



EXECUTIVE REMUNERATION – ABI POSITION PAPER

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1. INTRODUCTION AND SUMMARY CONCLUSIONS

The ABI's Executive Remuneration Guidelines set out criteria by which shareholders will judge remuneration policy as it applies to main board directors of companies in which they invest. The current economic climate has created challenges for remuneration policy. It falls to Remuneration Committees to address these challenges. Shareholders are keen to have high quality dialogue with them in order to minimise the risk of misunderstanding and confrontation.

This paper is therefore addressed to Remuneration Committees to help them understand how shareholders expect the ABI's Guidelines to be implemented in current conditions, and to encourage constructive dialogue between Remuneration Committees and shareholders on the delivery of core principles. It does not seek to supplant the Guidelines, which provide a detailed reference point for what shareholders will routinely regard as acceptable, but it aims to highlight those elements of the Guidelines that are currently of particular relevance.

Independent Remuneration Committees exist to resolve the potential conflict of interest between executive directors and shareholders. Their policies should be transparent, use simple structures, and deliver alignment with the strategy of the company so as to contribute to the creation of sustainable long term value. Policy should not focus excessively on the short-term or promote inappropriate risk taking.

The main conclusions are therefore as follows:

- Remuneration Committees should be accountable to shareholders for their decisions, especially when these involve the use of discretion. Shareholders seek an open and constructive approach to communication rather than a purely compliance-based approach to remuneration guidelines based on the advice of consultants.
- Remuneration structures that seek to increase tax efficiency should not result in additional costs to the company or an increase in its own tax bill. Remuneration Committees should be aware of the potential damage to the company's and shareholders' reputation from implementing such schemes.
- Windfall gains may arise if the level of share or option grants expressed as a multiple of salary is maintained after a substantial fall in the share price. Where this risk exists, grants should be scaled back.
- Shareholders discourage the payment of annual bonuses to main board directors when the business has suffered an exceptional negative event. In such circumstances shareholders should therefore be consulted on bonus policy and any proposed payments should be carefully justified.

- In the case of underpinning measures supporting relative TSR or other similar criteria, any determination of vesting should be justified in relation to the overall underlying financial performance of the company and not solely by performance relative to peer companies. This determination should be disclosed in the Remuneration Report.
- Experience has shown that retention awards to main board directors rarely work. Retention concerns on their own are not sufficient grounds for remuneration to increase.

2. ABI CORE REMUNERATION PRINCIPLES

Shareholders strongly encourage Remuneration Committees to have regard to the core principles set out in the ABI Guidelines. These are:

- Boards are responsible for adopting remuneration policies and practices that promote the success of companies in creating value for shareholders over the longer term. The policies and practices should be demonstrably aligned with the corporate objectives and business strategy, taking risks fully into account, and reviewed regularly.
- Remuneration Committees should be established in accordance with the provisions of the Combined Code. They should comprise independent directors who bring thought and scrutiny to all aspects of remuneration. It is important to maintain a constructive and timely dialogue between boards and shareholders regarding remuneration policies and practices.
- Executive remuneration should be set at levels that retain and motivate, based on selection and interpretation of appropriate benchmarks which should be used with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.
- Executive remuneration should be linked to individual and corporate performance through graduated targets that align the interests of executives with those of shareholders. The resulting arrangements should be clear and readily understandable.
- Shareholders will not support arrangements which entitle executives to reward when this is not justified by performance. Remuneration Committees should ensure that service contracts contain provisions that are consistent with this principle.

3. REMUNERATION COMMITTEES AND CURRENT PRACTICE

Remuneration Objectives

Performance-related remuneration seeks to reward business performance in line with corporate strategy which should aim at sustainable long-term value creation. As companies have different business models their remuneration policies and structures will vary. It is therefore incumbent on Remuneration Committees to explain to their shareholders the link between remuneration and strategy.

Remuneration structures should not encourage activities or risks that are not in line with agreed strategy. Nor should they allow reward for failure. Reward for failure fundamentally undermines the basis of performance-related pay, brings reputational damage to business and increases the risk of regulatory intervention.

Role of the Remuneration Committee

Since a UK unitary Board consists of both executive and non-executive directors, a board committee of non-executives is needed to resolve the conflict of the executive directors setting their own remuneration. The Committee should seek to achieve appropriate levels of remuneration over time whilst avoiding unnecessary increases driven by annual reviews and benchmarking. Shareholders welcome the fact that in present conditions many companies have decided to freeze base pay.

The Committee should have regard to the reputational risks and unnecessary costs posed by poor remuneration practices. In accordance with the Guidelines, it should also take account of, and be sensitive to, the employment conditions within the company and the wider prevailing economic conditions.

Bonuses should not be considered an automatic entitlement. They should be based upon outstanding contributions and not be paid as compensation for low or non-existent increases in base pay or as compensation for the failure of long-term share schemes to pay out.

The Committee should work with the board as a whole and with other committees. Decision-making should be joined up, with risk being properly taken into account. The board may wish to delegate to the Committee an oversight role to ensure that remuneration policy below board level is in line with business strategy. However, the Committee should not assume a quasi-executive role by setting the pay of individual employees or groups of employees.

The Committee should consider carefully the role of remuneration consultants. It should not place undue reliance on consultants or delegate responsibility for making decisions or dialogue with shareholders. The Remuneration Committee is responsible for consultants' activities and must manage the conflicts of interests that are inherent in the consultants' business models. Work performed by consultants should be disclosed in the Remuneration Report. The Report should also include the nature of the work performed during the year (both for the committee and management) and the level and nature of fees paid.

Shareholders should be consulted when Remuneration Committees contemplate a material use of discretion.

Transparency

A clear understanding of remuneration policies and structures is important to both directors themselves and to shareholders.

Where there are elements of remuneration that are unusual or complex, the company should seek to highlight and explain them.

Consultation with shareholders is an important element in both transparency and accountability. The ability of companies to discuss the issues with shareholders is valuable to both parties. However, for the process to function effectively shareholders must be given sufficient time to consider the issues and to respond.

Investors may have different views on a company's strategy and management. This will be reflected in their views on remuneration and other corporate governance matters. Although, it may be difficult for companies when they receive a wide range of views, this should also be expected.

The Remuneration Report provides the opportunity for Remuneration Committees to explain and justify their remuneration policies and structures, and to explain changes during the year. It should not be seen as merely an exercise in legal compliance.

The Structure of Remuneration

Remuneration should be aligned to and encourage the achievement of strategic objectives. This necessitates a balance of short and long-term elements. The specific balance and structures will vary according to the company, although the majority of performance related reward should be long-term related. Shareholders welcome the consideration of performance periods longer than three years together with subsequent holding periods for shares that vest. Deferring bonuses is also encouraged but companies should not seek to compensate for any perceived reduction in value by raising the overall quantum.

Pension arrangements should not provide for full pension on early retirement in a way that could commit companies to rewarding failure.

Salary

Salary is at the core of the remuneration structure. Respecting the Combined Code principle of paying no more than is necessary is the key. Account should be taken of the role and responsibilities involved, and the scale and complexity of the business. Salary decisions should not be taken on the basis of simple benchmarking against peer companies. If benchmarking is used, the aim should not solely be to match the "median" but to provide a point of reference for determining the appropriate salary for the specific job. The constant chasing of a perceived median has been a major contributor to the spiralling levels of pay.

Changes in market capitalisation alone are not justification for salary increases as responsibilities may not have increased. Whilst increased market capitalisation has on occasions been cited in support of significant increases in salary, there has been no corresponding reduction in salary as market capitalisations have decreased.

Annual Bonuses

Annual bonuses exist to reward contribution to the business during the year above the level expected for being in receipt of a salary. They should be clearly linked to business targets, ideally through the KPIs reported in the Enhanced Business Review. Where other measures are chosen these should be explained and justified. The KPIs can be both financial and non-financial. The measurements chosen should be quantifiable and the targets chosen should be set at the start of the year. The performance measures and targets should be publicly disclosed. If the targets are considered to be commercially sensitive they should be disclosed post hoc. Shareholders discourage the payment of annual bonuses to executive directors if the business has suffered an exceptional negative event, even if some specific targets have been met. In such circumstances shareholders should therefore be consulted on bonus policy and any proposed payments should be carefully justified.

Incentive Schemes

The level of grant should not always be the maximum available under the scheme rules. Shareholders are particularly concerned that dilution limits should be respected. In order to avoid windfall gains, grants should be scaled back where the share price has fallen substantially. Deferral and longer performance periods present issues in terms of participants' entitlement should they leave the company. Consideration needs to be given to continued operation of performance periods and deferral mechanisms even after a participant leaves the company. Deferred awards could be placed in escrow and performance measurement periods continue until vesting.

The concept of clawback is contained in the Guidelines and should be helped by deferral and longer performance periods.

In recent years quanta have increased with corresponding increases in performance targets. Care must be taken that in the pursuit of larger awards, participants are not encouraged to take excessive risks to achieve the required performance.

The performance metrics used for share awards should relate to long-term strategy and reflect the need for a quantifiable and sustainable improvement in business performance with shareholder value being added.

In the case of underpinning measures supporting relative TSR or other similar criteria, any determination of vesting should be justified in relation to the overall underlying financial performance and not solely by performance relative to peer companies. This determination should be disclosed in the Remuneration Report.

When a grant is made, the performance expected should be clear to the participants and to shareholders. Performance targets should not be amended retrospectively. The use of annual grants means that participants should always have an exposure to improving corporate performance.

Retention Awards

Special or one-off awards are not generally favoured. Effective remuneration planning involving a balance of short and long term plans, carefully selected and calibrated performance measures and targets, and annual grants, should make exceptional awards unnecessary. A need for special grants, particularly for continuing management, indicates poor planning by the Remuneration Committee and may be reward for failure. Special awards may be acceptable when, for example, a new team is brought in to turn around a company. When such awards are made the Remuneration Committee must justify them.

Experience has shown that retention awards for main board directors rarely work. Retention concerns on their own are not sufficient grounds for remuneration to increase.

Tax Avoidance

Tax efficient incentive schemes are being promoted as a means of providing incentive arrangements which are taxed as a capital gain rather than income. As a matter of principle remuneration policy should not seek to compensate directors for higher tax rates. Any tax efficient schemes should take account of the need not to incur extra costs through higher overall payments or an increase in the company's own tax bill. Shareholders are alert to the potential damage to their and the company's reputation from implementing schemes that are clearly aimed at tax avoidance.

Conclusion

Shareholders seek a constructive dialogue that results in remuneration policies that promote the creation of long-term sustainable value. This paper has sought to set out investor thinking on how this can be best achieved in the present market conditions.

Shareholders seek remuneration policies that encourage management to deliver long-term business performance in line with corporate strategy to deliver long-term value creation. Structures should be transparent and simple. Remuneration Committees should be accountable to shareholders for their decisions and the use of discretion.

ABI members are anxious to promote better dialogue and understanding, which they believe will help avoid unnecessary confrontation.