



**RiskMetrics Group**

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## 2009 RiskMetrics U.K. Remuneration Guidance

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Remuneration Committees are facing an indisputably challenging year, determining appropriate awards and incentive structures for executives against the backdrop of this unprecedented coincidence of negative market forces. The need for honest communication, clarity and cooperation between companies and shareholders has never been more important than right now, particularly in as sensitive an area as executive remuneration.

In publishing this document, RiskMetrics seeks to add to the community chest of shareholder perspectives in the U.K. on the key issues faced by management, in order that decisions may be taken with as great an appreciation as possible of the concerns and expectations of investors. In our position as a global provider of in-depth corporate governance analysis and vote recommendations to institutional investors (in the UK under the RREV banner), of the most constructive contribution we can make is by offering transparency and insight into the considerations we will be taking into account in the application of policy by our analysts in issuing vote recommendations for remuneration-related proposals by UK public companies in 2009. The guidance presented here is consistent with National Association of Pension Funds (NAPF) Policy of 2007 and we have consulted extensively with our clients to ensure we are in-step with prevailing investor sentiment

## General Remuneration Policies and Practices

RMG will maintain a robust approach to executive remuneration in 2009. The following are some statements of principle on general policy and practice:

- Remuneration committees should ensure that the performance measures chosen are aligned with business strategy and motivate executives appropriately, without promoting or rewarding disproportionate risk taking.
- Meaningful and timely prior consultation with shareholders is vital. Companies should avoid presenting finalized proposals without allowing shareholders a comment period and being responsive to their views, and the process should not be seen as a negotiation from base.
- UK boards must avoid rewarding for failure or for poor performance when approving executive compensation. Although some boards may face internal pressure to retrospectively revise performance targets to ensure bonus and stock plans pay out, the recession should not become an excuse to relax, revise or abandon performance targets retrospectively.
- Remuneration Committees should not use their discretion to make payments which are not justified by financial results.
- Companies need to pay close attention to total remuneration, which should not be expected to increase in absolute terms.
- Remuneration should be clearly linked to the 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 and performance and shareholder value creation.
- Companies should closely examine the behaviour the design of a remuneration package drives, particularly the attitude of executives to risk, which should become a factor considered and explained in disclosures with respect to a company's remuneration policy as a whole.

- Remuneration committees should take into account the pay and conditions across a company when setting the directors' pay. This is particularly appropriate in circumstances where the company has made, or is contemplating, significant redundancies within its workforce.
- Performance targets and individual award levels should be linked to overall company performance and profitability. Consequently, RiskMetrics will take into account the individual company's performance over the past year and we expect there to be a clear correlation between the remuneration proposals going forward and the profitability of the company.
- If a company's profitability declined in 2008, we do not generally expect to see any increases in Executive Directors' total remuneration for 2009, whether fixed or variable opportunities unless, in the case of the latter, it is in conjunction with a revised strategy and/or more demanding targets. We will expect a detailed and compelling explanation in the case of any exceptions to this principle.

## Guidance on the Components of the Remuneration Package

### 1. Basic Salaries

For 2009, we have already witnessed a freeze on salaries being implemented at a number of companies. Although we are not mandating such a step, it would appear to be a trend which is gathering momentum and influencing shareholders' expectations and it is certainly an approach that we support.

Were a company considering an increase in basic salary for 2009, any such increase should reflect:

- Salary increases across the company to align the interests and motivation of all employees.
- Increased company performance/profits in 2008. If profits are down or performance has been adversely impacted, there would seem to be little scope for justifying anything better than salaries remaining flat. If a company has performed well, of which there are very few, then salary increases should not exceed inflation.

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

### 2. Bonuses

#### a. Examination of the Financial Service Authority (FSA) Guidance

In recent months, attention has moved away from long-term incentives and severance payments and is now focused on bonus payments.

The Financial Services Authority (FSA) guidelines illustrate firm views that remuneration arrangements, especially bonuses, have certainly contributed to general instability where they have rewarded excessive short-term risk-taking without regard for longer-term stability.

A number of the stated principles may be generally applied to all industry sectors and will likely influence the expectations of institutional shareholders when looking at their portfolio companies.

Below we examine the key themes of the FSA guidance:

- **Bonuses should be driven by profits**

Most measures chosen for bonus plans have been poorly disclosed due to companies arguing that they are commercially sensitive in nature.

This lack of transparency has resulted in shareholders generally not being able to see/formulate a correlation between bonus awards and company performance. This has contributed to the lack of appreciation among shareholders of the risk associated with the pursuit of a company's objectives in order to meet its stated performance strategy.

Companies should ensure that bonuses are primarily driven by sustainable profits and not short term revenues.

Profits should be reflected in the size of a bonus potential available and be a product of the choice of appropriate KPI's designed to grow the business over the longer term

- **Bonuses should be partly payable in shares and deferred for an appropriate period**

A proportion of bonuses should be deferred to ensure that directors do not focus on a single year outcome. Although bonus awards should be paid based on performance in the year in question, actions taken during that year may not immediately manifest themselves in the company's financial results.

If these effects are unfavourable to long term company profit and general performance, the deferral of such awards may allow the size of a bonus to be reduced (clawed back). This can also be applied to subsequent awards such as the 'malus' condition recently applied to bonuses at UBS

- **Bonuses should not encourage or demand the taking of excessive risks**

Risk manifests itself in different forms across all business types and therefore companies need to adopt a balanced approach, focusing behaviour and activity and avoiding incentives at all costs.

#### **b. Bonuses for 2008**

In some cases, although 2008 targets may not have been met, companies will still want to award bonuses for the year, commonly in the face of professed issues regarding the retention and motivation of key executives who have come to rely on large bonuses and are performing well, set against a background of falling share prices and declining returns for investors. We would suggest that this temptation be strongly resisted by Remuneration Committees, as it is unlikely to meet with shareholder support.

Alternatively, 2008 performance may in fact result in higher bonus awards than is considered acceptable in the current climate and in view of share price declines. Notwithstanding that individual performance against internal targets may have been met, the overall corporate performance in 2008 may mean that the absolute amount of bonus payments will be viewed by shareholders as excessive and Remuneration Committees will need to be particularly sensitive in the exercise of their discretion to address such issues.

**For 2008 awards, companies should use discretion to justify if these awards are aligned to shareholder value creation during the past year.**

There may be cases when targets have been met for 2008 even though the position of the company at the end of the year and looking out into 2009 is severely compromised, for example where the chosen targets:

- Do not take account of financial performance (e.g. large percentage of individual qualitative targets or targets are not linked to company profit such as subscription target/ R&D)
- Q1 -Q3 performance has been sufficient for targets to have been met for the full year notwithstanding a turbulent Q4

Whilst respecting that entitlement to awards may be viewed as 'contractual' (whether that may be the strict legal case or not), in such cases the Remuneration Committee should use its discretion to award appropriate but not excessive awards, which are aligned to the company's overall profits and performance.

[NOTE: Q4 and 2009 performance should impact upon long term incentive awards granted in the 2006, 2007 and 2008 three-year performance cycles (as we do not expect performance targets to be amended retrospectively)]

### c. Bonuses in 2009

For many companies, the 2009 bonus targets are now being set. Given that the environment this time next year is not known, at the very least companies should allow themselves a certain amount of flexibility, whilst taking into account current economic conditions.

For 2009, bonus potential should be reduced in line with any reduction in company profits.

Bonus awards should be viewed as a cost and hence taken from a 'pool' that is funded from profits. If company profits are down, then this should be reflected in a reduced pool.

Most companies do not operate a bonus pool *per se* but rather define bonus awards based on individual award limits. Conceptually if these award limits are not reduced, then a participant (director) would get a larger percentage of any 'pool' and in turn this may impact on the amount outstanding available to pay bonuses to other participants.

**Targets should be challenging but realistic and consequently targets for 2009 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. This can occur either as described above or by reducing the amount of award earned for the base target hurdle, whilst ensuring that the stretch target remains robustly challenging.

If targets remain unchanged, companies may consider reducing the on-target hurdle i.e. 95% of target may be reduced to 90% of target for a lower award to vest.

It is reasonable to expect a greater amount of disclosure surrounding bonus plans and bonus awards going forward. We expect companies to provide clear disclosure of:

- Award limits.
- How bonus awards are divided between financial targets and individual targets.
- The types of financial targets chosen and the rationale for this choice with an explanation linking it to a company's strategy.
- Awards paid out during the last award cycle with reference to a retrospective discussion of how the pre-defined targets were achieved.

- How targets and subsequent awards correlate with the underlying performance of the business and the company's strategy.
- The risk factors that have been applied.

We expect companies to follow best practice by retrospectively disclosing performance against each target. In the current economic climate we consider it imperative that companies provide shareholders with a clear explanation of the rationale behind the size of awards made during the year. Whilst we acknowledge that in some cases full disclosure of targets is not appropriate due to commercial sensitivity, we nonetheless expect a clear explanation of why the awards made were considered to be appropriate, especially relative to the company's overall performance over this period.

### 3. Long Term Incentive Plans

For awards granted in 2008 and in previous years, RMG expects the terms of the plans to not be changed to the advantage of the participants. Companies should avoid:

*Retrospectively changing targets set for previous awards.*

Although internal expectation may exist to retrospectively revise performance targets, the current economic conditions should not be used as an excuse to relax compensation targets retrospectively, or encourage Remuneration Committees to use discretion to make payments in the absence of performance.

*Repricing options. The repricing of options that may be underwater is considered inappropriate and contra to long standing best practice.*

For awards granted in 2009, companies are encouraged to resist the temptation to lower targets under their long term incentive plans.

Long term targets should be clearly linked to a company's pre-stated long term strategy. In any long term cycle it should be expected that there will be periods of decline as well as buoyancy. As such, there should not be a knee-jerk response to changing conditions if the long term goals of the company remain the same. However, in circumstance where a company has fundamentally amended its strategy, the targets should be appropriately adjusted to achieve the objectives.

It is acknowledged that companies need to be responsive to changing market conditions and that targets need to be realistic so that participants view them as reasonably achievable. Although discouraged, any reduction in targets should be accompanied by

- A reduction in individual award limits/ award potential, and*
- A reduction in award levels for the lower level of performance.*

Companies are encouraged to give emphasis on performance periods beyond 3 years in order to create an alignment to long-term strategy. Such awards should not increase a directors' total remuneration package.

Consideration also needs to be given to total remuneration in absolute terms, which should not be expected to increase.

Companies are encouraged not to change the balance of its variable pay from long term to short term.

Many companies argue they no longer have clear visibility of the long term and many are unable to set appropriate targets beyond one year. Should companies decide to realign the balance of long term incentive

pay towards short term and a compelling justification is provided, we strongly recommend that performance targets remain unchanged. In the event of a shift in the distribution of the overall remuneration package, from the long term (where disclosure is typically higher) towards the near term then companies should ensure there is no reduction in disclosure or transparency *ergo* disclosure of performance criteria for short term incentives should increase accordingly.

**Dilution - where significant share price depreciation would lead to a vastly increased number of shares being awarded based on a percentage of basic salary, consideration should be given to lowering award levels to address the management of dilution.**

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