REMUNERATION POLICY FROM 2021

Introduction

The policy will take effect from 13 May 2021, subject to shareholder approval at the AGM. The letter from the Chair of the Remuneration Committee sets out the decision-making process for recommending a new policy (see page 81).

Key policy themes

At the 2020 AGM, shareholders approved a new remuneration policy, which was broadly similar to the one that was in place previously, on the basis that at the time the Committee felt that it continued to support the business strategy; however, the devastating impact of COVID-19 on the Aerospace sector has forced the Committee to review the policy once again to ensure that it is right for the current circumstances and supports the necessary restructure and the recovery required to secure future growth over the next three years. They have concluded that a bespoke solution is needed that is tailored to the specific challenges facing Rolls-Royce and which will:

- **Retain talent –** Ensure that we have the right talent in our organisation to deliver the financial recovery and a return to growth. Shareholders have shared this concern during the consultation process. The changes we are proposing to our remuneration policy are designed to engage and motivate our talent and reward the behaviours that we need to succeed in the current circumstances. We also need to be able to recruit new talent into the organisation over the next few years to secure our future. Our policy needs to attract and motivate key talent to deliver and execute our strategy.
- **Place emphasis on short-term performance turning into longer-term growth –** This reflects the urgency of our challenges and the importance of the actions during 2021 to restore financial stability. We also recognise that we must balance the incentivisation of key short-term measures that are critical to our future success with longer-term value creation for our shareholders.
- **Emphasise shares and long-term holding of those shares –** As part of the balance of incentivising short-term performance with longer -term shareholder interests we are proposing that 100% of any incentive payment should be delivered in shares with meaningful deferral requirements. In addition, a proportion of fixed pay will be delivered in shares. This both protects cash and increases executive alignment with shareholders.
- **Ensure alignment between Executive Directors and the wider organisation –** It is important that our policy cascades throughout the organisation and all employees are rewarded for delivery and execution of our policy.

The Committee sees this as a temporary intervention and intends to consider a more business-as-usual policy in due course.

Changes to policy design

We have developed a policy which is specific to the challenges facing Rolls-Royce which has been carefully designed to incentivise our people to restore our financial performance through:

- cash generation to strengthen the balance sheet and reduce net debt;
- improved operating margins to improve the quality of our underlying profit and cash;
- an ambitious restructuring plan in the Civil Aerospace business and the central functions;
- revenue growth in our Power Systems and Defence businesses; and
- engaging our people to deliver during an unprecedented period of disruption for the organisation.

In creating this solution we have aimed to ensure that the focus on short-term performance is balanced with long-term value creation and whilst the overall target reward package is maintained, there is a significant reduction in the maximum, together with heavy emphasis on delivery in shares and long-term deferral of those shares.

No Executive Director or Executive Team member was present during discussion of his or her own remuneration package and they were not involved in the final approval of the new remuneration policy design.

A new incentive plan

This has been designed to reward the key drivers for success across our businesses, supporting the financial recovery required in 2021 and beyond. Initially the focus will be on short-term metrics in 2021; cash, profit, cost base reduction and people. For 2022 and 2023 longer-term metrics will be introduced including net debt reduction, cumulative profit and cash, TSR and a sustainability metric. The short-term metrics will be set annually, whereas the long-term metrics have been set by the Committee at the beginning of 2021. The structure of the incentive plan is designed to reflect the urgency of our challenges and the importance of delivery and execution in 2021. There will be no cash awards from this plan – any awards will be delivered in shares.

	2021	2022	2023
Financial			
Cash	37.5%	20.0%	20.0%
Profit	37.5%	20.0%	20.0%
Costbase reduction	15.0%	10.0%	
Total financial	**90.0%**	**50.0%**	**40.0%**
Non-financial			
People	10.0%	10.0%	10.0%
Total non-financial	**10.0%**	**10.0%**	**10.0%**
Long term [1]			
Cumulative cash (2 year)		20.0%	
Net debt		20.0%	
Cumulative cash (3 year)			20.0%
Relative TSR			25.0%
CO_2 sustainability			5.0%
Total long term		**40.0%**	**50.0%**
Total	**100.0%**	**100.0%**	**100.0%**

[1] Long-term targets set in 2021.

This plan will be the only incentive plan in operation for the period of the policy; it will replace the current annual incentive and long-term incentive plan. This removes the risk of windfalls arising from grants issued at current share price and places greater control for the Remuneration Committee to determine incentive outturns based on performance against strategy.

The target award level for the CEO will be 220% of salary, and 190% of salary for other Executive Directors.

A reduction in maximum potential awards

This recognises the stakeholder environment and shorter-term performance periods upon which a significant proportion of the incentives over the three-year period would be based. The maximum is reduced from 200% of target to 175%. For the Chief Executive, this is from 430% to 385% and for other Executive Directors, from 375% to 333%.

Delivery of incentives and pay in shares

All awards from the incentive will be deferred into shares at the end of a performance period and will be settled as follows:

- 40% after three years
- 60% after four years

When compared with the current combination of cash bonus, deferred bonus shares and LTIP (including holding periods) the actual duration of shareholdings is materially increased. In addition, 30% of salary will be deferred into shares for the Chief Executive and 20% for other Executive Directors, which will be required to be deferred for two years. This creates alignment with the long-term interests of our shareholders and balances the focus on shorter-term metrics, helping to ensure the longer-term balance in the reward package.

Pension reduction

In the current policy we committed to reduce pension contributions for existing Executive Directors from a maximum of 25% of salary to 17% by 2022 to align with the wider workforce rate for existing UK employees. 17% was a weighted average wider workforce rate at that time, which has now reduced to 12% of salary following the closure of the UK Defined Benefit pension plan to future accrual. As part of the new policy we have reduced pension contributions to 12% of salary with effect from 1 January 2021.

Consideration of shareholder feedback

During the policy review we have engaged in detailed consultation with our largest shareholders and the proxy agencies to provide context for the proposed new policy and gain feedback on how it could be improved. We have been pleased that the majority of our shareholders understand the context for the new policy and support the approach of developing a bespoke solution that is unique to our circumstances. The overall feedback from this consultation was:

- an understanding of the need to place more focus on the short-term performance metrics to deliver financial stability;
- support for us continuing to apply performance based incentives, rather than using restricted stock;
- a need to align the incentive targets with the promises made in our equity raise;
- support for alignment of shareholder interests through a significant proportion of the package being delivered in shares;
- recognition of the accelerated pension reduction to 12% of salary and the reduction in maximum incentive award to 175% of target;
- the importance of focusing on talent retention and attraction;
- the importance of aligning the wider workforce with the Executive Directors' remuneration;
- the approach is simple and well balanced;
- the trust placed in the Remuneration Committee's track record in applying discretion – as this is expected to be key to ensuring appropriate outcomes for the next three years. Setting stretching but achievable targets will be key as will the disclosure of those targets; and
- support for inclusion of a CO_2 based sustainability metric as a long-term measure.

These views have been reflected in the final policy design for 2021.

Summary of our revised remuneration policy

Fixed pay

- Base salary
- Benefits
- Pension

Variable Pay

Rolls-Royce Incentive Plan

80% Group performance		20% personal performance
Financial: Profit, Cash, Cost base reduction	Non-financial: People	Goals and leadership behaviours

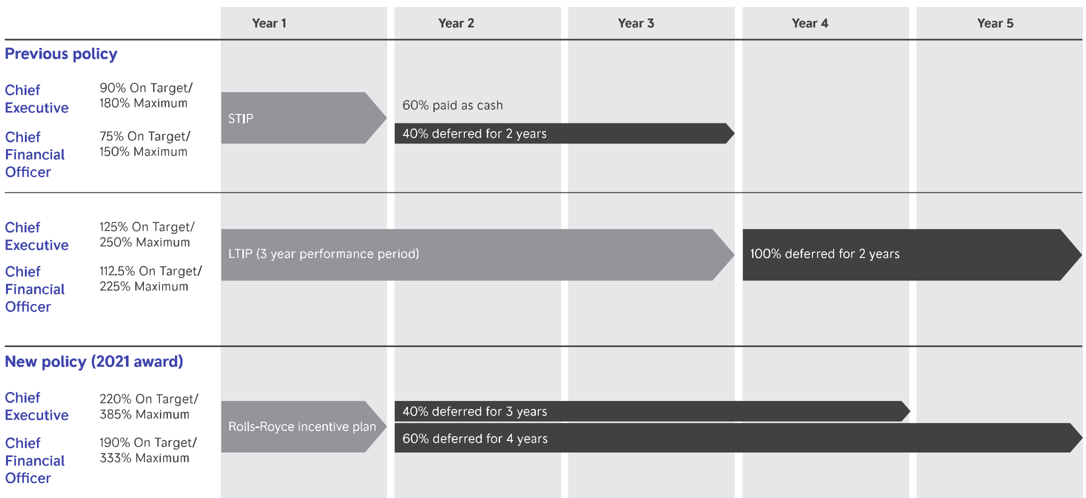
Long-term metrics to be included in 2022/2023
Cumulative profit, cumulative cash, net debt reduction, TSR, sustainability

All awards to be made at the end of the performance period in shares
40% settled after three years and 60% after four years

Malus and clawback – Incentive awards are subject to malus and clawback provisions where there has been a material misstatement of audited results; serious financial irregularity; material financial downturn or an event causing a material negative impact on the value of the Group; material failure of risk management; a serious breach of Our Code; individual misconduct or actions that materially damage the Group; a breach of or inadequate response to a significant HSE or other environmental issue; and/or materially incorrect calculation of an award. These provisions apply from the start of the performance period to three years after date of grant or the settlement date, if later.

Shareholding requirement – Executive Directors are required to work towards holding beneficially-owned shares equivalent in value to a percentage of their salary by retaining at least one half of after-tax shares released from the incentive plan until this requirement is met. For the Chief Executive this requirement is 250% of salary and for other Executive Directors this requirement is 200% of salary. In addition, the lower of their shareholding requirement or their actual shareholding at leaving date (based on shares vesting following the introduction of the 2020 policy) must normally be retained by Executive Directors for 12 months following leaving date and then 50% of that amount for the following 12 months.

Summary of new incentive compared to previous policy



Remuneration policy table

The table below sets out each element of Executive Directors' remuneration.

Pay element – fixed pay

Base salary	
Purpose and link to strategy	The Company provides competitive salaries suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.
Operation	Salaries are reviewed, but not necessarily increased, annually. Decisions on salary are informed but not led by reference to companies of a similar size, complexity and international reach. A proportion of salary may be deferred into shares for up to two years.
Maximum opportunity	Any salary increases will be assessed annually and will not normally exceed average increases for employees in other appropriate parts of the Group. The Committee may exercise discretion to make larger increases in circumstances where it is necessary to address particular issues or risks, including growth in the role for new appointments.
Benefits	
Purpose and link to strategy	The Company provides competitive benefits suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.
Operation	Benefits may include car or car allowance and related costs, financial planning assistance, private medical insurance, life assurance and other appropriate benefits at the discretion of the Committee. Relocation support or support for accommodation and travel may be offered to executives where necessary. Executive Directors may participate in all-employee share plans including ShareSave and the Share Incentive Plan.
Maximum opportunity	Benefits excluding all employee share plans, and any accommodation, relocation and associated tax costs will not exceed £100,000 per annum.
Pension	
Purpose and link to strategy	The Company provides a competitive retirement savings plan suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.
Operation	Executive Directors are offered membership of a defined contribution plan. A cash allowance may be payable in lieu of pension contributions.
Maximum opportunity	The maximum contribution is 12% of base salary only.

Pay element – variable pay

Rolls-Royce incentive plan	
Purpose and link to strategy	To incentivise the execution of the business strategy, delivery of financial targets, and the achievement of personal objectives.
Operation	Incentives are determined based on Group financial performance and the individual performance of the Executive Directors. Group measures may combine both short and long-term measures. The Committee may also apply non-financial metrics that support the underlying strategic priorities for the forthcoming year and/or adjust the pay-out level to ensure the outturns reflect performance. Maximum incentive levels will reduce from 200% to 175% of target. This reduction in maximum opportunity means that 29% of the maximum opportunity is payable if base performance is achieved and 57% of maximum for target performance. The financial and non-financial metrics are generally set with reference to the prior year and to the budgets and business plans for the coming year, ensuring the targets are appropriately stretching. Metrics may be one-year or a combination of one-year and multi-year cumulative metrics. All the incentive is compulsorily deferred into shares: 40% for three years and 60% for four years, and released subject to continued employment. Deferred shares may attract an issue of C Shares or equivalent during the deferral period.

Pay element – variable pay

Rolls-Royce incentive plan (continued)	
Operation (continued)	Awards are subject to malus and clawback provisions where there has been a material misstatement of audited results; serious financial irregularity; material financial downturn or an event causing a material negative impact on the value of the Group; material failure of risk management; a serious breach of Our Code; individual misconduct or actions that materially damage the Group; a breach of or inadequate response to a significant HSE or other environmental issue; and/or a materially incorrect calculation of an award. These provisions apply from the start of the performance period to three years from the date of grant or the settlement date, if later. For awards granted prior to the adoption of this policy, legacy malus and clawback provisions may apply. The Committee has discretion to adjust the formulaic outcome (including down to zero) to ensure alignment of pay with performance and fairness for shareholders and participants.
Maximum opportunity	The normal annual maximum for the Chief Executive is 385% of salary and 333% for other Executive Directors.
Performance measures	The incentive is weighted 80% on Group metrics, and 20% on individual performance. Within the Group metrics: — at least 85% is based on Group financial targets (for example profit and free cash flow); — up to 15% is based on non-financial metrics such as employee engagement and sustainability — individual objectives are set and agreed with the Remuneration Committee at the start of each year, to reflect the prevailing business context; and — the Committee may, in the context of the underlying business strategy, use different performance measures.

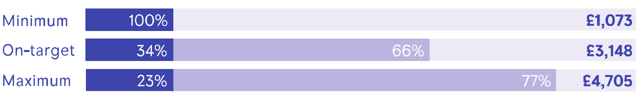
The table below sets out the main elements of Non-Executive Directors' remuneration.

Pay element

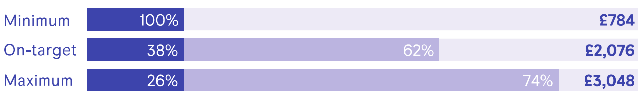
Fees	
Purpose and link to strategy	To reward individuals for fulfilling their role and attract individuals of the skills and calibre required.
Operation	The Committee makes recommendations to the Board on the Chairman's remuneration. The Chairman and the Executive Directors determine the remuneration of the Non-Executive Directors. Levels take into account fees paid by other companies of a similar size and complexity. The Chairman is paid a single fee. Other Non-Executive Directors are paid a base fee covering Board and Board Committee membership, with Chairs of Committees, the Senior Independent Director and the Employee Champion receiving an additional fee.
Maximum opportunity	The maximum total remuneration payable to Non-Executive Directors, including the Chairman, is £1,600,000 per annum.
Benefits	
Purpose and link to strategy	To devote maximum time and attention to the requirements of the role.
Operation	Travel, hotel and subsistence incurred in attending meetings are reimbursed by the Company. The Group may pay tax on such benefits. It may provide support with tax matters for Non-Executive Directors based outside the UK. The Chairman has occasional use of chauffeur services.
Maximum opportunity	Maximum value of £5,000 per annum towards tax advice and filing, and £15,000 per annum for chauffeur services.

Remuneration policy – worked examples for 2021

Chief Executive £000



Chief Financial Officer £000



■ Fixed remuneration (including salary, benefits and pension)
■ Rolls-Royce incentive plan

Minimum – fixed remuneration (salary, pension, benefits), no incentive award.
On-target – fixed remuneration, 57% of maximum incentive award.
Maximum – fixed remuneration, 100% of maximum incentive award.
There is no share price impact as incentive awards are granted following the end of the performance period.

Performance measures and targets

The Committee will set Group financial targets for incentive awards with reference to the prior year and to forward-looking business forecasts, ensuring the targets are appropriately stretching. Metrics may include both annual and longer-term measures.

The Committee may, in the context of the underlying business strategy, use different performance measures for incentives and/or vary the weightings of the measures, including increasing the proportion based on Group measures.

The measurement of performance against performance targets is at the Committee's discretion, which may include appropriate adjustments to financial or non-financial elements and/or consideration of overall performance in the round. Adjustments may be either upwards or downwards.

Long-term performance conditions may also be replaced or varied if an event occurs or circumstances arise which cause the Committee to determine that the performance conditions have ceased to be appropriate.

Policy on new appointments

The Committee will appoint new Executive Directors with a package that is in line with the remuneration policy. Base salary may be set at a higher or lower level than the previous incumbent. The maximum incentive opportunity on appointment is 385% for the Chief Executive and 333% for other Executive Directors.

Remuneration forfeited on resignation from a previous employer may be compensated. This will be considered on a case-by-case basis and may comprise cash or shares. In general:

- if such remuneration was in the form of shares, compensation will be in the Company's shares;
- if remuneration was subject to achievement of performance conditions, compensation will, where possible, be subject to performance (either Rolls-Royce performance conditions or actual/forecast performance outturns from the previous company); and
- the timing of any compensation will, where practicable, match the vesting schedule of the remuneration forfeited.

Legacy terms for internal appointments may be honoured, including any outstanding incentive awards. If an Executive Director is appointed following a merger or an acquisition of a company by Rolls-Royce, legacy terms and conditions may be honoured.

Wider workforce considerations

When setting remuneration for Executive Directors and the senior management team, the Committee carefully considers wider remuneration across the Group, including salary increases, bonus awards, share plan participation and pay ratios between Executive Directors and other employees.

This has been a particular area of focus for the Committee in designing a new policy that is capable of cascade down the organisation.

There have been a number of additional areas where alignment has been created between Executive Directors and the workforce in 2020 including salary reductions and deferrals, and alignment of pension contributions at 12% of salary.

At more senior levels, remuneration is increasingly long-term and larger proportions are dependent on Group and business performance, as well as individual performance and an increasingly larger proportion is delivered in the form of shares. In terms of the management population generally, the direction of travel is to re-balance the total reward package from fixed elements to variable performance-related elements to support cultural transformation. The Committee periodically reviews benchmarking data to ensure that they are aligned with market practice within the appropriate comparator groups, as one source of data.

We are committed to sharing business success across the organisation, with employees participating in a short-term incentive plan. There is strong alignment of business metrics between the Executive Directors bonus plan and those in which the majority of the workforce participate. In addition, the Group offers an all-employee sharesave plan to eligible employees globally every two years which aligns employee interests with those of our shareholders. This continues to be a popular benefit with over 40% of employees joining the most recent plan.

Input on the new remuneration policy was sought from the Company's Board apprentice cohort. Application of the policy will be influenced by the remuneration arrangements for all employees. Irene Dorner has designated responsibility for engaging with employees and bringing their voice into the boardroom, in addition to being the Chair of the Remuneration Committee, which further strengthens the link between employees and executive remuneration. See stakeholder engagement, page 72.

Share plans

The Committee retains a number of discretions consistent with the relevant share plan rules. In the event of any variation in the share capital of the Company, a demerger, special dividend, distribution or any other transaction which will materially affect the value of shares, the Committee may make an adjustment to the number or class of shares subject to award.

The treatment of leavers in our ShareSave and Share Incentive Plan is covered by the respective plan rules. Change of control provisions in respect of employee share plans are set out on page 210.

Termination

The Company is required to give Executive Directors 12 months' notice under their service contracts. Payment in lieu of notice will not exceed the value of 12 months' salary, benefits and pension contributions. Both mitigation and the timing of payments through the notice period will be considered by the Committee where appropriate, as will the funding of reasonable outplacement and other professional fees. There is no automatic entitlement to an incentive. Taking into account the circumstances, the Committee has discretion to award an incentive applying the relevant performance conditions and with appropriate time pro-rating.

Deferred shares from the incentive plan will generally be retained in cases such as retirement, death, injury, ill-health, redundancy or any other reason at the discretion of the Committee and may include appropriate time pro-rating. Awards will typically vest at the normal time unless the Committee determines otherwise.

For the LTIP grants issued under the previous policy, the rules state that unvested awards may be preserved at the Committee's discretion according to the circumstances. In such cases vesting will be at the normal date, subject to the established performance conditions, and pro-rated to employment in the performance period. In cases such as death and terminal illness, the Committee also has the discretion to vest the awards immediately using an estimate of future outturn. If an individual leaves after the LTIP shares have vested but during the holding period, shares will not be forfeited but the holding period will remain in force. The Committee also has the discretion to mitigate or clawback awards where an Executive Director retires and then becomes employed or engaged by another business in a non-voluntary capacity within 12 months.

Post-employment

Post-employment, an Executive Director will normally be required to retain the lower of their shareholding requirement or their actual shareholding at leaving date (based on shares vesting following the introduction of the new policy) for one year after leaving, and 50% of this level for a second year. The Committee can waive or modify this requirement (for example in compassionate circumstances).

Service contracts

The service contract for Warren East includes 12 months' notice of termination from the Company and six months' notice from the Executive Director. The service contracts for Stephen Daintith and Panos Kakoullis include 12 months' notice from the Company and 12 months' notice from the Executive Director. All contracts include the entitlement to paid holidays, sick pay, and other standard employment terms including reimbursement of reasonable business expenses.

The Chairman and Non-Executive Directors have letters of appointment. No compensation is payable to the Chairman or to any Non-Executive Director if the appointment is terminated early or if they fail to be re-elected at an AGM. Service contracts and letters of appointment can be viewed at the Company's registered office.

Legacy commitments

Any remuneration payments and/or payments for loss of office made under legacy arrangements prior to the approval of the Company's remuneration policy may be paid out subject to the terms of the remuneration policy in place at the time they were agreed. For these purposes, 'payments' include the Company satisfying awards of variable remuneration and, in relation to an award over shares, the terms of the payment are agreed at the time the award is granted. LTIPs granted under previous policies remain in place, consistent with the terms of that policy.

Minor amendments

The Committee may make minor amendments to the policy (for regulatory, exchange control, tax or administrative purposes or to take account of a change in legislation) without obtaining shareholder approval.

Provision 40, section 41 disclosures

When developing the proposed remuneration policy and considering its implementation for 2021, the Committee was mindful of the Code and considers that the executive remuneration framework appropriately addresses the following factors:

Clarity	We provide open and transparent disclosures regarding our executive remuneration arrangements. We have explained the changes to our proposed remuneration policy in a way that highlights their alignment to both our vision and strategy as well as the provisions of the Code.
Simplicity	Remuneration arrangements for our Executives and our wider workforce are simple in nature and well understood by both participants and shareholders.
Predictability	Our remuneration policy contains details of maximum opportunity levels for each component of pay, with actual incentive outcomes varying depending on the level of performance achieved against specific measures.
Proportionality, risk, and alignment to culture	The metrics used to measure performance for incentive awards drive behaviours that are closely aligned to our vision and strategy. In particular our variable pay arrangements continue to focus on delivering an unprecedented level of transformation. The Committee considers that our variable pay structure does not encourage inappropriate risk-taking. The incentives are subject to the achievement of stretching performance targets, and the Committee's holistic assessment of performance that can result in the application of discretion. The use of holding periods, the payment of fixed salary in shares with holding periods, and our shareholding requirements (including after leaving employment with Rolls-Royce) provide a clear link to the ongoing performance of the business and therefore alignment with shareholders. Malus and clawback provisions also apply to the incentive plan.