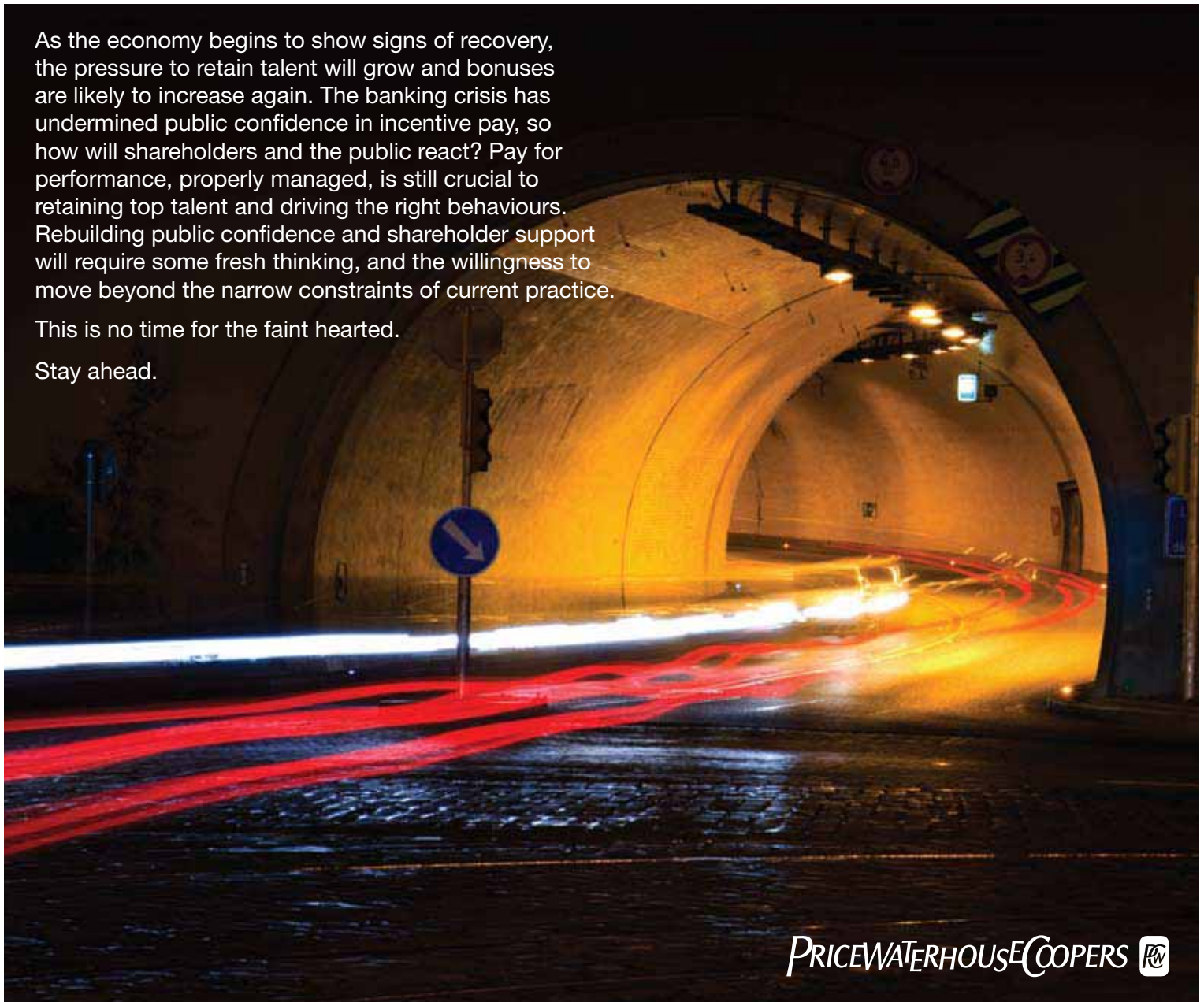


Is pay for performance a force for good?

As the economy begins to show signs of recovery, the pressure to retain talent will grow and bonuses are likely to increase again. The banking crisis has undermined public confidence in incentive pay, so how will shareholders and the public react? Pay for performance, properly managed, is still crucial to retaining top talent and driving the right behaviours. Rebuilding public confidence and shareholder support will require some fresh thinking, and the willingness to move beyond the narrow constraints of current practice.

This is no time for the faint hearted.

Stay ahead.



Blip or turning point?

Executive remuneration has been through yet another period of unprecedented turbulence. Remuneration has been at the heart of debates about the banking crisis and has once again come to the forefront of public consciousness in the severest recession of this generation.

So has the world of executive remuneration changed for ever, or will business as usual return? In other words, are we at a turning point or just experiencing an aberration of late twentieth century governance thinking? The answer to this depends fundamentally on whether we believe pay for performance is a force for good. During the events of the last year, cracks in the historic reward model have appeared which suggest that, at the very least pay for performance in its current form should be rethought.

Remuneration is being substantially remodelled in the banking world. But what about other industry sectors? To date, the world of executive pay has carried on largely as normal:

- base pay was generally frozen – but this seems to be for one year only (although time will tell)
- annual bonuses were down in 2009 but only by around 15% to 20%
- long-term incentives reduced, but only where companies had dramatic share price falls

So based on these facts, it would appear this is a blip rather than a turning point. But we believe otherwise.

Already, shareholder activism in 2009 has not been restricted to financial services, with an increased willingness of shareholders to deploy their vote against the remuneration report. And many notable examples of contentious AGMs were outside the financial services sector.

The UK Corporate Governance Code review by the Financial Reporting Council (FRC) contains remuneration-related revisions that apply to all companies. The main shareholder representative bodies (Association of British Insurers, National Association of Pension Funds and RiskMetrics) have all either issued (or are about to issue) new statements on remuneration, in all cases picking up on some of the themes of the banking crisis, in particular relating to risk.

It is said that the impact of a technological advance is often overestimated in the short-term but underestimated in the long-term. For this reason ‘game-changing’ technologies rarely produce money for the early investors, but can subsequently be seen to have reshaped the economy.

In the same way, the short-term changes in executive pay may not be as dramatic as some expect, but the medium to long-term ramifications of recent events could be very significant indeed.

We believe that looking back in five years time we will see some very significant changes in the executive remuneration area, covering design, performance measurement and governance. Now is the time to act to ensure you are well placed to meet these challenges and we hope that you will find this publication thought provoking and an aid to your preparation.

Tom Gosling
Partner, Reward
PricewaterhouseCoopers

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Introduction

The key themes of governance, design and performance measurement will be fundamental to the evolution of executive compensation going forward. Each theme is introduced below with links in to the chapters where you can find further insight.

Governance

The Governance Code review places renewed emphasis on the role of non-executive directors in challenging strategy and decision making in the board room. A common theme running through the FRC's review and the Walker Review is that governance issues are more to do with behaviour than formal structures.

As a result the challenge within remuneration committees over remuneration proposals is likely to increase. *Last chance (chapter 5)* highlights the potential issues for committee members who will need to be prepared for, and equipped to deal with, a greater degree of constructive conflict than previously. This will also require a greater emphasis on board effectiveness (see *Being independent – chapter 7*) and the performance of the remuneration committee. The focus should be on helping them work effectively as a team, providing the right environment to air and deal with difficult issues.

The Governance Code did not formally extend the remuneration committee's remit, as recommended in the Walker Review and FSA Code of Practice. However, it reminded non-executive directors about their responsibility for wider policy and recognition of company-wide practices. Therefore, remuneration committees across all sectors are likely to take a wider interest in the company's remuneration policy.

If remuneration committees are to embrace this wider remit, they will need input from a broad range of functions across the business. *Governing pay (chapter 6)* shows how this might be achieved. In our view, the remuneration discussion has become too narrowly focussed and there has been insufficient input from functions outside HR. There is already evidence of a shift, with a number of our clients adopting more formal processes whereby a range of identified functional inputs is obtained in the design and decision making phases. This includes strategy, finance, risk, as well as HR. This is not about creating a new industry around remuneration, but more about getting information about performance and risk that already exists in the business, and reporting it in a way that aligns appropriately with the remuneration information on which the remuneration committee is basing decisions.

This requirement for a broader view of performance, reward and risk will also lead remuneration committees to review the input that they receive from internal and external advisers. Remuneration committee advice focused primarily on descriptions of market practice and shareholder guidelines will no longer be seen as sufficient. Therefore, expect to see remuneration committees drawing on a wider range of external sources of expertise, as well as the broader range of internal sources.

Design

Executive reward has been transformed over the last decade. The model has shifted from one of fixed pay forming a high proportion of the package, with incentives an added extra for superior performance, to a model in which incentives form two thirds or three quarters of the total package. In this model, incentives are an integral part of total compensation.

In particular, long-term incentives have caused problems – often being unsuccessful in meeting the goals of motivating executives and aligning outcomes with shareholders. Many remuneration committees find themselves struggling to set robust targets over three years. The outcome too often is that long-term incentives reward volatility of performance rather than sustained strong performance. The pressure is

increasing now that long-term incentives are, in effect, having to replace the long-term wealth-building role of pensions especially given the continuous change currently being seen in the pensions arena.

So we are in a strange situation where shareholders, executives and remuneration committees are unhappy with how long-term incentives are operating.

The current climate encourages conservatism, so long-term incentive plans are being tweaked rather than evolved. However, a ground-swell of frustration is building which we believe will lead to significant change in the long-term incentive model over the next five years.

Breaking the mould (chapter 1) considers some of the possible directions of the evolving pay model. Firstly, we think that there will be greater variety in incentive models, linked to companies' specific circumstances (there is no one-size fits all model). Secondly, we expect to see a simplification of long-term incentive plans to enhance engagement and make them more effective at driving the desired behaviours. This may result in higher levels of stock ownership to create alignment rather than complex long-term arrangements. Thirdly, companies will think harder about whether long-term incentives are necessary at all.

Performance measurement

A few years ago, benchmarking and literal interpretation of shareholder guidelines had led to an extraordinary convergence around earnings per share (EPS) and relative total shareholder return (TSR) as the performance measures of choice in long-term incentive plans. Although TSR remains the most common single measure in 2009, often it is now combined with measures that are more aligned with the specific priorities of an organisation. We expect this trend to persist, with a continued move away from relative TSR which in practice often rewards volatility of performance rather than sustained strong performance in light of the median cut-off favoured by UK institutions.

A lesson from the financial crisis is that some reward systems did not reflect a build up of unrecognised risk during the boom years. Shareholders are questioning whether this applies to other sectors. *Risk and reward (chapter 2)*, considers how the differential levels of financial and operational risk were exposed by the recession in sectors other than banking. Analysis shows that, as in financial services, this differential risk build-up during the boom years was not reflected in remuneration systems.

Reflection of risk in remuneration systems will be a major theme for the next year. Institutional investors have already highlighted the importance of taking risk into account in incentive plans. The Association of British Insurers have made references in this regard in their update to shareholder guidelines. However, whether or not their potential influence will have sufficient impact remains to be seen (*Powerful or posturing? – chapter 4*).

Better risk-adjusted metrics are one element of addressing risk in remuneration and possible approaches to this are discussed in *Nice in theory (chapter 3)*. Outside of financial services, performance metrics play a much smaller role in achieving risk adjustment. In our view, the initial focus needs to be on getting the right information about risk and performance in the right place, at the right time and in the right format to enable the remuneration committee to make appropriate judgements about the sustainability of performance. In cases where doubts arise, remuneration committee discretion may be used either to adjust incentive outcomes or increase the role of deferral.

If this sounds difficult, it's because it is. There is a need for constant vigilance against complexity. But done well, it goes to the heart of the remuneration committee's responsibility: ensuring that executive pay is not too little, not too much, but just right.

1

Breaking the mould

Given the failings of the current pay model, it is time to start asking some fundamental questions to try to find a better model.

Over the last decade, executive pay in the UK has increased significantly. The increase in pay has mainly been in the form of higher annual bonuses and long-term incentive (LTI) awards, which are nearly always performance-related. As our previous research has shown, the outcome has left almost everyone dissatisfied:

- Generally management feel that incentives have become too complex and prescriptive, and are not aligned to the business strategy or within their control. As a result, they do not believe incentives drive performance or change behaviours and many perceive incentives simply to be a lottery.
- Many institutional shareholders believe there is a tenuous link between pay and performance. The shareholder perception is that incentives ratchet up each year in line with annual benchmarking while incentive design and performance measures chop-and-change depending on management's expectation of them paying out (or not). Underlying these perceptions is a feeling that remuneration committees are not being tough enough and exercise poor discretion that always favours executives.
- Remuneration committees are caught in a calibration hell trying to design incentives that are durable and balance the expectations of executives and shareholders.
- Few really believe that complex long-term incentives retain executives; they just make it more expensive for a new employer to buy-out the executive with golden hellos and guarantees.
- The public, particularly since the banking crisis, see executive pay as nothing other than a gravy train – pay regardless of performance rather than pay for performance.

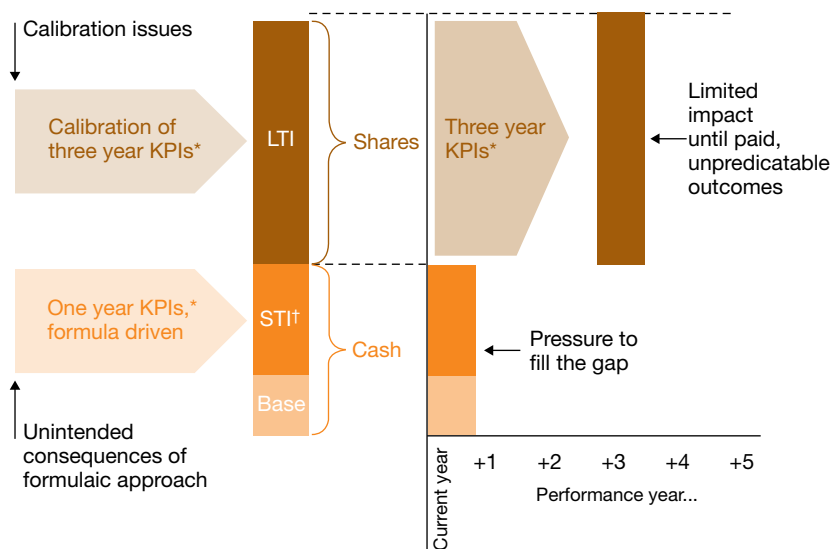
The UK has led the way in terms of corporate governance, disclosure and remuneration practices. We have high standards of disclosure, a plethora of best practice guidance, and healthy levels of shareholder engagement on executive pay compared with many other countries. This has not led to a particularly successful outcome, yet the danger is that the prescription will be more of the same, with calls for tougher performance conditions, long-term incentives, greater disclosure and more governance.

What's the problem?

Figure 1.1 illustrates the problems with the current model:

- A formulaic approach to annual bonus leads to excessive complexity and loss of control over outcomes.
- The attempt to set long-term incentive targets over a three-year timeframe leads to complicated calibration and intensive negotiation between remuneration committees, executives, and shareholders, none of whom can be certain how tough the targets will turn out to be.
- Long-term incentives can be considered too complex by executives, largely out of their control or unachievable almost as soon as they are granted. They therefore provide limited incentive effect until the few months before they vest.
- The outcomes from long-term incentives, because of calibration difficulties, seem rarely to be aligned with what the remuneration committee believes a fair result (whether too high or too low).
- As a result the remuneration committee loses control over total quantum of reward, and may have difficulty reaching the right figure through the bonus scheme.

Figure 1.1
Problems with the current
incentive model



Source: PwC Reward Practice
* Key performance indicators
† Short-term incentives (STI)

In light of these problems, is there a better way? Some alternatives for debate follow:

Model A: basic incentives

Yes, you read it right. If there is any truth in the observations above then perhaps it is time to simplify incentives. Some in the media have already compared performance-related pay to the Emperor's new clothes.

The alternative could be to significantly increase basic salaries but require the executive to purchase shares on a monthly basis with the additional salary. The employee keeps the shares irrespective of whether they leave or stay but cannot sell the shares for five years. There would be no annual bonus and no long-term incentive.

Consider the following example:

A FTSE Chief Executive Officer (CEO) currently earns a salary of £1m p.a. The CEO is eligible for a performance-related annual bonus of up to 200% of salary (with a target bonus of 100% of salary). The CEO also receives an annual award of shares with a face value of 200% of salary under a long-term incentive plan (LTIP), again with a target value of 100%. The LTIP vests subject to relative total shareholder return (TSR) over three years.

The theoretical range of package values is £1m to £5m, with a target value of £3m although in practice the bonus pays out at or around target level. The LTIP tends to be feast or famine.

Under the alternative model, the CEO's salary would be increased to £3m of which £1m is paid in cash as normal salary and the balance, £2m, would be used to buy shares on a monthly basis, which must be held for at least five years. There would be no annual bonus or LTIP. Equivalently, the CEO could be paid a £1m base salary with a £2m annual restricted stock award.

Figure 1.2
Illustration of
stock-based model

	Traditional	Model A
Base salary (cash)	£1m	£1m
Base salary (shares)		£2m
Bonus	£0m – £2m	
Long-term incentive	£0m – £2m	
Total	£1m to £5m	£3m

The alternative model would deliver a similar target value to the current package though it would be a lot simpler and more transparent. It would also potentially put an end to golden hellos and buy-outs as the shares are not forfeited on leaving. However, the CEO would forgo the potential upside of the current package for the certainty under the alternative model.

What about performance? Well, as shown in *Pay without performance in Review of the year 2008*, over the long-term, regular stock awards without performance conditions provide better alignment with shareholder returns than complex LTIPs. We conducted analysis of the average compensation actually received by FTSE 100 CEOs over the period 2001 to 2006 compared to the absolute shareholder returns created over the period. Our findings showed that for all but the most outstanding performers, the linkage between pay and performance has been tenuous. However, the correlation between pay and performance was much better (albeit not perfect) if restricted stock and a high shareholding guideline is used instead of LTIP awards.

While the CEO is in role they are paid the market rate, or above for high performance, but with a significant amount linked to the fortunes of their company. If they do not perform, it is left to the board and shareholders to take the obvious action.

In practice this is likely to be a step too far for the current UK environment. So let us consider some other alternatives.

Model B: deferred bonus model

The deferred bonus model introduces more performance linkage. Instead of receiving long-term incentives subject to performance, executives simply receive an increased salary, partly paid in stock, and an annual bonus, the majority of which is paid in shares, which vest over five years. In addition, the executive must build and maintain a significant shareholding in the company (e.g. 5 x salary as opposed to the typical 1 x to 2 x salary).

So in our example, the executive is paid a salary of £1.5m rather than £1m, of which £0.5m is paid in shares. In addition they get a bonus of up to 200% of salary each year:

Figure 1.3
Illustration of deferred bonus model

	Traditional	Model A	Model B
Base salary (cash)	£1m	£1m	£1m
Base salary (shares)	–	£2m	£0.5m
Bonus (cash)	£0m – £2m		£0m – £1m
Bonus (shares)			£0m – £2m
Long-term incentive	£0m – £2m		
Total	£1m to £5m	£3m	£1.5m to £4.5m

This approach has some precedent, but has the weakness that the whole system becomes dependent on the bonus paying out, and arguably creates an excessive focus on short-term performance; the issue many have suggested led to so much trouble in the banking sector.

Model C: bonus banks

Last year, we reported that economic profit as a performance measure is experiencing a renaissance, particularly in the financial services sector where there has been much talk about risk-adjusted performance. This year, we have heard much talk from regulators and shareholders about the concepts of bonus clawback and the phasing of annual bonuses over a much longer timeframe. Like economic profit, bonus banking may be due a revival.

In its simplest form, bonus banking is the partial deferral of bonuses and aims to smooth out bonus payments over time. Bonus banks accrue a reserve balance in good years which can be drawn down in years of poorer performance. This can help enhance morale for the management team in the face of adverse trading conditions, and increases confidence in the overall incentive structure.

The criticism of bonus banks is that they became overly complex through complex mechanistic approaches. However, simpler approaches can be taken. The key insights of bonus banks are that:

- bonuses should be paid based on the cumulative/average performance over a number of years rather than just based on one year; and
- years of poor performance can offset years of good performance to reduce the bonus bank, giving a stronger relationship between reward and performance over time.

The thinking is that this provides a balance between short-term measurement providing strong line of sight for management, but with payments smoothed over time.

Model D: multi-year incentive plan

Bonus banking, despite its many good qualities, encounters significant criticism due to the complexity it can create. Is there another way of taking the good points of bonus banking and leaving behind the bad?

One approach is a multi-year incentive plan. Under this approach:

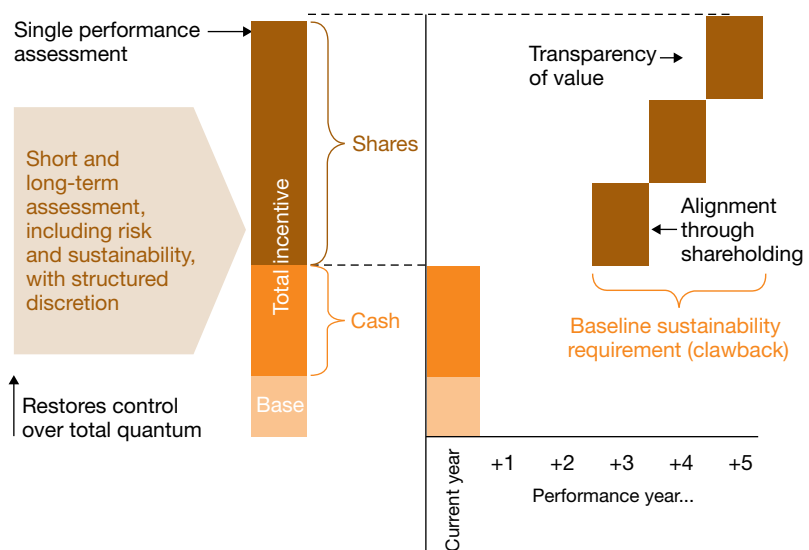
- the remuneration committee makes an annual assessment of performance against a balanced scorecard of objectives;
- the performance assessment looks back over the prior three years, not just a single year, subject to an over-riding remuneration committee discretion;
- an incentive award is made part in cash and part in shares with the share award vesting over a further three to five years to ensure sustainability of that performance; and
- once through a transition phase, this forms the single incentive plan operated.

The key features of this approach are:

- a transparent single performance assessment each year, looking back over the prior three years, which enables a more constructive conversation with shareholders about performance, rather than the current discussions that focus on calibration of performance conditions;
- transparency for executives – they know the domains in the balanced scorecard on which they are to be measured, and once the performance score is assessed the value of deferred shares they will receive is completely transparent;
- performance based over the long-term, with the average performance measured over three years and shares vesting over three to five years the total measurement period is six to eight years;
- a simplified incentive structure, with a strong focus on share ownership; and
- an enhanced role for remuneration committee discretion, assessing performance in the round in light of events, restoring control over remuneration quantum.

The approach is illustrated in the chart below:

Figure 1.4
Illustration of multi-year incentive plan



Source: PwC Reward Practice

‘Outstanding companies have a clear idea of what they are trying to do, and are in line with design reward programmes that are aligned to that.’

What do high performing companies do?

This year, we extended our research to consider the attributes of reward structures in outstanding companies in the FTSE 100 to see if there were any similarities. The first stage of our research was to identify outstanding performance in a broad sense and over a longer time horizon. We assessed each company against a range of financial and non-financial metrics. Financial metrics included earnings per share (EPS) growth, TSR growth, economic profit growth, and cumulative free cash flow over a 10 year period. Non-financial metrics included people, customer/service, corporate social responsibility and most-admired company rankings as determined by independent organisations. This gave us a group of seven companies across the major industry sub-categories.

This research is in its infancy, but raises a few interesting points. Compared to the FTSE 100 as a whole, the outstanding companies demonstrated the following characteristics in their executive reward programmes:

- more focus on variable rather than fixed pay;
- balance towards long-term rather than short-term reward;
- performance targets based on financial measures rather than relative TSR;
- high levels of share ownership amongst the board; and
- reward programmes that were durable.

We would not want to fall into the fallacy of causation versus correlation, and our research is in its early days. And of course, it is easier not to chop and change reward programmes (and CEOs) when you are being successful. But some of the results are in line with our anecdotal experience.

Outstanding companies have a clear idea of what they are trying to do, and are in line with design reward programmes that are aligned to that, rather than to what everybody else does. Reward plays out over longer timeframes, and there is a strong emphasis on executive share ownership. Finally, reward programmes, once designed, are left to work.

‘Stakeholders with an interest in executive pay should be prepared to consider all possibilities.’

What to do?

The time has come for remuneration committees to ask some hard questions about their incentive programmes, in particular long-term incentives:

- What is their purpose within the package and are they achieving that purpose?
- Are they motivating for executives and influencing behaviour?
- Are they achieving alignment with shareholders?

In many cases the answers will be uncertain or in the negative. So what is to be done?

We have set out some radical alternatives to the current incentive model to provoke some fresh thinking within organisations and shareholder groups. However, while in quiet moments shareholders and non-executive directors (NEDs) will admit the current model is broken, the appetite for radical change is limited in the current political environment.

We hope some leading companies will be brave enough to try something radically different, simpler and new. But in the meantime, what can be done within the current short and long-term incentive framework?

- First, wherever possible, try to develop relevant internal metrics of performance for long-term incentives, rather than relying on the vagaries of relative TSR (other than for a top-slice element of the package).
- Second, consider ways in which greater discretion and broader measurement can be brought into incentives to avoid complex calibration with over-reliance on formula. There are already examples of long-term incentive plans that incorporate a greater element of discretionary measurement and broader assessment against a mix of financial and non-financial measures.
- Third, focus on making executives significant shareholders. Require very significant shareholdings in exchange for greater predictability and control in the incentive package.

To achieve this requires trust between the remuneration committee and its shareholders. This means greater openness and disclosure, and a more grown-up dialogue about the levels of performance achieved. The chair of the remuneration committee will need to actively engage with shareholders if greater discretion is to be allowed.

There must be a simpler and better solution to designing executive pay than the current best practice norm, and one that will better align pay with performance. Stakeholders with an interest in executive pay should be prepared to consider all possibilities. Otherwise the pain and frustration will only continue.

2

Risk and reward

One of the lessons of the banking crisis was that risk was not adequately reflected in reward. How does this apply to other sectors?

Remuneration: cause or symptom of the banking crisis? The question will provide the nourishment for many a doctoral thesis in future years, and still will probably never be answered conclusively. Regulators, however, are not waiting for incontrovertible evidence. They have latched onto the suggestion that incentive systems that took inadequate account of the risk underlying the profits (or in some cases just revenues) being generated played a significant role in adding fuel to the fire of the banking crisis.

Few are arguing with their prescription that risks should be taken into account much more comprehensively in financial services than has been the case in the past. As a result, all the major banks are working hard at understanding how risk is reflected in remuneration structures and metrics, and making changes where required to capture risks to which incentives were previously not sensitive.

Is this an issue that those outside banking can ignore, or do the principles and approaches being developed in banking have wider application? After all, enterprise-wide risk management has become a vogueish topic in many sectors other than financial services.

Case study: the resources sector

Up to 2008, the resources sector enjoyed a period of unparalleled buoyancy as commodity prices hit record highs. Mining, oil and gas extraction companies saw revenues grow significantly and made impressive margins.

Companies responded to this in different ways. Some took a cautious approach, focused on building high-quality asset portfolios and maintaining strong, unleveraged balance sheets. Others allowed costs to rise as they competed for scarce mining expertise and local labour. And a number took advantage of cheap money to increase gearing and go on an acquisition spree.

On the way up the share price performance of the more cautious companies often suffered. They were not the darlings of the market. But when the market turned, those that were over-leveraged or had not paid attention to rising costs were hit hard.

Of course, risk is not a bad thing. Business is about taking risk. But the right risks, risks that are understood and articulated – and are within the company’s risk appetite. Where firms did choose a riskier strategy it may have been understood and endorsed by shareholders happy to take higher risk for higher potential returns.

However, as has been shown in financial services, having reward systems where the incentives are inconsistent with this risk appetite can have significant consequences. There is no reason to assume that other sectors are immune from this problem. Outside financial services as much as within, the key weaknesses of traditional incentive programmes apply:

- Short-term profit measures can encourage unsustainable growth.
- During an upswing in the market, relative TSR measures reward companies that adopt the highest risk profile of the peer group to outperform.
- Decisions made this year can have consequences way beyond the time horizon of typical three year incentives.
- Simplistic financial measures can ignore the real drivers of long-term risk and value.
- Formulas can have unintended consequences.

So what is to be done?

Understand your risks

Any risk-adjusted approach to reward must take place within the context of the company’s approach to enterprise-wide risk management.

Put simply, the first step is to understand and articulate the key risks in the business, and the appetite the business has for risks in those areas. This is standard risk management fair and will be undertaken in some form by most large companies. So, for example, continuing the resources example, the principle risks might be as follows:

Figure 2.1
Example of principle risks
in a resources company

Principle risk	Example
Commodity price/exchange	Adverse commodity price or exchange rate movement
Financial resilience	Change in cost or availability of finance
Operational	Breakdown of key production facility
Depletion/asset quality	Failure to replace reserves
CAPEX execution	Major project over-run or failure
Political risk	Threat to ownership rights or cost structures
Reputation	Significant environmental or safety incident
Talent	Failure to develop robust succession plans

The business is likely also to articulate the appetite for each of these risks. The risk appetite will set out a number of parameters that the business is prepared to take in relation to each of the risks above, for example:

- the earnings volatility they are prepared to sustain given typical movements in commodity prices and exchange rates;
- the earnings exposure from a major accident in a single processing facility; and
- the percentage of earnings derived from territories categorised as high political risk.

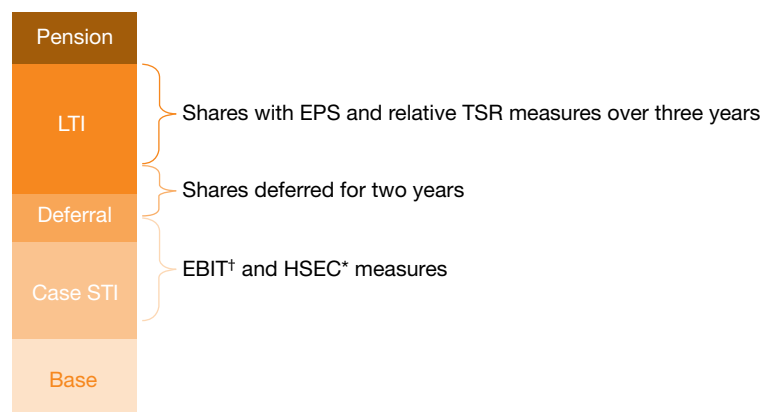
The business will aim to deliver performance goals within the parameters of this risk-appetite framework.

So far so good, and nothing to do with remuneration. The challenge is then to make the appropriate linkages, and bring the risk discussion into the remuneration committee.

Understand how the risks are reflected in your current remuneration plans

As a first step to understanding how risk and remuneration link together, a business can map its principle risks against the existing executive remuneration arrangements. Continuing with the resources example, a typical remuneration structure would be as follows:

Figure 2.2
Typical remuneration structure
in a resources company



*Health, safety, environment and community
†Earnings before interest and tax

So how would a build up of risk be reflected in the remuneration elements?

Figure 2.3
Example mapping of risks to remuneration elements

		Commodity	Financial	Operational	Depletion	CAPEX	Political	Reputation	Talent
Measures	EBIT		?						
	HSEC							✓	
	EPS	x	x						
	TSR	x	x	?	✓	✓	✓	✓	?
Structures	Bonus deferral	In principle provides recoupment mechanism, but short period and blunt instrument							
	LTI	In principle provides recoupment mechanism, but period shorter than commodity cycle							
	Pension	Arguably encourages longer-term view and hence risk mitigation							

The earnings per share and relative TSR measures arguably encourage gearing during the upswing and so potentially discourage the management of commodity and financial soundness risk. For other risks, there is very little connection between the remuneration measures and structures and the build-up of those risks.

Of course, if a risk has been taken and does not prove to be beneficial, bonus deferrals will fall in value and LTIs may fail to vest. But the lesson from the financial crisis is that the negative impact on executives may not be comparable to the damage caused by the collapse of a business. Deferral will never be enough by itself to influence behaviour. It is crucial also that the incentive measures should send the right signals as the risk build-up is occurring.

For many of the risks, the relative TSR measure is the only line of defence reflecting the risk build-up. In a perfect world the market would reflect risk accurately. However, the reality is that in a boom the market gets it wrong as much as anyone else. During the build up to the banking crisis it was largely those who had delivered the highest TSR in previous years that were hardest hit.

So the conclusion has to be that it is not just in financial services where there is an inadequate reflection of risk in remuneration. Good risk management happens in spite of, not because of, the incentive structures put in place.

So what to do about it?

‘Economic profit is making something of a revival given the range of risks that a good formulation of the measure can capture’

Linking risk to remuneration

There are three main mechanisms for reflecting risk in remuneration:

First, non-financial measures can encourage a forward-looking focus which can prevent risk build-up. For example, measures relating to reserves replacement, succession planning, or capital projects can reflect sustainability of performance. Many organisations are already looking at ways in which well-structured balanced scorecards can play a role in remuneration.

Second, better risk-adjusted financial measures can be used. Within the banking sector economic profit is making something of a revival given the range of risks that a good formulation of the measure can capture. A range of measures is available that take better account of the risks and costs of capital than simple profit-based measures. However, this is not something that should be driven by remuneration, it should be driven by how the business is managed. Remuneration should not introduce measures unless they are embedded in management reporting, decision making and investment appraisal processes.

Third, appropriate deferral mechanisms can enable alignment if things do go wrong. Our view is that deferral should not be relied upon to change behaviour. It is important instead to focus on the signals being sent by the incentive measures, rather than just saying ‘we’ll hold it all back until we’re sure’. Getting the measurement right in the first place is the most important thing. Also, deferral does not distinguish between good risk decisions, that just happen to turn out bad, and bad risk decisions that were never within the firm’s risk appetite. However, the mood of the nation is for more deferral, reinforced by the FSA Code of Practice and the Walker Review. There is a role for deferral of bonus, with a forfeiture possibility if the performance on which the bonus was based is found to be unsustainable.

A balance of all three of these mechanisms can be looked at in order to bring greater risk-sensitivity to reward outcomes. This can help ensure against performance being delivered (and incentives paid) but at the cost of excessive risk build up.

Use your judgement

A constant danger with incentives is the temptation to take a too mechanistic approach. Introducing risk-adjustment gives ample opportunity to succumb to this temptation. Yet introducing ever more complex metrics into the incentive formula may simply lead us to the land of unintended consequences.

Our view is that the best way to start reflecting risk in incentives is to give the remuneration committee the tools to apply their discretion in a sensible way. What does this mean?

First, it means understanding the principle risks faced by the business, and how the business articulates the risk-appetite for each of those.

Second, it means understanding where the potential weak spots of the current remuneration system are. Map the risks against the remuneration elements. How and where are the risks picked up? Are risks just reflected in remuneration when the risks turn bad, or is there sensitivity to the build of risk over time?

Third, it may mean introducing, in a focused way, a small number of new or amended metrics to reflect risk better.

Fourth, it means collecting existing information about risk that is captured for the audit or risk committees and making this available to the remuneration committee when they are deciding about incentive outcomes.

Finally, it means the remuneration committee being prepared to judge the performance against targets in the context of the risk information provided. If the committee judges that excessive risk has been taken to generate the performance, then performance outcomes may be scaled back, or a greater amount of remuneration may be deferred to enable the risk to play-out over time.

For example, two firms may make the same profit of £1bn, but it doesn't mean they should get the same bonus. Stress tests and probability modelling may show one firm's profits to be much more vulnerable to changes in commodity prices, exchange rates or operational risks. If this is so, the remuneration committee may judge that firm's performance to be less sustainable and as a result either pay less or defer more.

This requires much better information to be provided to remuneration committees about risk. But remuneration should not drive risk management. If risk management information is being created just for the purposes of remuneration plans then either there is something wrong with how the business is being run, or the information being gathered is irrelevant. Remuneration will never be a substitute for good risk management, and so the focus should be on getting the existing information about risk that is collected in the business in the right place at the right time for the remuneration committee.

The finance or risk function should work with HR to produce a report for the remuneration committee that identifies the key risks, outcomes for the year's profit under identified stress tests and problem areas identified through the year. This information should be segmented (e.g. by division) in a way that matches up with the information that the remuneration committee is reviewing on incentives. Getting the right information, presented in the right way, in the right place, and at the right time for the remuneration committee, is essential to informing discretionary judgement.

Stepping up to the plate

Remuneration committees may be reluctant to take on this role. But life is complex. It is generally not possible for performance to be encapsulated in just one or two simple metrics, much though we would like to believe it to be the case. It is time for remuneration committees to take responsibility for judging performance in the round.

3

Nice in theory

Criticisms of relative TSR have led to debates about whether it can be risk-adjusted to reflect the different risk profiles of comparator group members. Nice in theory, but does it work in practice?

Among the many other issues it addresses, the FSA's recently published Code of Practice on remuneration calls for performance measures in long-term incentive plans to be risk-adjusted. The guidance notes that both TSR and EPS – that is, the two most common measures used under this type of scheme – can be boosted during the life of the plan (for example by increasing leverage) 'to the detriment of the true longer-term health of a firm'.

This has led to debate about how a TSR measure might be risk-adjusted. Here we look at some of the possibilities and ask: would it have made any difference?

TSR is a measure that looks at how much return has been delivered to shareholders, taking account of both share price growth and dividends paid. Perhaps its key strength as a performance measure is that it is an objective, external view of management's success driven largely by the market price of the shares. The flip side to this is that management can view the outcome of a TSR condition as essentially arbitrary and subject to the vagaries of market timing. As a result, the measure loses its incentive effect.

We have for some time highlighted the problem that relative TSR, especially with a median cut-off, rewards volatility of performance rather than sustained strong performance. In our publication, *Financial Services Remuneration Best Practice Principles published in March 2009*, we argued that relative TSR could give rise to a 'strategic herd mentality' with banks forced to adopt the risk profile of the riskiest bank in the peer group in order to outperform in a bull market. This aspect of relative TSR is the one that is of most concern to the FSA. This has led them to ask firms to explore ways of risk-adjusting the measure.

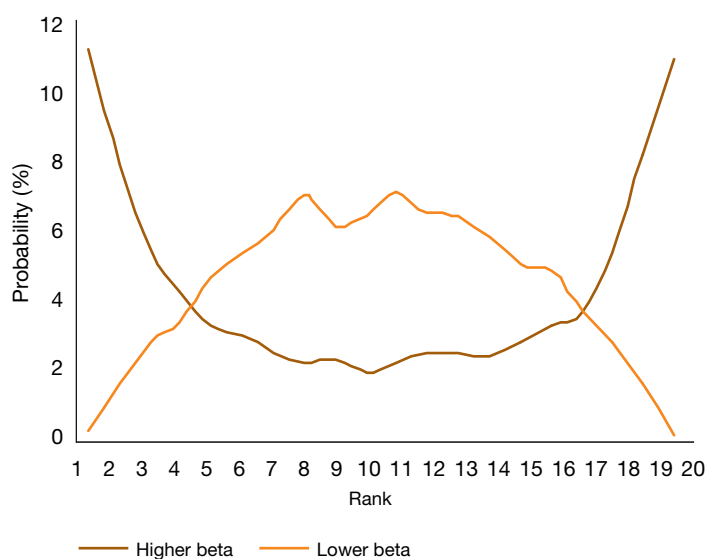
But how might this be done?

The problem

Financial economists measure the sensitivity of the share price to movements in the stock market as a whole using what they call beta. A share with a beta of 1 would generally be expected to move by the same percentage as the market as a whole; if the market rises 10%, the share price is expected to rise by 10%. Shares with a beta greater than 1 are riskier than the market – with a beta of 1.5, if the market rises by 10% the share price would rise by 15%. But if the market falls by 10%, the share with the higher beta would fall 15%. The share with the higher beta is, in some sense, riskier than the market.

Where TSR is measured relative to a group of comparators, the group will often contain comparators with a range of betas. The impact this can have is illustrated below. The chart shows the modelled likelihood of finishing in each position for a company with a high beta and a company with a low beta against a comparator group of 20 companies.

Figure 3.1
Modelled ranking outcomes
for low beta and high beta
shares in a comparator group



We can see that the riskier company is more likely to finish at the top or bottom of the comparator group. This is due not to the skill of management, but solely because its share price tends to move around more than its less risky comparators. Similarly, the less risky company will tend to sit in the middle of the comparator group, with little prospect of reaching the top or the bottom.

So, when we overlay these results with a typical LTIP design (100% vesting for upper quartile performance, 25% vesting at median and nothing below median) we find that the management of the riskier company are in a feast and famine environment – they will tend to get either 100% vesting or nothing. Meanwhile the management of the steadier company will receive lower compensation – they too will get something about half the time, but when they do get something the vesting will be much more modest.

The FSA clearly has a point: the TSR measure may be inadvertently rewarding the management of the more risky company, just because they are more risky. Is there anything that can be done about it? Well, perhaps. The same types of issue arise when trying to compare the performance of investment managers – have they really outperformed the market, or was it just that their portfolio was more risky? – and there are some approaches that we may be able to adopt to help us.

Adjusting for risk

A starting point might be the Sharpe ratio. This has been around since 1966 and there are a number of very closely related variants. At its heart, the formula is a measure of excess return divided by a measure of risk. The measure of excess return on its own would give the same ranking as TSR. The risk factor is based on how volatile the share has been relative to some common reference investment (probably the equity market as a whole). It scales back the returns achieved by the riskier shares, and boosts those achieved by the less risky shares, so should achieve a fairer outcome.

$$\text{Sharpe ratio} = \frac{R_S - R_M}{\sqrt{\text{Var}(R_S - R_M)}}$$

where

R_S = return on the share

R_M = return on a common reference investment – could be a bank deposit or the market as a whole

Figure 3.2

Modelled outcomes for high beta share in comparator group based on unadjusted and Sharpe ratio approaches

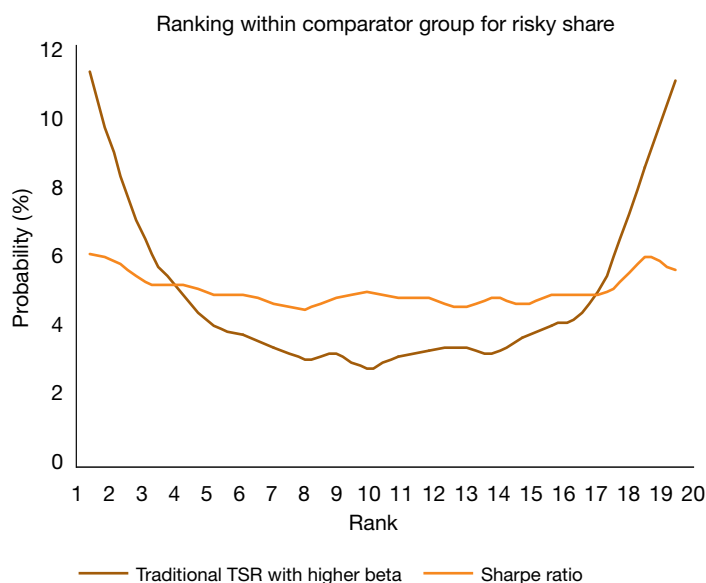


Figure 3.2 shows the modelled impact of using the Sharpe ratio to rank performance rather than traditional TSR. For clarity we show only the impact for the riskier share, but the picture for the less risky share is similar – using the Sharpe ratio substantially removes the tendency for the TSR ranking to clump around certain ranks, and so places all the comparators on a more even playing field.

Other approaches that achieve similar results are Jensen's Alpha and the Modigliani & Modigliani risk-adjusted performance (RAP). Jensen's Alpha measures the return relative to that expected under the capital asset pricing model (CAPM). The RAP approach normalises the measure against the market return based on total volatility rather than just beta, as does the Sharpe ratio. They achieve similar but slightly different objectives.

Jensen's Alpha

Definition

$$\alpha_s = R_s - (r + \beta \times (R_M - r))$$

where

β = a measure of the risk of the stock relative to the market (under CAPM)

r = a risk-free interest rate

- A measure of returns achieved in excess of those predicted by the CAPM given the volatility of the stock.
- The riskier the stock, the higher the return predicted by the CAPM, and therefore the greater return required to generate positive alpha.

Modigliani & Modigliani risk-adjusted performance

Definition

$$RAP = r + \frac{\sigma_M}{\sigma_s} (R_s - r)$$

where

σ_s = volatility of the stock

σ_M = volatility of the market

r = risk-free interest rate

- Calculates the return that would have been achieved from holding a portfolio of cash and the relevant stock in such a way that the volatility of this portfolio matches the volatility of the market.
- In a sense normalises the return on the stock so that it has the same risk as the market.

Does it work?

All of these measures scale back the returns of more relative to less volatile companies, thereby reducing the problem that relative TSR measures tend to favour more volatile companies. This is an attractive feature that could be worth considering, were it not that the added complexity introduced would be likely to make the outcomes seem even more arbitrary to executives.

But what about the FSA's key concern that measures should be risk-adjusted? All of the measures outlined here have a key drawback. They all base the risk-adjustment of return on the volatility or beta of the share price. This is a limited measure of risk, and one which does not capture the major systemic risks that are the FSA's concern. Indeed, if the fundamental problem is that during booms the market misprices risk, this is not going to be solved through a market-based measure.

Our analysis of the banking sector over the decade up to and through the banking crisis shows that use of these different risk-adjusted TSR measures would have had no material impact on ranking outcomes. For example, looking at the three year period from 2004 to 2006, which immediately preceded the credit crisis, the ranking of the UK banks under the different approaches were as follows:

Figure 3.3

Performance cycle	Unadjusted TSR	Sharpe ratio	Jensen's Alpha	M&M RAP
Northern Rock	1	1	1	1
Bradford & Bingley	2	5	4	2
Standard Chartered	3	4	5	4
HBOS	4	2	2	3
Lloyds	5	3	2	4
Barclays	6	6	6	6
Alliance & Leicester	7	7	7	7
RBS	8	8	8	8
HSBC	9	9	9	9

Where does this leave us?

Risk-adjusted TSR measures do appear to offer some hope of removing the perennial problem with relative TSR measures: that they reward volatile performance rather than sustained performance. However, the adjustment methods are likely to be perceived by shareholders, remuneration committees, and executives themselves as complex and arbitrary, and are likely to lead to even less understanding of TSR plans.

In terms of risk-adjustment from the FSA's perspective, these approaches are not robust. The type of risks that concern the regulator are not reflected in share price beta or volatility measures. Use of the adjusted approaches would have led to no improvement in the risk-sensitivity of relative TSR outcomes.

We come back to our advice of recent years. Endless attempts to refine TSR measurement through complex techniques and adjustments will only lead to unintended consequences and greater cynicism about such measures on behalf of executives. Better to recognise relative TSR for what it is: poor at distinguishing between average and good performance, but pretty good at distinguishing the best from the worst. If you use it, use it as a top-slice element to the reward package and don't expect too much of it.

4 Powerful or posturing

Only a year ago, institutional shareholders were regarded as gaining more authority, power and influence over remuneration and remuneration committees. Now they are concerned that their influence is on the wane.

It is not a comfortable time to be an institutional shareholder, in the spotlight as never before. Shareholders are under pressure from a number of quarters:

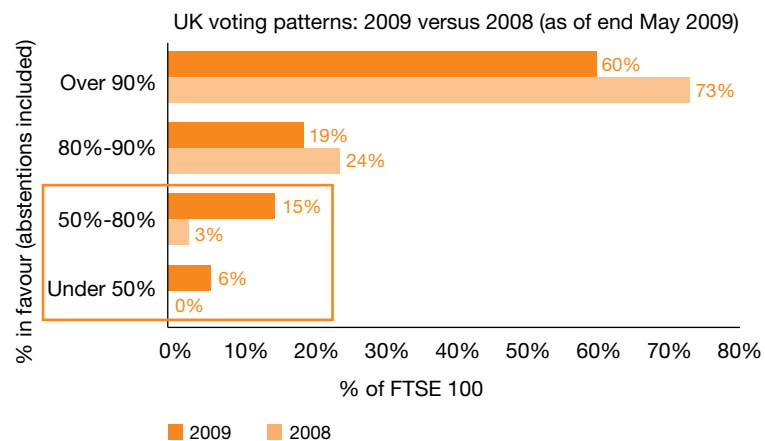
- their clients are unhappy as share prices have fallen and dividends have been reduced and yet the perception of many is that shareholders have allowed executives to reap inappropriate rewards;
- the Government has raised concerns shareholders especially in respect of the financial sector;
- politicians have also criticised institutional shareholders publicly – perhaps most notably via the House of Commons Treasury Committee report on the banking crisis issued in May 2009 which stated that shareholders had ‘failed to exercise effective control over remuneration policies’. The report also argued that the advisory vote on remuneration had ‘largely failed to promote enhanced scrutiny of, or provided an effective check on, remuneration policies in the financial sector’;
- the Walker Review placed significant focus on the role of institutional shareholders and made no fewer than nine recommendations on this front;
- the Financial Reporting Council (FRC) in its review of the Combined Code had a section on engagement between boards and shareholders. It noted the ‘frustration on the part of companies and investors about the quality of existing engagement’. It raised the question as to ‘what role, if any, it would be appropriate for the FRC to play in encouraging collective engagement’; and
- many remuneration committees are unhappy with the method of engagement with shareholders – not only the process, namely how many should one visit and over what time scale, but also the individual views of shareholder and shareholder bodies. There has been a call by companies for a number of years that they would like to see a simplified process, more consistency of view, and greater understanding of the commercial reality of motivating an executive team.

And through all of this, Lord Myners has expressed strong views about the role of institutional shareholders, carrying the implied threat of Government action. Shareholders have tried to respond with the engagement principles of the Institutional Shareholder Committee (ISC), which has been in existence for a number of years but has not had a particularly high profile.

Flexing muscles

In the pay arena, shareholders have responded by trying to prove they are becoming more assertive on pay matters. Figure 4.1 shows that the willingness of shareholders to withhold their support for remuneration proposals has increased significantly over the last year. A mere 3% of FTSE 100 companies had more than 20% of their shareholders withhold support for the remuneration report in 2008. This has risen to over 21% this year, with two reports voted down altogether.

Figure 4.1
FTSE 100 shareholder voting
outcomes in 2008 and 2009



Source: Data compiled from company websites and London Stock Exchange announcements

The Association of British Insurers (ABI) has also been much more willing to issue red and amber tops to companies of whose proposals it disapproves. The range of issues that have received amber tops is much wider than in previous years. Rather than restricting themselves strictly to breaches of the guidelines, amber tops have been widely issued for:

- increasing incentive opportunities;
- increasing base salaries; and
- failing to reduce long-term incentive plan face values where share prices have fallen.

As a result nearly half of FTSE 100 companies have received amber or red tops in 2009. But how influential is the ABI's guidance?

Figure 4.2

ABI colour flag	% of FTSE100 companies	Average % vote in favour (abstentions included in total votes)
Red	5%	75%
Amber	44%	95%
Blue	51%	97%

Source: Institutional Voting Information Service (IVIS)

A red top is still something to be avoided since this often brings much press attention and only in exceptional circumstances will companies be willing to risk the potential increased number of shareholders withholding their support. However, an amber top has not generally been translated into much in the way of votes against. In 2007, an amber top would typically have cost a company the support of 7% of its shareholders. This year it has fallen to 5%. Hardly a drastic change.

Holding the remuneration committee accountable

Shareholders, and in particular the ABI, are worried that the vote against the remuneration report is losing its influence. In the early days even 10% of support withheld would cause remuneration committees to think again. Shareholders now fear that any majority is viewed by companies as a victory.

As a result, the ISC put forward a proposal, adopted by the Walker Review, that on receiving the support of less than 75% of shareholders, the chair of the remuneration committee should put themselves up for re-election the following year. The data above suggests that this would give significantly more weight to receiving a red top.

However, in our experience many non-executive directors that we have chatted to as they already feel that as chair of remuneration committee, their personal credibility and reputation is on the line and having to stand for a vote annually would not change behaviour. In any case, this may be superseded by a requirement for all directors to stand for re-election annually.

In practice, companies do take a significant vote against the report seriously. Where a report is voted down, there is typically a change of membership of the remuneration committee, or a commitment to a full-scale review of the remuneration process and arrangements. Companies realise that there is genuine reputational damage from a remuneration report that is voted down.

What does it all mean for shareholder communication?

Interestingly, this is a difficult question to answer due to a number of factors. Firstly, the traditional UK representative bodies of the ABI and National Association of Pension Funds (NAPF) represent a declining proportion of UK stock market ownership. Depending on which commentator one follows, it appears that ABI members represent on average about 15% of the shares in a UK FTSE 100 company and NAPF members around the same. If we then add in other UK entities and individuals, it has been suggested that traditional UK shareholders as a whole represent approximately 50% of the overall shareholders in any large company. Most of the remaining shares are held by a range of entities from hedge funds to sovereign funds.

There is also the fact that the next AGM season will be held in an election year and we will see significant focus on the reporting by banks and other financial institutions plus we will have traditional UK shareholders seeking to demonstrate that they have listened to the Treasury and Walker guidance and are more engaged and robust in their interaction with companies.

In our view, there are steps that remuneration committees can take to be prepared for the forthcoming AGM season. Firstly, they need to ensure they are fully up to speed on all the major current influences on remuneration, including the FSA Code of Practice, tax changes, Walker and FRC implications. They also need to review the quality and frequency of their engagement and communication with shareholders and consider how this can be enhanced. Consideration should also be given to ensuring that their remuneration report is not only a fully functional compliance document but is increasingly a clear, concise and transparent communication document.

We would advise chairs of remuneration committees to consider reaching out to their key shareholders much earlier than historically has been the case. Where any significant changes are being considered it would be prudent to reach out at the early planning stages and float current thinking with your key shareholders in order to both get them up to speed with the underlying issues, but also to test their appetite for change.

Towards the date of publication of the annual report, consider whether it contains any surprises for shareholders. If so, inform them of any issues before the report goes public. It is then much easier to get your version of events across.

Given all the turmoil and changes of the last twelve months, it's highly likely that the institutional shareholders will become far more engaged both before and during the next AGM season. There is much to be done by all to prepare for this. And it is time to remember that shareholders and remuneration committees are on the same side – they both wish to see an increase in shareholder value that results in shareholders getting a good return for their investment, and a fair sharing of the gains by those who directly contributed to it – the employees.

5 Last chance

The Walker Review and the recently revised UK Corporate Governance Code (Governance Code), may represent a last opportunity for the comply or explain approach to govern executive pay in the UK. It would be a shame if companies did not take it.

With the recent publication of the Governance Code by the Financial Reporting Council (FRC) and the Walker Review, now seems an appropriate time to consider the evolution of the governance model and the impact this will have on companies. There is clearly a considerable amount of cross-pollination between the two documents. However, it should be remembered that the Walker Review was specifically asked to address how to improve corporate governance in banks while the FRC work was part of a regular review of the Governance Code and is not sector specific. For this reason while the FRC based their revised guidance on much of what had already been published by the Financial Services Authority (FSA) and the recommendations in the Walker Review they avoided going as far – understandable when the focus of this recession has been squarely on the banks and the wider financial services sector.

The overriding view emerging from the FRC consultation was that the Governance Code is effective and that the comply or explain approach is sufficiently flexible to embrace different companies' circumstances. However, while other industry sectors may not be bound by the same stringent rules, there are undoubtedly lessons that are worth learning and more detailed guidance that can provide a useful steer in aligning the general principles recommended in the Governance Code.

If we look at the key sections and guidance relating to governance and remuneration from both reviews, the lessons for all UK industries can be grouped under the following headings:

- Oversight
- Accountability
- Remuneration
- Disclosure and communication
- Remuneration consultants

To provide some context it is worth quoting the paragraph on remuneration in the executive summary of the Walker Review in its entirety:

‘...against a background of inadequate control, unduly narrow focus and serious excess in some instances, substantial enhancement is needed in board level oversight of remuneration policies, in particular in respect of variable pay, and in associated disclosures. The remit and responsibility of board remuneration committees should be extended beyond executive board members to cover the remuneration structure and levels for all senior employees whose role puts them in a position of significant potential or actual influence on the risk profile of the entity. With expectation, guidance and, ultimately, pressure from major shareholders, the remuneration committee, in its enlarged role, should ensure that remuneration structures for all such ‘high end’ employees are appropriately aligned with the medium and longer-term risk appetite and strategy of the entity; and should be a key and mature counterbalance to any executive pressure to boost short-term remuneration provision in response to a perceived threat of competitor pressure.’

Source: Walker Review of Corporate Governance of UK Banking Industry, 26 November 2009.

Oversight

- There is a consensus that, at least in banking, the remuneration committee’s remit will need to be much broader than in the past. Walker states that remuneration committees should be responsible for wider oversight within the organisation, particularly in relation to risk.

We welcome the move in the final Walker Review to a less formulaic approach to determine the extent of the remuneration committee’s remit compared to the original draft. High end employees are now defined as those individuals who perform a significant influence function for the entity or whose activities could have a material impact on its risk profile. This supports our preference for a principles-based approach to the remuneration committee’s remit avoiding the potential for arbitrary outcomes.

To manage their broader remit effectively, the remuneration committee will need a detailed understanding of the remuneration structures and performance measures applied to what could be a sizeable population. In many cases, the remuneration committee’s remit will already cover all of these individuals, but where the remit has been limited to the executive cadre, this recommendation would result in a significant extension. In comparison, the FRC does not consider it necessary to extend the remit of the remuneration committee in non-financial companies where, typically, there are not a large number of high earners below senior management who could have a material impact on the company’s risk profile. How FSA regulated but non-financial services companies will position themselves between these two stand points is as yet unclear.

In addition to the remit of the remuneration committee, the FRC has also revised the Governance Code to increase its focus on the effectiveness of the board. The FRC has made clear their increased expectation of non-executive members with the introduction of references to:

- personalised training and development programmes for each director;
- the importance of directors acquiring appropriate knowledge of the company; and
- the need for the provision of constructive challenge by NEDs.

We believe it is a positive development that companies will be encouraged to provide their NEDs with the opportunity to get under the skin of the business and therefore we support the FRC proposal of expanding the development principle to include giving NEDs access to company operations and staff.

In terms of the time commitment required from NEDs, the FRC has steered away from stipulating a minimum time commitment, but there is a recognition that NEDs need to play a more significant role at certain times and potentially exceed the agreed number of days per year.

While all of these changes are positive, companies must be aware of the fact that this increased level of commitment could mean that NEDs have to limit the number of positions that they hold. Therefore, competition for high quality individuals is likely to increase, as will their fees commensurate with the additional time commitment.

‘An important remuneration committee role is to protect against shareholder short-termism as well as executive excess.’

Accountability

As well as extending the remit of the remuneration committee, the Walker recommendations would increase the committee’s direct accountability to shareholders. This arises from a concern amongst some shareholders that companies are becoming accustomed (and therefore immune) to significant levels of opposition in the advisory vote on the remuneration report. Walker Recommendation 36, which echoes a proposal put forward by the Institutional Shareholders’ Committee (ISC), aims to provide a more direct line of accountability for the remuneration committee chair.

The FRC has not adopted the Walker proposal that the remuneration committee chair should be subject to re-election if the vote on the remuneration report attracted less than a 75% vote in favour. However, the FRC has put forward two alternatives to improve the accountability of the board to shareholders, either of which would override the recommendation in the Walker Review.

The first proposal is that the chairman of the company should be re-elected each year, to enable shareholders to demonstrate their support for the chair’s leadership of the board and the company. The second proposal is for every director to be re-elected annually.

We do have concerns about this second suggestion because annual election of the whole board may lead to instability and we are concerned that re-election

could become a routine step without due consideration. Therefore, we are pleased that the FRC proposes to invite further consultation on this issue.

Remuneration

Overall, we believe that the Governance Code has been effective in adopting recommendations from the Walker Review and FSA Code of Practice where appropriate, while retaining the flexibility for it to be applied across sectors.

Some may think that more specific provisions could have been imported from the Walker Review, but we believe that the proposed Governance Code will allow companies to enter into the spirit and intent of the principles rather than adopting a rules-based approach.

Performance measurement

The FRC has adopted aspects of the FSA Code of Practice relating to payouts or grants under all incentive schemes being subject to challenging performance criteria reflecting the company's objectives, including non-financial performance metrics.

However, the idea that performance conditions should be materially more demanding than previous industry norms could be missing the point. We would argue that the issue has less been the level of difficulty of the targets (in terms of probability of achievement), but rather what has been measured and arguably targets and performance measurement have taken insufficient account of risk.

Also, it is important to remember that the requirement that a significant proportion of compensation be deferred may not be the whole answer. We believe that up-front risk adjustment, use of non-financial performance metrics and rounded performance assessment in the context of discretion, are all at least as important as deferral in creating an environment in which awareness of risk is built into day-to-day decision making. In addition, it is important that the criteria for paying bonuses is risk-adjusted and that incentives should be compatible with risk policies and systems. There is a danger that implementing a formula for incentive structuring becomes seen as the one-size-fits-all answer. In our view, adopting such a prescriptive approach may not achieve the desired results.

Therefore, the involvement of the risk committee on appropriate risk-adjustments to performance measures is a sensible step forward, and is consistent with the approach of regulators such as the FSA. The input of the risk committee needs to be well-defined and limited, as highlighted by the Walker Review, which in our view, should be at the start and end of the process. Ideally setting targets using appropriate risk-adjusted measures and advising on the discretionary assessment of achievement against those targets taking risk into account.

This is likely to remain a specific financial services recommendation. However, as discussed in the earlier article on Risk and Reward (page 12), we believe that consideration of how risk is reflected in reward is of importance to businesses in all sectors and something we expect to see as an area of focus for 2010.

Executive shareholding

While the Governance Code does not offer explicit guidance on executive shareholding, it does reaffirm that the board must be aligned and engaged with shareholders. The Walker Review was more prescriptive and recommended a requirement for executives to build up significant shareholdings, but this could have a significant impact in practice for two reasons.

First, the requirement is framed in terms of having a shareholding that meets the executive's historic or expected total compensation, which may easily be four or five times base salary for the affected individuals. This contrasts with current shareholding policies within UK banks, which often do not extend beyond two times base salary. Second, the requirement applies to all high end individuals, whereas current requirements often do not apply below main board or executive committee level.

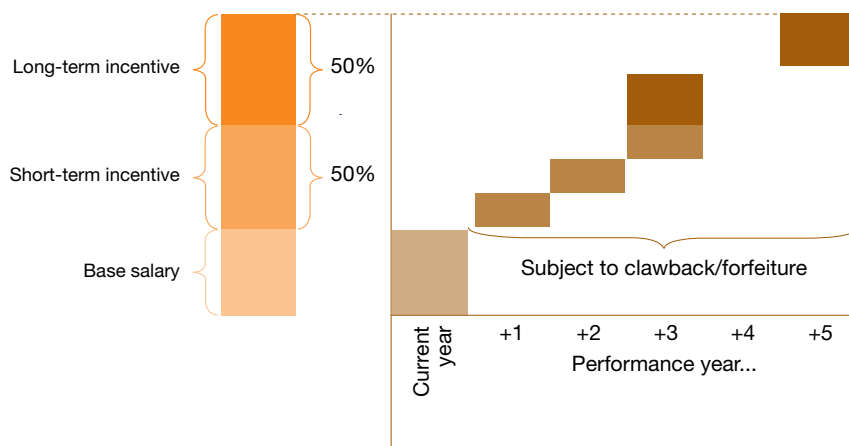
The concept of an increased focus on shareholding should be welcomed. For some time we have maintained that ensuring that executives are significant shareholders can be a more effective way of achieving alignment with shareholders than complex long-term incentive plans with hard-to-calibrate performance conditions. To ensure a significant impact on behaviour, the shareholdings must be meaningful.

Aligning remuneration with long-term performance

It should not be forgotten that Walker and the FRC reviews had different objectives and therefore it not surprising that they diverge in some areas. Most notably, around the focus and level of specifics regarding the structure of remuneration. Whilst the FRC has stated specifically that the Governance Code should not be prescriptive with regard to the design of remuneration, Walker clearly believes that specifics are necessary for the financial services sector.

However, Walker did relax Recommendation 33 in the final Walker Review, moving to a comply or explain approach from 2010. The principle that senior individuals within banks need to have the majority of their incentive compensation paid in deferred form is widely accepted, as is the requirement to have multi-year performance measurement. However, the precise nature of the deferral structure (see figure 5.1) still seems too prescriptive given the range of businesses to which the recommendations are intended to apply.

Figure 5.1
Incentive structure according
to Recommendation 33



Source: PwC Reward Practice

Walker has proposed 'that the FSA should incorporate the remuneration structure recommended...when consulting on revision of the Remuneration Code next year'. We believe this has the potential to create confusion regarding which entities may be subject to this recommendation while the FSA considers the manner in which the Remuneration Code will be extended.

Moreover, the recommendation locks in a model of current practice which may stifle helpful innovation. In particular, long-term incentives do not appear to have been particularly successful in influencing behaviour in the banking sector.

There are many reasons why this may be the case, but two worth highlighting are:

- long-term incentives are often heavily discounted by executives until paid – in part because of their complexity – and so the behavioural influence of unvested awards can be limited; and
- performance conditions on long-term incentives are very hard to risk-adjust.

On the second point, the earnings per share (EPS) and relative TSR performance conditions traditionally used by UK banks did not adjust for risk. Indeed, as we have outlined elsewhere¹ there is a strong argument that they encouraged risk – EPS by encouraging leverage during a bull market and relative TSR by encouraging a strategic herd mentality whereby management teams were incentivised to match the risk profile of the comparator group in order to have a chance of out-performing.

In practice, it will always be difficult to encapsulate what it means to produce good risk adjusted performance in two or three pre-defined formulaic metrics over three years. Given the weak track record of long-term incentive plans in creating the desired results we would like to see scope for innovation. For example, there could be a greater role for remuneration committee discretion. Alternatively, multi-year performance could be taken into account by looking

1. PwC report: Remuneration best practice principles – Financial services reward (March 2009).

back at performance over the last three years, taking into account a wide range of performance and risk data, with delivery in deferred stock (potentially with some forfeiture conditions if estimated performance is found to have been inaccurate). The introduction of such arrangements are likely to apply more widely than just financial services with a new provision inserted in the Governance Code covering the potential for clawback of incentive payments in exceptional circumstances of misstatement or misconduct. These types of deferral and clawback arrangements may be more effective than relying on hard-to-calibrate performance measures in a long-term incentive plan.

Communication and disclosure

Both companies and shareholders have reported frustration over the quality of current engagement. Companies criticised investors for taking a box-ticking approach to engagement, while shareholders criticised companies for approaching consultation as a presentation rather than a dialogue.

The Walker Review recommends that investors are subject to a Stewardship Code and that the FRC plays a role in overseeing the operation of this in practice. This is to ensure shareholders are more pro-active in their engagement with companies. The FRC has committed to developing the Stewardship Code and will delete Section E of the Governance Code if implementation is successful. We regard the development of the Stewardship Code as a positive move.

There is no appetite within the FRC to formally monitor companies' reporting in this respect as this could be regarded as reducing the flexibility of the Governance Code. As auditors, we would have concerns about the proposal for the full corporate governance report to be published on the company website with a more concise version included in the annual report. Mainly because this could cause potential confusion over which elements were auditable. Companies need to carefully consider the need for this information to be contained in the directors' report.

On disclosure, we welcome Walker's move away from a formulaic approach to a more principles-based disclosure of pay bands for high end employees. This puts the emphasis on the governance procedures of the entity in identifying these individuals appropriately and so places more reliance on a robust corporate governance framework – and arguably this information could give more insight into the culture of a firm.

Increased disclosure requirements are in response to a longstanding demand for further information in this area from certain shareholder bodies. However, new rules on disclosure could be closely followed by the unintended consequences of their introduction. It remains possible that increased publicly available data will lead to an upward ratchet in pay levels below board level in the same way that the widespread availability of data at board level is perceived to have had an inflationary impact over the last decade or so.

Nonetheless, with some refinement, the proposals for additional disclosure could provide helpful information for shareholders wishing to assess the culture and risks of firms that they invest in. It does seem as though greater disclosure of below board pay is on the way. This is more a financial services issue than elsewhere, but it is consistent with shareholder desires to have more information about how pay operates more widely and is consistent with the new Companies Act provision for remuneration committees to consider the link between executive and firm-wide remuneration.

Remuneration consultants

Remuneration consultants are following the Walker recommendation that they should put in place a formal constitution for the professional group with provisions for independent oversight and review of the remuneration consultancy code. The FRC is comfortable with the progress being made and has agreed to oversee its application.

But the Walker Review is also right to re-emphasise that ensuring independence is primarily the responsibility of the remuneration committee. Under the Governance Code, it is the responsibility of the remuneration committee to establish the process for setting remuneration policy and levels, and to ensure that conflicts of interest are recognised and managed. The remuneration consultants' code of conduct should not distract from a remuneration committee's primary responsibilities in this regard.

We also support the concept that firms can legitimately provide other services to companies where they advise the remuneration committee, provided that appropriate safeguards and practices are in place. However, we are concerned that an industry code should not result in a resort to the lowest common denominator that sets a standard lower than that already operated by regulated firms in the area.

The Remuneration Consultants Group (RGC) is in the process of being formalised at the time of writing. Further communication about the role of the RGC will follow in the near future.

A last chance?

It may not be too dramatic to say that we are entering a battle for the survival of the UK's voluntary governance regime, with all of its advantages. Companies, remuneration committees and consultants need to recognise this, and be prepared to go the extra mile in order to preserve these freedoms for the future.

6 Governing pay

Recommendations from the FSA and the Walker Review state that in the banking sector the remuneration committee should have remit covering remuneration policy throughout the firm. Pressure is likely to grow for similar requirements across all sectors. But how is this achieved?

Change is coming

Perhaps one of the most profound changes to come out from the current crisis will be changes to governance arrangements. This will extend beyond pay. However, governance in relation to pay is important in its own right. Partly because, as much as the technical design of incentives, it is how pay systems are governed that influence behaviour. But also because how a firm is governed in relation to pay can be an observable signal of how its governance operates more widely.

We expect changes to remuneration governance to be profound. Pressure in relation to governance is coming from a number of areas including:

- regulators who have been, or will be, putting forward views on good practice in relation to governance;
- government support programmes, participation in which is likely to involve requirements in relation to remuneration, reporting, and governance;
- shareholders, who are increasingly focusing on the oversight applied by remuneration committees to remuneration both at board level and below; and
- the perceived triangle of mistrust between shareholders, remuneration committees, and management, which demands a more transparent and effective governance framework.

If the current focus on financial services institutions does lead to additional requirements on all companies, they would be wise to be prepared. For example, all companies, may be required to put in place a framework that enables the demonstration of good governance and independent oversight. The aim must be to achieve this at minimum cost and disruption to the business management processes.

As is already the case within the banking sector, all companies could potentially be required by regulators to produce an annual report on remuneration practices throughout the firm, including certification from the remuneration committee chair that the policies discourage excessive risk taking and are robustly enforced. It is likely that this will include an annual interview of the chair of the remuneration committee on this statement.

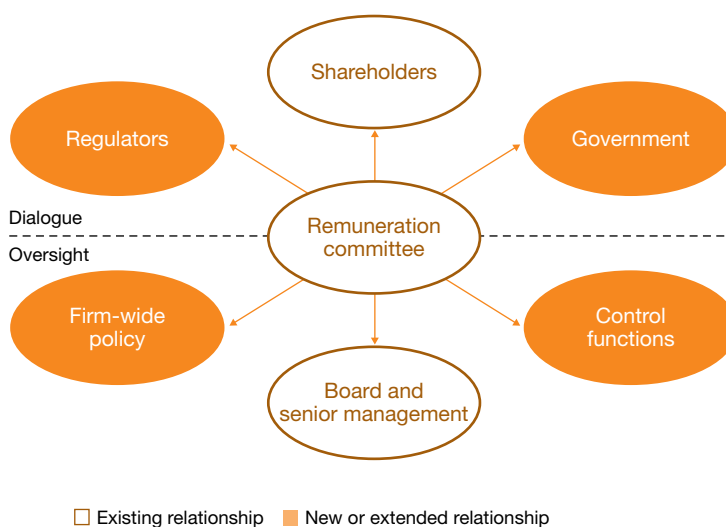
These developments represent a significant extension of the remit of remuneration committees. Consideration needs to be given to how certifications of the type likely to be required will be supported. In our view, this requires the governance arrangements covering pay more widely to be reviewed.

Governance of remuneration

The remuneration committee's traditional role has been to provide oversight of remuneration of the most senior executive cadre, with reporting accountability to shareholders through the remuneration report. The remit has typically involved oversight of broader remuneration policy, but this, in practice, declines rapidly below executive committee level.

There are now two significant potential changes to this remit. On the one-hand both regulators and, for banks receiving state aid, governments, are now potential stakeholders in relation to remuneration practices. Both are likely to have reporting requirements. On the other, the interest of these stakeholders extends far beyond the traditional shareholder interest in executive director remuneration, and into remuneration policy across the firm.

Figure 6.1
Oversight of
remuneration policy



Boards need to consider whether the remuneration committee as currently constituted can effectively fulfil, and be demonstrated to fulfil, this broadened mandate. Our view is that the remuneration committee is the correct committee to own the company-wide remuneration issue. Consistency between the approach to issues governing executive and wider management and employee remuneration is vital, and there will be a body of expertise built up in the committee that is relevant to both discussions.

However, the composition of the committee will need to be looked at critically. Depth of sector expertise is more likely to be required of non-executives sitting on a committee dealing explicitly with company-wide remuneration arrangements. Moreover, who attends the committee may require review, including greater involvement from control functions other than HR (for example risk and finance), when appropriate.

Cascading governance

A formal – yet pragmatic and workable – governance structure should be adopted to provide appropriate oversight from the remuneration committee down into the divisions and individual bonus determinations. This should encompass an explicit role for control functions, especially risk, and should enable the remuneration committee to demonstrate appropriate oversight of the remuneration process.

In an ideal world, management of remuneration risks would be included within the firm's normal risk management processes and reporting lines. However, recent events have thrust remuneration into the spotlight, and regulators are paying special attention to it. There is an expectation of a separate reporting and assurance process relating to remuneration, in order to satisfy regulatory requirements. Firms need to respond to this pressure.

The rigour and formality of oversight below the remuneration committee therefore needs consideration. This covers both the oversight of divisional decision making and also the appropriate involvement of group control functions. In our experience, the risk function rarely has formally defined, or scrutinised, roles in the compensation process. Even the involvement of finance can be somewhat limited. Too often the process is disproportionately borne by human resources. Yet the complexity of modern financial services businesses, and the requirement for a deep understanding of the risk implications of remuneration arrangements, means that this is no longer viable.

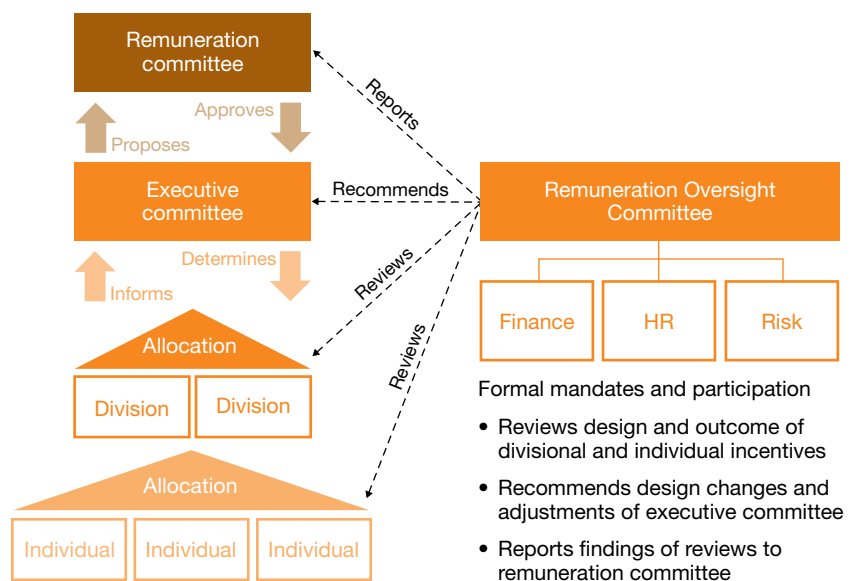
It is now necessary for the involvement of control functions in remuneration to become formalised. A number of models may be appropriate, depending on the particular business structure and issues.

Any such model must meet the following criteria:

- creates a direct line of oversight to the remuneration committee;
- defines an explicit role for the control functions, especially risk;
- minimises the disruption to the management of the business on a business as usual basis through the line management structure;
- enables the remuneration committee to provide assurance to regulators and other external parties as required;
- ensures appropriate flows of information; and
- provides appropriate checks and balances to manage conflicts of interest.

One such model is shown below, illustrating how a formalised Remuneration Oversight Committee (ROC), with representation across the control functions, could add supporting rigour to the normal remuneration process. Note that in this model the left-hand side represents the normal management hierarchy. The ROC sits alongside this process, rather than supplanting it. This is important for ensuring that remuneration remains a legitimate tool of business management. The purpose of the ROC is to review, challenge, and report issues from a risk perspective to the remuneration committee.

Figure 6.2
An approach to formalised remuneration committee oversight



As well as reviewing the design of remuneration plans and processes, the committee would provide independent oversight of divisional incentive outcomes. This might include, for example, a review of bonus hotspots, to ensure that the results delivered accorded with the group centre's qualitative understanding of the quality of those businesses and the risks being run. Or an assessment of the extent to which bonus had been achieved at the cost of not meeting the firm's risk appetite.

The committee would make recommendations to the executive committee, and would report to the remuneration committee on the reviews it had undertaken and any adjustments recommended. In some cases there would be separate ROCs for different divisions or regions. Where a firm already has divisional remuneration committees, then the ROC would not operate in addition. Instead the constitution of those divisional committees would be amended to ensure appropriate risk and control function representation, and also potentially to include a NED from the group remuneration committee.

‘This is an area where a large number of firms will have to undertake significant changes.’

One of the remuneration committee members (not the remuneration committee chair) could act as a point of liaison from the ROC to the remuneration committee, while leaving the remuneration committee chair free to challenge the ROC’s conclusions.

Who would chair the ROC? The role of the committee would be to critique and monitor remuneration designs and outcomes, not to originate them. Its primary purpose would be to provide assurance in relation to the management of risk, and to enable reporting in this regard to external stakeholders. Accordingly, the chief risk officer (CRO) would be one obvious choice of chairman. However, in practice, given the knowledge of remuneration arrangements and practices required to fulfil the role, the HR director would be the likely chair. Where the approach is to amend divisional remuneration committees, it may be appropriate for the existing chairman to be retained.

Establishing the remit and membership of the ROC is not trivial, and requires careful planning. In our experience, this is an area where a large number of firms will have to undertake significant changes.

Managing discretion

Robust processes to support the application of discretion need to be developed and documented. The requirements of internal and external advice to the committee need to be reviewed to ensure that the committee is obtaining access to appropriate information.

In the emerging governance environment, it will be necessary to have processes that are strong, and seen to be strong. Remuneration processes that are able to sustain board level certification to regulators and governments must be capable of demonstration, and resilient to audit. This will require a review of compensation processes to ensure appropriate recording of evidence and audit trails. Data collection protocols will need to be reviewed.

Data on risk and compensation will need to be cross-referenced in a much more rigorous way than previously to identify any misalignments. This will require consistency in reporting segmentation, timing and frequency.

Remuneration committees will need to review the advice that they receive both from within the business and from external sources. Few remuneration committees currently receive a briefing from the CRO in the context of remuneration decision making. Introduction of the ROC will facilitate changing that. Remuneration committees should have available appropriate data on quantitative and qualitative risk measures when determining bonuses.

At the same time, in our view external advice requirements will need to be reviewed. Advisors will need to be able to help remuneration committees to make decisions that fit their business. Data on what everyone else does will become of more limited value.

‘judgements made without proper substantiation will be even more likely to be seen as arbitrary, inconsistent, or capricious’

Regulators are seeking greater transparency. It is probable that regulators may want some sort of report or certification from the employer as to the suitability of bonus awards, and even if it does not go that far, may subsequently investigate remuneration practices. They are likely to be particularly keen to ensure that robust performance management is in place which means that risks are managed.

Finally, the nature of the discretions held by remuneration committees is becoming more complex. The use of risk adjusted measures and the increased importance of deferred compensation (and the decision of whether to forfeit) create an environment in which judgements made without proper substantiation will be even more likely to be seen as arbitrary, inconsistent, or capricious – and therefore a source of legal risk.

In our view, the basis for determining bonuses will need to be more open, and with that will come the need for clear controls and processes to ensure that proper and defensible determinations are made. And that does not just mean adherence to general principles, but it means robust and documented evidence of how and why individual bonus decisions are made, supported by a culture in which adherence to those controls and processes is embraced. Criteria for awards will be more strictly defined and become less subjective. Performance assessment will be more rigorous. Documentation and scrutiny will be more detailed, from the individual bonus determination all the way up to the paperwork supporting the final decisions of the remuneration committee.

Within this, robustly applied performance management systems and processes will help ensure implementation of the firm’s policies, and will be a crucial line of defence against external scrutiny.

External stakeholder liaison

In our opinion, firms should establish a proactive programme of interaction with stakeholders, based on a premise of communication rather than compliance.

A firm’s interaction with the outside world on remuneration matters has hitherto been largely via the remuneration report to shareholders. In our experience, too often this document is driven by compliance rather than communication considerations. Firms now need to take into account the needs of multiple stakeholders:

- shareholders;
- regulators;
- governments;
- public; and
- employees.

Remuneration reporting will need to move from compliance to communication. Consistency of message will be required in the submissions going to different stakeholders. Increasingly, remuneration reporting will need to explain and justify policies, rather than just present arid facts. There will be a greater need for clarity of expression and the avoidance of remuneration gobbledygook. The focus should be on transparency rather than volumes of information. This will particularly be the case with regulatory submissions.

In addition, with international firms operating in multiple jurisdictions, governance processes will be required to ensure consistency of response to requests for information.

For larger companies the chair of the remuneration committee should be prepared to meet face to face with regulators and shareholders on a regular basis. Their time commitment is likely to be significantly increased as a result of this new role as spokesperson and advocate for the firm on remuneration matters. The boundary between remuneration reporting and public relations will blur.

In our view, financial firms will need to make their case on remuneration in a much more compelling, sensitive and thoughtful way than in the past. Those that succeed in getting their message across will have much greater freedom of action.

Review of effectiveness

We believe remuneration committees should undertake robust and comprehensive periodic reviews of their effectiveness as a committee, including supporting processes.

The burdens and expectations placed upon remuneration committees will rise significantly. They will be seen as encroaching on territory hitherto reserved to executive management. How will they cope?

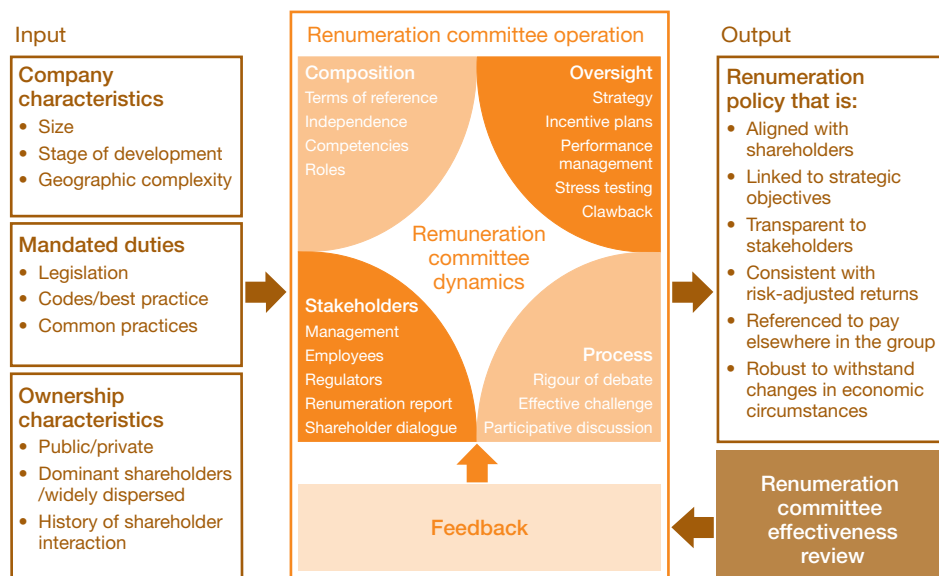
In our view, there needs to be a new relationship between the remuneration committee and the CEO, and a real focus on the effectiveness of the committee. Remuneration committees, more than ever, need to be a team working together, yet mutually challenging and holding each other to account.

The time requirements for remuneration committee chairmen will increase substantially, as will the reputational risks. Much greater emphasis on continuing professional development and training will be required. The qualification of NEDs will need to be considered. Will fees follow the increased burdens? Time will tell, but it is hard to see how it could be otherwise.

In our view, reviews will be required to ensure the challenge is being met. Such reviews will need to be open and candid, probably facilitated externally to ensure all relevant issues are surfaced. Recent events will be shown to demonstrate that governance failures contributed to the current financial crisis. In future, boards must be able to show that they did all they could to prevent a recurrence.

Through our extensive experience of working with organisations in this area we have developed a review framework which is illustrated below:

Figure 6.3



The review covers the key responsibilities and activities within the remuneration governance framework. But in addition, and crucially important, is the matter of remuneration committee dynamics – how well the committee operates as a team, the level of challenge in the room, and how it goes about its business.

In our view, all aspects must be operating well for a remuneration committee to be truly effective.

Summing up

The burden on remuneration committees is about to increase significantly, particularly in financial services. With Walker indicating significantly increased time commitments for NEDs acting on financial services company boards, there will undoubtedly be a review of how boards work more generally and what a practical number of appointments is for a NED.

Delivering change in governance processes takes time. The banks are already underway, but it is now worth remuneration committees outside the banking sector considering whether their remit should be reviewed. Now is the time to get on the front foot.

7

Being independent

Too many solutions to the perceived executive pay problem focus on the form of governance rather than its substance. More attention needs to be paid to behaviour, which is where the true source of independence lies.

Something must be done

Act in haste, repent at leisure is a sound motto, and never more so than when responding to a perceived crisis. Yet the sense that something must be done about executive pay is proving irresistible to various stakeholders including politicians and regulators. The problem is that what is easily done may not address the core issues, and may even have unintended consequences worse than the problem being addressed. This is the risk we now run with executive pay.

The focus of this chapter is on the role of remuneration committees and their consultants, both of whom have been charged with lacking independence from management in the setting of executive remuneration leading to, the accusation goes, an unjustified inflationary spiral. We will argue that to the extent that there is a problem it is not down to the formal governance rules, which are perfectly adequate. The focus needs to be on behaviour in the boardroom.

So what's the problem?

In the UK, governance of executive pay is currently based on the three pillars of:

- remuneration committees constituted of independent non-executive directors;
- transparent disclosure of remuneration policy and practice; and
- an advisory vote on the remuneration report.

Combined with best-practice guidelines produced by shareholders and their representative bodies, such as the ABI, this approach has underpinned the UK system since 2003.

It is easy to forget that this system has had some spectacular successes. Within a period of just a few years it virtually eradicated:

- contract terms of more than 12 months;
- retesting of performance conditions;
- full vesting of awards on change of control; and
- given rise to pressures bearing down on generous pension augmentations on termination.

With such an impressive array of achievements, why is this system felt to be in need of reform? After all, shareholders remain generally supportive of the remuneration arrangements at UK plc. Even this year, more than three quarters of companies received the support of over 90% of shareholders for their remuneration report. This is not indicative of a widespread problem.

The issue has been the minority of situations where shareholders are showing greater opposition. Around one in five FTSE 100 companies have had more than 20% of their shareholders withhold support for the remuneration report this year. This compares with fewer than 5% historically. These cases generate a profile out of all proportion to their frequency, and generate the impression of a wider problem. Shareholders also feel that remuneration committees are too ready to test the limits of what is acceptable to shareholders, rather than the limits of what is acceptable to management.

This is leading for calls for tougher action, from bodies as diverse as the ABI, the European Commission and the Treasury Select Committee. Potential changes could arise through the FRC's review of the Combined Code, through the Walker Review, or through revisions to the ABIs' guidelines.

Advice in whose interest?

Remuneration consultants are being increasingly blamed for having an inflationary impact on executive pay. The accusation is that they get hired by convincing the CEO he or she is underpaid. They then bamboozle remuneration committees into accepting unjustified pay packages, before forcing them on unwilling shareholders. Worse still, they use their skills in achieving high settlements for the executives to curry favour in order to win other lucrative contracts with the company. The proposed solution to this from some parties is to require remuneration committee consultants to do no other work for management, to ensure their independence.

This analysis could have some validity if pay was set purely on the basis of a consultant's recommendations, using data to which only the consultant was privy, and without checks and balances. But this is not the reality. With full disclosure of pay for executive directors, a remuneration committee can see the pay of comparators on a company-by-company basis. In large companies, even the salary for the coming year is generally disclosed. False predictions about pay trends will typically become very obvious within a short space of time.

Moreover, company remuneration policies are put forward for shareholder vote. In the UK, shareholders employ their own governance experts to analyse these, and receive advice from organisations such as the ABI and RiskMetrics, who increasingly benchmark packages against the market, as well as commenting on structure and design. A consultant claiming to a remuneration committee that shareholders will not object to a specific proposal had better be right, as the prediction will be tested publicly.

The important point is that the remuneration consultant is not giving an opinion on which others must rely without access to the underlying evidence. Instead they are providing data and ideas, on the basis of which remuneration committees decide. The results of those decisions are then made fully public to shareholders, who then analyse and decide whether or not to support them. The data on which decisions were made is ultimately disclosed. Serious failures of independence from a remuneration consultant would very quickly become public, resulting in the destruction of that consultant's reputation and business.

At the time of writing, the major consultancies are working with Sir David Walker to finalise a code of conduct for the profession and an associated governance process. While this is to be welcomed, it is unlikely to have the impact desired by its advocates.

Be careful what you wish for

This is because the independence of consultants is not at the root of the problem. But given the importance of rebuilding public trust in executive pay, surely it is better to avoid even the perception of a conflict, and to mandate use of entirely independent advisors by the remuneration committee? We think not, for two reasons.

First, focus on this issue would distract from the areas of executive pay where change is genuinely required. Second, the unintended consequences of the change in rules could be worse than the problem it is trying to solve. More on the first point later. What of the unintended consequences?

There are practical constraints. Pay advice is becoming increasingly complex. It requires firms with access to: international networks of pay advisers; pay surveys; technical skills covering tax, accounting, and pensions; risk and performance measurement expertise; stakeholder communications; and so on. Firms with the scale to support the required investment in learning, skills, and infrastructure are unlikely to submit themselves to the constraint of only being able to perform remuneration committee advice for a client. This would drive remuneration committee advice into a boutique business area, with the inevitable consequence that management will then need to appoint their own advisor in order to have a firm with the depth of skills required to come to a rounded remuneration solution.

This dual advisor model – which already exists in some cases in the UK – has the risk of institutionalising conflict where none need exist. An advocacy model can arise, with one advisor batting for management and the opposing advisor batting for the remuneration committee. Not only does this duplicate costs (which would be particularly onerous for smaller companies), there is also a reduced incentive to achieve a balanced outcome

As is often the case with changes to governance rules, the danger is that the only beneficiaries are the professional advisers for whom additional fees are generated.

‘The beauty of market economics is that the market adapts to supply the services demanded.’

If the market demands dumbed down advice, the market surely supplies

Another common presumption is that use of consultants is inherently inflationary because they bid up pay. The reality is that consultants just speed up the transmission of information on trends, whichever way they are going.

As recently as October last year, only a small minority of companies were planning to freeze pay for senior executives and many were planning substantial pay increases. In the end, just two to three months later, around half of companies froze pay, and those that made increases made them at levels significantly below historic norms. By ensuring a rapid flow of information around the market, consultants will tend to increase the speed with which companies react to events – this has now been shown to be true on the way down as well as the way up.

This highlights what is perhaps the key conflict for remuneration advisors regardless of who appoints them: they rarely get paid much for recommending the status quo. Consultants have a vested interest in complexity and change, two of the features that so inhibit their effectiveness. Therefore, remuneration committees need to be appropriately challenging of consultants’ conclusions.

The key issue is not whether the consultant also works for management, but how their inputs are used by the remuneration committee and what is demanded of them. The beauty of market economics is that the market adapts to supply the services demanded. If all remuneration committees ask for is simplified advice about what everybody else does, then that is what remuneration consultants will duly supply.

Why have some remuneration committees become so dependent on market data? As ever there is a mix of reasons, some good some bad. First the good. It is a core part of the role of remuneration committees to ensure that they have remuneration policies that attract and retain talented executives. Ensuring they are appropriately competitive against the packages offered by other companies is an important part of this.

What about the bad? As in any non-executive oversight role, there is safety in being part of the pack, doing what everyone else does. Being an outlier is an uncomfortable, exposed place to be. But also, data provides a helpful way to side-step difficult discussions. Relying on a median figure to set the pay of a chief executive avoids the need for difficult and emotionally charged discussions in the boardroom about performance and pay.

It is the responsibility of remuneration committees to be independent, and to organise their advisory relationships as they see fit to ensure this. A focus on consultants ducks the core issue: how their advice is used by remuneration committees. No amount of governance process will bring about change if this remains unaltered.

‘Will it really be that much more effective for 20% of shareholders to abstain from a director’s re-election than for 20% to vote against the remuneration report?’

How to be independent on pay

Most remuneration committees take their responsibilities extremely seriously and shareholders are frequently happy with their work. Remember that even in this difficult year, three quarters of remuneration committees received a vote in excess of 90% in favour of the remuneration report.

But there are problems. In shareholders’ eyes too large a minority of remuneration committees act as management advocates with shareholders, entering into a negotiation rather than an open discussion about what is appropriate. This then erodes shareholder trust in all committees to some degree, and this trust needs to be rebuilt.

Are changes required to hold non-executive directors more strongly to account? It is possible that annual re-election of directors would bring more focus on the personal reputational implications of decisions made. But the remuneration committee makes recommendations for adoption by the board. And the chairman of the committee is just that – the chairman, not the chief executive. Annual re-election would therefore seem to place an unfair focus on just one individual.

And would it really change behaviour? Possibly, but that would depend on how willing shareholders would be to exercise a vote with such extreme potential consequences as removing a director. If abstentions were then the main source of protest, will it really be that much more effective for 20% of shareholders to abstain than for 20% to vote against the remuneration report? We are not convinced, but it may be that remuneration committees will need to accept some concessions to the perception of more direct accountability in order to get greater freedom to act in the best interests of the company and its shareholders.

In our view, the change in behaviour needs to come from within boards and will not be brought about by further changes to formal governance rules. There needs to be a greater willingness of remuneration committee members to challenge remuneration proposals brought to them. They need to equip themselves for a more pro-active and less reactive approach to remuneration, particularly of the executive directors. How can a remuneration committee maintain independence – many do, so what can be learned?

The remuneration committee should satisfy itself that the advice is delivered with integrity and is unfiltered. There is no single model for achieving this, and committees will meet this responsibility in different ways. Where a single advisor is in place, it should be absolutely clear that in their task of developing an executive remuneration strategy, the remuneration consultant is accountable to the remuneration committee as the delegated sub-committee of the board. This makes clear their responsibility to produce a mutually acceptable outcome rather than act as a management advocate. This can be reinforced by creating a direct line of communication between the remuneration committee chairman and the adviser, setting up clear protocols for flow of information and advice, and providing regular opportunities for the whole remuneration committee to

question the advisor without management present. It may be appropriate on occasion for the remuneration committee to seek a second opinion from an advisor that has not been involved in the development of the proposals.

But it is not all about the relationship between the remuneration committee and its advisers. More important is how independently the committee behaves. Behaviour is different from process, but some safeguards to independence can include the following:

- be clear about why you are taking advice and what you expect from your adviser. In the new world a remuneration committee (especially in financial services) may require advice on: market data; investor relations; governance and regulatory standards; incentive design; risk and risk-adjusted measures; legal considerations. Few traditional remuneration advisers are competent in all of these areas, so the remuneration committee should be clear where the gaps and limitations in the advice may be;
- prior to each meeting have a short session of non-executive directors only, not to rehearse the meeting but to allow any key issues arising from the papers to be raised for the chairman's attention. This should be done as a matter of course before every meeting, to avoid it being a big issue when it is truly necessary;
- be sceptical about proposals for change and whether they really represent an improvement;
- make sure the committee sets the objective criteria for establishing the pay comparator group and confirm any deviations from this chosen group in the pay data provided, and use data as a context for decisions, not a determinant of them, and focus on the range of data as well as the median;
- encourage remuneration committee members to attend workshops, seminars and networking events to enhance their remuneration expertise, and engage the whole committee in the remuneration debate and avoid becoming over-reliant on the chairman;
- bring together information from the board meeting about performance and risk with information about remuneration decisions, so that remuneration is discussed in the explicit context of business performance;
- create a regular and open dialogue with shareholders, including face-to-face meetings with the remuneration committee chairman, to build trust and mutual understanding; and
- undertake a serious and independently facilitated review of the remuneration committee's effectiveness at least once every three years.

Perhaps most challenging, remuneration committee members need to be prepared to have difficult conversations about pay and performance with executive management. The tolerance for (constructive) conflict needs to rise.

While this may seem challenging, the stakes are high. Failure to rebuild trust in the remuneration process may lead to regulation, with all the unintended consequences that could bring. But perhaps even more seriously, shareholders, particularly following the banking crisis, increasingly view governance about remuneration as a visible signal of the quality of governance more widely in the board. After all, if the non-executive directors are not prepared to stand up to the chief executive on their remuneration, will they be prepared to stand up to them on strategy, or a major acquisition?

The relationship between non-executive and executive directors should always remain constructive, and nowhere is that more difficult than in a remuneration committee. But now more than ever, this must not be at the cost of robust and independent challenge.

Change is underway – let's not undermine it

The early evidence is that increased shareholder pressure is having an effect. The recession hit many companies late in 2008, with the result that full year financial results were often still strong. Moreover, the real hardening of shareholder pressure only came about in the early part of the year. Notwithstanding this, many companies reacted, amending their proposals late in the day:

- around half of large companies have frozen base pay for senior executives;
- bonus payments for 2008 are around 15% lower than for 2007, and around 15% of companies paid no bonus at all (up from 5% last year); and
- average long-term incentive awards for 2009 are lower than 2008, as a number of companies have reflected lower share prices, and in some cases lower targets.

The current system gives shareholders the power to engage forcefully with companies on the executive pay issue. They have once again started to do so. It is now necessary to give companies time to respond. The early evidence is that companies are doing so and are exercising moderation.

In business, as in life, conflicts cannot be avoided – they must be managed. As we have stated elsewhere, there is plenty that is not working in executive pay. Our view is that the current governance rules for executive pay provide all the tools required to provide a mutually satisfactory outcome for shareholders and executives, while rebuilding the trust of wider stakeholders. It is now up to all of us involved in the process to raise our game to prove it to be so.

8 Choppy waters

We are in a period of unprecedented complexity for remuneration committees. What are the short-term challenges that need to be navigated en route to a longer-term strategy?

Preparing for the challenge ahead

As well as focusing on this year's requirements, companies also need to keep one eye on the future. Below are nine principles that offer a guide for organisations as they develop their executive reward strategies for the long-term. The key issues for focus in the short term are expanded later in this article and we hope we have provided more insight on them in the articles in this publication.

1. Change is coming and trust needs to be rebuilt

There is tangible public anger around remuneration which impacts every organisation's ability to do business. To bring about change requires an improvement in trust, between remuneration committees, shareholders, and executives. Companies need to improve consultation with shareholders, which will lead to greater support for the judgement of remuneration committees and greater trust in executives to act responsibly.

2. A new executive reward model is needed

Organisations need to tailor their remuneration models to their business strategy, moving away from a follow-my-leader mentality. Simplification is key to success. Often this will involve fewer complex incentives and a greater focus on long-term stock ownership to achieve alignment.

3. Pay for performance must become a reality for all

Shareholders need comfort that pay for performance is real. This means an end to pay for effort and a clear articulation of what constitutes performance. Skill and luck must be separately identifiable.

4. The upward ratchet in executive pay should cease

Executive pay must reflect the nature of supply as well as the demand for talent. For average performers this will mean that pay will come down, but for the best it will continue to grow, as individuals are differentiated based on the value they add to the enterprise.

‘High potential pay for performance, responsibly governed, is a force for good’

5. The reward package should be considered in its totality

Salary and incentives are not the only components of an executive’s pay. Other aspects of pay cannot be ignored and the difficulty in assessing the competitiveness of the total reward package must be overcome.

6. Remuneration committees must stop over-relying on data

Following the market has contributed to the problems that are now being faced. In times of major change, the measurement and use of historic remuneration data has limited relevance.

7. Governance must have substance as well as form

Being a remuneration committee member is, and should be, a tough job. There is a need for committees to be more challenging, to exercise more discretion whilst managing the board to avoid divisiveness over pay. Robust governance processes must be in operation throughout the organisation with clear oversight of responsibilities.

8. Advisers need to up their game

In the future, there needs to be less focus on the supply of market data and greater focus on advisers providing high-quality, robust challenge, strategic input and analysis. Conflicts of interest must be managed to ensure that the remuneration committee has access to independent advice, without introducing unproductive conflict into the relationship with management.

9. The case for executive pay needs to be made

Pay is part of the equation that can assist in supporting skilled executives to perform to the best of their abilities. High potential pay for performance, responsibly governed, is a force for good. This needs to be remembered, emphasised, and communicated. With all of the changes afoot, it is important for remuneration committees to take a step back and consider what should be on the agenda for the coming year. For those outside financial services it is easy to pretend that none of this applies to them. But with a significant probability of Walker recommendations finding their way more broadly into the Combined Code, a bit of forward thinking may deliver a big pay-back in future. As a number of banks are currently finding to their cost, waiting to think about change until you are forced can create significant time pressure.

So what should be on the remuneration committee's agenda now?

For those organisations within the financial services sector the road map is pretty clear – the FSA has issued its Code of Practice which covers a whole raft of items from governance to deferral and the whole discussion on risk adjusted measures. Clearly remuneration committees need to review the current suite of incentive arrangements and consider how they are aligned with the new environment.

In addition, remuneration committees within the financial services sector need to consider their extended remit – how will they deal with the oversight of all incentive arrangements within the organisation. This is not an easy issue and requires considerable thought before any changes are made. The balance needs to be struck between oversight and governance on the one hand and, on the other, the freedom of management to use compensation as a strategic tool to support enhanced performance. Consideration will also need to be given to the detail of the final Walker recommendations.

Outside of the financial sector, there's still much work to be done.

Remuneration committees, at a minimum, should be starting to consider which of the FSA and Walker items may migrate across to the non-financial sector and, secondly, of those that might migrate across what potential impact will they have either on the remuneration committee's role and method of operating and/or on the structure of incentive arrangements within the organisation.

At first blush, this would appear a rather simple exercise that could be dealt with via a simple checklist. Those who have attempted to undertake this in practice have found that matters are much more complicated and indeed views are highly subjective. Real issues of substance are being raised that require further consideration by the committee at future meetings.

By December 2009, there should be a reasonably clear road map with the final outcome of the Walker Review and the latest thinking from the Financial Reporting Council (FRC) on implications for the Combined Code and thus what action needs to be taken by the remuneration committee.

Freeze or unfreeze?

Base salary reviews will be a tricky area for 2009/10. Last year the majority of FTSE 100 companies did freeze salaries, and those that did not made only modest increases. For the coming year, most businesses are planning a salary review for senior management, on the basis that it is too demotivating to freeze salaries two years running, particularly if bonus payments are down and with income tax due to rise in April.

But recall that as late as October last year most companies were expecting to make pay rises, but the mood changed very rapidly during the last quarter of 2008. There will also be significant tensions with shareholders who are not all of the view that one year of pay restraint is sufficient, given the severity of the downturn and the impact on profits.

Issues to keep an eye on relating to the base pay debate:

- Evolving shareholder attitudes and guidance – how strongly will they push for a continued pay freeze?
- The economy – indications of a double-dip recession could change sentiment on pay increases very quickly.
- Politics – next year's pay rises for executives will be reported during (or in the run-up to) an election campaign. Recent evidence from the banking sector has shown how hard it is for politicians to resist public pressure in the executive pay area.
- Public sector pay – if consensus forms among both political parties that a public sector pay freeze is inevitable then expect significant union pressure on any 'unjustified' pay increases in the private sector.

This is an area on which remuneration committees need to keep a close eye, and ideally defer decision making as late as possible.

Pay for performance?

Another major item that will need to be in focus is the appropriateness of performance measures for the coming year in respect of annual bonus and the LTIP.

Many of our clients have spent considerable time debating and mapping out potential changes to performance measures, both in respect of the measures themselves, but more importantly the absolute targets. We are undoubtedly going to see a number of organisations again having to reduce the performance targets within the long-term incentive plans for the next award compared to historic awards. This will require not only careful calibration and scenario testing but also real craftsmanship in respect of the communication of such changes within the remuneration report. Calibration will be genuinely tough: the timing of any economic recovery will significantly affect how tough any revised measures are.

Remuneration committees need to bear in mind the institutional shareholder mind-set that if performance targets are reduced from historic levels then they would expect the incentive opportunity to be correspondingly lower. This needs to be balanced against the requirement to motivate executive teams through an extremely difficult period. Remuneration committees will need to be prepared to explain how they addressed this issue and the conclusions reached, with the underlying rationale, again clearly explained within the remuneration report.

The other issue requiring careful handling will be bonus outcomes for 2009. Bonuses were reduced in 2008 compared with the prior year, but only by around 15% to 20%. This was explained by the fact that the recession hit many businesses hard and fast in the last quarter of 2008, and so did not affect the full year results too badly. However, the recession did hit early enough for companies to rebase their incentive targets for 2009.

Many remuneration committees were sensitive to the lower profit outlook and set targets that were tougher, relative to budget, than would previously have been the case. However, in a number of cases it may well be that resetting of targets means that bonus payments rise at the same time as profits fall significantly. The communication of this issue needs to be handled carefully with shareholders, and could be one of the biggest sources of dispute for the 2010 AGM season. Remuneration committees should be sensitive to the issue when considering any discretion they apply in determining bonus outcomes.

Pensions and contract terms – a growing issue

Much has been in the press over pension plans in the last 12 months and it's undoubtedly going to be the case that institutional shareholders will focus on this little explored area in the next review of the papers submitted to AGMs. Committees should therefore be reviewing the existing pension arrangements for their top executives, in particular any early retirement provisions.

Contractual arrangements will be increasingly under scrutiny from shareholders, particularly in the areas of termination terms and liquidated damages, where some shareholders are looking for further voluntary reductions.

‘A balance between giving employees a choice to manage their tax position versus the potential impact on corporate reputation.’

Taxing times

A key item for consideration in the current environment is the implication of the proposed tax changes and reduced tax relief both in annual allowance and contributions to pension arrangements. Potentially this would make significant difference to UK executives and middle managers plus increase the cost of expatriates who are subject to tax equalisation. These are not simple issues – do global companies amend incentive arrangements and offer tax planning in one country which may have no impact on executives and employees in other territories? Whilst generally they do not, it’s fair to say that most of our clients have taken the view over the last couple of months that the changes in the UK are so significant that they really need to have a look at all the implications if only to manage the adverse consequences, particularly of the changes to the pension regime.

From our discussion with many institutional shareholders this is an area that they are gradually getting themselves educated on and, not unnaturally, are approaching the topic with great scepticism. Their starting point is that companies should not be engaged in tax planning for a select few, rather than making such arrangements available to all those affected by the tax changes. Moreover, while they are generally relaxed about sensible arrangement of the tax consequences of pay programmes, they do not want to see the economics of the programmes changed purely for tax reasons.

Much of the discussion in this area is likely to come down to a balance between giving employees a choice to manage their tax position versus the potential impact on corporate reputation.

And of course at the time of going to print the ‘bank payroll tax’ was sending shock waves through the banking sector, and leading to some tough discussions on how to respond.

It will be a busy year for remuneration committees across all sectors. More or longer meetings may be required than in previous years to cover all of the relevant items in an appropriate manner. Remuneration committees should consider setting up an away day without formal decision making required, purely with the aim of reviewing the strategic landscape and agenda.

This will require greater time commitment from the NEDs both within and outside the meetings. Which brings us to another item for the year’s agenda: NED fees.

Our view of the market: FTSE 100 and FTSE 250

In this chapter we look at the main elements of remuneration and use the latest data to explore trends and design for executives.

There have been very few changes to the total remuneration package in the last year, however there has been an increased focus on the structure and composition of an executive's package. Some of the key findings, using forward looking data and July 2008 to June 2009 company report and accounts, include:

- In the FTSE 100 median increases in base salary this year have fallen to around 1% for executives and in the FTSE 250 the median level of increase for was 0% where around 60% of executives received no pay rise at the last review date.
- The median maximum bonus opportunity for CEOs in the FTSE 100 and FTSE 250 have remained stable at 150% of salary, and 100% respectively. However, some companies have increased maximum potential bonus and while the median and the upper quartile remain the same for the FTSE 100 and FTSE 250, the lower quartiles have increased. It should be noted however, that institutional shareholder bodies are wary of companies increasing bonus potential without a corresponding toughening of the performance conditions which must be achieved for maximum bonus payout.
- Actual bonus payments have decreased for 2009 by 20% to 25% reflecting current business performance and the economic climate. The number of executives receiving nil bonuses has doubled in the FTSE 100 and increased by 40% in the FTSE 250. This statistic is primarily driven by financial services companies where the median payout in the FTSE 100 was zero. Non-financial services company's actual bonuses have remained broadly similar to last year.

- Median total long-term incentive grant values have decreased at CEO level, the median economic (or expected) value of awards is 140% of salary in the FTSE 100, and 80% of salary in the FTSE 250. This reduction was primarily driven by a fall in some of the larger awards which were made in 2006 and 2007, and through companies voluntarily reducing award levels where they had experienced significant share price falls.
- As frustration with TSR and EPS has grown, there has been greater use of bespoke measures that focus on the main goals of the company within long-term incentives. However, TSR and EPS remain the most common measures, and in some cases difficulties with calibrating financial measures in the current environment has led companies back to relative TSR.
- The pension's landscape has changed very little in the last year. Half of FTSE 100 and one-third of FTSE 250 CEOs participate in a final salary pension plan and the use of a notional earnings cap is now fairly common. Provision through a defined contribution scheme is now the prevalent type of arrangement for all executive directors. We expect to see major change in this area as a result of the tax changes announced in Finance Act 2009.
- NED's fees have been broadly flat for both FTSE 100 and FTSE 250, but we would expect to see significant pressure in this area in future years given the increase responsibilities and scrutiny of NEDs.

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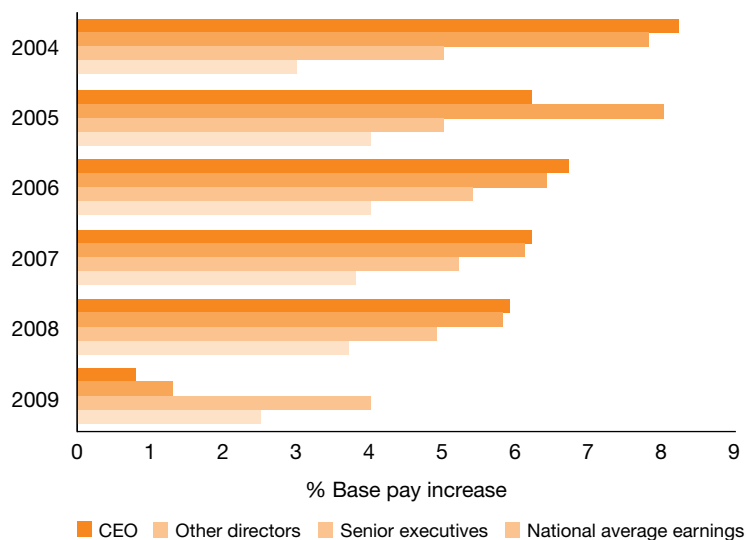
Our view of the market: FTSE 100 executive compensation

In this chapter we look at the main elements of remuneration and use the latest data to explore trends in quantum and design for executives. Data is based on July 2008 through to June 2009 year ends. Where disclosed, prospective 2009 data has been used to give the most up to date picture of 2009 practice.

Base salaries

Increases this year have fallen to around 1% for executives of FTSE 100 companies. In our experience companies are either freezing or applying minimal increases to salaries as the full impact of the recession, coupled with restructuring of their businesses have made boards decide that above inflationary rates of increase to executive pay would not be appropriate. For the first time in over a decade, national average earnings are outstripping executive pay.

Figure 9.1
Median base pay increase
in FTSE 100



Source: Annual reports, PwC-Monks database

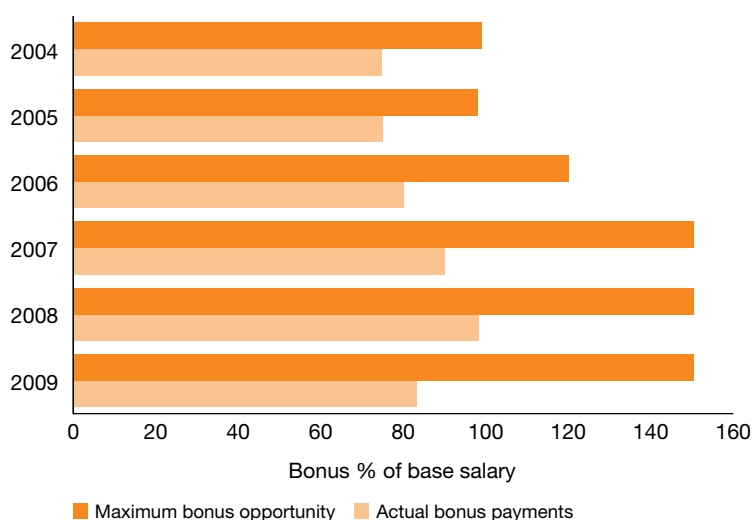
Annual bonus

The median maximum bonus opportunity for CEOs in the FTSE 100 has remained stable at 150% of salary. However, a handful of companies have increased maximum potential bonus and while the median and the upper quartile remain the same as 2008 (150% and 200 respectively), the lower quartile has shifted to 125% from 120%.

In our opinion, maximum bonus potentials will continue to reflect a level of around 150% for FTSE 100 companies in the next reporting season. In the current economic climate we envisage that most companies would not be able to justify any increases to their shareholders.

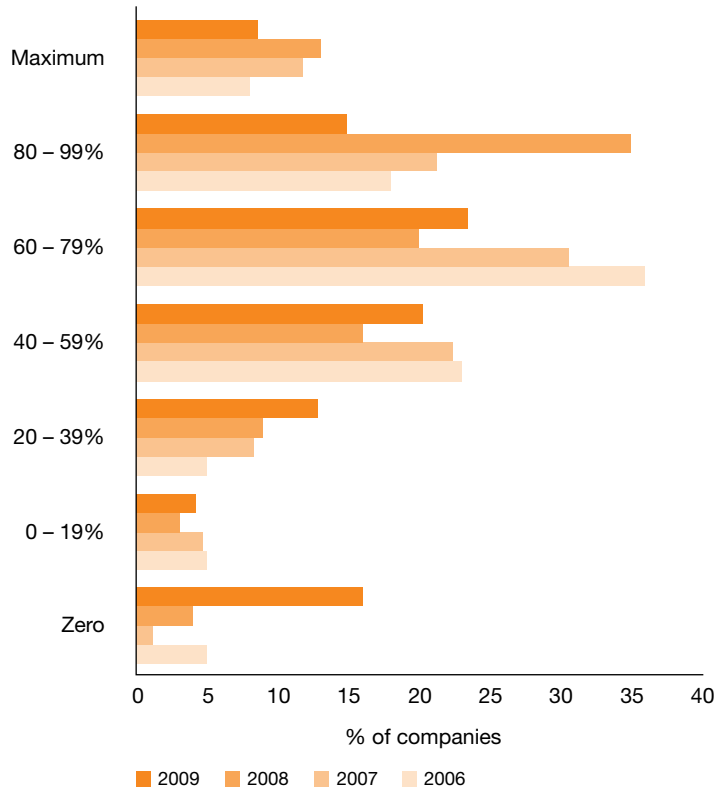
Actual bonus payments have decreased for 2009 reflecting current business performance and the economic climate. The main contributors to this decrease are the financial service companies whereas non-financial businesses only saw relatively modest falls in payouts (the median bonus payment for FTSE100 Financial companies was 0% of salary). There has also been a doubling in the number of nil bonus payments to around 16% of board directors (from 8% last year).

Figure 9.2
Annual bonus trends median
FTSE 100 CEOs



Source: Annual reports, PwC-Monks database, IVIS

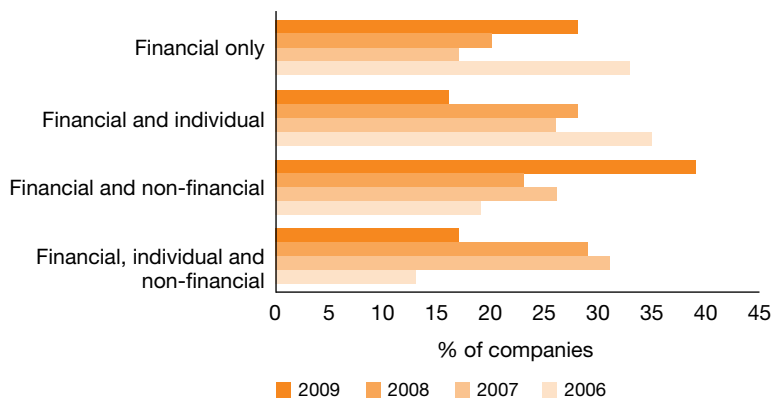
Figure 9.2b
Distribution of annual bonus payouts (as a % of maximum)
FTSE 100 CEOs



Source: Annual reports, PwC-Monks database, IVIS

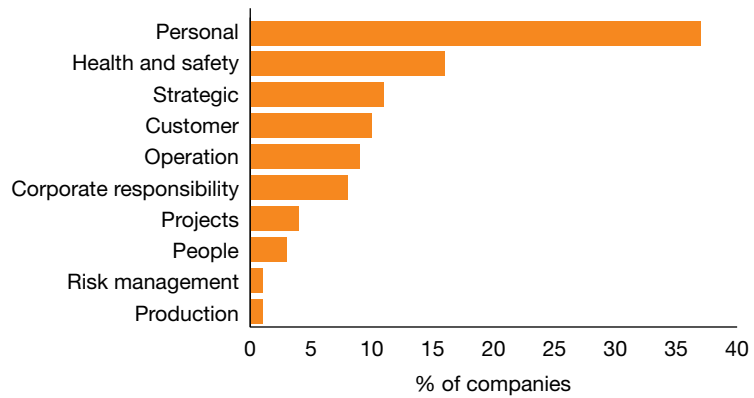
More and more, the design of bonuses means that earnings against budget are not the sole indicator of performance. The use of shared non-financial measures focusing on the specific business goals for the year as well as individual performance goals continues to be highly prevalent in 2009.

Figure 9.3
Use of measures in annual bonus plans in FTSE 100



Source: Annual reports, PwC-Monks database

Figure 9.4
Types of non-financial
measures in use in FTSE 100
(where disclosed)

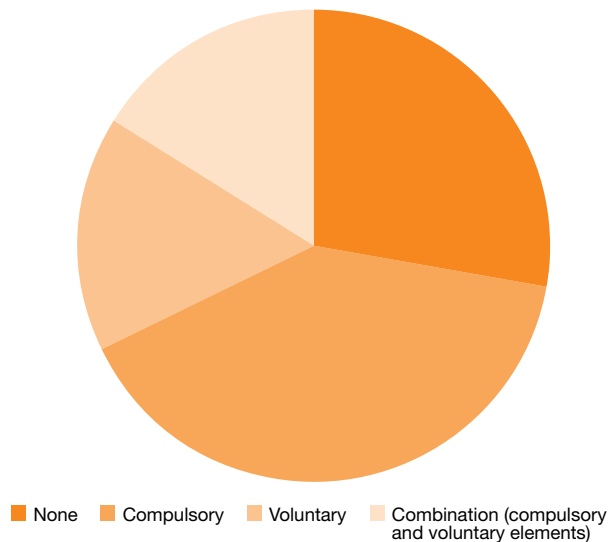


Source: Annual reports, PwC-Monks database

Deferred bonus plans

Our data shows that 72% of FTSE 100 companies now operate a deferred bonus plan, in which executives can choose to, or are required to, defer some of their annual cash bonus into shares. Around three quarters of these have a compulsory element to deferral.

Figure 9.5
Incidence of deferred bonus
plan in FTSE 100



Source: Annual reports, PwC-Monks database, IVIS

Figure 9.6
Design of deferred
bonus plan – FTSE 100

Types of deferred bonus	Compulsory	Both	Voluntary
% of all plans	56%	22%	22%
of which % with share match	24%	63%	100%
of which % with performance conditions on match	80%	90%	100%

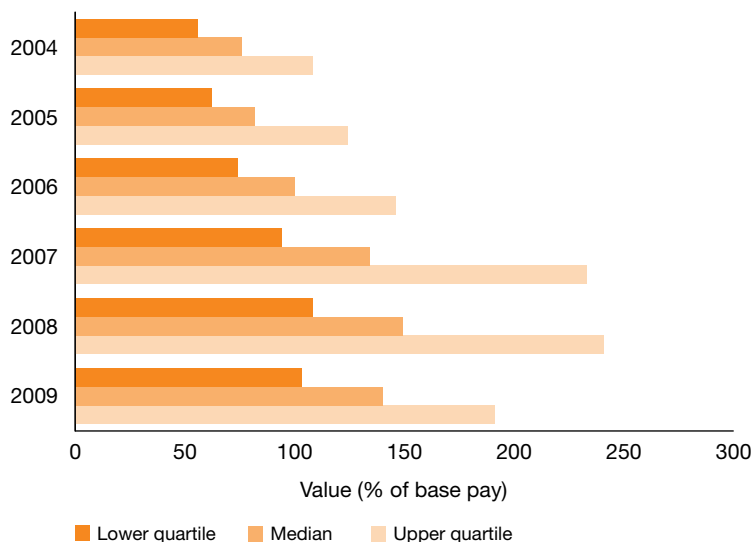
Source: Annual Reports, PwC-Monks database, IVIS

Long-term incentives

Median total long-term incentive grant values have slightly fallen at CEO level, the median economic (or expected) values of awards is now 140% of salary compared with 150% in 2008. Our data suggests this fall has been primarily driven by a minority of companies reducing award levels. Companies experiencing significant falls in share price have scaled back award levels by anything between 20% and 40% in response to shareholder pressure.

For reference, an economic (or expected) value of 140% of salary typically equates to a face value performance share plan award of 233% salary or an option grant of 467% of salary.

Figure 9.7
Long-term incentive
grants (economic values)
FTSE 100 CEOs

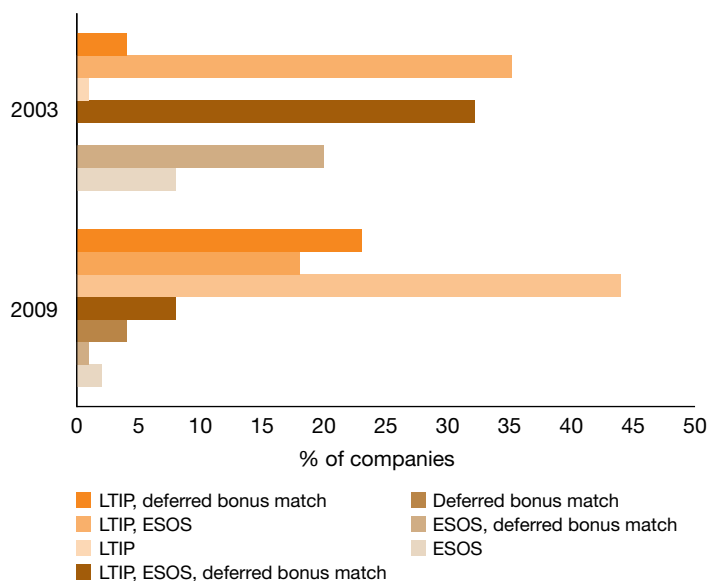


Source: Annual reports, PwC-Monks database, IVIS

The most common plans for executives in UK companies remain performance share plans, deferred bonus plans and share options. Deferred bonus plans have, together with performance share plans, increased in popularity over recent years while the prevalence of share options has declined (although this has slowed since the dramatic falls in the middle of the decade).

Within the FTSE 100, the median annual award of performance shares is 200% of base salary face value. For options, the median level of award is 270% while the typical maximum matching award under deferred bonus plans is 2:1.

Figure 9.8
LTI plan participation in
FTSE 100



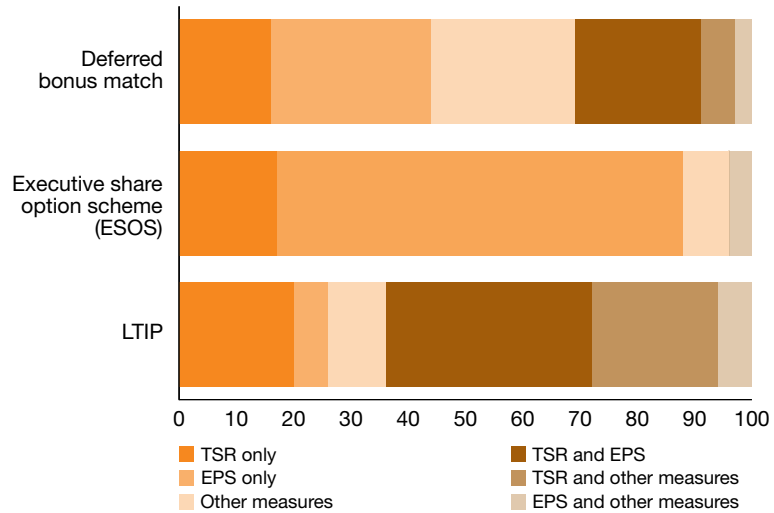
Source: Annual reports, PwC-Monks database, IVIS

As in recent years LTIP awards continue to be the mechanism of choice. The general theme this year has been one of changes to performance conditions or targets, rather than introduction of new plans. In previous years' reviews, we have noted the emergence of bespoke plans such as those mirroring private equity type arrangements. However this has not taken off beyond a handful of companies.

Performance measures

TSR and growth in EPS remain the most common performance conditions in UK plans. Whilst we know that companies have become frustrated with both TSR and EPS for differing reasons, their dominance has only been dented slightly by the introduction of new measures such as economic profit, cash flow, or return on capital. Instead, these measures tend to operate as an additional performance condition alongside those which are popular and recognisable with shareholders.

Figure 9.9
Performance condition
long-term incentives –
FTSE 100 CEOs



Source: Annual reports, PwC-Monks database, IVIS

Pensions

The pension's landscape has changed very little in the last year. Half of chief executives participate in a final salary pension plan and the use of a notional earnings cap is now fairly common.

Figure 9.10
Overview of pension provision
in FTSE 100

	CEOs	CFOs	Other directors
DB on full salary (% posts)	30%	26%	38%
DB to earnings cap (% posts)	18%	20%	13%
DC / cash	63%	62%	56%
Median DB accrual	30ths	30ths	30ths
Median DC contribution	20%	20%	20%

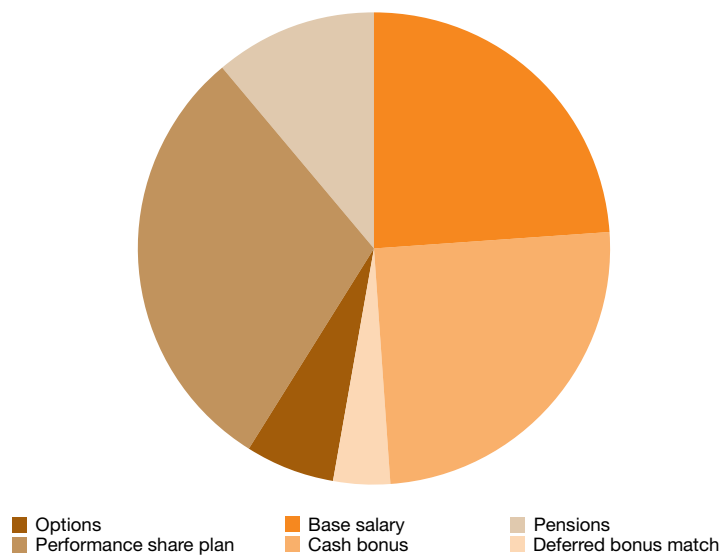
Source: Annual Reports, PwC-Monks database
DB = Defined benefit
DC = Defined contribution

Total compensation

In terms of changes to the package, there have been very few changes to the total remuneration available to a chief executive however there has been an increased focus on the structure and composition of the total package.

We believe that the main focus for remuneration committees in the next reporting season will be the balance between annual bonus and long-term incentives given the challenge of setting long-term financial targets with the current economic uncertainty.

Figure 9.11
Average package mix 2009
for FTSE 100 CEO



Source: Annual reports, PwC-Monks database, IVIS

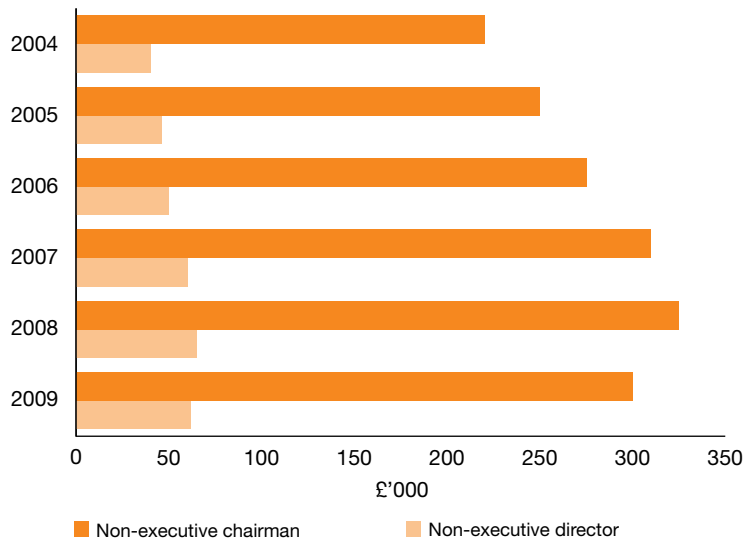
Non-executive director fees

Non-executive director base and total fees showed a decrease in the last year bringing down the median FTSE 100 chairman fees to £300,000 and director fees to £62,000. This fall is a reflection in the changes to the constituents of the FTSE100, compared with last year, rather than a clear trend as our consulting experience suggests that non-executive director's fees have been broadly flat over the past few years.

However we have continued to see increases to committee chairmanship fees. The fees for chair of the audit committee at the median are now £18,000, and at the upper quartile £25,000, while the typical membership fees in the FTSE 100 have remained between £5,000 and £10,000. We have also seen a rise in senior independent director's fees which now stand at £12,500.

Non-executive director fees were generally frozen last year, in alignment with the approach taken for executive directors. But with significantly increased responsibilities being placed on non-executive directors, with much additional time commitment required, we are expecting some very substantial realignment of non-executive director fees over the next 24 months.

Figure 9.12
FTSE 100 non-executive
director and chairman fees



Source: Annual Reports, PwC-Monks database

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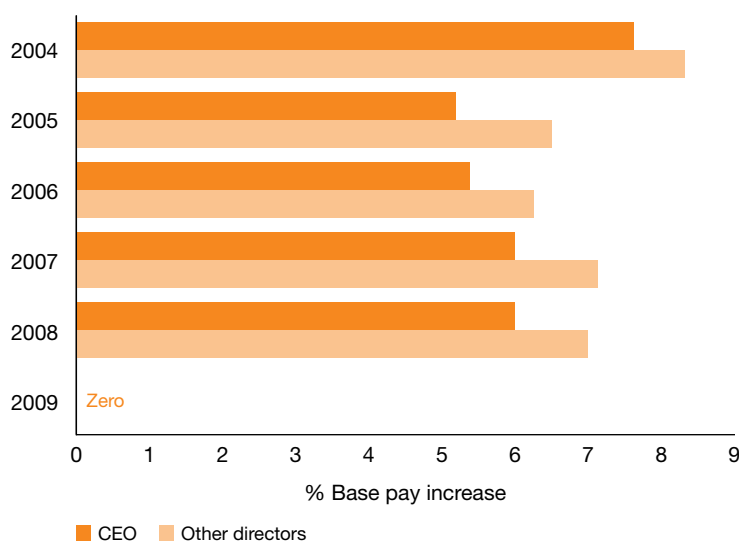
Our view of the market: FTSE 250 executive compensation

Data is based on July 2008 through to June 2009 year ends. Where disclosed, prospective 2009 data has been used to give the most up to date picture of 2009 practice.

Base salaries

The median level of increase for CEOs and other directors was 0% for 2009. In our experience companies are either freezing or applying minimal increases to salaries as the full impact of the recession, coupled with restructuring of their businesses, have made boards decide that above inflationary rates of increase to executive pay would not be appropriate. For the first time in over a decade, national average earnings are outstripping executive pay.

Figure 10.1
Median base pay increase
in FTSE 250



Source: Annual Reports, PwC-Monks database

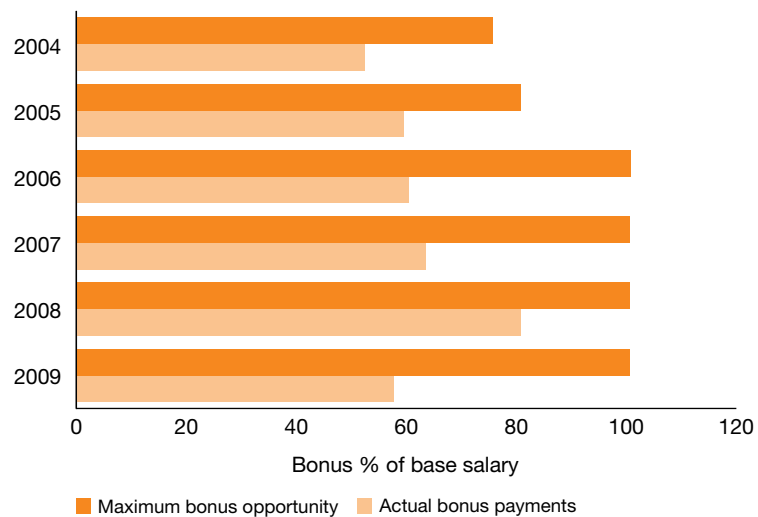
Annual bonus

The median maximum bonus opportunity for CEOs in the FTSE 250 has remained stable at 100% of salary. However, a handful of companies are still increasing the maximum potential bonus and while the median and the upper quartile levels are the same as 2008 (100% and 150% respectively), the lower quartile has shifted to 100% from 90%.

In our opinion, maximum bonus potentials will continue to reflect a level of around 100% for FTSE 250 companies in the next reporting season. In the current economic climate we envisage that most companies would not be able to justify any increases to their shareholders.

Actual bonus payments have decreased for 2009 reflecting current business performance and the economic climate. The fall in bonus payments has been consistent across both financial and non-financial companies. There has also been an increase in the number of nil bonus payments to around 15% of board directors (from 11% last year).

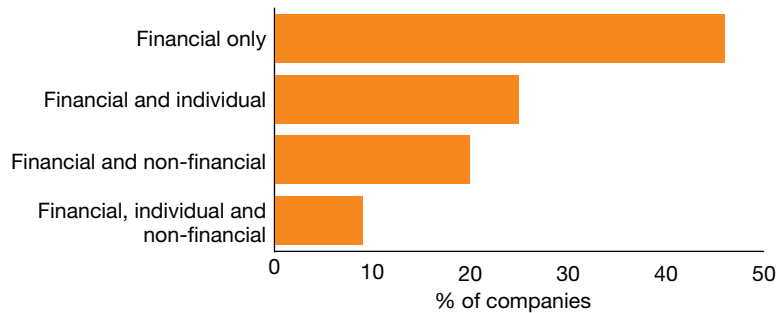
Figure 10.2
Annual bonus trends
median FTSE 250 CEOs



Source: Annual reports, PwC-Monks database, IVIS

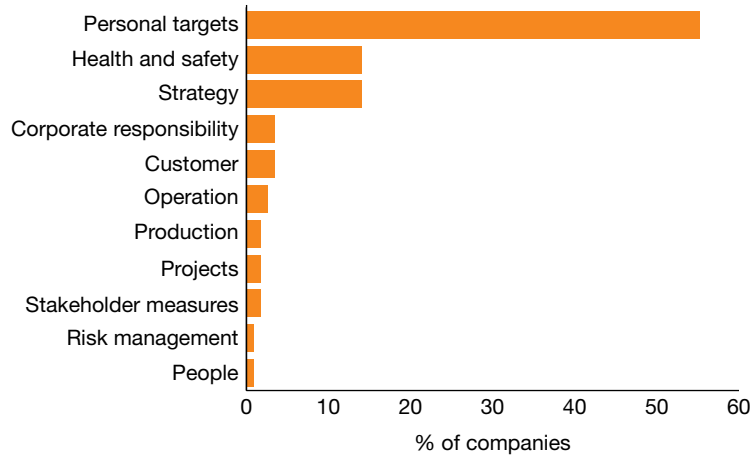
More and more, the design of bonuses means that earnings against budget are not the sole indicator of performance (this is now the case in over 50% of plans). The use of shared non-financial measures focusing on the specific business goals for the year as well as individual performance goals continues to gain popularity.

Figure 10.3
Use of measures in annual
bonus plans in FTSE 250



Source: Annual reports, PwC-Monks database

Figure 10.4
Types of non-financial
measures in use in FTSE 250
(where disclosed)

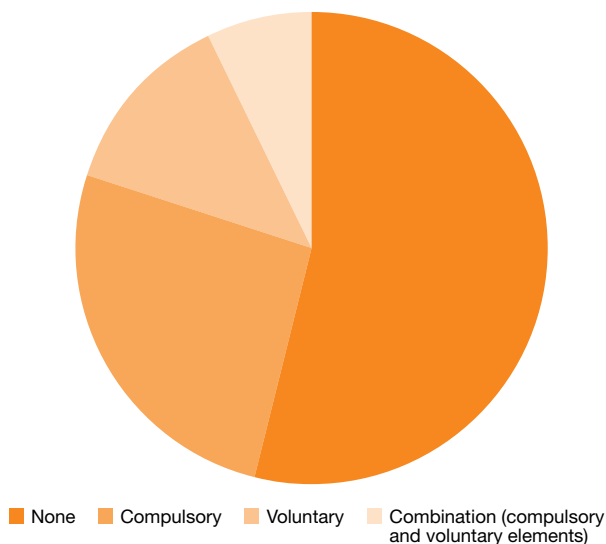


Source: Annual reports, PwC-Monks database

Deferred bonus plans

Our data shows that 46% of FTSE 250 companies operate a deferred bonus plan, in which executives can choose to or are required to defer some of their annual cash bonus into shares. Around two thirds of these have a compulsory element to deferral.

Figure 10.5
Incidence of deferred bonus
plan in FTSE 250



Source: Annual reports, PwC-Monks database, IVIS

Figure 10.6
Design of deferred bonus
plan – FTSE 250

Types of deferred bonus	Compulsory	Both	Voluntary
% of all plans	56%	14%	30%
of which % with share match	20%	62%	100%
of which % with performance conditions on match	100%	100%	95%

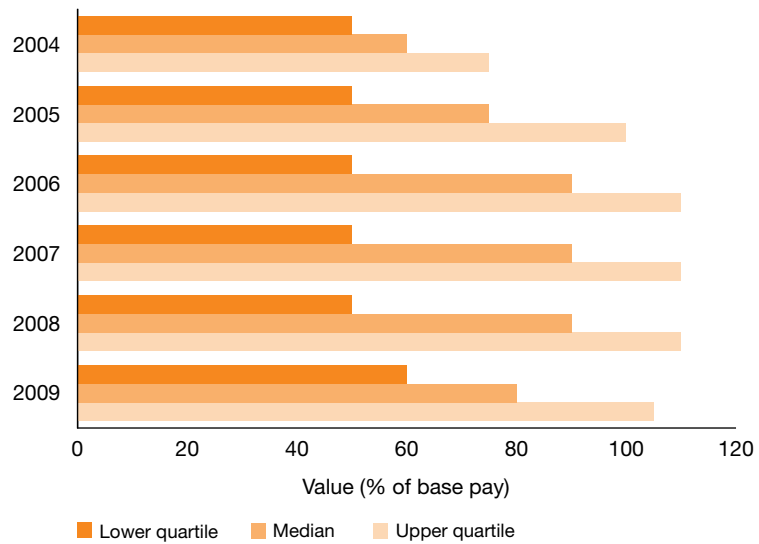
Source: Annual Reports, PwC-Monks database, IVIS

Long-term incentives

Median total long-term incentive grant values have slightly fallen at CEO level, the median economic (or expected) values of awards is now 80% of salary compared with 90% in 2008. Our data suggests this fall has been primarily driven by modestly declining award levels.

For reference, an economic (or expected) value of 80% of salary typically equates to a face value performance share plan award of 133% salary or an option grant of 267% of salary.

Figure 10.7
Long-term incentive grants (economic values)
FTSE 250 CEOs

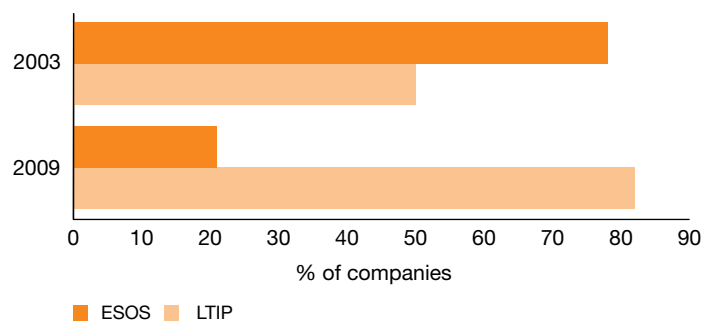


Source: Annual reports, PwC-Monks database, IVIS

The most common plans for executives in UK companies remain performance share plans, deferred bonus plans and share options. Deferred bonus plans have, together with performance share plans, increased in popularity over recent years while the prevalence of share options has declined (although this has slowed since the dramatic falls in the middle of the decade).

Within the FTSE 250, the median annual award of performance shares is 100% of base salary face value. For options, the median level of award is 100% while the typical maximum matching award under deferred bonus plans is 2:1.

Figure 10.8
LTI plan participation in
FTSE 250



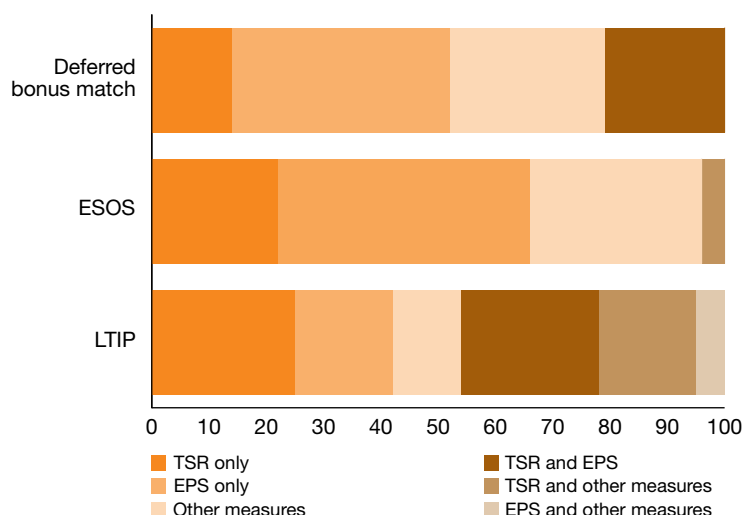
Source: Annual reports, PwC-Monks database, IVIS

As in recent years LTIP awards continue to be the mechanism of choice. The general theme this year has been one of changes to performance conditions or targets, rather than introduction of new plans. In previous years' reviews, we have noted the emergence of bespoke plans such as those mirroring private equity type arrangements. However this has not taken off beyond a handful of companies.

Performance measures

TSR and EPS remain the most common performance conditions in UK plans. Whilst we know that companies have become frustrated with both TSR and EPS for differing reasons, their dominance has only been dented slightly by the introduction of new measures such as economic profit, cash flow, or return on capital. Instead, these measures tend to operate as an additional performance condition alongside those which are popular and recognisable with shareholders.

Figure 10.9
Performance condition
long-term incentives –
FTSE 250 CEOs



Source: Annual reports, PwC-Monks database, IVIS

Pensions

The pension landscape in the FTSE 250 is very different from the FTSE 100. Only around one-third of chief executives now participate in a final salary pension plan and the use of a notional earnings cap is now fairly common. Provision through a defined contribution scheme is now far and away the prevalent type of arrangement for all executive directors.

Figure 10.10
Overview of pension provision
in FTSE 250

	CEOs	CFOs	Other directors
DB on full salary (% posts)	20%	18%	28%
DB to earnings cap (% posts)	8%	10%	8%
DC / cash	73%	76%	69%
Median DB accrual	30ths	40ths	40ths
Median DC contribution	15%	15%	15%

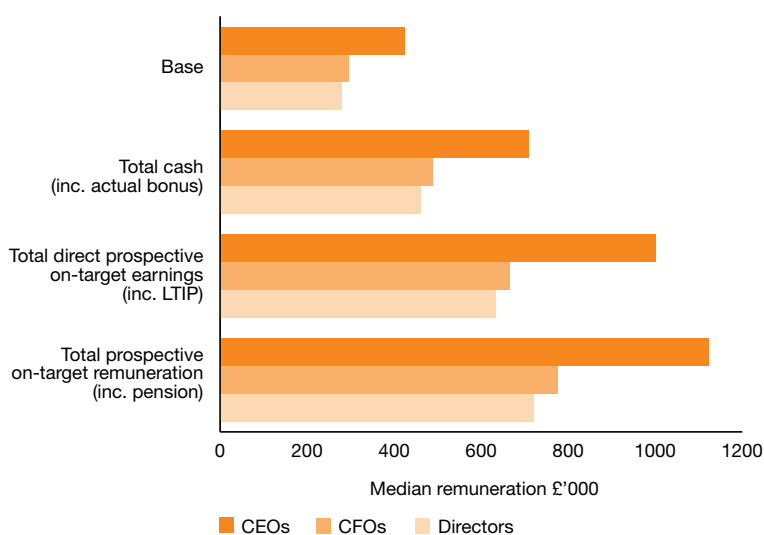
Source: Annual Reports, PwC-Monks database

Total compensation

In terms of changes to the package, there have been very few changes to the total remuneration available to a chief executive however there has been an increased focus on the structure and composition of the total package.

We believe that the main focus for remuneration committees in the next reporting season will be the balance between annual bonus and long-term incentives given the challenge of setting long-term financial targets with the current economic uncertainty.

Figure 10.11
Executive director package
2008/2009 in FTSE 250



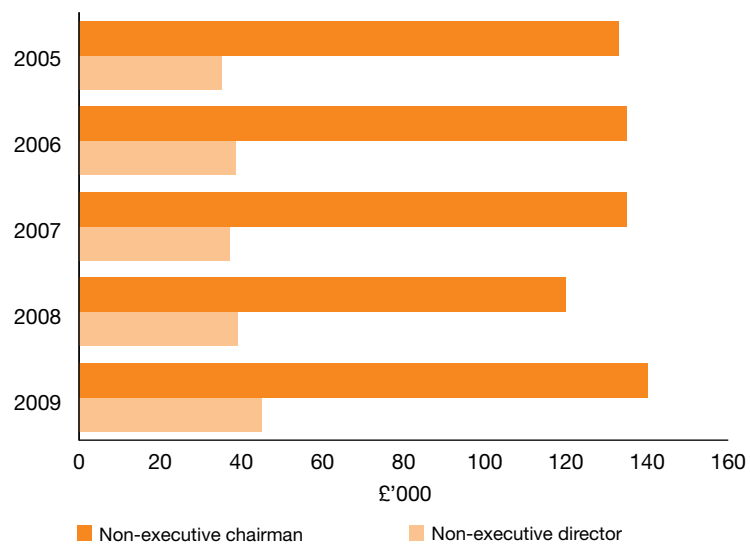
Source: Annual reports, PwC-Monks database, IVIS

Non-executive director fees

Non-executive director base and total fees showed an increase in the last year bringing the median FTSE 250 chairman fees to £140,000 and director fees to £45,000. This increase is a reflection in the changes to the constituents of the FTSE250, compared with last year, rather than a clear trend as our consulting experience suggests that non-executive director's fees have been broadly flat over the past few years.

We have continued to see increases to committee chairmanship fees. The fees for chair of the audit committee at the median are now £7,500, and at the upper quartile £10,000. The membership fees in the FTSE 250 remain around £4,000 to £5,000 for the audit committee and £4,000 for other committees.

Figure 10.12
FTSE 250 non-executive
director and chairman fees



Source: Annual reports, PwC-Monks database

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Other PwC publications

Throughout the year we have been keeping our clients abreast of current executive remuneration issues both within and outside financial services. If you would like a copy of any of the publications listed below please contact Edward Irwin on the details listed above.

Financial services briefing: Reward a new paradigm
Financial services reward – remuneration best practice principles
FSA draft Code
FSF Principles
Pay: a problem of independence*
Preparing for the challenge ahead – the future of executive reward*
Walker Review*
FSA final Code
FSB Principles

*A version of this paper is included as a chapter within this publication.

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