

## Changes to the ABI and the NAPF Remuneration Guidelines

*prepared by MM&K Limited*

Both the ABI and NAPF have recently updated their remuneration guidelines. The ABI changes are minor but the NAPF changes, in our view, reflect a significant change of approach.

### **The NAPF published its new guidelines on 27 November 2007**

The 2007 NAPF Guidelines are a significant change in respect of remuneration as they now follow the Combined Code and ABI guidelines wherever possible, thus making it easier for Companies to identify what is expected of them. The NAPF notes that “In the UK, good practice in remuneration has been set out by the Association of British Insurers (ABI) in its “Executive Remuneration - ABI Guidelines on Policies and Practice”. These can be found at <http://www.ivis.co.uk/>. The NAPF anticipates that most institutional investors and issuers will use the ABI Guidelines as a benchmark for remuneration policies and has therefore chosen not to re-interpret them in detail.”

Prior to this, the NAPF Guidelines were interpreted by RREV, who produced a lengthy 84 page set of guidance notes, which appears now to have been superseded. There is no mention of RREV in the new NAPF guidelines.

The Appendix to this note contains the parts relevant to remuneration from the NAPF Guidelines. According to the NAPF, remuneration practices which would be likely to cause concern and may trigger a voting sanction are listed on page 7 below.

### **The ABI published its revised Executive Remuneration Guidelines on 3 December 2007**

In their covering letter, sent to FTSE350 Rem Com Chairman, the ABI highlighted some specific points of current interest.

“As in previous years, quantum remains a key issue and Remuneration Committees should provide a clear explanation and justification of year-on-year changes. Our members acknowledge the need to set remuneration at levels that retain and motivate executives. However, they expect companies to follow the principle established in the Combined Code “of not paying more than is necessary”. It is therefore important for Remuneration Committees to consider each element of pay in light of the total package and to explain to shareholders any changes and their consequences for the total package.

There have been a number of other issues arising from this year’s reporting round that have concerned members, including one-off or exceptional grants. Although these issues have not caused any specific changes to the Guidelines, members wanted me to draw your attention to these where they relate to share incentive schemes.

- Performance conditions. Members expect performance to be measured either as a single primary measure or as a combination of measures which contribute to the creation of shareholder value. Where two or more performance measures are used, consideration should be given to making them inter-dependent i.e. integrated in a matrix rather than evaluating them independently. This will strengthen the alignment of vesting with improvements in the overall financial performance of the company.
- Vesting schedules for long-term incentive schemes. Remuneration Committees should:

- take account of the proportion of remuneration that is fixed when setting the vesting schedule;
- ensure that the performance threshold equates to a level of attainment that exceeds, or at least matches, the market's expectations;
- consider using wider performance targets such as upper decile in the case of TSR performance;
- recognise the value of performance shares at initial vesting should not be significant in relation to base salary.

Finally, it is helpful for shareholders if there is disclosure in the Remuneration Report of the overall share usage for remuneration purposes, actual and potential, with an indication whether this is dilutive or has been sourced from market purchase shares.”

**The main changes (apart from minor drafting revisions) are as follows:**

## **Para. 2 Pensions**

New Para. 2.2

- 2.2 Payments in lieu of pension scheme participation should be clearly disclosed and treated as a separate non-salary benefit. Accordingly, they should be excluded from the calculation of bonus entitlements and share scheme grants.

Para. 2.4 amended (formerly 2.3)

- 2.4 Changes in **pension benefit entitlements** or to transfer values reflecting significant changes in actuarial and other relevant assumptions should be fully identified and explained. Where *changes* to pension benefit entitlements or transfers *are of a discretionary nature*, these should be made clear and justification provided.

Note the capitalisation, underlining and italics are ours to help readers identify the changes.

## **Performance Criteria**

New Para. 4.9

- 4.9 The calculation of starting and finishing values for TSR should be made by reference to average share prices over a short period of time at the beginning and end of the performance period. Lengthy averaging periods should be avoided.

*Note: The new guideline does not specify what is understood as “Lengthy”. We understand up to 3 months is usually acceptable.*

## **Cost and Basis of Participation**

Para. 5.1 amended; New Para. 5.2; and Para. 5.3 amended

- 5.1 The primary information that should be disclosed includes:
- The potential value of awards (see Appendix) due to individual scheme participants on full vesting. This should be expressed by reference to the face value of shares or shares under option at point of grant, and expressed as a multiple of base salary.
  - The maximum dilution which may arise through the issue of shares to satisfy entitlements.

- 5.2 Shareholders also wish to understand the Expected Value (see Appendix) of incentive awards at the outset, bearing in mind the probability of achieving the stipulated performance criteria. **Where changes to award levels or structures are being proposed, shareholders wish to have disclosed what changes in Expected Value will result and the reasons why the Remuneration Committee considers this justified.**
- 5.3 There should be prudent and appropriate arrangements that are fully disclosed, governing the acquisition of shares, and financing thereof, to meet contingent obligations under share-based incentive schemes.

*Note. The part in 5.2 about “Where changes to award levels or structures are being proposed, shareholders wish to have disclosed what changes in Expected Value will result and the reasons why the Remuneration Committee considers this justified.” is new.*

### **Change of Control Provisions**

Para. 5.10 amended

- 5.10 In the event of a change of control, the key determinant of the level of awards vesting should be underlying financial performance. Also, any such early vesting as a consequence of a change of control should be on a time pro-rata basis i.e. taking into account the vesting period that has elapsed at the time of change of control. Remuneration Committees should satisfy themselves that the measured performance provides genuine evidence of underlying financial achievement over any shorter time period. They should explain their reasoning in the Remuneration Report or other relevant documentation sent to shareholders.

*Note. The change in the new guideline refers to underlying financial performance and the need for the Remuneration Committee to explain their rationale for early vesting. Changes to scheme rules may be required to reflect this and if the change of control occurs the Remuneration Committee will need to satisfy themselves about their decisions and explain them to shareholders.*

## Appendix: NAPF Guidelines about Remuneration

The following are the relevant extracts from the NAPF Guidelines that concern remuneration.

### **Global Remuneration Principles**

In July 2007, a group of leading UK institutional shareholders<sup>1</sup> prepared a set of high-level guidelines on executive remuneration, relevant to both UK and overseas markets. The NAPF supports these principles which are summarised below.

The structure of how directors and employees are rewarded for their efforts is of considerable interest to investors. It gives insights into the methods of incentive being used to reward the operators of a company. It is also important for investors to understand the cost and potential costs to their company associated with reward mechanisms that may be in operation.

Shareholders wish to be able to support the remuneration arrangements of companies in which they invest and will take into account explanations offered by a company. However, where the explanations do not appear to be reasonable, institutional investors owe a duty to their clients to express their concern. Consequently, it is helpful to investors when a company's statement of its remuneration policy is comprehensive, transparent and easily understood.

### **Formulation and Implementation of Policy**

Investors expect companies to give a transparent, succinct and easily understood statement of the objectives of their remuneration policies.

In formulating policies and overseeing their implementation, companies should:

- Avoid paying more than is necessary;
- Use company comparisons with caution given the risk of ratcheting up pay with no corresponding improvement in performance;
- Be sensitive to pay and employment conditions elsewhere in the group;
- Avoid rewarding departing directors for poor performance.

### **Dialogue with Investors**

There should be a dialogue between companies and their shareholders on the rewards given to executives and board members, in order to:

- Ensure that the correct alignments are set between executives and shareholders to deliver the company strategy that provides the best return to shareholders;
- Ensure that conflicts of interest are appropriately managed;
- Align the interests of senior employees with shareholders to create value in implementing the company's business strategy;
- Recognise good performance by the company and individual;
- Encourage the right behaviours to achieve good performance;
- Recruit and retain successful employees by being commercially competitive.

### **Factors for Consideration**

The alignment of interests between Executive Directors and shareholders is greater where senior management have made a significant financial investment in the equity.

Well designed remuneration arrangements allow for both incentivisation and retention of executives. Investors are likely to look unfavourably on special one-off arrangements, in the absence of a compelling business case, as indicative of poor planning.

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<sup>1</sup> Institutional investors include Railpen, Newton Investment Management, JPMorgan Asset Management, Baillie Gifford, Hermes and F&C Asset Management.

In formulating proposals, Remuneration Committees should be sensitive to the need for an appropriate balance between long and short-term elements of pay.

Remuneration committees will inevitably benchmark the pay of executives to what is paid in companies with whom they compete for talent. Disclosure of the benchmark group and target positioning will help investors understand the policy. Benchmarks should be used with caution. Benchmarking has been a factor behind the upward ratchet of executive pay.

The Remuneration Committee should provide a report to shareholders, explaining how it undertakes its activities. The explanation should demonstrate the steps taken in arriving at pay policy, including advice received, and the evidence that shows it takes account of the nature and development of the company's business strategy.

### **UK Corporate Governance Principles**

The NAPF supports the Combined Code in its entirety and wishes to add minimal requirements to that body of work.

In relation to remuneration it has the following principle:-

- The Remuneration Committee has a particular responsibility to ensure that Executive Directors and senior management are appropriately rewarded. This can best be achieved by establishing incentives which are harmonised with the stated objectives of the Company.

The NAPF Voting Guidelines follow the format of the Combined Code. The parts relevant to remuneration are as follows:-

#### **A.1.2: Committees**

##### **A.1.2.1: Committee Composition**

The Combined Code stipulates that the Audit, Remuneration and Nomination Committees are constituted as follows:

- Audit and Remuneration Board Committees of FTSE 350 companies are required to have a minimum of three members each.
- Listed companies outside the FTSE 350 are required to have a minimum of two Independent Non-Executive Directors on their Audit and Remuneration Committees.
- The Remuneration Committee is to comprise independent Non-Executive Directors. In addition, the Company Chairman may also be a member of, but not chair, the Committee if he or she was considered independent on appointment as chairman.

##### **A.1.2.2: Non-Independent Non-Executive Director on Committees**

Where a non-independent Non-Executive Director sits on the Audit or Remuneration Committee, the onus is on the Company to justify the arrangements and for investors to assess this explanation.

#### **Voting:**

Where a non-independent Non-Executive Director sits on the Audit or Remuneration Committee, investors may wish to consider voting against that individual's re-election. Where the Nomination Committee does not comprise a majority of Independent Non-Executive Directors, voting against a non-independent Non-Executive Director may be appropriate.

It is especially important that the Chairman of the Remuneration and Audit Committees be independent and investors will wish to be particularly rigorous in applying a sanction where this is not the case.

Investors might, however, wish to avoid an adverse vote where such a move would exacerbate the situation which they seek to remedy.

#### **A.1.2.6: Chairman on the Remuneration Committee**

The Chairman may sit on the Remuneration Committee (although not chair it) if he/she met the independence criteria on appointment and where independence has not been compromised in the interim.

#### **Voting:**

Where the Board Chairman was not independent on appointment and sits on the Remuneration Committee, investors may wish to abstain on his/her re-election. A similar sanction may be appropriate where the Board Chairman chairs the Remuneration Committee, irrespective of his/her independence on appointment.

### **SECTION B: REMUNERATION**

#### **B.1: REMUNERATION POLICY**

The principles discussed earlier in this document, although applying globally as well as domestically, echo the Combined Code's main principles on remuneration, as set out below:

"Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance." [B.1]

and;

"There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration." [B.2]

In the UK, good practice in remuneration has been set out by the Association of British Insurers (ABI) in its "Executive Remuneration - ABI Guidelines on Policies and Practice". These can be found at <http://www.ivis.co.uk/>. The NAPF anticipates that most institutional investors and issuers will use the ABI Guidelines as a benchmark for remuneration policies and has therefore chosen not to re-interpret them in detail here.

#### **B1.1: Voting on the Remuneration Report**

Most individual elements of remuneration policy are likely to be insufficient to trigger a voting sanction in isolation, but might warrant such a measure when coupled with other deviations from good practice. It is also important for investors to be aware of recurring trends in remuneration (for example, a basic salary increase in excess of inflation in a particular year may not cause excessive concern whereas a trend of such increases might well).

Just as the Remuneration Committee should adopt a holistic approach when designing and assessing packages, so investors should evaluate remuneration arrangements in their entirety.

Remuneration practices which would be likely to cause concern and may trigger a voting sanction include:

- Increases in base salary in excess of inflation, unsupported by a satisfactory explanation
- The use of inappropriate benchmarks when setting base pay
- Guaranteed, pensionable or discretionary annual bonuses
- Insufficient disclosure on the scope of annual bonuses and performance conditions (retrospective disclosure is acceptable)
- The absence of individual participation limits for long-term schemes and annual bonuses
- Transaction-related bonuses
- Grants of 'matching shares' without attendant performance conditions
- Long-term incentives featuring a performance period of less than three years
- Insufficient disclosure on performance conditions attached to long-term share schemes
- A disproportionate amount of a long-term award vesting on median or on-target performance
- Any provision for re-testing of performance conditions
- Grants of options at a discount to market value
- Breaching of the dilution guidelines
- Provisions for early vesting of share awards where pro-rating (for both time and performance) is not applied
- Ex-gratia and other non-contractual payments
- Change in control provisions triggering earlier and/or larger payments and rewards
- Extra-contractual payments on termination of employment
- Notice periods in excess of one year
- The absence of service contracts of Executive Directors
- Unwarranted use of discretion

This checklist is not exhaustive, particularly as good practice in this area continues to evolve.

### **B.1.2: Voting against Chairman/Member of Remuneration Committee**

The resolution on the remuneration report is generally an appropriate channel for registering concern at a company's remuneration practices.

However, where severe or persistent infringements of good practice have been identified, or there is evidence from the remuneration arrangements of a policy generally unaligned with shareholders' interests, a vote against the Chairman (or member) of the Remuneration Committee may also be appropriate.

## **B.2: WORK OF THE REMUNERATION COMMITTEE**

### **B.2.1: Responsibilities of members of the Remuneration Committee**

“The Remuneration Committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments” [B.2.2]

The Remuneration Committee is responsible for the formulation and implementation of executive remuneration packages. While remuneration consultants may act as advisers, they should not involve themselves in the decision-making process, which is the responsibility of the Committee members.

Members of the Remuneration Committee should fully understand:

- The key parameters and structure of the remuneration policy set by the Committee
- How this has been applied to the remuneration and incentive arrangements for the Executive Directors and other senior executives falling within the Committee’s responsibilities
- the cost to the Company and (b) the potential end-value to each participant of the Company’s remuneration schemes (with reference to a reasonable range of assumptions regarding personal and corporate performance)

### **B.2.2: Use of Remuneration Consultants**

Consultants to the Remuneration Committee should be independently appointed by the Committee and be independent of the Company’s management. Potential conflicts of interest should be scrupulously and demonstrably avoided.

The Remuneration Committee is exclusively responsible for the selection and appointment of its advisers.

“Where remuneration consultants are appointed, a statement should be made available of whether they have any other connection with the company” [B.2.1]

If any services are provided by the same Remuneration Consultants to the Company:

- They should be minimised with respect to both the scope and value of services provided to the Remuneration Committee
- Fully disclosed to the Remuneration Committee and to shareholders
- The Chairman of the Remuneration Committee should explain to shareholders why it is appropriate for the Committee to appoint the same Consultants as the Company, notwithstanding this conflict of interest.