



**JOINT STATEMENT ON EXECUTIVE CONTRACTS
AND SEVERANCE BY THE ASSOCIATION OF BRITISH
INSURERS (ABI) AND THE NATIONAL ASSOCIATION
OF PENSION FUNDS (NAPF)**

18 February 2008

1. Introduction

- 1.1 Our two organisations, whose members are leading institutional investors in UK markets, are publishing an updated statement of best practice on contract and severance policy for directors.
- 1.2 This statement is aimed at assisting Boards and their Remuneration Committees with the design and application of contractual obligations for senior executives. Shareholders have an expectation that Boards will consider the risks of negotiating inappropriate executive contracts that can lead to situations where failure is rewarded.
- 1.3 Institutional shareholders believe executives of listed companies should be appropriately rewarded for the value they generate. However, they are also concerned to avoid situations where departing executives are rewarded for under-performance. For many years the ABI and NAPF have considered this to be a matter of good governance and it is clearly addressed in the FRC's Combined Code on Corporate Governance.

2. Principles

- 2.1 The responsibility for setting directors' contracts lies primarily with the Remuneration Committee.
- 2.2 In line with the Combined Code, contracts should be set with reasonable notice periods.
- 2.3 Boards should ensure that executives show leadership by aligning their financial interests with those of the company.
- 2.4 The level of remuneration received by senior executives already factors in the risk associated with their role. Boards should ensure that contracts do not include any additional financial protection in the event of poor performance leading to termination.
- 2.5 The Remuneration Committee should carefully consider what commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination.
- 2.6 Directors' contracts should ensure that severance payments arising from poor corporate performance should not extend beyond basic salary.
- 2.7 Companies should clearly disclose key elements of directors' contracts on their website and summarise them in the Remuneration Report.

- 2.8 Companies should fully disclose in their Remuneration Report the constituent parts of any severance payments and justify the total level and elements paid.

3. Guidance

- 3.1 This Guidance is intended to emphasise certain aspects of the Combined Code and where appropriate provide guidance as to shareholders' expectations.
- 3.2 Contract policy including terminations and the approach to mitigation should be clearly explained in the Remuneration Report. Also, corporate objectives set for executives by the Board should be clear. The more transparent and understandable the objectives, the easier it is to determine how an executive has performed and therefore prevent payment for failure. Wherever possible, objectives against which performance will be measured should be made public.

Contract Terms

- 3.3 Remuneration Committees should ensure that the policy and objectives on directors' contracts are clearly stated in the Remuneration Report. Shareholders will take account of contracts and the way they are implemented in considering their vote on the Remuneration Report and the re-election of members of the Remuneration Committee.
- 3.4 When contracts are being negotiated, boards should consider and avoid the reputational risk of being obliged to make large payments to executives who have failed to perform. Contracts should be reviewed periodically and Remuneration Committees should consider whether the contract provisions are in line with their policy and this Statement.

Notice Periods

- 3.5 The Combined Code states that under normal circumstances directors should be retained on contracts of one year or less. However we believe that a one-year notice period should not be seen as a floor, and we would strongly encourage boards to consider contracts with shorter notice periods. Compensation for risks run by senior executives is already implicit in the absolute level of remuneration, which mitigates the need for substantial contractual protection.
- 3.6 If it is necessary to offer executives longer notice periods, for example for incoming executives at companies in difficulties, we would expect the length of the contract to be justified. In that case the termination provisions attached should be fully disclosed and the length of the contract should reduce on a rolling basis in line with the recommendations contained in this Guidance.

Severance Payments

- 3.7 Remuneration Committees should have the leeway to design a policy appropriate to the needs and objectives of the company, but they must also have a clear understanding of their responsibility to negotiate suitable contracts and be able to justify severance payments to shareholders.
- 3.8 From the outset, Boards should establish a clear policy to ensure any non-contractual payments are linked to performance. No director should be entitled to discretionary payments in the event of termination of their contract arising from poor corporate performance. Remuneration Committees should consider retaining their discretion to reclaim bonuses if performance achievements are subsequently found to have been significantly mis-stated.
- 3.9 Contracts should not provide additional compensation for severance as a result of change of control.
- 3.10 Remuneration Committees should ensure that full benefit of mitigation is obtained. This includes the legal obligation on the part of the outgoing senior executive to mitigate the loss incurred through severance by seeking other employment and reducing the need for compensation. Phased payments are generally appropriate for fulfilling compensation on early termination. The ABI and NAPF are not supportive of the liquidated damages approach which involves agreement at the outset on the amount that will be paid in the event of severance.

Pensions

- 3.11 Pension entitlement or contributions on severance can represent a large element of cost to shareholders. Remuneration Committees should identify, review and disclose in the Remuneration Report any arrangements that guarantee pensions with limited or no abatement on severance or early retirement. These pension arrangements are no longer regarded as acceptable, except where they are generally available to all employees. Where opportunities arise, existing contracts should be amended. Such conditions should not be included in new contracts.

Inspection Arrangements

- 3.12 Directors' contracts and any side letters relating to severance terms and pension arrangements should be readily available for shareholder inspection.

4. **Conclusion**

- 4.1 It is unacceptable that poor performance by senior executives, which detracts from the value of an enterprise and threatens the livelihood of employees, can result in excessive payments to departing directors. Boards have a responsibility to ensure that this does not occur.

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