Department for Business, Innovation and Skills

Long-term Focus for Corporate Britain

A call for evidence

14 January 2011

TOWERS WATSON

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Introduction

- Towers Watson welcomes the opportunity to provide evidence to the Department for Business, Innovation and Skill's initial consideration of whether the focus in corporate Britain is sufficiently long term.
- Towers Watson is a global professional services firm. We have been providing advice to companies in the area of executive remuneration for close to forty years. Given the perspective that this provides us, we have focused our responses on the remuneration-related questions in the Call to Evidence that is Questions 11, 12, 13 and 14.
- We would be happy to expand on any of the aspect of our submission should this be helpful, in person or otherwise. Our contact details are:

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- We note that, while the Call for Evidence does not specifically ask about the role of remuneration consultants, commentators have questioned our role in connection with, for example, the rise in directors' remuneration. The Code of Conduct for remuneration consultants was published by the Remuneration Consultants Group in response to these concerns. Towers Watson was an initial signatory. The Code seeks to clarify the scope and conduct of the remuneration consultant's role, particularly when advising UK-listed companies, to ensure consultants are supporting informed and robust decision making by remuneration committees.
  - For example, in response to Question 14, we mention the inappropriate use of market data in the context of increases in directors' remuneration. The good practice guidelines attached to the Code of Conduct specifically cover market benchmarking.

Question 11. What are the main reasons for the increase in directors' remuneration? Are these appropriate?

Below is a summary of the factors that Towers Watson has identified as contributing to the increase in directors' remuneration[1] over the past 30 years and their 'appropriateness' when considering what, if any, policy action is required. Attached as Appendix 1 is a more detailed review of the research evidence underlying our list of factors and a discussion of the factors.

Summary list of factors

- There is no doubt that directors' remuneration in UK public limited companies has increased significantly and, with some brief exceptions, consistently since the early 1980s. This mirrors the pattern in other large countries in Western Europe and also the United States of America.
- Our review of academic research, research carried out by our firm, and our own experience suggests that there is no single explanation for the absolute increase in directors' remuneration, and its increase relative to that of manual and white collar private sector workers. Rather there are a number of reasons which relate, in part, to the global economy in which the UK now participates compared to 30 years ago and to:
  - The changing nature of UK companies and the role of directors as a result;
  - Labour market developments;
  - Changing pay structures; and
  - Governance interventions
- Below is a summary of the main factors that we have identified under each of these four areas as contributing, in varying degrees, to the increase in directors' remunerations. These are further explained in Appendix 1.

A. Changing nature of companies and the role of directors

1. The level of skill and competence required to perform the key leadership and management roles in large UK public limited companies has risen in the past 30 years.
2. Shareholders are prepared to pay significantly more for individuals who use these skills to produce higher shareholder returns.

[1] Throughout our submission, when we refer to "directors' remuneration", we are referring to the remuneration of executive directors (as opposed to non-executive directors or executives not on the board).

3. The rise of agency theory[2] in relation to the behaviour and remuneration of directors has increased the level of 'at risk'[3] remuneration.

B. Labour markets

4. The level of executive mobility has increased, creating a more active, if imperfect, talent market and thus more opportunity for employers and executives to engage in optimal contracting in relation to remuneration.

5. Remuneration practices in other countries, notably the US, have entered UK practice through the operation of international labour markets.

6. There are attractive alternatives for those with the skills and competencies to be executive directors which offer similar or higher remuneration opportunities.

C. Remuneration structures

7. The practice of remuneration elements being expressed as a percentage of base salary means that as directors' salaries have increased, the impact on total remuneration opportunity has been compounded.

8. The increase in the proportion of remuneration 'at risk' has led to executives requiring higher *opportunity* levels (although *realised* levels, as opposed to remuneration granted, will fluctuate with performance).

9. The decrease in severance terms and pension accumulation opportunities over the last ten years and the loss of protection this has provided to executives.

D. Governance interventions

10. Weaknesses in the functioning of some remuneration committees.

11. The disclosure of directors' remuneration and the availability of comparator information on remuneration to executives and remuneration committees.

12. The impact of fairly rigid investor guidelines on share-based remuneration.

[2] Agency theory explains the relationship between shareholders and managers in terms of owners and their agents. It explores what needs to be done to align their interests. The granting of share-based awards is viewed as one way of alignments as managers also become shareholders.
[3] In this paper we use the term "at risk" to reference those remuneration elements where actual receipt is dependent on some form of performance requirement, for example, share-based awards and annual bonus.

Appropriateness of factors

- We would view it as appropriate that executive pay has risen at a faster rate relative to that of manual and white collar private sector workers due to some of the factors outlined above, for example, because of:
  - The changing nature of UK companies and the role of executive directors; and
  - The UK labour market becoming more dynamic, global and varied.
- We see these factors as outcomes of the UK having a more open economy than thirty years ago. The price paid to directors as a result is insignificant compared to the value created by successful UK companies.
- However there are some factors that we see as inappropriate, for example:
  - The over-reliance on market information to determine pay levels, rather than using it as one of several relevant factors into their decision-making;
  - Too much emphasis on the individual elements of a director's package and not enough on the totality of the package;
  - An increase in base salary automatically increasing the opportunity under each of the other pay elements including pension; and
  - The fairly rigid investor guidelines on long-term share-based remuneration which have reduced their perceived value by executives and encouraged, for example, a greater emphasis on short-term cash arrangements.
- However, we think that the Government, market regulators and investor bodies should proceed carefully when determining what developments to encourage or prescribe in the area of director remuneration. Experience shows – both in the UK and elsewhere - that there are often unintended consequences of regulation and prescription in the area of remuneration policy. For example the transparency provided to shareholders under the Directors' Remuneration Report Regulations 2002 has also provided executives themselves with the details of how much comparable roles are being paid in peers which can lead to internal pressure for increases.
- We would also note that there are some recent developments where the full impact is yet to be felt, which address, in whole or in part, some of the less appropriate factors to increasing directors' pay

and also address the underlying “short-term” concern to the consultation as a whole. Examples of this include:

- The new UK Governance Code’s emphasis on improving board quality and effectiveness;
- The new emphasis in the Code on remuneration being designed to support the long-term success of the company;
- The new disclosure requirement for remuneration committees to disclose the extent to which they have taken account of pay and conditions elsewhere in the group in reaching their decisions;
- The renewed emphasis of investors and their representative bodies for remuneration committees to (a) demonstrate the linkage between the structure of directors’ pay and long-term strategy and the linkage between pay and actual performance and (b) not to over rely on market data;
- The increased willingness of some investors and their representative bodies to consider share-based arrangements structured to reflect the nature and needs of the business, rather than to meet investor guidelines.
- The impact of the pension tax legislation on executive pension benefits.

- However, notwithstanding these developments, there remain deficiencies in the area of directors’ remuneration. We outline various suggestions throughout our submission, for example, we would recommend that it was time for a review of the remuneration report requirements.
  - Better disclosure on **realised** remuneration (as opposed to remuneration granted) and the linkage between this and company performance would support a better-informed debate on whether the remuneration earned was appropriate relative to the remuneration earned by shareholders.

Question 12: What would be the effect of widening the membership of the remuneration committee on directors' remuneration?

- Remuneration committees are an essential part of the executive remuneration determination process. As we commented under Question 11, it is our experience that the functioning of remuneration committees is not always fully effective.
- In our view it is helpful to recast the question as follows:
  - Would diversifying the range of people who become members of remuneration committees improve the effectiveness of committees?
- This is in line with the focus in UK Governance Code's focus on improving the effectiveness of boards and by implication board committees.
- Our answers below are informed both by research undertaken by Towers Watson with Professor Brian Main of Edinburgh University on the functioning of remuneration committees as well as our own experience.
- If "diversifying the range of people who become members of remuneration committees" means allowing for employee representation, it is our experience from working with companies with employee directors that the decision making is not significantly better as a result.
  - Currently all remuneration committee members, as directors, have the overriding responsibility to act in the best interests of the company and their decisions have to be made in this context. What duties would an employee representative have, if not the same as directors? Would a difference be constructive?
- Our research has shown that, with respect to people and effective remuneration committees, the following are more important:
  - given the critical role of committee chairman to a successful committee, having a remuneration committee chairman with prior experience of executive remuneration decision making and supporting processes; and
  - having experienced internal and external support to ensure the decisions of the committee are fully informed (these individuals do not need to be committee members) .

- However we believe that if “diversifying the range of people who become members of remuneration committee” means increasing the talent pool from which non-executive directors are recruited as encouraged by the late Sir Derek Higgs then this may have a positive effect.
  - It supports recruitment from, for example, professional services, academia and public service where there are individuals with the type of executive remuneration experience and insights that would support informed and robust decision making by remuneration committees.
  - We observe that although Derek Higgs made his recommendations in this area in 2003, progress has been slow perhaps because the recruiters often insist that candidates have experience of serving on corporate boards or at a senior corporate level.

Question 13: Are shareholders effective in holding companies to account over pay? Are there further areas of pay, e.g. golden parachutes, it would be beneficial to subject to shareholder approval?

- It is our view that institutional investors and their representative bodies have used the advisory vote given to them under the Directors' Remuneration Report Regulations 2002 to:
  - Effectively hold some individual companies to account over one or a series of pay concerns resulting generally in the relevant company adjusting the offending policy or practice; and
  - Campaign against certain pay practices common across a number of companies leading to their removal, for example: the cessation of the re-testing of performance conditions attached to the vesting of share options; a reduction in severance terms, and the move away from enhanced termination provisions following a change of control.
- We would also note that one positive side effect of institutional investors using their remuneration report vote is that it has encouraged major companies to engage more with key investors and to consult actively with them in advance about any substantive and/or sensitive changes.
  - The fact that relatively few remuneration reports have been defeated over the last eight years should not, in our view, lead to an assumption that investors have not been effective at holding shareholders to account. Rather, we view this as showing, in part, that shareholders are now being given a greater opportunity to voice their concerns ahead of the vote and companies are taking these concerns into account when making their final decisions.
- However there are limitations on the extent to which institutional shareholders may be prepared to hold companies to account:
  - The Government's own analysis suggests the majority of UK stocks are held by non-UK entities and hedge funds that may have divergent interests and appetites for engaging on directors' remuneration.
  - With respect to UK institutional investors, the effectiveness of such tools as the vote on the remuneration report also depends on their willingness and ability to actively engage on remuneration across all their investments.
    - From our own meetings with UK institutional investors we are aware of some that as a matter of policy focus on key investment issues rather than monitoring the details of a

company's executive remuneration and of others whose practical constraints, such as lack of resources, impact their ability to hold all their investee companies to account on remuneration.

- It is also our experience that investors are less concerned about absolute quantum when a company is performing well and shareholders are gaining the benefit than about ensuring the rewards have been appropriately structured. This highlights that the concerns of investors in holding companies to account for remuneration can be very different from broader socio-political concerns.

- We would also note the role of those organisations offering voting advisory services and particularly the influence of those organisations offering voting advice on UK PLCs to overseas investors.
  - Our analysis of the strong correlation between a recommendation to vote against a report and the actual outcome of the vote for companies with a large overseas investor base.
- Generally, in terms of shareholders holding companies to account, our experience is that the most constructive aspect of this has been the increased engagement between companies and their main investors. We would therefore suggest that attention is focused on how to make this engagement as effective as possible. We believe that this in turn supports the longer-term focus desired by the Government, the functioning of remuneration committees and their decision-making.

Are there further areas of pay, e.g. golden parachutes, it would be beneficial to subject to shareholder approval?

- We do not take the view that other areas of pay such as 'golden parachutes' should be put to shareholders for approval as shareholders already have ways to express their concerns over all aspects of executive remuneration.
  - Shareholders are already able to vote on the directors' remuneration report which includes detailed information on remuneration policy (including policy and practice on service contracts and amounts payable on early termination of the contract).
  - Shareholders have for many years been required to approve long-term incentive arrangements for directors. They must also approve all share schemes for which newly-issued shares will be required.
  - Shareholders are also able to exercise their vote in favour of directors and, if they dislike the decisions of the board and of individuals, they may vote against their re-election.

- The introduction of new areas of pay for approval would carry the risk of further diverting the attention and resources of companies and major shareholders towards executive remuneration and away from the overall business strategy and performance.

- It might be more helpful to consider if there was any further information that companies should be making available to shareholders in their remuneration report and/ or presenting that information in such a way that shareholders, in exercising their current votes, can make more informed decisions. For example, the current disclosure regulations in respect of service contracts and termination arrangements could be clarified so that:
  - The total compensation *potentially* payable on early termination of a director under both their service contract **and** any incentive agreements is set out in the same place, possibly in tabular format; and
  - The total compensation *actually* received on termination is set out in a single table.

Question 14: What would be the impact of greater transparency on directors' pay on the:

- Linkage between pay and meeting corporate objectives
- Performance criteria for annual bonus schemes
- Relationship between directors' pay and employees' pay?

Linkage between pay and meeting corporate objectives

- The disclosure requirements on directors' remuneration and the guidelines and exhortations of institutional shareholders and their representatives have encouraged major listed companies in recent years to show more clearly (a) how the structure of director remuneration is linked to corporate objectives and (b) how actual remuneration is linked to actual company performance. The directors' remuneration report is usually the place for this.
- However, in both instances the level of detail and clarity is varied. Some companies are better than others at clearly and effectively linking performance outturns as described in the Operating & Financial Review, for example, and the description of 'realised' pay for the year in the Directors' Remuneration Report.
- As already noted, we would view greater transparency on realised pay and the link to company performance as a positive development, as is greater transparency on the linkage between pay structure, corporate strategy and the company's risk appetite.
  - However, if the disclosure regulations were updated, care does need to be taken to ensure the disclosure required is going to be meaningful and helpful – it should be about quality not quantity.
  - For example, incentive pay realised in one year can relate to both performance over the financial year under review and to performance over a multi-year period, typically three to four years. So where performance in the year under review has been poor but performance over the past three or four years has been strong, this can lead to apparent incongruities between pay and performance. Such incongruities need to be effectively explained but the form of the disclosure should not aggravate the problem.

Performance criteria for annual bonus schemes

- Given the levels of bonus opportunity available in UK listed companies and the levels of actual pay out, we consider that shareholders have every right to be informed about the overall structure of annual bonuses, the nature of the performance criteria, the levels of opportunity and the basis on which bonus decisions for executive directors are made. Such requirements might be added to the disclosure regulations.
- However we would expect many companies quite justifiably to resist any disclosure requirements on the standards of their performance conditions (whether before or after the year end) and performance levels on the same grounds that they did when the disclosure regulations were first being considered - that for some companies this information can be commercially sensitive information.
- Institutional shareholders have been encouraging better ex-ante and ex post disclosure of performance targets (and/or standards). If profit before tax ("PBT") is a key performance goal, shareholders would like to know, at the end of the year, the standard of performance of PBT that has been achieved so as to be able to understand better the level of bonus that has been paid out. This is consistent with our recommendation on more effective disclosure over realised pay. But it is often forgotten that even ex post, the disclosure of certain performance measures could remain sensitive. The Government needs to be wary that these initiatives support rather than detract from the desired focus on long-term performance.

Relationship between directors' pay and employees' pay

- Our research has shown that it is important for effective remuneration committees to be updated on key reward developments and issues in the company as a whole as part of the internal context outside to their decision making.
- However, there are a number of factors, such as the terms of reference for remuneration committees and the time available to committees them that can mean that remuneration committee decisions on top executive pay are made in isolation of the broader internal reward context.
- We have noted that the recession has encouraged more companies to place greater emphasis on the internal context, for example, how do individual executive base pay increases compare to the overall pay budget for the organisation. Another encouragement has been the new disclosure requirement (for committees to state how they have taken account of pay and conditions in the rest

of the group when determining directors' pay). However, it is too soon to establish whether this will impact the decisions on director remuneration over the longer-term.

- We think it is much more sensible for the Government to be encouraging remuneration committees' due consideration of the internal reward context rather than asking companies, for example, to disclose a single pay ratio figure which will take up precious remuneration committee time, company resources and produce a figure which may be meaningless and misinterpreted.
  - The popular presumption will be that the narrower the ratio, the better (or 'fairer') the executive pay policy. We doubt this.
  - Compare the pay ratios for two FTSE100 Chief Executives whose total realised earnings for the last reported year are broadly similar but whose business are very different:
    - Based on the last disclosed information, we estimate the ratio for the total earnings of the CEO of a leading brokerage company to be 33 times the average earnings of the company's workforce;
    - Whereas the total realised earning of the Chief Executive of a major international supermarket is 404 times the average earnings.
    - The ratio varies widely because of the vast differences in staff and skills profile, international coverage, the nature of business and whether low-paid work has been outsourced to low-paying countries. Who is to say which of these ratios is right or wrong?
  - It is already our experience in the US that the inclusion in the Dodd-Frank Act for US-listed companies to disclose the total compensation of the CEO and the median total compensation of all employees is acting as an unhelpful distraction on committee time.
- We would also warn of the unintended consequences:
  - Pay ratios that are narrow may erroneously be seen as an indicator of 'fairness' and vice versa.
  - Disclosure of pay ratios may create another form of 'arms race' where companies have low ratios and see – from the practice of others – that 'headroom' remains.
  - Disclosure of pay ratios may not only be misleading but may also encourage yet more emphasis on executive remuneration when shareholders and indeed other stakeholders should be focused on long-term business success.

Towers Watson, January 2011

Appendix 1: Evidence of the factors which may have resulted in the rise in directors' remuneration and whether these are reasonable reasons.

There is no doubt that directors' remuneration in UK public limited companies has increased significantly and, with some brief exceptions, consistently since the early 1980s. This mirrors the pattern in other large countries in Western Europe and also the United States of America.

Academic research, using both empirical evidence and economic theory, has failed to demonstrate a single conclusive reason for the sustained upward trend in executive remuneration across many economies. A recent analysis of US research on this topic by Frydman and Jenter cited over 150 academic texts and concluded that 'many important questions remain unanswered.' In particular the research points to lack of a sound explanation of why the trend upwards started and whether theories regarding 'economic rents' and 'optimal contracting' can explain the determination of director remuneration. There are also similar gaps in understanding of the causal effects of executive remuneration on behaviour and firm value.

Towers Watson has been surveying executive remuneration in the UK, and in other major economies, for over 35 years, and has been advising companies on aspects of executive remuneration design for a similar period. We agree with Frydman and Jenter's conclusion that there is no simple explanation or single theory that explains the growth of executive remuneration.

We also view with concern the continued problem, particularly in the UK, of establishing robust and consistent information on executive remuneration quantum (in terms of remuneration opportunity and the remuneration actually received by executives) to inform the debate. For example data sources, including those used in the BIS document 'A Long-term Focus for Corporate Britain', frequently include inadequate information in relation to actual long-term incentive values at vesting and use averages which are significantly impacted by widely dispersed and skewed data sets (see Appendix A at the end of this paper illustrating the difference between using average and median data from the same source as used by BIS and also the difference between awarded and realised remuneration). This difficulty in grappling with remuneration data is relevant to the discussion regarding the degree to which remuneration is size or performance-related and can, in some cases, lead to significant over (and under) estimates of the remuneration levels of directors.

However, use of CEO remuneration averages gives a misleading picture of directors' remuneration in the FTSE350, given the high remuneration of a small number of CEOs in Britain's largest companies. While this does not in any way undermine the general proposition that directors' remuneration has

risen, this lack of thorough analysis makes it more difficult to establish the extent and causes of high pay.

In answering the questions posed in this Call for Evidence regarding the reasons for the absolute increase in directors' remuneration, and its increase relative to that of manual and white collar private sector workers, our review of academic research; research carried out by our firm; and our experience suggests the explanations can be organised into four categories:

- The changing nature of companies and the role of directors
- Labour markets
- Changing pay structures
- Governance interventions

A. The changing nature of companies and the role of directors

This section identifies three factors in the rise of directors' remuneration:

1. *The level of skill and competence required to perform the key leadership and management roles in large UK public limited companies has risen in the past 30 years*
2. *Shareholders are prepared to pay significantly more for individuals who use these skills to produce higher shareholder returns*
3. *The rise of agency theory in relation to the behaviour and remuneration of executive directors which has increased the level of at risk remuneration*

The upward trend in UK directors' remuneration started in the early to mid 1980s. This start of the trend follows, or is co-incident with, a number of other changes in the UK economic, taxation and fiscal environment which continue to provide a business context in which directors' remuneration is determined today. These changes included:

- ***Financial reform:*** major changes in the financial services sector opened up access to new capital for industry and resulted in an increase in company mergers, take-overs and spin offs;
- ***Reduction of trade barriers:*** trade barriers were lowered increasing international opportunities for UK companies, but also making them more vulnerable to competition (or acquisition) by foreign firms;
- ***Globalisation of manufacturing and service sourcing:*** overseas sourcing of manufactured goods at lower prices meant that a number of companies fundamentally changed their business operational and employment model;
- ***Privatisation and de-regulation:*** a number of major companies in the UK were privatised and with their businesses opened up to competition;

- ***Share ownership:*** shareholding in UK businesses became more diverse through the growth of both international investors, individual investors and greater investment in the stock market by new investment institutions.

The combined impact of these major economic changes, which have provided a back drop to the last three decades, created an environment in which:

- performance differentials between successful and less successful companies grew;
- the competitive position of business could change rapidly; and
- failing companies were less protected from takeover or liquidation.

There is academic research evidence supporting the view that this combination of factors changed the role of executive directors and increased the level of general management and leadership skills necessary to do the role. This in turn has resulted in shareholders being prepared to pay highly for the 'right people' to lead large businesses and to share returns with them.

The sensitivity of shareholders to an organisation having the 'right' executive leadership is clearly shown in:

- increased institutional shareholders interest in the executive talent in organisations;
- sensitivity of share prices to announcements of director appointments;
- active engagement of shareholders in some key appointments and departures; and
- preparedness of institutional shareholders to agree significant remuneration packages for executives who have their confidence.

Towers Watson's studies also show the criticality of the 'right leadership' in employee engagement which shows a close link with organisational performance.

The creation of a more competitive business environment was also accompanied by the rise of "agency theory" thinking amongst shareholders and company boards, first in the US and then in the UK. This was influential in defining the role of directors and in determination of their remuneration. This theory, which regarded executive directors as the agents of the shareholders, strongly encouraged the alignment of executive director rewards with shareholder interests, rather than paying them as bureaucrats at the top of a management pyramid. This influenced boards to adopt both annual cash incentives and long-term incentives (in the form of share options and then performance share plans) which rewarded successful executives and effectively reduced the relative rewards for executive failure.

Companies in the UK rapidly embraced this change in remuneration philosophy with the introduction of tax effective executive share options to the UK in 1984. This policy was seen to endorse the view that

executives should be incentivised to increase shareholder value and be able to share in increases in company value.

There is less hard research evidence which confirms, as some commentators have suggested, that the 1980s also marked the start of an era when it became more socially acceptable to have high differentials in the environment of paid employment, rather than just in situations of foundation entrepreneurship and inheritance. Nonetheless, the abandonment of UK government pay controls and reduction in higher rate tax in the early 1980s may have encouraged this view.

In effect it appears that a combination of factors contributed to the commencement of widening differentials and the sustained trend of increased director and executive remuneration. These factors were sufficiently strong to reverse nearly four decades (1940s to 1970s) of compression of differentials between the top executives in organisations and skilled manual and white collar employees.

B. Labour markets

This section identifies three factors in the rise of executive remuneration:

4. *The level of executive mobility has increased, creating a more active talent market and thus more opportunity for employers and executives to engage in optimal contracting in relation to remuneration*
5. *Remuneration practices in other countries, most notably the US, have entered UK practice through the operation of international labour markets*
6. *Alternative roles for those with the skills and competences to be executive directors offer similar or higher remuneration opportunities*

Labour markets all have their imperfections and the executive labour market is difficult to study. However, in the 30 years during which executive remuneration has risen in the UK, the labour market for executive talent has certainly become more active, as witnessed by the rise in the number of recruitment consultancies and the high proportion of CEO posts filled by individuals who have not spent their whole career in a single firm. There is also some research evidence which shows that in recent years the number of direct appointments of external candidates to CEO roles has increased (see Appendix B).

The task of recruitment of new executives, either internally or externally, is also one which companies regularly undertake. For example the median tenure of chief executives of FTSE 350 companies has been reasonably constant since 1996 at four to five years. Therefore, nominations and remuneration committees are reasonably familiar with the issues of indentifying suitable candidates and agreeing the remuneration terms for appointments. Two consequences follow from these experiences.

First, the general mobility in higher management and executive levels provides a real market for contracting remuneration arrangements between executives and remuneration committees. Labour market economists support the view that increasingly there is enough of a market to provide for optimal contracting terms to be driving the remuneration outcomes.

Second, research by Towers Watson indicates that labour market experiences make remuneration committee chairmen concerned about retention of key executives when determining remuneration levels for incumbent executives. The perception of executives being at risk of employment offers from other firms is high. This encourages the view that paying less than median ('the market rate') in the market place increases risk to the company, and failure to offer competitive performance pay opportunities may similarly make it easy for predatory companies to bid away talented executives. Improvements in internal development of executive talent and succession planning can assist companies in protecting themselves from talent risk, but this has costs to a company and of itself can make some companies actually more vulnerable to predatory recruitment from other firms.

The general labour market for executives has also become more international. While the proportion of CEOs in FTSE350 companies who are not UK nationals is small, the impact of remuneration practices in other countries impacts the UK executive labour market in a number of ways:

- An increasing number of UK executives have worked overseas at some point in their career and have been exposed to senior management and executive remuneration practices in other countries including overall high paying, low tax countries such as the USA.
- The majority of FTSE100 companies and a significant proportion of FTSE250 companies have overseas operations employing executives and senior managers who form part of their executive management cadre. In many cases there is considerable reluctance to allow a situation to emerge where a subordinate earns considerably more than his or her immediate line manager, or CEO. While there are clearly cases where this is regarded as acceptable (for example in the case of individual contributors or sales staff in the banking sector) it is generally regarded as inequitable in a normal line of managerial accountability, or as providing little incentive for individuals to take on more demanding international roles or group head office roles in the UK.

Another critical factor in our view has been the development of high levels of remuneration in other areas of the UK economy, which provide attractive alternatives for people with the skills and competencies to be executive directors. This serves both to potentially reduce the talent pool entering corporate life and to attract people away from public quoted companies at key career stages on the track to executive director positions. This clearly impacts the turnover of managers and executives both at and below director level.

In terms of attracting talent to corporate roles, it is noticeable that only a small proportion of the MBA graduates from the top UK business schools (such as London Business School, Said Business School

and Cass Business School) enter UK public limited companies, other than financial services organisations or consultancies.

This move away from corporate careers, by those who have chosen to invest in their advanced business education, appears to be economically rational. Research by the London School of Economics on the changing make up of employees in the top 1% of earners in the UK shows a high proportion of these employees, 60%, are employed in the banking sector. Publicly available earnings statistics also understate the number of high earners outside the corporate sector as they do not include the high levels of income earned in professional partnerships or carried interest arrangements in private investment and hedge funds.

Changing pay structures

This section identifies three factors in the rise of executive remuneration:

7. *The practice of remuneration elements being expressed as a % of base salary*
8. *The increase in the proportion of remuneration 'at risk'*
9. *The decrease in severance terms and more certain pension accumulation opportunities*

The rise in directors' remuneration has been accompanied by changes in its structure. Some of these structural changes, such as the introduction of annual bonus opportunities and the use of share-based elements of remuneration, were first introduced in the 1980s but have undergone changes in terms of design over the years, as well as taking an increased proportion of total remuneration. A number of these changes have been elective on the part of companies and others have been influenced by intervention of government (principally through tax changes) or strongly encouraged by investor institutions (see following section).

One underlying feature of the structural changes has been that the opportunity level to the additional elements of remuneration (such as bonus and share-based remuneration) is typically defined in terms of "percentage of salary", for example, a maximum bonus opportunity of 100% of salary. As shareholders have encouraged the use of performance-related pay, this linkage has meant that as base salary moves the proportion of performance-based pay to fixed pay is not diminished. However, it means that there is in-built compounding effect to any base pay increase on the overall total remuneration opportunity.

Although there are clear advantages to shareholders in encouraging the use of performance-related pay and equity vehicles to align executive interests with their own, the impact is to increase the specific risks in payments to the executives. This was shown in the last two years where directors' median annual bonuses in payment fell and median realised rewards from vesting of long term incentives fell as a result of the economic situation in the UK and other countries. For many executives the decline in

company performance was beyond direct executive control and could not have been avoided even with good risk management in place. While the situation of organisations could be improved by good management there was, for many organisations, no way to mitigate the whole loss of performance and director remuneration in these years. This indicates that incentives are a 'two way street' and a £ of incentive remuneration is not the same as a £ of fixed remuneration. With fixed remuneration often only accounting for one third of total on target opportunity in FTSE 100 companies (and less than a quarter of total remuneration opportunity) it is important to recognise that director remuneration levels quoted widely in the press, and in the BIS document calling for evidence, are often not realised by the executives.

It is economically rational for executives to require additional remuneration opportunity as risky incentive opportunity makes up more of the remuneration package. This was evidenced in the early 2000s when executive share options in the UK became riskier as a result of the insistence of institutional shareholders that performance conditions for vesting were tightened. The increase in face value of share option awards after the tightening of the conditions almost exactly mirrored the reduced fair value of the awards because of the new conditions.

At the same time as risk has been increased in the incentive opportunity, two fixed elements of remuneration - severance arrangements and pensions - have shown a downward trend in the past 10 years.

- One of the major changes looked for by UK institutional shareholders in the past 10 years has been a reduction in severance arrangements which, prior to 1995, had typically amounted to three years remuneration plus a non actuarially reduced pension. In the years immediately after 2002, after the advisory vote on directors' remuneration was introduced, this was reduced to one year's remuneration and by 2006 most companies had also moderated policies in relation to early payment of pensions. In an environment of relatively short median service as a CEO, with a large number of CEOs leaving before reaching retirement age, this reduction in total remuneration value has largely gone un-noticed.

- Similarly executive pensions have also declined in the past 20 years, and particularly since 2004. In 2004 the median annual pension value[4] for CEOs of leading UK PLCS was 43% of salary, it is now 34% for incumbent CEOs and 24% for new chief executives.

These non-cash elements are often excluded from reported remuneration (as they are in the BIS call for evidence), but have in the past provided 'insurance' benefits and value to executives with only a short duration of peak earnings.

[4] Pension value means the annualised value of one additional year of pension accrual

Governance Interventions

This section identifies four factors in the rise of executive remuneration:

10. *The functioning of remuneration committees*
11. *The disclosure of directors' remuneration and the availability of comparator information on remuneration to executives and remuneration committees*
12. *The impact of investor guidelines on the structure of directors' remuneration*

There have been five major governance interventions in relation to executive remuneration since directors' remuneration started to rise in the 1980s:

- The Cadbury report in 1992 which first recommended the formation of remuneration committees consisting mainly of non-executive directors. This addressed the conflict of interest in an executive being involved in the determination of his or her remuneration.
- The Greenbury report in 1995 which is incorporated (with various modifications) into what is now the UK Governance Code. This strengthened the independence of the remuneration committee and recommended a number of changes to remuneration structures.
- The Directors' Remuneration Report Regulations in 2002 which included enhanced disclosure requirements and introduced the advisory vote on directors' remuneration policy.
- Successive versions of 'guidance' on executive remuneration by shareholders and the two main UK institutional shareholder bodies – the Association of British Insurers and the National Association of Pension funds.
- The introduction of the Shareholder Stewardship Code in 2010.

It is too early to establish the impact of the last of these governance interventions, but it is clear that the others have all had an impact on executive remuneration determination and executive remuneration levels and structure. Some of these interventions have clearly had beneficial effects and may have exerted downward pressure on executive remuneration – such as:

- establishing a position where an executive cannot determine his or her own remuneration (Cadbury)
- the use of phased share plan awards (Greenbury)
- reduction in severance payments to executives who leave as a result of poor performance (NAPF)

However, other elements of these interventions have led to some undesirable side effects – such as:

- the widespread adoption of relative TSR as a performance condition which has increased executive remuneration volatility (Greenbury); and
- tight controls on long term incentive design which may have encouraged some remuneration committees to raise short-term cash based remuneration (ABI) .

Remuneration Committees are an essential part of the executive remuneration determination process and Towers Watson has undertaken research jointly with Professor Brian Main on the functioning of these committees. In addition, as executive remuneration advisors, Towers Watson is frequently present, and provides inputs, to these committees. Our conclusions as to how these committees may have played a role in the increase in executive remuneration are:

- Remuneration Committees are focused on ensuring executive remuneration is aligned with successful performance outcomes for shareholders though alignment of directors' remuneration with shareholder financial interests and their interests in attracting and retaining of an appropriately skilled and motivated executive management. In an environment where there is a significant, but imperfect, body of information regarding 'market practice', and concern about retention and ensuring an executive feels fairly treated, it is inevitable that benchmarking information is extensively used to help set pay levels. Most remuneration committees use benchmarking information with care. However when executives are personally seen to be performing and the company performance is also meeting shareholder expectations, remuneration committees find it difficult to justify adopting a position below what is seen to be the 'market rate'. In our view so called 'market pay ratcheting' has made a contribution to the rise in executive remuneration and is an inevitable consequence of directors' remuneration disclosure, however desirable transparency may be in terms of governance. In our view remuneration committee functioning would also be improved if comparator-pay benchmarking also included robust and comprehensive analysis of comparator performance.

- Towers Watson research has shown that remuneration committees place considerable weight on the design criteria contained within the institutional shareholder executive remuneration guidelines, particularly as they relate to long-term incentive plans using shares and share options. This is understandable given that such plans are normally subject to shareholder approval. However this conformance has led remuneration committees to introduce share plans with performance metrics which have significantly increased the risk element in remuneration and which are, in their design, often imperfect and volatile. A particular example of this has been the use of relative Total Shareholder Return on performance share plans vesting based on fixed three year performance periods. Research by Towers Watson has shown that use of this performance metric, with the performance thresholds recommended in institutional guidelines, creates significant volatility in payout which can show low correlation with shareholder value creation on a year-by-year basis. In our view this has created the type of volatility in remuneration outcomes that reduces the perceived value of incentives by executives. This can drive up the fixed or less variable elements of remuneration, or lead to high levels of share award, such that when vesting occurs it is disproportionately large relative to performance.

- The complexity of executive remuneration packages requires remuneration committees to consider the detail of each item and to understand the executive remuneration packages as a whole in relation to the potential performance scenarios for the company. This has increased the workload of the remuneration committee and in particular increased the required knowledge and skill of the remuneration committee chair. Resourcing committees with appropriately qualified members is a challenge for some companies.

- The terms of reference of remuneration committees, as recommended by the various enquiries listed above, has limited the focus of many remuneration committees to the remuneration of a small group of executives, normally the CEO and those reporting to the CEO. This has allowed committees to become divorced from remuneration developments in other employee groups in the company and in the wider economy. New recommended terms for reference for remuneration committees now require them to take account of the remuneration of other employee groups when determining executive remuneration, and in some cases to oversee or review the remuneration policy of the whole company. It is too soon to establish whether this will impact on the remuneration decision making relating to directors.

- In large companies remuneration committees are seldom constrained by the ability to pay for the executive team as a whole. It is notable that the remuneration in larger companies in the FTSE100 has risen further and faster than remuneration in the smaller companies in the FTSE 250 where ability to pay is more likely to constrain pay decisions.

In our view the impact of greater disclosure and the advisory vote at AGMs is right from a governance view point, but has had a variety of consequences for executive remuneration determination and executive remuneration levels:

- As stated earlier, the availability of remuneration information in annual reports has been linked to increasing remuneration levels
- The information contained is comprehensive, yet incomplete. In particular the lack of a proper format for disclosure of realised remuneration (particularly in relation to long-term incentives), and an effective tally sheet to calculate remuneration on severance, may have led to both under and over estimates of executive remuneration values. This is a handicap to remuneration committees and shareholders in decision making and also in providing an accurate picture of remuneration to wider stakeholders.
- The shareholder vote has, in our view, exercised some downward influence on executive remuneration, and has in particular resulted in reduction in some aspects of the package, but possibly at the expense of a rise in other aspects of the package.

Investor guidelines have had a significant impact on executive remuneration in the UK. In our view this has moderated remuneration in some instances, but in others has served to increase remuneration. In general our experience is that shareholders expect companies to follow the UK Governance Code in relation to design but do not seek to intervene as frequently in relation to quantum unless there are compelling reasons to believe that quantum is not justified by performance.

As referred to above, an area where we believe shareholder guidelines have resulted in an increase in overall remuneration levels links to guidelines regarding the operation of share-based long-term incentives. In this respect there has been a divide between the UK and a number of other countries in terms of the use of share incentives. The proposition that share-based remuneration in the UK should only vest to executives when there is 'superior company performance' has, in our experience, contributed to higher base salaries in the UK than in many other European countries and the USA, and also greater reliance on annual incentives, rather than long term incentives, for both motivation and retention. This has also reduced the emphasis in the UK on encouraging executives to build significant long-term share stakes in the business during and beyond the immediate end of employment.

Recent research by Towers Watson and Professor Brian Main of Edinburgh University shows the smaller share grants of shares which time vest over longer retention periods could prove an effective reward for executives and link well to achievement of sustained performance, with the possible reduction in extreme high payouts from highly leveraged share plans with fixed three-year performance terms.

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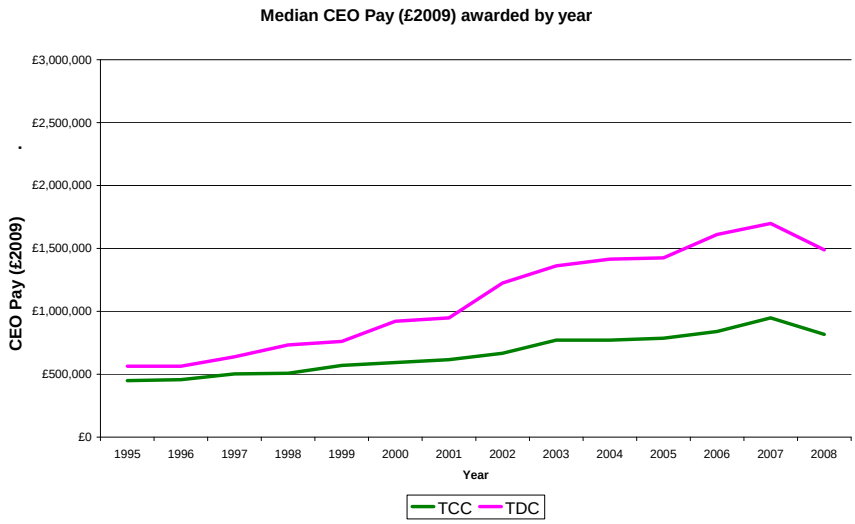
Appendix A

The differences between median and mean CEO remuneration from Manifest data 1996 to 2008 for awarded remuneration and realised remuneration (net of inflation).

This indicates that the average awarded data often used to describe executive remuneration overstates the remuneration of the 'typical' CEO by reflecting a marked skew in the data, and also failing to appreciate the impact of performance conditions on long term incentive awards.

Table 1: Mean, awarded CEO pay for FTSE350 companies, 1996-2008

Table 2: Median, awarded CEO pay for FTSE350 companies, 1996-2008



Key: *TCC – Total Cash Compensation (base salary plus annual bonus in payment)*
TDC – Total Direct Compensation (base salary, annual bonus plus annualised value of long term incentive awards) [5]
£2009 – all values have been adjusted to 2009 monetary values
Source: Manifest

[5] Note: The total direct compensation figure includes an over-estimate of long term incentive values as share options have in the past been recorded by Manifest as the face value of the underpinning shares.

Table 3: Mean, realised CEO pay for FTSE350 companies, 1996-2008

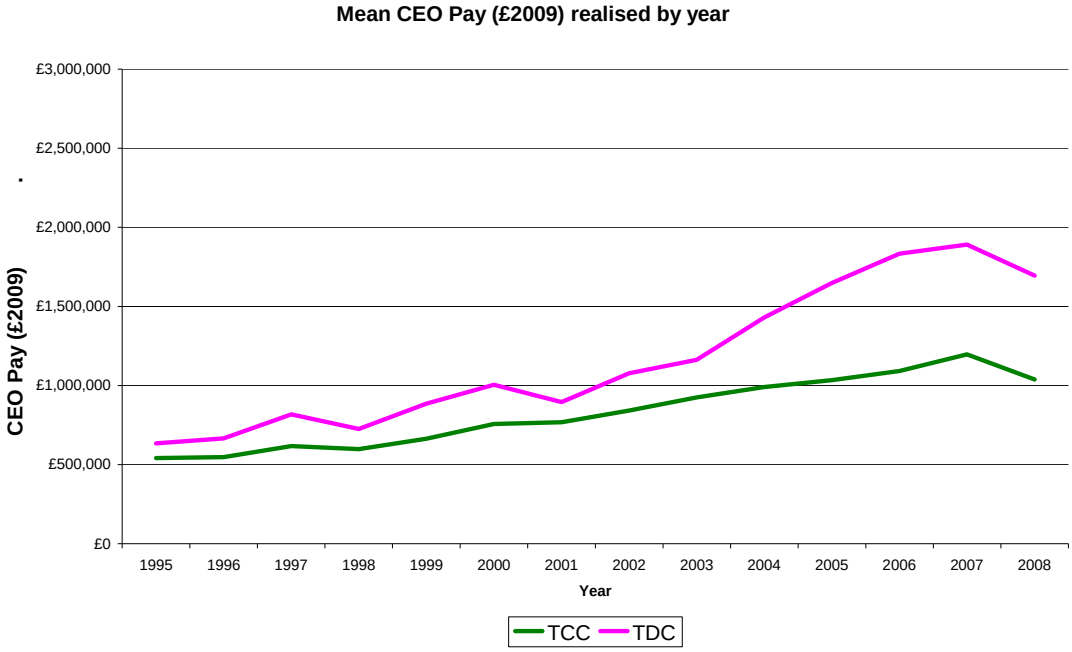
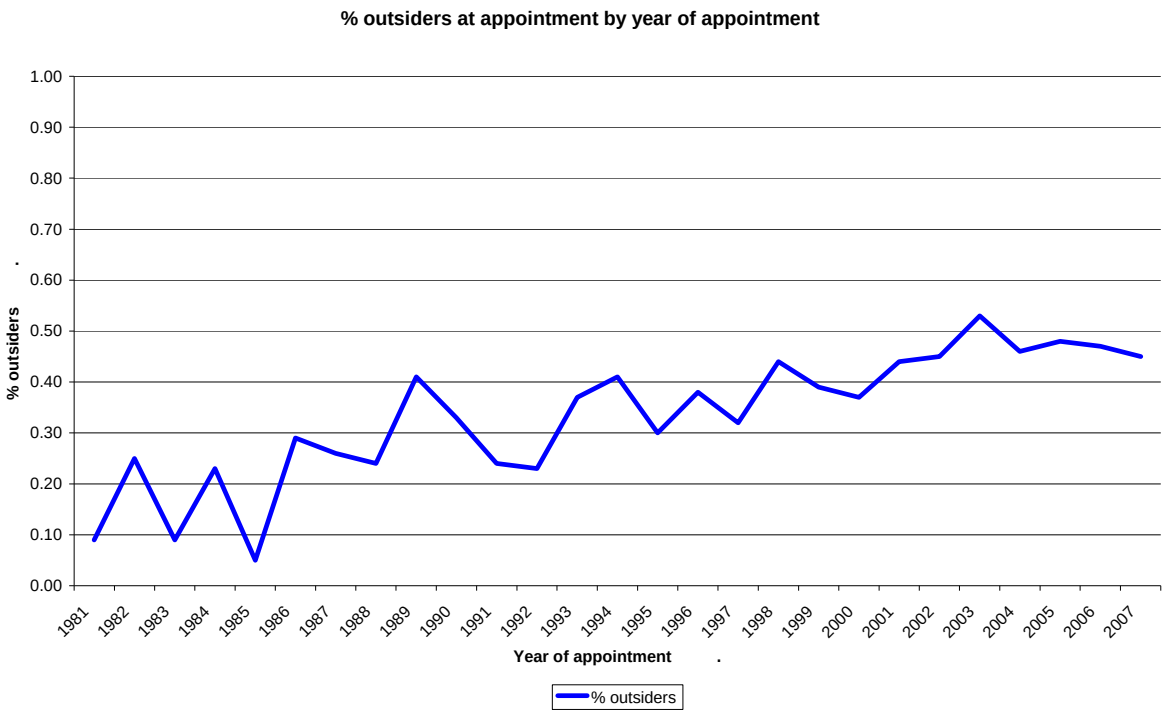


Table 4: Median, realised CEO pay for FTSE350 companies, 1996-2008

Appendix B

Proportion of outside appointments of FTSE350 CEOs 1981 to 2007

This graph shows that in the early 1980s the proportion of CEO appointments from outside the company was around 15%; by the early 2000s this had risen to 45%, suggesting a very active market for talent.



Appendix C

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