Executive Remuneration

Enough is Enough

Responsible reward for sustainable leadership

July 2022

Triodos Investment Management

Executive Summary

Inequality is a pressing issue in today's world, and the gap in the wealth and income distribution has reached unsustainable levels, despite declining poverty levels. Inequality can be addressed by empowering marginalised people, but importantly also by limiting the income and wealth growth of the (ultra)rich. There are several ways for financial institutions to do this. Triodos Investment Management's (Triodos IM) responsibility as an impact investor is to encourage balanced and fair remuneration policies and practices, limiting excessive CEO remuneration and reducing the income spread in listed companies.

At Triodos IM, we have always rejected a variable pay system in our own operations, and thereby set an example of attracting co-workers whose intrinsic motivation is to work for a mission-driven and value-based company. While non-fixed pay systems typically favour individuals working in sales teams or top leadership, a company's success is the result of a collective effort, where the individual can thrive and contribute to the group's success.

Beyond translating this vision into in-house remuneration principles and practices, we also use our leverage as an investor to address income and wealth inequality by curbing executive remuneration via our investment and engagement activities.

We exclude companies from investment that exceed our limits and have problematic remuneration policies and pratices in place. We do so via a two-step approach. In the first step we assess whether or not a company exceeds our thresholds on:

- size-corrected average CEO remuneration over the last five years (max. EUR 2.5 mln); and
- CEO-to-median employee pay ratio (max. 100:1).

If a company exceeds both thresholds in the first step, we perform an in-depth qualitative analysis of the company's remuneration structure based on best-practice principles in four categories: disclosure, transparency and responsiveness; risk-taking; pay for performance; and sustainability and long-term success.

Absolute and relative limits on CEO remuneration should be the norm, especially for listed companies. For this purpose, we have created a comprehensive framework to analyse companies' remuneration systems and to engage with companies to improve their remuneration practices. By taking a clear stance, we support efforts to rethink compensation packages and their underlying ideology.

Rethinking and adjusting executive compensation packages is a tall ambition and will not be achieved in the very short term. Nevertheless, as a responsible shareholder, we must make a start towards a more equal and fair income distribution by excluding companies with the most excessive and inherently unequal remuneration systems, and by engaging with these companies on the topic. In doing so, we also hope to raise awareness and to inspire other investors to adopt clear absolute and relative thresholds on executive remuneration.

Content

Introduction

Inequality – whether in opportunities, health, or wealth and income – detracts from societal wellbeing, and fuels and perpetuates social, economic and political divergence. If we look at income and wealth inequality, the sharp contrast between the world's poorest people and the very wealthy is alarming. This is best illustrated by the recreational space trip taken in June 2021 by the world's richest man in his own spacecraft, while over 10% of the world's population do not have enough to eat.

Where access to basic needs, healthcare and education is limited, societal hardship increases, and social inclusion is hindered. Even in countries with strong social security systems – for example in Europe - the number of people living below national poverty lines is still around one tenth of the population.[1] This deep divide between the poor and the rich within and across countries fuels political and social polarisation, which in time may lead to social and political instability. Even disregarding all ethical objections against it, inequality can have detrimental consequences for society and the economy, as well as crucial implications for investors. The UN Principles of Responsible Investment state that inequality "has the potential to negatively impact institutional investors' portfolios as a whole; increase financial and social system-level instability, damage output and reduce economic growth, and contribute to the rise of populism, extremism, isolationism, and protectionism. Extreme levels of income inequality hinder economic growth, destabilise society, and are unethical." [2]

Companies have an important responsibility to tackle wealth and income inequality. They need to rethink structures, processes and decision-making paradigms that contribute to fuelling inequalities. Responsible investors also play a role in curbing inequality by making conscious investment decisions and by including the rights and needs of all stakeholders through good stewardship. Executive remuneration is a good example where investors can exercise stewardship, as excessive remuneration fuels both income and wealth inequality. Inequality is not a given feature of business, but the result of decision-making about compensation based on certain values and a narrow set of priorities.

Today's world is facing the pressing issue of inequality. The gap in wealth and income distribution has reached unsustainable levels, despite declining poverty levels. In this paper, we examine the link between global inequality and excessive executive remuneration and call for a shift in CEO compensation models to tackle inequality worldwide. As an impact investor, we recognise investors' role in this process, and are we committed to creating positive change and impact. We have integrated the concern for inequality on different levels, from in-house remuneration polices to hand-on approaches with investees through company selection, exclusion, and active ownership on the topic of CEO remuneration.

1. Trends of income inequality

Income generally refers to capital flows stemming from production factors, such as labour, land, capital, and entrepreneurship. It is earned or received over a given period. In common understanding, however, income is often defined and limited to the income from labour, e.g. salary, which will also be the definition used in this paper.

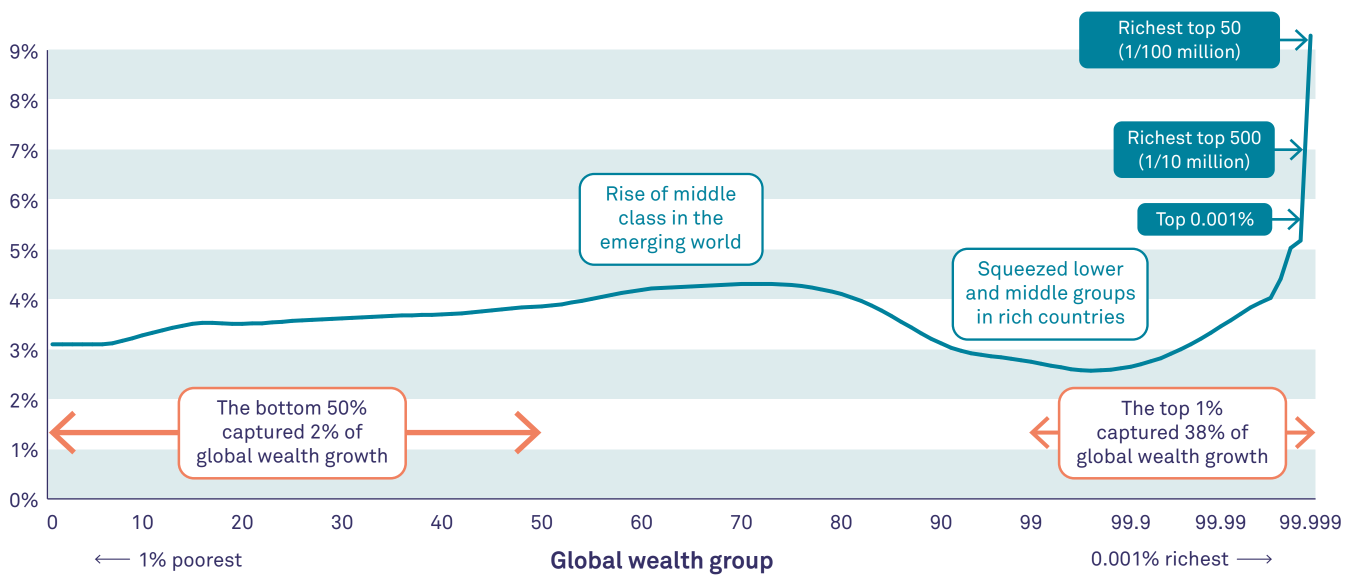
Nevertheless, capital income from owned assets are an important accelerator of wealth, such as the appreciation or the value of owned assets (such as real estate of stocks), or the capital distribution thereof, such as dividends or rental income. High incomes are thus a source of wealth in two ways, as excess income - money that does not directly need to be spent – can be saved or invested and may grow in value over time. Income and wealth inequality are closely interlinked and usually reinforce each other.

Increasing wealth and income inequality

While global income inequality between countries has been falling since 1980, the level of income inequality within countries has been growing dramatically. [3] While the gap between poor and rich nations may have narrowed, the gap between the upper and lower classes has widened, not the least because the issue of so-called cheap labour continues to be pervasive, especially in developing societies. Regardless of the levels of economic development, the top 1% around the world have seen their wealth increase enormously over the past two decades, while for the bottom half, growth remained close to zero (below 5%).[4]

Between 1995 and 2021, the average annual wealth growth for the poor and the rich diverged quite substantially (figure 1). For the bottom 50%, annual growth hovered around 3% to 4%, representing 2% of global wealth growth, while the top 50 richest billionaires enjoyed a rapid wealth growth of up to 9% per year. The middle classes in the emerging world, however, have seen a higher annual wealth growth than the squeezed middle class in rich countries.

Figure 1 Average annual wealth growth rate, 1995-2021[5]



The wealth divide between the global billionaires and the bottom half of humanity is steadily growing: between 2009 and 2018, the number of billionaires it took to equal the wealth of the world's poorest 50% fell from 380 to 26.[6] The 2021 Credit Suisse Global Wealth Report assessed that the world's richest 1% owned almost half of the world's wealth. To be part of this group, an individual had to have an accumulated wealth of a little over USD 1 million. Out of these approximately 79 million people, 215,030 had a net worth above USD 50 million at the end of 2020, earning them the label 'ultra-high-net-worth individual' (UHNW). Alarmingly, this is over 40,000 more than the previous year, a growth of almost 24% from 2019.[7] The top 10 billionaires, meanwhile, doubled their global wealth.[8] This trend was interrupted in 2022, as the 500 richest people collectively lost USD 1 trillion due to plunging stock markets. Also, according to the US Bureau of Labour Statistics, average hourly earnings in the US rose 5.5% from April 2021 to April 2022.[9] Conversely, the number of people living in extreme poverty, i.e. living on less than USD 1.90 per day, has steadily declined since the 1990s. The COVID-19 pandemic, however, turned this trend, driving 97 million people worldwide into poverty since 2019.[10]

Regional differences

Most of the world's richest people are from western countries (North America and Europe). Among the advanced economies, the US stands out in the matter of income inequality, and more than half of the UHNW individuals are from the US.[11] The level of wealth inequality in the US has been skyrocketing and has reached an alarming historical peak level. The top 1% in the US own 38% of the national wealth, a far greater share than in any other OECD country.[12]

Income and wealth inequality have risen within most countries, including in emerging economies such as China. However, there is no single pattern on trends and levels of top income shares that can be applied to all countries. In Europe, for example, the top income shares in some countries remain constant while others have been increasing since the 1980s. Compared to Europe, top income concentration is much higher in African and Latin American countries and this unequal income distribution has remained unchanged over the last decades.[13]

The different patterns in income and wealth inequality can be explained by differences in the political economies of countries. The Varieties of Capitalism framework (Hall & Soskice, 2001) helps to distinguish among developed countries in terms of income distribution and employment. The two distinct types of market economies are liberal market economies (LME) on the one hand and coordinated market economies (CME) on the other hand. Countries like the US, the UK, Canada, Australia, New Zealand, and Ireland are classed as LMEs and countries like the Netherlands, Belgium, Germany, Sweden and Japan as CMEs. Companies in LME countries coordinate their actions based on hierarchies in corporate structures and formal contracting, and competitive market mechanisms. In contrast, companies in CME countries are more dependent on non-market, institutionalised relationships with other actors, such as suppliers, clients, trade unions, governments, and other stakeholders.

Rising executive remuneration

When considering remuneration practices within companies, the differences among national political economies and their policies on a macroeconomic level are reflected at microeconomic level, ranging from very high executive remuneration rates in some countries to more balanced ones in other countries and regions. This is especially visible when analysing listed companies. The MSCI World Index is a broad global equity index that includes over 1,500 large and mid-cap companies across 23 developed markets.[14] The US is an important case to look at more closely.

Scrutinising available data on absolute executive remuneration for these companies shows that the US has by far the highest average CEO remuneration (size-corrected for market cap, revenues and number of employees) at on average EUR 2.36 million. Argentina, Ireland, the UK, UAE, Canada, Hong Kong, and South Africa also have size-adjusted payouts higher than EUR 1 million. In the US and Canada, size-adjusted CEO remuneration is 3-4 times higher than in Europe and the rest of the world. Hence, in liberal market economies, companies 'reward' executives the most.

2. The institutions underlying inequality and CEO compensation

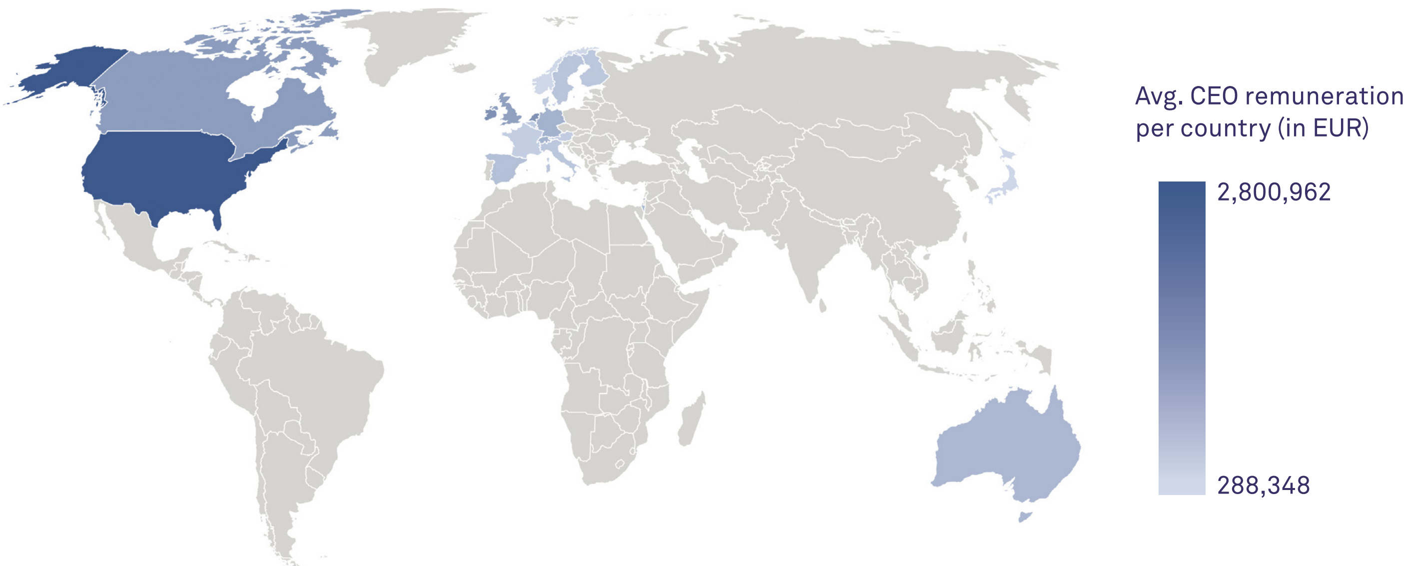
Huntington (1969) defined institutions as "stable, valued, recurring patterns of behaviour, defined by their adaptability, complexity, autonomy and coherence."[15] It is such institutions that underlie political economies and shape different national employment and tax systems. Organisations are embedded into a broader social structure and the variety of institutions influence the decision-making of people and companies.[16] Such institutional structures of formal and informal rules directly influence companies' behaviour in terms of social beliefs, values, relationships, constraints and expectations, and thus also affect executive remuneration practices.

The rules of the game and ideology

As already highlighted, political economies and ideologies differ along the Varieties of Capitalism framework. Policymakers have addressed the dangers of inequality to varying degrees and implemented preventive or corrective measures in terms of legislation and taxation. Liberal market economies tend to pursue a strategy of individual capital allocation and competition, while coordinated market economies seek to counteract wealth inequality by adhering to progressive income tax systems and by supporting wealth redistribution via other taxes, such as inheritance taxes, and public spending. The difference can be illustrated by the juxtaposition of the Swedish or Rhineland model prevailing in many European countries and the Anglo-Saxon model of US 'rugged individualism' which prevails in the US and the UK. The Swedish model is a "strategy for inclusive growth" with the objective to "increase prosperity to the benefit of all, while safeguarding the autonomy and independence of citizens."[17] Key features of the Swedish model are high taxation, provision of public services, centralised wage settlements and extensive social insurance. The term rugged individualism refers to the belief system or ideology that problems of poverty and unemployment are best left to voluntary organisations and community service, and the fear that federal relief programmes would undermine individual character by making recipients dependent on the government.

Such different visions and ideologies have translated into different policies and practices in terms of labour markets, capital returns, inheritance, taxation, globalisation and other potential determinants of top incomes. They also find their reflection in the respective executive remuneration regimes in different countries, for instance in terms of disclosure and reporting requirements on executive remunerations. In Japan, which is classified as a CME, the Financial Services Agency requires publicly listed companies to disclose in detail the salary (bonus, stock options and

Figure 2 **Regional differences in remuneration**



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The selection of countries is defined by the MSCI World Index (i.e. 23 developed countries).

other compensation of individual executives) only when the total exceeds 100 million yen (EUR 0.71 million).[18] However, CEO remuneration in the US is about six times as high as in Japan.[19] Since 2015, the US Securities and Exchange Commission requires public companies to disclose the ratio of CEO compensation to the median compensation of employees.

National corporate governance codes typically require companies to have formal and openly stated processes for deciding on the remuneration of executive management and board members. Usually, the board establishes a remuneration committee and assigns it the responsibility of evaluating all compensation plans, policies and programmes of the company, as well as for producing an annual remuneration report. However, requirements on the independence of the committee, its discretion in decision-making and the comprehensiveness of disclosure differ across companies and jurisdictions.

According to a recent study, in Japan appears to be a positive and significant relationship between directors' pay and employees' average wage, suggesting that both directors and employees have similar incentive systems. No such relationship can be seen in the UK, suggesting that the difference in corporate governance affects the director's salary and their incentives.[20]

Overall, the Anglo-Saxon model places more emphasis on individual performance and higher salaries and is significantly less stakeholder-oriented than the Swedish or Rhineland model, which is based on concepts of cooperation, consensus, social justice and serving the interests of multiple stakeholders.

Arguments for curbing and rethinking executive remuneration

There are different arguments to rethink executive remuneration. The ethical argument for curbing excessive executive remuneration draws on the philosophical concept of limitarianism, which stipulates that people should not have "more resources than are needed to fully flourish in life" (Timmer, 2021; Robeyns, 2017).[21] The needs argument states that surplus wealth should be used to satisfy people's or society's unmet and most urgent needs. Further, the democratic argument reasons that concentrated wealth undermines political equality and fairness in democratic procedures, as very rich people have the means to influence policymaking directly and indirectly. Finally, the ecological argument states that the wealth of the superrich should be used to publicly finance climate mitigation and adaptation. While difficult to define, the level of wealth needed to be considered 'superrich' has been approximated in a study based on a representative sample of the Dutch population suggested a riches line between EUR 1 and 3 million for the Dutch society, irrespective of the respondent's own income and education.[22] This aligns roughly with the USD 1 million wealth an individual needs to be part of the top 1% wealthiest people in the world.

Remuneration rationales refuted

The agency theory, which attempts to explain and resolve issues in the relationship between business principals and their agents – usually the relationship between company management and shareholders, provides rationales for setting executive remuneration. The theory highlights the issue of the separation between possession of the company (shareholders) and control over the company (management and supervision).[23] In order to align the interests of CEOs, i.e. their own wealth maximisation, with those of the companies' owners and improve the manager's involvement in achieving the shareholders' objectives. Executives should be paid relative to the economic value they create (for shareholders) at a given cost (market efficiency). Consequently, an increase in executive pay could only be justified if the value added by a CEO increases significantly. Yet, in the US from 1978 to 2020, top CEO compensation grew about 60% faster than the stock market, and market-related arguments are often used to justify high compensation packages.[24] The problem with the agency theory - in addition to the oversimplified assumption of a profit-maximising homo economicus - is the definition of "value" as well as the sole focus on "shareholders". Value as measured in the share price is misleading as it is only one of many understandings, approximations and measurements of value. Share price as a measure of value is based on the market, but not on the inherent value creation of a company's products or services. Moreover, attributing the proportion of value added to the CEO only instead of to the entire company with all its employees is problematic, as a company's success (or failure) also depends on market circumstances and the entire human capital of the

CEO remuneration packages

CEO remuneration packages are typically composed of a fixed and a variable part. The base or fixed salary is considered to reflect the responsibilities at the company, is not at risk when company performance disappoints and is paid out in cash. Beyond that, one-off rewards or bonuses for special achievements are also common for non-executive employees, as are other benefits such as defined contribution/benefit plans, retirement plans and healthcare benefits. What is different for executive remuneration is that CEOs may often receive one-off rewards when joining a company (signing bonus) or if they voluntarily (golden handshake) or involuntarily (golden parachute) leave the company.

The role and proportion of variable remuneration is also far greater. These rewards are intended to set incentives to achieve certain short- or long-term goals, defined in performance metrics. A short-term incentive plan (STIP), also called an annual bonus, is either paid out in cash or awarded in company stocks. A long-term incentive plan (LTIP) is based on a predefined performance period and often paid out in equity-based compensation. LTIPs often also include retention-based elements. Non-cash compensation or equity-based compensation can take the form of stock options, stock appreciation rights, restricted stock units or performance-based restricted stock units. The composition of the compensation package, the underlying performance metrics, as well as the form of pay-out mirror the underlying ideologies and economic thinking that either the liberal or the coordinated market economies are based on.

In addition to the weight of the different components of compensation packages, the performance metrics used to measure a company's success are also of crucial significance. In the Anglo-Saxon model, in which CEOs tend to be excessively rewarded, growth metrics are a commonly used measure of company success and consequently often determine a CEO's short- and long-term incentives. These growth metrics are purely financial: common indicators are return on equity, earnings per share, and earnings before interest and taxes. It should be noted that these metrics are directly tied to a company's profits, and therefore focus on shareholders as the predominant stakeholders.
Also important is how the reward is paid out, for example in cash, shares or stock options, or other benefits. Stock-related elements in remuneration packages usually result in a higher wealth increase. In 2020, most of the increase in average CEO pay, as estimated by EPI data, were exercised stock options.[25]

Variable pay is mainly intended to incentivise and improve performance to reach targets, for instance in terms of growth or share price. Remuneration plans substantially based on variable pay, however, may stimulate CEOs to take excessive risks leading to negative consequences for the company.[26]
On the other hand, variable pay can also be used to drive sustainability performance in terms of specific Environmental, Social and Governance (ESG) indicators, such as employee satisfaction or greenhouse gas emission reduction targets.
The practice of linking executive remuneration to ESG performance criteria, while increasing, is far from common practice yet.[27] Explicit, non-discretionary ESG incentives are mostly found to be economically insignificant relative to executives' incentives to maximise share value. They are also often limited to annual bonus schemes, i.e. short-term incentives.[28] Furthermore, designing comprehensive but not overly complex ESG metrics that performance can be tied to, can be difficult and inefficient with unintended consequences.[29] For instance, achieving a board level gender diversity target without introducing additional measures to address management diversity or the gender pay gap would not be the desired achievement and even be a distraction from the underlying problem.[30]

While useful practices in CEO pay should not be compromised, excessive remuneration should be curbed to reduce social inequality. It is key to include the interests of all relevant stakeholders in measuring company success and in the structure and rationale of CEO remuneration. Best practices of executive remuneration packages include high standards of transparency and accountability, sound performance-related pay, not rewarding excessive risk-taking, inclusion of sustainability considerations and alignment with long-term success.

Figure 4 **Elements and best practice principles of executive remuneration packages (Triodos Research)**

1 Disclosure, Transparancy and Responsiveness

- Disclosure and Intelligibility
- Transparancy and Power
- Responsiveness

2 Risk-taking

- Cap on variable pay
- Clawback / malus
- Performance Target and Threshold

3 Pay for Performance

- Type of Performance-based payouts
- Performance metrics and Total Shareholder Return (TSR)
- Company Value

4 Sustainability and Alignment with Long-term Success

- ESG metrics
- Alignment with Long-term Success
- Severance Agreement

company. A narrow focus on individual achievements or leadership denies the importance of teamwork or a group's accomplishment. Furthermore, shareholders are not the only stakeholders of a company and the value it creates. Employees, customers, as well as communities and the environment per se are equally important stakeholders and must not be ignored when judging the performance and value creation of a company.

Another common economic rationale for setting high executive remuneration is that of competitive labour markets, which prescribes that a high-performing CEO needs to be attracted with high executive remuneration.[31] The 'market conform' argument is often referred to without confirming its applicability and truth. Therefore, high executive pay may be a loss from an economic point of view. Finally, the widespread belief that linking executive remuneration to growth metrics makes business sense, and that the more a company pays its CEO, the better the CEO will perform, is refuted by research.

Furthermore, relatively minor redistributions from the upper quarter of earners to the lower quarter in a company would make a significant difference to the income of the latter group, making the case for a more equal in-company wage distribution.[32]

Elements of best practice

To assess and understand individual companies' remuneration policies and practices, Triodos Investment Management has developed a scorecard with best practice principles that companies can be checked against. These can be classified into four categories:

1. Disclosure, transparency and responsiveness

Decision-making on executive remuneration must be transparent, with decisions clearly documented and explained. Decision-makers need to be held both accountable and responsive to their various stakeholders. National regulation as well as corporate governance codes generally contain provisions on executive remuneration and the disclosure thereof.

2. Risk-taking

The 2008 financial crisis was partly caused by incentive pay that purportedly encouraged excessive risk-taking. We advocate measures that prevent risk-taking, such as a cap on variable pay, clawback mechanisms, and challenging yet realistic performance targets. Although avoidance of excessive risk-taking does not directly relate to a more equal pay system, it does help to keep the company's focus on the long-term performance and on the needs and interests of all stakeholders involved.

3. Pay for performance

People are not only motivated by financial impulses, but also by a company's success, by successful cooperation with others and by achieving a company's purpose. Variable pay should therefore not make up the main part of a remuneration package, but should be limited. Incentive plans should be based on creating value, better measured by both cash flow and return ratio metrics instead of total shareholder return or earnings per share. Executive pay should remain in line with the development of these metrics.

4. Sustainability and alignment with long-term success

The integration of ESG criteria in the executive remuneration plan can incentivise management to strengthen its strategic orientation towards a transition to a more sustainable economy and stronger sustainability performance, as well as a longer-term performance horizon. For instance, executive remuneration can be linked to achievements based on environmental and social indicators in relation to companies' activities, including the reduction of the company's carbon footprint or increased diversity at higher management levels and job satisfaction among employees, or relate to product governance in terms of value creation and durability.[33] However, in order to be impactful these remuneration drivers must be of significant size in the remuneration package, and ESG metrics must be carefully designed in order to achieve the desired sustainable and long-term impact.

In addition to adopting or living up to best practices, companies also need to set their own principles to safeguard these best practices. As stated earlier, there are significant differences in levels of executive remuneration and societal inequalities across jurisdictions. Our stance on this topic is also based on an ideology, i.e. our vision for a just and equal society, as well as on value creation. As such, we favour remuneration systems that put more emphasis on wealth distribution and redistribution at societal level. This underlying ideology should be reflected in corporate remuneration practices, i.e. a system that allows for curbing excessive remuneration and redistributing wealth in society to foster a just and fair society and a fruitful community.

The Icelandic salmon farming company Bakkafrost has a very moderate remuneration package and a simple structure. Its remuneration policy aims to create a framework for long-term values and to comply with governance best practices. The policy emphasises that remuneration should promote Bakkafrost's competitiveness in the relevant labour market. It should not be too high (reputation risk) or too low (risk of not attracting and retaining senior executives with the desired skills and experience). The company states that "the total of non-variable elements in the remuneration is established in consideration of market level, e.g. the company's size and course of development".[34] The only variable pay is an annual bonus, which is determined with consideration to its goal achievement, and the maximum bonus is limited to 100% of fixed salary. In terms of transparency, the supervisory board has no discretionary powers and cannot deviate from the agreements. For its employees, the company has a share saving plan which involves employees and reduces inequality by increasing wealth: Up to 5% of employees' base salary may be invested in Bakkafrost shares, and the company will award an extra share for each purchased share if they are kept for one or two calendar years. This stimulates loyalty and a long-term focus on value creation.

3. Towards a different CEO compensation model

Investors are important actors in the economy. Collectively, their decisions deeply influence business priorities - and often also political agendas. As an impact investor, Triodos IM invests to make positive impact. Reducing inequality is a key step in reaching a more just and inclusive society. Curbing excessive executive remuneration is one way to achieve this. Using our leverage as an investor in terms of stock selection, exclusion and engagement on excessive executive remuneration are a means to doing so.

Our approach to excessive remuneration

We integrate inequality concerns in our investment strategy and activities on multiple levels. Our overall investment process rests on three pillars: selection of companies that make positive impact, exclusion of companies that do not meet our minimum standards and engagement with companies on material sustainability and financial topics during the entire investment period. As an investor, we can address challenges in jurisdictions' legal and tax systems through advocacy in the financial sector and our public voice. And we take a hands-on approach to address inequality when we discuss the topic of rethinking and curbing executive remuneration with our investees. In our own company, we aim to set an example by limiting the CEO-to-median-employee pay ratio to 7, and by foregoing a variable incentive structure.[35]

For investors, the corporate governance practices of their investees are of paramount importance. They help to assess the business integrity of a company and ensure transparency and accountability, thereby reducing a certain investment risk. Considering corporate governance aspects, such as independence of supervisory board members, diversity and nomination procedures, is common practice among investors when making investment decisions. Governance and remuneration are a central part of our company analysis, both to identify potential weaknesses as well as best practices. Remuneration and governance are at the core of a company's organisational structure and reflect a company's intentions.

Excluding the extremes

In our approach to exclude the extremes, we look at three elements of CEO remuneration: First, the actual level of absolute executive remuneration; second, the ratio of the CEO's remuneration compared to the median employee's wage; and third, the composition of the compensation package. As the ultimate outcome of such analysis, we exclude companies that exceed the limits and have problematic remuneration policies in place.

1. A threshold of EUR 2.5 million

CEO remuneration - corrected for the company's size in terms of market cap, revenue, and number of employees, and based on the average of the last five reporting years - above EUR 2.5 million is excessive in our view. We have set this threshold after analysing executive remuneration of the MSCI World Index and cutting off the top 10% of size-corrected CEO remuneration. Although an absolute threshold always remains somewhat arbitrary and this approach does not include all individual company characteristics, we consider the size-corrected threshold of EUR 2.5 million reasonable from an economic and ethical rationale. To illustrate: for the largest companies in the world, we apply the highest size-adjustment factor (i.e. factor 8) in our assessments, meaning that the CEO remuneration we would accept for such a company (on a 5-year average) cannot be higher than EUR 20 million.

2. CEO-to-median-employee pay ratio threshold of 100:1

As a second threshold, the ratio between CEO remuneration (not size-corrected five-year average) and median employee remuneration shall not exceed 100:1. If a figure on median remuneration is not available, given that the definition of the median employee and the calculation of their wage can differ across companies, we use the average compensation to approximate this ratio. Consistent and comparable company pay ratio data is therefore important, as it shows which companies are investing in their workforce to create high-wage jobs.[36] By setting a threshold on CEO-to-median-employee ratio, collecting data, and communicating to companies, the public and other investors, we draw attention to this approach and foster improvements in the ratio for listed companies.

3. Qualitative analysis of remuneration policies

If both the thresholds above are not met, we evaluate the structure of the compensation package with the aim to qualitatively assess whether the compensation structure and policies are significantly aligned with long-term value creation and ESG impact. If this is the case, even excessive pay levels can be tolerated. We will initiate and pursue engagement with the company to reduce the CEO remuneration level and to further align the remuneration system with long-term value creation and ESG impact. If the company has not already adopted some best practices and/or is not open for dialogue, the company is excluded from our investment universe.

Active stewardship

Active stewardship is an important aspect of our investment strategy. This includes regularly reviewing and monitoring companies and encouraging them to improve on sustainability topics, as well as exercising voting rights (with arguments). The best way to do this is through active dialogue with companies.

Engagement refers to the goal-oriented dialogue between investors and investees. Triodos Investment Management has a long history of ongoing dialogue with companies about their corporate governance practices, including remuneration systems and corporate leadership. We evaluate the structure of compensation packages to assess whether compensation structures and policies are aligned with long-term value creation and ESG impact. If this is not the case, we engage with the companies to better align the remuneration system with long-term value creation and ESG impact, and in doing so, to reduce the CEO remuneration level (or at least reducing the CEO-to-median-employee ratio).

Proxy voting is the investor practice of casting shareholder votes at investees' AGMs via a proxy adviser. We take a strict approach regarding remuneration systems and consequently vote against most remuneration-related resolutions. For example, in 2021, we voted in favour of only 21% of remuneration-related resolutions. The reasons we voted against Say-on-Pay resolutions and other remuneration-related resolutions included excessive pay levels, board discretion on payout levels, unchallenging targets, unnecessarily complex variable pay schemes and golden handshakes or parachutes.

Remuneration engagement programme

To strengthen our approach, we started a dedicated engagement project in 2021, focusing on companies with the most excessive and inequal remuneration systems in our equity portfolios. Our long-term engagement goal is to encourage companies to reduce the pay gap between CEOs and employees while increasing the fairness, simplicity and transparency of remuneration packages.

We first analysed the compensation packages of companies that did not meet the thresholds on absolute and relative executive remuneration to understand the underlying ideological drivers. This analysis led to the exclusion of some companies, where engagement on remuneration practices was unlikely to succeed given the gap between best practices and their remuneration practices. We then selected companies for an engagement trajectory on income inequality, which is still ongoing.

Conclusion

Inequality is a clear and present danger that can have grave consequences for society and the environment if we do not address it. It can be countered in several ways. Limiting the income and wealth growth of the (ultra)rich is an important way to do this. Financial institutions can contribute in several ways. As an impact investor, it is our responsibility to encourage balanced and fair remuneration policies and practices, limiting excessive CEO remuneration and reducing the income difference in listed companies.

Beyond translating this vision into in-house remuneration principles and practices, we use our leverage as an investor to address income and wealth inequality by curbing executive remuneration with our investment and engagement activities. Absolute and relative limits on CEO remuneration should be the norm, especially for listed companies. For this purpose, Triodos has created a comprehensive framework to analyse companies' remuneration systems and to engage with companies to improve their remuneration practices. By taking a clear stance, Triodos supports efforts to rethink compensation packages and their underlying ideology.

Rethinking and adjusting executive compensation packages is a tall ambition and will not be achieved in the very short term. Nevertheless, as a responsible shareholder, we must make a start towards a more equal and fair income distribution by excluding companies with the most excessive and inherently unequal remuneration systems, and by engaging with these companies on the topic. In doing so, we also hope to raise awareness and to inspire other investors to adopt clear absolute and relative thresholds on executive remuneration. We call on the financial sector to follow our example.

Sources

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