

# **CEO PAY AND THE WORKFORCE**

How employee  
matters impact  
performance-related  
pay in the FTSE 100

The CIPD is the professional body for HR and people development. The registered charity champions better work and working lives and has been setting the benchmark for excellence in people and organisation development for more than 100 years. It has more than 150,000 members across the world, provides thought leadership through independent research on the world of work, and offers professional training and accreditation for those working in HR and learning and development.

# CEO pay and the workforce: how employee matters impact performance-related pay in the FTSE 100

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## Acknowledgements

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## Foreword

The aim of this paper is to encourage a conversation among corporate stakeholders, primarily investors, regulators and remuneration committees (RemCos), as to why employee metrics play a limited part in the executive performance-related pay plans of our largest public limited companies (PLCs).

Businesses often say that their people are their most important asset – while according to a recent report from Grant Thornton UK, 75% of UK listed companies include employee-related factors (such as recruitment and retention) amongst the greatest risks facing their organisation.<sup>1</sup> This is likely to be even higher next year, when annual reports will reflect the impact of COVID-19. Similarly, many large investment houses stress the importance of workplace issues through environmental, social, and governance (ESG) considerations when making financial decisions. This is borne out by a recent CIPD report that finds responsible business has been steadily climbing up the corporate agenda, driven by growing investor and regulatory interest in responsibility and sustainability, and an organisational focus on values and purpose.<sup>2</sup>

Therefore, we could expect most chief executives of the UK's largest firms to be rewarded significantly for the investments they make in the management, development and reward of their people. However, analysis by the High Pay Centre of the targets used by FTSE 100 firms in their CEO bonuses and long-term incentive plans (LTIPs) suggests this is not always the case.

According to this report, just over a third (34%) of our largest PLCs (31 firms) use employee measures in their CEO performance-related pay plans, while the typical proportion on offer in these firms is 5.9% of total variable pay. By contrast, 100% of the FTSE 100 companies that have analysable data on executive performance-related pay have some form of financial metric in their performance-related pay plan (92 firms),<sup>3</sup> while the typical proportion on offer in these firms for hitting these targets is 82.4% of total variable pay.

There are several possible explanations to explore for this situation. Some of the responsibility lies with investors: as things currently stand, investors on the whole have not been voting against remuneration policies that fail to include employee metrics. By way of example, Legal & General Investment Management's most recent executive compensation guidelines are telling in this respect, as they do not mention ESG metrics as a factor to consider when deciding whether to vote on a remuneration policy.<sup>4</sup>

This lack of engagement on employee measures might be because the investor community perceives these measures as unreliable. If shareholders do not regard employee measures as being reliable, it is unlikely that they will support their use in executive remuneration. Similarly, if these measures are not comparable, it becomes difficult for investors to benchmark CEO impact across firms and industries.

Related to this, there might be a lack of awareness among investors about which of the many existing employee measures they should be asking firms to provide. While absolute and relative financial indicators such as total shareholder return (TSR), earnings per share (EPS) or return on capital employed (ROCE) have been used for many years and most

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<sup>1</sup> Grant Thornton UK. (2020) *Corporate governance review 2020*. UK: Grant Thornton UK.

<sup>2</sup> Hope Hailey, V. (2020) *Responsible business through crisis: senior leaders on trust and resilience during COVID-19*. London: Chartered Institute of Personnel and Development.

<sup>3</sup> Not all companies have performance-related pay plans, and of those that do, not all have published analysable data on their pay plans. This is further discussed in the 'Methodology' section of the report.

<sup>4</sup> LGIM. (2019) *LGIM's principles on executive remuneration*. London: Legal & General Investment Management.

investors know what these measures are and why they're important, this is not the case for employee measures.

As yet, there's little agreement about how to define and measure employee absence rates and costs, let alone measures such as employee engagement or inclusivity. Gradual progress is being made in these areas, through such initiatives as the ISO standard for human capital reporting,<sup>5</sup> the reporting requirements of the Securities and Exchange Commission (SEC) in the USA,<sup>6</sup> and the Financial Reporting Council (FRC)<sup>7</sup> in the UK. Adopting a standardised approach to measuring human capital will allow investors and RemCos to benchmark the performance of organisations and CEO remuneration. However, a lack of consensus over what methodology to use should not prevent companies from developing their own approaches.

There is a role for the RemCo to explore with their stakeholders which people metrics, as well as other ESG measures, should be used to reward, recognise and incentivise senior executives and why. The default ought to be that all publicly listed firms should use such measures, but they must also be free to select those that make most sense for their situation. There are implications for the people profession in terms of working with RemCos to help them to produce the right workforce metrics, at the right time and in the right format.

This report is part of wider work in this area. In recent years, the CIPD has partnered with the FRC to deliver work and insight on the role of people metrics in corporate governance. We were one of the partners contributing to the FRC's 2016 Culture Coalition project, culminating in the report *Corporate Culture and the Role of Boards*.<sup>8</sup> In 2019, the CIPD held several HR leader roundtables on reporting on culture and people and the adoption of the revised Corporate Governance Code, in partnership with the FRC. Looking forward, the CIPD and the HPC are engaged in a project to help RemCos have better conversations with their investors.

The CIPD is also working with UK and international bodies to help standardise employee measures so that investors and other corporate stakeholders know what they mean and how they should be calculated. It is also looking at the links between employee engagement and organisation performance, and metrics in this area that may be appropriate to inform CEO pay. In addition, the CIPD is also exploring how firms can report on their people measures more generally so stakeholders get a better idea of the effectiveness of the people management policies.

Hopefully this report will help kickstart a conversation among investors, regulators and RemCos about their attitudes to the use of employee measures, both in terms of how they should be used to determine senior pay as well as how employee measures should be reported so that appropriate investment decisions can be made.

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<sup>5</sup> ISO. (2018) [\*Human resource management: guidelines for internal and external human capital reporting\*](#). International Organization for Standardization

<sup>6</sup> Clayton, J. (2020) [\*Modernizing the framework for business, legal proceedings and risk factor disclosures\*](#). U.S. Securities and Exchange Commission. 26 August.

<sup>7</sup> FRC. (2020) [\*Workforce-related corporate reporting: where to next?\*](#) London: Financial Reporting Council.

<sup>8</sup> FRC. (2016) [\*Corporate culture and the role of boards\*](#). London: Financial Reporting Council.

## Key findings

Based on analysis of active FTSE 100 board-level performance-related pay plans, using information available from the most recently published annual reports as of the first quarter of 2020, the High Pay Centre finds:

- **34%** of FTSE 100 companies used employee metrics in their performance-related pay package (31 companies). This comprised **30%** of companies with employee metrics in their bonus (27 firms) and **9%** with employee metrics in their LTIP.
- The average weighting of employee metrics in performance-related pay across the FTSE 100 was **2%**. If we consider only those businesses with employee metrics in their incentive plans, average weighting was **5.9%**.
- The companies with the highest weighting attached to employee-related metrics were Fresnillo (17%), BHP (11.8%), Polymetal (11.4%), Whitbread (10%) and Centrica (9%).
- In annual bonuses, the average weighting for employee metrics was **3.3%** across all companies and **11.2%** for those firms with employee metrics in their bonuses.
- For LTIPs, the average weighting was **0.8%** across the FTSE 100 and **9%** for those businesses with employee metrics in their LTIPs.
- The three most used employee metrics for bonuses were: health and safety (12 companies); employee engagement (10); and diversity and/or inclusion (9).
- The three most used metrics for LTIPs were: employee engagement (4 firms); conduct/culture (2); and diversity and/or inclusion (2).
- By way of contrast, financial metrics were universally used in performance-related pay. All (**100%**) of the FTSE 100 organisations that had analysable data on performance-related pay had some form of financial metric in their performance-related pay plan (92 companies).
- This comprised **99%** of companies with financial metrics in their bonus (90 companies) and **100%** of companies with financial metrics in their LTIP (88 companies).
- Financial metrics had an average weighting of **82.4%** of total maximum incentive pay across the FTSE 100. Given that the average weighting for employee metrics in performance-related pay across the FTSE 100 was **2%**, this suggests that pursuing financial returns is potentially 41 times more rewarding than prioritising the interests of workers.
- Though the analysis finds that employee-related metrics still constitute a small proportion of total potential incentive pay, their use is increasing, albeit from a low base. The challenge for stakeholders now is to highlight the value of corporate measurement of employee-related performance, and to enhance our understanding of the most effective performance metrics.

## Introduction

### Profit or progressive employment: potentially competing objectives

Approximately 11 million people in the UK are employed by large businesses, roughly a third of the UK's working population.<sup>9</sup> Given that the largest employers often outsource a substantial portion of their operations and also play a major role in determining the pay and conditions of workers across their sectors and along supply chains, even this large number is likely to understate the influence of their employment practices on people's incomes, skills, career progression and, ultimately, their quality of life.

By providing decent, well-paid employment, with training that improves workers' capabilities and opportunities in a welcoming, productive environment, businesses as employers can undoubtedly be a force for good.

Yet at the same time, it is not hard to imagine circumstances in which the pursuit of profit can come into conflict with the interests of their workers and of wider society.

Holding down wages or deferring investment in training or health and safety processes can reduce business costs – at least in the short term. Managers striving to raise output may be tempted to make more onerous demands of their workforce.

The pressure to deliver greater profits makes these kinds of decisions more tempting, but poses a risk to the finances and wellbeing of UK workers.

### The economic and social impact

There is evidence to suggest that these conflicts of interest are negatively affecting employment practices. The UK is one of the most unequal countries in the developed world, with higher levels of income inequality than all EU member states except for Bulgaria, Lithuania, Latvia and Romania.<sup>10</sup> A decade on from the financial crisis, real average weekly earnings for UK workers only passed pre-crisis levels in 2020, and this is before the likely negative impact of COVID-19 on pay and employment levels is accounted for.<sup>11</sup>

It is not the case that businesses, let alone large businesses, are solely responsible for these developments. But obviously, the pay practices of our largest employers do contribute towards pay inequality and pay stagnation across the wider economy.

Public opinion certainly appears to hold that businesses focus too much on profit maximisation and not enough on their responsibilities to society. Polling by YouGov found that a majority of people in the UK disagreed with the notion that what is good for business is usually good for the rest of society.<sup>12</sup> A similar poll by Populus found that 71% of respondents disagreed that profit should be the primary concern for businesses ahead of other.<sup>13</sup>

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<sup>9</sup> BEIS. (2019) *Business population estimates for the UK and the regions 2019*. London: Department for Business, Energy and Industrial Strategy.

<sup>10</sup> Eurostat. *Gini coefficient of equivalised disposable income – EU-SILC survey*.

<sup>11</sup> ONS. (2020) *Labour market economic commentary: February 2020*. London: Office for National Statistics.

<sup>12</sup> Montgomerie, T. (2015) *What the world thinks of capitalism: YouGov's seven nation poll for the Legatum Institute*. Shorthand Social.

<sup>13</sup> Populus. (2017) *Left wing populism survey 2017*. London: Populus

If we want to create a fair and sustainable society – where businesses enjoy the full confidence of the public – we must ensure that the pursuit of profit maximisation does not conflict with society’s urgent need for well-paid, secure, fulfilling work.

### **Employment practices and the pandemic**

The COVID-19 pandemic has brought the subject of corporate employment models to the fore. Several high-profile examples have highlighted the impact that health and safety issues and compliance with labour standards can have on both individual businesses and society as a whole. In the case of Boohoo.com, revelations of exploitative working practice and breaches of COVID-19 health and safety regulations in the UK led to a sudden and dramatic fall in the value of its shares.<sup>14</sup> As of September 2020, the Food Standards Agency was reporting COVID-19 outbreaks at 40 separate food processing factories, including operations run by major listed companies such as Greencore and Greggs.<sup>15</sup>

The pandemic has also brought about an increased public recognition that many of the UK’s essential and front-line workers are on low wages and insecure contracts that do not reflect the value of their contribution to society. It is possible that in the long term this may result in greater public scrutiny over how companies treat their workers.

### **The business case for progressive employment practices**

More broadly, the importance of companies’ overall resilience and sustainability has been starkly highlighted by the pandemic. Environmental, social and governance (ESG) funds have outperformed their broad-market equivalents during the economic downturn.<sup>16</sup> While it is unclear how much of this is related to workforce strategies as opposed to ‘E’ or ‘G’ factors, it seems intuitive that those companies that were already engaging effectively with employees and had measures in place to promote health, safety and wellbeing would be better prepared for a public health crisis.

This emphasises the more positive argument that, in addition to the fact that good treatment of workers is good for the workers and society, in many cases it is also good for the company in the long run. Workers who are fairly paid and fairly treated at work, and feel they are contributing to a meaningful project while progressing their careers and having a sense of ownership and agency in their working lives, are likely to be more engaged, committed and productive.

This is borne out by several studies. In particular, measures of ‘work engagement’, employee commitment, and how strongly employees identify with their organisations are seen to predict performance. This is especially the case for contextual performance (the contributions an employee makes in addition to their core role) and to some extent task performance (the contributions an employee makes within their role). This is discussed further in a forthcoming CIPD evidence review on employee engagement. Overall, there is an increasing appreciation amongst investors and boards alike of the value the workforce brings to the company and the importance of employee engagement.<sup>17</sup>

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<sup>14</sup> Butler, S. (2020) [Boohoo shares drop 18% as new Leicester factory reports threaten sales](#). *The Guardian*. 13 July.

<sup>15</sup> Culbertson, A. (2020) [Coronavirus: why are COVID-19 outbreaks happening in food factories?](#) *Sky News*. 1 September.

<sup>16</sup> Nauman, B. (2020) [Coronavirus is strengthening the hand of investors](#). *Financial Times*. 15 May.

<sup>17</sup> See, for example, FRC. (2020) [Workforce-related corporate reporting: where to next?](#) London: Financial Reporting Council

## The rise of ESG

While the practice of ethical investing in the UK can be traced as far back as the eighteenth century,<sup>18</sup> there has long been a notion amongst investors that a trade-off exists between financial returns and the pursuit of an ethical business strategy.

Over the last couple of decades, a growing body of evidence has emerged to suggest that the incorporation of ESG factors into business investment and stewardship strategies creates long-term value for companies.<sup>19</sup>

Along with shifts in societal attitudes, changes in regulation, and international initiatives providing frameworks for sustainable investing such as the UN Sustainable Development Goals and the UN Principles for Responsible Investment, this has led to an increase in investor and employer interest in ESG. Analysis by Morningstar noted that ESG funds experienced a record \$21 billion of inflows in 2019, four times the previous record set the previous year.<sup>20</sup> In 2019, the Business Roundtable group of CEOs of American companies also issued a statement repudiating the notion that corporations exist principally to serve their shareholders, and setting out obligations to a broader range of stakeholders.<sup>21</sup> And in September 2020, the 'Big Four' accounting firms revealed a framework that they had jointly created for ESG standards, stating that this framework would *'take what the Business Roundtable put out last year and make it real'*.<sup>22</sup>

## Social movements

In addition to this, recent social movements and developments have brought workforce issues to the fore in public debate in a number of ways: for example, the Black Lives Matter and #MeToo movements have respectively drawn attention to institutional racism and sexual harassment in the workplace, and initiatives such as the 30% Club,<sup>23</sup> the Hampton-Alexander Review<sup>24</sup> and the Parker Review<sup>25</sup> have been pushing for greater gender and ethnic diversity at board and senior management levels. These campaigns have put pressure on companies to demonstrate how they are tackling these problems and to report on their strategies regarding inclusion and diversity.

It is clearly the case that there is both a 'high road' and a 'low road' to business success in terms of treatment of workers – and high-profile examples of poor employment practices associated with companies such as Boohoo.com and Sports Direct (where there have been ongoing concerns over breaches of minimum wage law) suggest that some business leaders

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<sup>18</sup> Portfolio Adviser. (2020) [John Monaghan: a short history of ESG investing](#). *Portfolio Adviser*. 28 May.

<sup>19</sup> See, for example, International Finance Corporation. (2005) [Investing for long-term value: integrating environmental, social and governance value drivers in asset management and financial research](#). Who Cares Wins 2005 Conference Report.

<sup>20</sup> Iacurci, G. (2020) [Money moving into environmental funds shatters previous record](#). *CNBC*. 14 January.

<sup>21</sup> Business Roundtable. (2019) [Business Roundtable redefines the purpose of a corporation to promote 'an economy that serves all Americans'](#). *Business Roundtable*. 19 August.

<sup>22</sup> Nauman, B. (2020) [What you might have missed on day 1 on UNGA and Climate Week](#). *Financial Times*. 22 September.

<sup>23</sup> [The 30% Club](#).

<sup>24</sup> [Hampton-Alexander Review](#).

<sup>25</sup> [The Parker Review](#).

are still to be convinced that treating their workforce better will yield increased financial returns.

But the fact that research suggests that more progressive pay and employment practices need not necessarily compromise profitability and financial returns, while undoubtedly providing better outcomes for workers and for society as a whole, only emphasises the imperative for good people management at the UK's biggest companies.

### CEO pay incentives

One way of working towards better people management is to establish incentives, penalties and governance structures for business leaders that encourage them to act in a manner consistent with the public interest. The executive pay packages of our biggest businesses offer a useful insight in this respect.

CEO pay is heavily incentivised, with 74% of the average FTSE 100 CEO pay awards consisting of short- and long-term incentive payments.<sup>26</sup> These incentive pay packages tend to be made up of a range of different performance metrics.

If CEOs receive higher pay awards from generating higher returns to shareholders, we can arguably expect them to take decisions that will lead to this outcome, even when these decisions also result in negative social or environmental outcomes. However, if their pay packages reflect a more balanced range of stakeholder interests, with targets linked to social or environmental as well as financial measures, it follows that they will also act with greater regard to society and the environment.

It is, of course, important to recognise that financial incentives are not the only factors that drive CEOs' decision-making, or indeed human decision-making more generally. However, they are usually the most direct way that a company can influence the behaviour of its employees. The composition and weighting of incentives provides an insight into the priorities of the committee that sets the targets, and thus of the priorities and culture of the company as a whole, since their decisions and delegations are likely to focus on whatever performance target will trigger an incentive payment. Including ESG targets in the CEO's remuneration package demonstrates that these targets are a priority at the highest level of the organisation. For this reason, the use of ESG metrics in performance-related pay is becoming an increasingly important consideration for investors.<sup>27</sup>

The High Pay Centre undertook an analysis of the type of performance-related metrics used across the FTSE 100 index, which comprises the biggest UK-listed businesses. Our analysis focuses on employee-related metrics, looking at how many companies use metrics related to their workforce in their performance-related pay plans, and what proportion of maximum incentive pay these metrics relate to. The analysis differs from many others on this topic, in that we have only considered companies to have used employee-related metrics if the potential value of the metric is disclosed (either in cash terms or as a percentage of salary). This is because the presence of a particular performance metric in a pay plan tells us little if its potential value is incalculable, both in absolute terms and relative to other (potentially conflicting) performance targets. The full details of our approach are given in the 'Methodology' section at the end of the report.

The data we use is from company reports published by Q1 2020 with the latest year-ends being in September 2019: in this respect, the analysis will provide a useful basis for

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<sup>26</sup> CIPD. (2020) *FTSE 100 CEO pay in 2019 and during the pandemic*. London: Chartered Institute of Personnel and Development.

<sup>27</sup> Dunne, M. (2020) *Executive pay: a piece of the action*. *Portfolio Institutional*. 7 September.

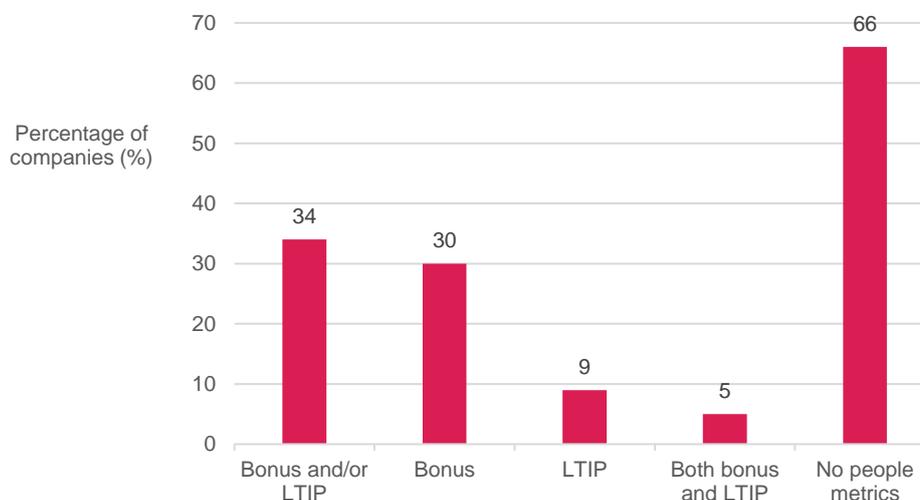
comparing the use of people metrics by companies before and after the COVID-19 outbreak, given that the pandemic has brought increased scrutiny into how companies treat their workers.

## Findings

### Proportions of companies using particular metrics

**34%** of FTSE 100 companies used employee metrics in their performance-related pay package (31 companies). This comprised **30%** of companies with employee metrics in their bonus (27 companies) and **9%** with employee metrics in their LTIP (8 companies). Anglo American, Barclays, Lloyds and Standard Chartered include employee metrics in both their bonuses and their LTIPs (**5%** of companies).

**Figure 1: Percentage of FTSE 100 companies using employee metrics in their performance-related pay plans**



The recent rise of ‘ESG investing’ means that ESG performance measurement – including, but not limited to, executive pay plans – is a relatively new development. As bonus payments account for a smaller proportion of variable pay and operate on a shorter timescale (typically 12 months) than multi-year LTIPs, companies may see it as more straightforward to incorporate ESG metrics into the bonus rather than the LTIP. This possibly explains why employee-related metrics are much more common in bonus plans than LTIPs.<sup>28</sup> However, this arguably makes little sense, as better people management ought to be seen as a long-term strategy with long-term goals and targets.

Providing good-quality work should also be seen as a long-term objective for companies in its own right, rather than as a ‘means’ to a more important ‘end’ (with the end being financial returns to shareholders).

### Weightings of metrics

As well as establishing how many companies use some form of employee metric in their performance-related pay plan, it is important to know what proportion of the CEO’s total

<sup>28</sup> Personal correspondence with Corinne Carr, 4 September 2020. See also Carr, C. (2018) *Responsible reward: fulfil your environmental, social and governance promises through performance and pay*. Kent: PeopleNet, p46.

maximum pay these metrics account for. The average weighting of employee metrics in performance-related pay across the FTSE 100 was **2%** and **5.9%** if we take into account only the companies with employee metrics in their incentive plans.

In annual bonuses, the average weighting for employee metrics was **3.3%** across all companies and **11.2%** for those companies with employee metrics in their bonuses.

For LTIPs, the average weighting was **0.8%** across the FTSE 100 and **9%** for those companies with employee metrics in their LTIPs.

Our analysis finds that all ESG metrics (including employee metrics, but also other social metrics as well as environmental and governance metrics) account for just **4.2%** of total potential incentive pay on average across all FTSE 100 companies, and **9.4%** for those companies that use some form of ESG metrics.

Interestingly, this means that across the FTSE 100 employee metrics account for almost half of all potential pay linked to ESG metrics. Given that the ‘social’ element of ESG covers issues relating to customers, suppliers and communities as well as direct employees, the ‘S’ of ESG element is likely to comprise over half the value of potential ESG-linked performance-related pay.

It is generally felt that in recent years shareholders have engaged less on the ‘social’ element in ESG than on the ‘environmental’ and ‘governance’ elements.<sup>29</sup> The fact that social issues are more highly represented in CEO pay packages – which serve as a useful proxy for the priorities of the boards who set them and the shareholders who validate them – suggests that on this aspect of shareholder stewardship, the reverse may be true.

However, there is of course no reason why environmental, social and governance metrics could not all be incorporated into performance-related pay plans to a much greater extent.

The main implication of our finding on employee-related metrics is that they are still only used by a minority of companies, and that they only account for a tiny proportion of maximum incentive pay.

### **Financial metrics**

It is instructive to compare the prevalence of employee-related metrics with those measures relating to earnings, profitability and returns to shareholders.

We have grouped the following performance measures under the heading ‘financial metrics’ to contrast with our analysis of the ‘employee metrics’:

- earnings per share
- total shareholder return
- earnings or profitability
- net asset value or property-related metrics
- return on capital employed
- cashflow-related metrics
- revenue or sales-related metrics.

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<sup>29</sup> See, for example, Esposito, A. (2020) [Why the ‘S’ in ESG is important](#). *Morningstar*. 21 July.

Using this definition, 'financial metrics' are universally used: **100%** of the FTSE 100 companies that have analysable data on performance-related pay have some form of financial metric in their performance-related pay plan (92 companies).

This comprises **99%** of companies with financial metrics in their bonus (90 companies) and **100%** of companies with financial metrics in their LTIP (88 companies).

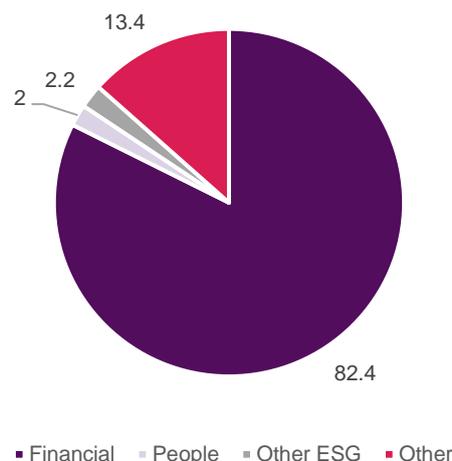
Financial metrics have an average weighting of **82.4%** of total potential incentive pay across the FTSE 100. All of the companies with analysable data for performance-related pay used financial metrics somewhere in their pay plans.

The average weighting for financial metrics in bonuses was **71.3%** for all companies, and **72.1%** across the companies that used financial metrics in their bonuses (this was all companies bar one).

For LTIPs, the average weighting for financial metrics was **93.2%** across the FTSE 100. All of the companies with analysable data for LTIPs used financial metrics.

On average, then, **82.4%** of maximum performance-related pay was based on financial targets versus just **2%** for employee-related targets. Pursuing financial returns is therefore potentially around **41 times** more rewarding than pursuing good outcomes for employees.

**Figure 2: Average weightings of financial and employee metrics in incentive pay plans across the FTSE100**<sup>30</sup>



This is an extreme imbalance. Weightings of performance metrics reflect what boards and investors prioritise from their CEOs. There are inevitably occasions when companies' responsibilities to their workforce will come into conflict with the possibility of maximising profits, at least in the short term. It would be unsurprising if this vast imbalance in favour of financial metrics was also reflected in CEOs' decision-making whenever these conflicts occur.

For the minority of companies that do include employee-related targets in performance-related pay plans, it is still the case for many that the incentive to act in the interests of employees is so small in comparison with the incentive to pursue financial returns that it is essentially no incentive. To give a typical example, if a CEO is faced with an 80% weighting

<sup>30</sup> 'Other' metrics tend to be strategic targets and could include goals such as rolling out new technologies or expanding operations.

on financial metrics and a 5% weighting on employee-related matters, in practice that CEO is likely to give very little consideration to the employee-related target, if any at all.

### **Other studies on the use of ESG metrics in performance-related pay**

ESG performance metrics are an area of increasing interest for researchers as well as practitioners, and several other studies have been carried out looking into this in the UK and across Europe. Findings differ according to the methodology used, including the sample of companies, the period covered, what kind of metrics are counted and whether metrics are counted if they are disclosed without a weighting. Nonetheless, the findings of recent studies are consistent in that they all find a minority of companies using ESG metrics and with low average weightings (or whichever subset of ESG metrics they are looking at). However, they do suggest that the use of ESG metrics, including employee-related metrics, is increasing.

One example is a study by Vlerick Business School.<sup>31</sup> Their sample included the STOXX Europe 600 (the largest listed European firms) as well as full coverage of the Belgian and Dutch stock exchange. In this study, UK companies (a much smaller sample than in this report) compared favourably with others in terms of the percentage of companies that used employee metrics and disclosed weightings for these. In the UK sample, 16.8% of companies used weighted employee metrics in their bonus, and 2.2% used weighted employee metrics in their LTIP. For bonuses, this was the highest percentage of any of the countries included. Belgium and Germany, for example, had 4.8% and 3.6%, respectively, of companies using weighted employee metrics.

The Grant Thornton annual *Corporate Governance Review 2020* found that 19% of the FTSE 350 use employee metrics in their bonuses (53 companies) and 4% use it in their LTIPs (11 companies). This is despite 75% of companies listing employee aspects as a major risk to their business (such as the risk of not being able to recruit or retain talent) and 44% of companies having an employee metric listed as a key performance indicator for their business.<sup>32</sup> The lower percentage of companies using employee metrics in pay is likely due to studying the FTSE 350, and suggests the issue is worse in smaller companies.

Deloitte's 2020 *Executive Remuneration* survey reported that 40% of FTSE 100 firms used ESG metrics in their performance-related pay plans – but that this represented an increase from around 20% the previous year.<sup>33</sup>

When the High Pay Centre previously looked at this topic in 2013, it also found that far fewer companies used ESG metrics than is currently the case.<sup>34</sup>

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<sup>31</sup> Data provided for the HPC and the CIPD by Bettina De Ruyck and Xavier Baeten of Vlerick University, March 2020.

<sup>32</sup> Grant Thornton UK. (2020) *Corporate governance review 2020*. UK: Grant Thornton UK.

<sup>33</sup> Thomas, D. (2020) [UK companies take pay cuts ahead of pandemic](#). *Financial Times*. 10 August.

<sup>34</sup> High Pay Centre. (2013) [Paid to perform: what do we want our business leaders to achieve?](#) London: High Pay Centre.

## Top employee-related performers

While the average weighting for employee-related metrics in performance-related pay plans across the FTSE 100 is very low, there are a small number of companies with substantially higher weightings.

Table 1 shows the five companies with the highest weighting for employee metrics as a proportion of maximum incentive-related pay.

**Table 1: The five companies with the highest weighting for employee metrics as a proportion of maximum incentive-related pay**

Company	Percentage of total incentive pay comprising employee metrics (%)
Fresnillo	17
BHP	11.8
Polymetal	11.4
Whitbread	10
Centrica	9

Mining companies (Fresnillo, BHP and Polymetal) rank particularly highly in this table. Mining is a high-risk operation and given the risk to employees involved, these companies usually include significant weightings for health and safety metrics – which come under the category of employee metrics – in their performance-related pay plans.

This reflects our wider findings: health and safety metrics were the most commonly used employee-related metrics across the FTSE100, followed by employee engagement.

Table 2 shows the five most used employee metrics for bonuses.

**Table 2: Most commonly used employee-related performance metrics in FTSE 100 CEO bonuses**

Performance measure	No. of companies using in bonus
Health and safety	12
Employee engagement	10
Diversity and/or inclusion	9
Succession planning	4
Conduct/culture	3

Table 3 (see p 14) shows the employee metrics used most often by companies in their LTIPs.

**Table 3: Most commonly used employee-related performance metrics in FTSE 100 CEO LTIPs**

Performance measure	No. of companies using in LTIP
Employee engagement	4
Conduct/culture	2
Diversity and/or inclusion	2

The dominance of ‘health and safety’ and ‘employee engagement’ metrics may reflect the mantra that ‘what gets measured gets managed’ – employee engagement through staff surveys and health and safety through proxies, such as the number of workplace injuries, are both relatively simple to measure. Conversely, performance in areas such as corporate culture is more nebulous. However, many measures of employee engagement are not seen as reliable, and the vast array of potential measures makes standardised reporting and comparisons difficult. Forthcoming work by the CIPD will provide an evidence review of employee engagement to investigate this further and advise how organisations can measure it robustly.

The dominance of financial measures relative to employee measures is consistent with corporate governance structures that give shareholders the final say over the appointment of directors and the approval of their pay policies. Therefore, financial metrics that benefit shareholders are strongly favoured over employee-related metrics that relate to good outcomes for employees.

However, the fact that the metrics for measuring financial performance – profits, revenue, shareholder returns – are well established is also significant. Measuring performance in terms of people management is less well understood and less common practice.

Therefore, our findings suggest a potential need both for additional stakeholder voices in corporate governance structures, and for more work exploring how to understand company performance in terms of people management.

## Conclusions and recommendations

Despite the growth of investor interest in ESG over recent years, our analysis finds low average weightings for employee metrics in CEO performance-related pay plans, with most performance-related pay plans lacking any employee metrics. While changes such as the impact of COVID-19, the rise of ESG investing and continued wider social pressure on business practices may encourage more companies to use employee metrics, this growth is starting from a very low point when it comes to incentive pay. Most FTSE 100 companies’ incentive pay plans do not reflect a balance of stakeholder interests, and are dominated by financial measures.

The low usage of employee metrics in performance-related pay is likely to be due to several factors and a range of different actors. Attitudes are important: while institutional investors largely acknowledge that sustainability is growing in importance in financial markets, many see it as a challenge and some still think that there is a trade-off between sustainable investing and financial returns. Attitudes vary amongst individual, private investors too:

Millennials on average care much more about environmental and social issues than older investors.<sup>35</sup>

The same issue exists amongst employers, many of whom still state in their annual reports that shareholder value is their top priority. Nonetheless, a growing number are recognising the material benefits of treating their workers well. In 2013, only two of the FTSE 100 had signed up to pay their employees the Living Wage, but as of September 2020 the number stands at 41, demonstrating that these companies recognise the importance of financial wellbeing<sup>36</sup> across the workforce.

However, companies often find it challenging to connect their business strategy to their remuneration strategy. It is common to see companies discussing ESG as part of their business strategy, but omitting to reflect this in their performance-related pay.<sup>37</sup> This is in part due to the difficulty or perceived difficulty of measuring 'softer' and potentially interconnected targets such as employee engagement, culture or inclusion. It is also the case that connecting stated company values with incentive pay is a very recent development, and companies are still working out how best to do this. Finally, media, consultancies and the investor community generate far more hype and 'noise' relating to companies' financial affairs than they do in response to ESG matters: this creates a culture that elevates financial measures above all others.

How can we ensure that pay packages reflect a balance of stakeholder interests? One approach is to focus on pay governance. Previous research by the High Pay Centre and the CIPD<sup>38</sup> has highlighted the need to broaden the remit of RemCos to ensure that when setting executive pay they have a wider focus on issues such as organisational culture, diversity, wellbeing and the rewards of the wider workforce.

The need for RemCos to have a broader remit to consider workforce engagement and pay is highlighted in the UK Corporate Governance Code, which requires companies to monitor pay practices across their organisation and ensure that executive pay levels are fair and proportionate. It will be impossible to fulfil this remit without reflecting on factors such as the diversity, skills, capabilities, stability and morale of the company workforce, which both determine pay levels and are shaped by them.

We recommend that to ensure that RemCos meet this wider remit they should evolve into people and culture committees, or at least their scope should be formally extended in their terms of reference so they adopt this broader, more strategic role in setting executive pay.

Our research also found that RemCos tend to have a narrow range of expertise and backgrounds represented, notably lacking members with HR or people management experience.<sup>39</sup> This results in a limited understanding of the broader system that is the company, meaning that the company's purpose is understood predominantly in financial

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<sup>35</sup> See, for example, Carr, C. (2018) *Responsible reward: fulfil your environmental, social and governance promises through performance and pay*. Kent: PeopleNet; and Businesswire. (2019) *Socially responsible investing and ESG: it's not just a millennial trend*. Businesswire. 12 August.

<sup>36</sup> Living Wage Foundation. (2020) *Investing in the Living Wage: a toolkit for responsible investors*. London: Living Wage Foundation.

<sup>37</sup> Carr, C. (2020) *Paying for good: 'the world of reward' with Matt Brooks*. Podcast. Series 1, episode 2. 9 July.

<sup>38</sup> CIPD. (2019) *RemCo reform: governing successful organisations that benefit everyone*. London: Chartered Institute of Personnel and Development.

<sup>39</sup> Ibid.

terms. This perspective is then likely to be reflected in performance metrics. We suggest that professionals with people management experience, as well as representatives of stakeholder communities, including the company's workforce, should be appointed to RemCos more frequently than they are currently.

On the company board as a whole a similar problem is apparent. Boards are dominated by senior business figures and leading professionals who have spent a relatively long time in executive roles. They in turn are accountable to shareholders, whose interests are managed by professional investment fund managers, and who are primarily concerned with generating a financial return on their investment. In this system there is little space given for input from other stakeholder voices with a practical perspective on why the company needs to improve the working lives of its employees and how they might go about doing so. Worker representation on company boards is one mechanism that would fill this gap; non-executive directors with an HR background is another.

There is also scope to solidify directors' responsibilities to their workforce in company law. Section 172 of the Companies Act 2006 requires directors to 'have regard' for stakeholder groups such as their employees, customers, suppliers and the wider environment, while taking decisions in the long-term interest of the company's shareholders. Amidst concern that boards were only paying lip service to their responsibilities to other stakeholders, requirements for directors to report on how they have complied with their Section 172 responsibilities were included in the 2018 Companies (Miscellaneous Reporting) Regulations. It is vital that compliance with these requirements is monitored and enforced.

Similarly, while the requirements of the Stewardship Code were strengthened significantly in the area of workforce issues in 2020, there is still scope for improvement in this respect. Currently, the Code states that signatories should 'consider' a range of issues including 'diversity, remuneration and workforce interests': acting in the interests of employees therefore remains a discretionary matter for investors.

Workforce interests can also be better met through an improved understanding and more consistent measurement of extra-financial performance. The International Organisation of Securities Commissions is working on a framework for ESG reporting, based on the experience of the International Financial Reporting Standards developed to harmonise global financial accounting. Similarly, in the UK, the 2019 Brydon Review of the audit profession recommended that the Audit, Reporting and Governance Authority (successor to the Financial Reporting Council) establish a framework for auditing ESG reporting and a professional body that would oversee education and authorisation of potential auditors.<sup>40</sup> Policy-makers should support such initiatives, both domestically and with international partners.

However, while regulations and adherence to them are important, the factors which shape how businesses operate are far broader than this. Norms and public expectations are fundamental in determining business decisions. It is therefore extremely important that investors, employees, civil society, politicians, media and the public in general continue to hold businesses to account and push for them to act in the interests of wider society.

We have shown that the public expect more of businesses than simply the pursuit of profit: this is of crucial importance, as legitimacy is needed for businesses to operate. This

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<sup>40</sup> Brydon, D. (2019) *Independent review into the quality and effectiveness of audit*. London: Department for Business, Enterprise and Industrial Strategy.

expectation reflects an urgent need for businesses to act quickly in the interests of their employees, the environment and wider society. The UN Sustainable Development Goals are unlikely to be achieved if environmental, social and governance metrics continue to be absent from most executive reward packages. Furthermore, the COVID-19 pandemic has highlighted the fact that businesses are intrinsically dependent upon their employees, the environment and wider society. Businesses cannot afford to delay on this.

## Methodology

This report is based on analysis of active FTSE 100 board-level performance-related pay plans using information available from the most recently published annual reports as of Q1 2020. By active, we mean that companies had disclosed their intention to make share awards and/or bonus payments to executive directors in the following financial year. For the purposes of comparing like with like, we have only analysed performance-related pay plans that apply to CEOs. In the small number of cases where the CEO waives performance-related pay, we have excluded the company from the sample.

The data is sourced from [E-reward.co.uk](https://www.e-reward.co.uk) using information stored on its Summit Executive Remuneration Database.

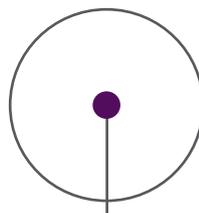
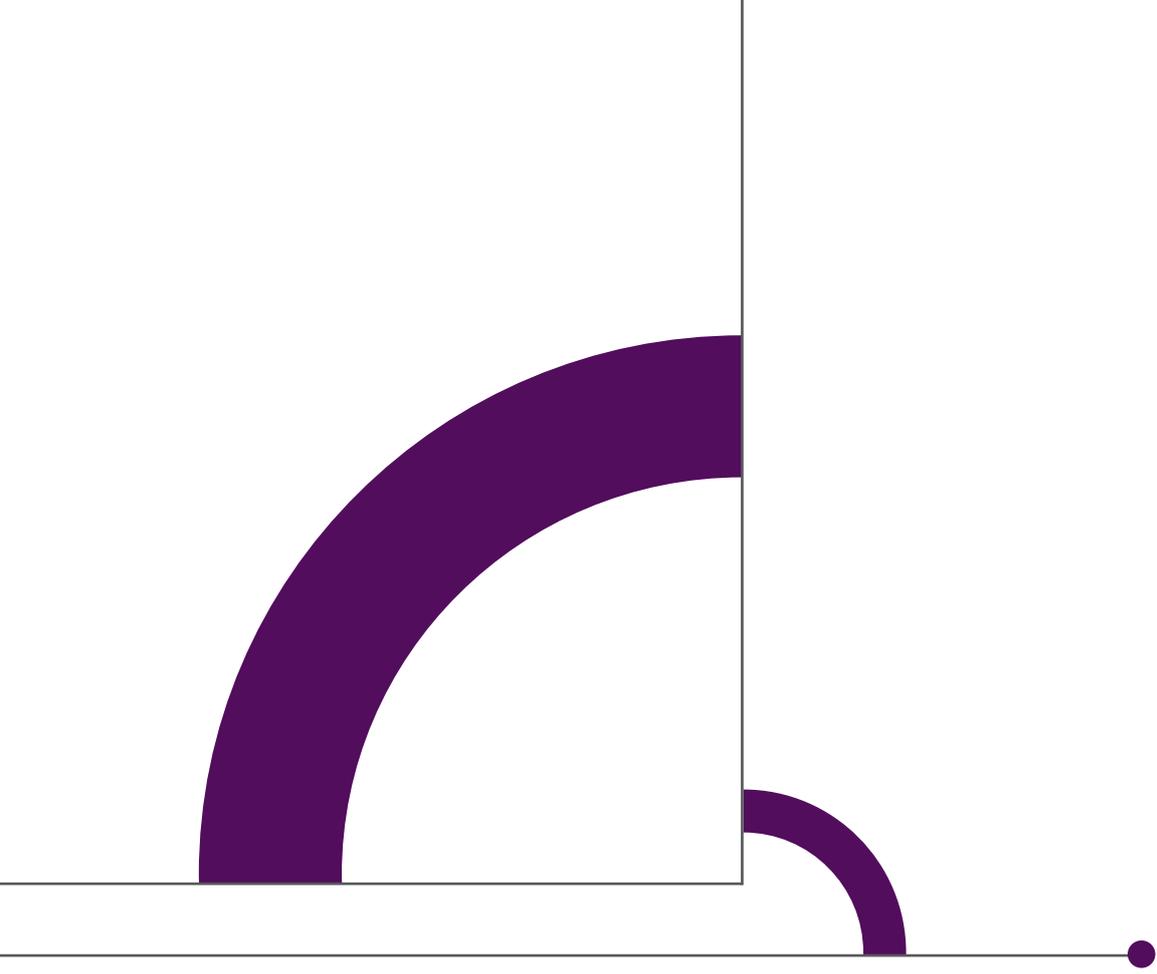
The analysis also looks at what we have termed employee metrics. These cover anything relating to employees, such as employee engagement, health and safety, and relationships with unions. It should be noted that this does not cover the whole range of metrics that come under the 'social' element in ESG, since this also includes metrics relating to suppliers, customers and communities.

Pay packages have only been counted as including employee metrics if the potential value of the metric is disclosed (either in cash terms or as a percentage of salary) enabling us to calculate their weighting as a proportion of total incentive pay.

In the analysis, we have used the total 'single figure' pay package for CEOs. This includes a base salary, bonus, LTIP, benefits, and pension or pay in lieu of a pension. The variable, performance-dependent elements of this package are the bonus (also known as the short-term incentive plan (STIP)) and the LTIP. Bonuses reward CEOs for meeting annual targets, while the LTIP is an arrangement whereby the employee is rewarded for the achievement of long-term company goals, usually over a three- to five-year period.

The percentage of companies using employee targets is taken as a proportion of the FTSE 100 companies with active, analysable performance-related pay plans (92 companies meet these requirements) rather than of the FTSE 100 as a whole.

We have excluded an investment trust from our review as it does not employ a CEO.



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