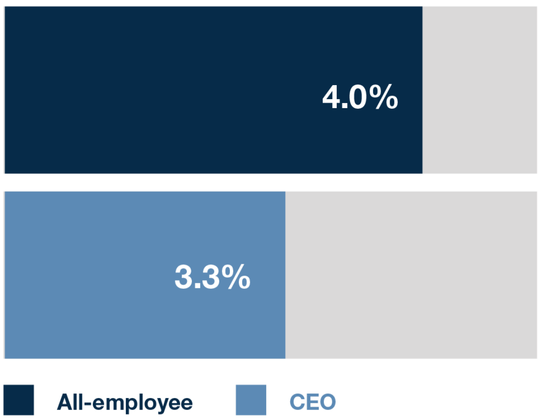
Median salary increases — CEO vs all employees | **Proportion of market taking discounted approach**

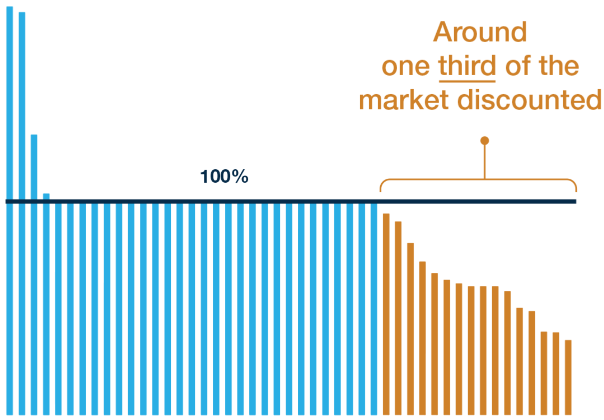
Year-ends around December 2021



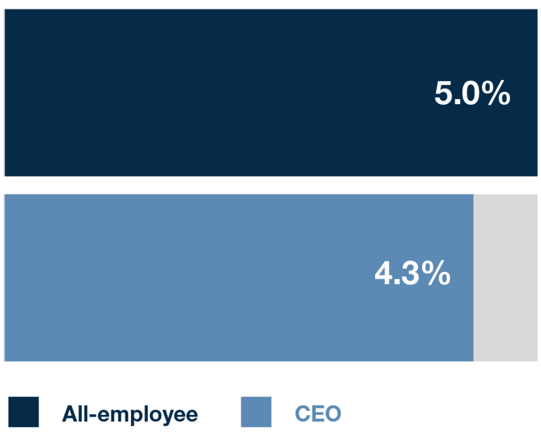


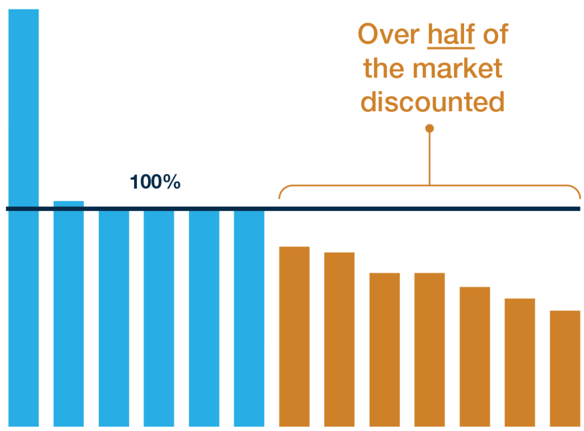
Year-ends around March 2022





Year-ends around June 2022





The sample above for companies with a year-end around June 2022 provides the latest snapshot of practice in the UK market, from the most recent disclosures. While it can be seen that this is a relatively small sample, it would not be surprising for practice in the September year-end sample to follow a broadly similar pattern, or indeed potentially see a further acceleration in the proportion of companies using a discounted approach, particularly now in the additional context of the latest shareholder perspectives outlined above.

We believe that this trend is not simply reflective of a discount being applied to just the CEO (or executive director) roles, but in some cases representative of a "graded" approach to salary increases throughout the wider organisation. As an indicative example, where the overall salary budget "pot" is, say, 7%, this might break down as >10% for the lowest-paid employees, 5-7% for middle management roles, and then lower increases (<5%) for senior management / executive roles. In addition, a number of companies have implemented further one-off cost-of-living support payments, either to all employees or to those below a threshold level of income or seniority.

LOOKING FORWARD – KEY FACTORS TO CONSIDER

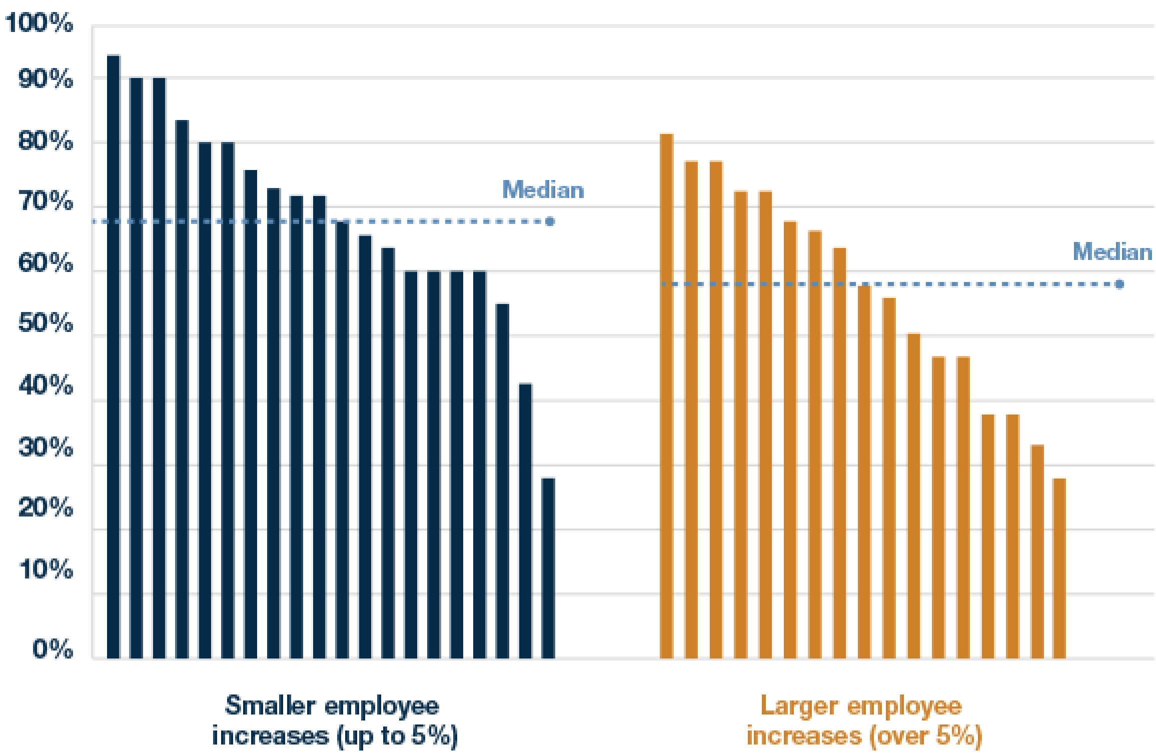
For those companies about to enter their year-end cycle, there is much to think about. While a discounted approach may make sense, it is a complex area to think through. For example:

- What should the discount be? While the latest data above indicate practice coalescing around discounted salary increases of generally around 50-70% of the all-employee rate, clearly this should take into account the absolute level of the all-employee increase itself.

The charts below illustrate the level of discount for the CEO relative to the all-employee rate applied for all companies that have adopted a discounted approach in the samples shown above (i.e. as a reminder, where the CEO increase was 3% and the all-employee increase was 6%, the value shown would be 50% and each bar represents one company).

The data are categorised into two groups based on the level of all-employee increases (one category where the employee increase was up to 5%, and one where the increase was above 5%).

This analysis suggests that the greater the level of all-employee increase, the greater the discount for the CEO increase might be.



- What is our market positioning? For any companies seeking to address an identified shortfall in executive director salaries as compared to the market, discounting at this stage may compound that problem.

- Will we get “left behind”? While unlikely in the context of the latest shareholder guidance, if the emerging trend above does not continue through into the December year-end companies, then discounting now might create a market competitiveness issue tomorrow, which can be challenging to address. Staying abreast of the latest market insights will therefore be important.

- What is our approach to shareholder dialogue and communication? Shareholder scrutiny of executive director salary increases has increased in recent years, and we expect this to be one of the key areas of focus in the 2023 AGM season, as evidenced by the prominence of this issue in the recent guidance released referred to above. In these circumstances, failure to provide a compelling rationale for larger salary increases could increases the risk to the DRR vote, particularly where this is combined with other shareholders concerns. Effective shareholder engagement and communication in the DRR will be critical.

Investment Association Publishes Updated Guidance on Executive Remuneration

Earlier today, the Investment Association published updated Principles of Remuneration and a letter to remuneration committee chairs setting out their members’ expectations for the 2023 AGM season.

Non-Executive Director Fees in the FTSE All-Share – Summer 2022

We have recently completed A&M’s 2022 report on Non-Executive Director (NED) fees for FTSE 100, FTSE 250 and FTSE SmallCap companies.

First 50 Directors’ Remuneration Reports published in 2022

This report identifies executive remuneration trends in the FTSE 350 by analysing the first 50 Directors’ Remuneration Reports published in 2022, and comparing these with the reports for the prior year, for these same companies.

FTSE SmallCap Directors’ Remuneration Trends 2021

A&M is pleased to provide our latest summary of observable trends in FTSE SmallCap Executive Director compensation outcomes.

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