2012 RREV U.K. Remuneration Guidance

November 2011

Institutional Shareholder Services Inc.

2012 RREV U.K. Remuneration Guidance

November 2011

Daniel Jarman
Head of U.K. Governance Research
daniel.jarman@issgovernance.com
+44 (0)207 618 2084

Tom White
U.K. Governance Research Lead Analyst
tom.white@issgovernance.com
+44 (0)207 618 2115

Introduction

Executive pay continues to be debated in the mainstream political arena in the UK. The discussion focuses on what might be done to improve transparency and links between pay and performance and better justification regarding quantum. The continuing gloomy economic outlook in the UK, Europe and the US is providing a sharp focus on the differences between pay generally and the pay of executives, with the latter considered not only to have pay that is already high but also receiving higher pay increases compared with the general workforce.

Comments on Pay

Some recent comments provide insights into topical thinking on executive pay:

Shareholders will object to levels of pay "that do not respect the core principles of paying no more than is necessary and a linkage to sustainable long-term value creation" *Principles of Remuneration 2011 - Association of British Insurers*

"We believe that companies should not over-obsess about benchmark data generally - and the median number in particular. …. There is increasing pressure on greater levels of bonus disclosure - such as the targets actually used in the plan on at least a retrospective basis." *2011 report on FTSE 100 Directors' Remuneration - New Bridge Street*

"The challenge for remuneration committees – operating, as they do, in an open economy and a competitive labour market – is to make sure they are clear about what they are paying for, what level of performance they should demand in return, and to communicate this more effectively." *Katherine Turner – Towers Watson (Financial Times)*

"Annual bonus plans are an area where some hard thinking should be done. There is a very strong argument for a recalibration of both targets and expectations to ensure that these payouts do not, in effect, become almost guaranteed." *Stephen Cahill – Deloitte (Financial Times)*

"Business leaders can either wait for politicians to be stirred to action by voters, or they can put their own house in order first. It's time to think about stiffening the sinews of remuneration committees." *Richard Lambert - Former director-general of the Confederation of British Industry and a former editor of the FT (Financial Times)*

"One of the biggest causes of shareholder concern has been bonuses paying out even when company performance has been disappointing, as was sometimes the case in 2010. Toughening up executives' targets and ensuring they reflect business strategy has become a major focus." *Sean O'Hare - PricewaterhouseCoopers (Financial Times)*

"We need accountability to strengthen the hands of shareholders so that they feel they are taking responsibility for remuneration in the boardroom. I think that is important." *David Cameron - Prime Minister (Daily Telegraph)*

"People are not against those at the top getting higher rewards if those rewards are earned, if more wealth is created, if more jobs are created. But when people are struggling, when the middle is being squeezed, when people are seeing their living standards fall, it is not fair for those at the top to get runaway rewards not related to the wealth they have created. This is what we need to change about our economy." *Ed Miliband – Leader of the Opposition (Labour Party website)*

Context for 2012 Assessments

Principle 3 of the U.K. Financial Reporting Council's Stewardship Code, published in July 2010, states that institutional investors should monitor their investee companies. A significant part of discharging this responsibility is to monitor and then register an opinion on remuneration arrangements through voting at company meetings. This guidance paper provides an outline of the most common considerations that RREV will be taking into account before issuing vote recommendations to our institutional investor clients on U.K. listed companies' remuneration-related resolutions. The guidance described is consistent with National Association of Pension Funds (NAPF) Policy.

The U.K. Corporate Governance Code published in May 2010 applies to financial years beginning on or after 29 June 2010 and maintains the now long established main principle that:

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.***

In addition, in September 2011 the Association of British Insurers launched an update to their widely accepted remuneration guidance, entitled Principles of Remuneration, which made clear that the remuneration committee is accountable to shareholders for both the structure and quantum of total remuneration.

Although the majority of recommendations in our previous guidance are still relevant [http://www.issgovernance.com/files/ISS-RREV_2011UKRemunerationGuidance.pdf] these guidelines summarise RREV's anticipated focus areas for the 2012 proxy season.

Despite improvements since the depths of the global financial downturn in 2008, especially in certain regions and in certain sectors, the current global economic outlook remains uncertain. Therefore, most shareholders continue to have minimal appetite for a return to the steady upward pay ratcheting that was a feature of the pre-downturn years and expect a continuance of restraint on executive pay.

General Remuneration Policies and Practices

RREV will continue to maintain a robust approach to executive remuneration in 2012. The following are some statements of principle on general policy and practice:

- Remuneration should motivate executives to achieve the company's strategic objectives, targets and key performance indicators set out in the company's business review. A good performance target is aligned with company strategy, future direction, performance and shareholder value creation, without promoting or rewarding disproportionate risk taking. Changes in pay levels should take into account the pay and conditions across the company.

- Any increases in total remuneration for executives should not be out of line with general increases in the company, with increases in response to a peer group comparison discouraged. We expect a detailed and compelling explanation for any increases.
- Boards must avoid rewarding for failure or for poor performance and the current economic environment should not become a justification to relax, revise or abandon performance targets retrospectively.
- Engagement by remuneration committees is expected to be in the form of a meaningful, timely and responsive consultation with shareholders prior to the finalisation of changes to the remuneration package, whether or not they require separate shareholder vote, and not simply advice of changes already agreed by the remuneration committee.
- Remuneration committees should not use their discretion to make payments which cannot be clearly justified by financial results and the underlying performance of the company.
- Remuneration committees should closely examine the behaviour that the design of a remuneration package drives and ensure that it reflects the board's appetite for risk.
- Targets should be set to achieve long-term growth and any high growth targets should be accompanied by a justification and information on risk management to ensure company stability.
- Remuneration arrangements that are based on a tax-efficient mechanism that favour the participants should not lead to increased costs for the company, including the company's own tax liabilities, nor be overly complex or have performance targets that leave their alignment with the business strategy unclear. The company should demonstrate why this step is positive for the company and for shareholders, not merely that the impact is cost neutral or cost negligible.
- Dividends relating to the duration of the performance period may be paid retrospectively on shares that the executive retains after the performance targets have been measured, but no dividends should be paid on shares that are lost when the targets are assessed.
- One-off pay awards to address concerns over the retention of an executive director are not considered to be effective and are therefore not justified.
- For shareholder alignment, the development of a shareholding of at least 100 percent of basic salary by executive directors is encouraged.
- Remuneration policies should be clearly disclosed and any divergence from the application of the stated policy when payments are made require an explanation of the exceptional circumstances so that an assessment can be made as to whether it was justified.

Guidance on the Components of the Remuneration Package

1. Basic Salaries

Any increase in salary is expected to be low and be in line with general increases in the company; post-freeze 'catch-up' salary increases or benchmarking related increases are not supported. In order to restrain an increase in total remuneration, a significant salary increase should be offset by a reduction in variable pay.

Exceptions may be made for promotions, increases in responsibilities and new recruits to the board. Companies are required to justify salary levels and increases in basic salary with reference to their remuneration policy.

2. Bonuses

There should be transparency over the annual bonus targets for the current year. For bonuses paid there should be retrospective disclosure of targets and the extent to which they were achieved. In the absence of a specific explanation, RREV will expect bonus payment levels to move in the same direction as the movement in the company's profits.

Although the introduction of deferral and/or claw-back of annual bonus is encouraged, this does not merit on its own an increase in the maximum size of award. In addition, the stated deferral policy should be applied at the end of the performance period and the expected level of deferral not replaced by an immediate payout except in circumstances that are clearly exceptional.

Bonuses should not encourage or demand the taking of excessive risks.

Targets should be challenging but realistic and should closely reflect a company's ongoing business expectations. However, the lowering of targets should generally be reflected in a reduction of the bonus potential.

If the bonus potential is to be increased, there should be a corresponding increase in the targets coupled with informative retrospective disclosure of the targets and the level to which they were achieved to explain the bonus payments made.

3. Long Term Incentive Plans

Targets should reflect the board's appetite for risk and be set to achieve long-term growth. High growth targets should be justified and accompanied by information on controls to manage the risk created to ensure the business remains stable. The lowering of targets should generally be reflected in a reduction of the amount that can vest and, similarly, any increase in award size should be linked to more challenging targets. The forecast level of performance should be located well within the lower end of the target range.

Companies are encouraged to provide greater disclosure on the extent to which performance targets have been met and the link with the amounts that vested.

Post-vesting holding periods are encouraged.

4. Service Contracts

Guidance on the terms of service contracts and termination arrangements is unchanged for 2012.

We expect companies to have a policy for new service contracts that limits the termination provisions to one year's basic pay and benefits, with no specific agreement on the amount to be paid on termination. All payments should be subject to mitigation. We continue to encourage companies to take steps to limit termination payments solely to meet contractual obligations applicable to that individual's service contract. We will seek explanations for any payments made in excess of basic pay and benefits, including what steps have been taken to mitigate the cost to the company. We also expect the vesting of outstanding long-term awards to be prorated for time and performance and for companies to explain any use of discretion. Where the termination arrangements do not appear to be justified we may recommend that shareholders vote against the resolution to approve the remuneration report and, in cases considered to be extreme, the chairman of the remuneration committee.

5. Pensions

In conjunction with the change in the taxation of pension arrangements, companies are requested to outline their pension policy going forward. Any compensation to executives for the loss of tax relief is not considered to be acceptable.

6. Total Pay

Restraint is expected to be observed over any desire to increase quantum.

DISCLOSURE/DISCLAIMER

This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of Research, Recommendations and Electronic Voting Limited ("RREV"), its affiliates or, in some cases, third party suppliers.

The Information has not been submitted to, nor received approval from, the United States Securities and Exchange Commission, the United Kingdom Financial Services Authority or any other regulatory body. None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), or a promotion or recommendation of, any security, financial product or other investment vehicle or any trading strategy, and RREV does not endorse, approve or otherwise express any opinion regarding any issuer, securities, financial products or instruments or trading strategies. The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information.

RREV MAKES NO EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION AND EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by law, in no event shall RREV have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited.