

PRIVATE AND CONFIDENTIAL

1 October 2009

Sir David Walker
By email delivery

Dear Sir David

**A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER
FINANCIAL INDUSTRY ENTITIES**

We are responding to your requests for comments on the above review and set out our responses via two documents. Shortly after the initial publication of the draft we provided our clients with a summary of our observations on the recommendations on the chapter dealing with Remuneration. We may not have copied you in on our mailing and we therefore attach a copy of this document for your information.

Since we drafted that summary we have also had the opportunity to reflect on the recommendations set out in the chapter on Remuneration and include our further thoughts on some of those recommendations in the balance of this letter.

Perhaps we should also note that as a firm we advise the remuneration committees and executive management of a number of large UK and non-UK banks. We have drafted these comments and observations without any contact or reference to these institutions and the views expressed in this letter are therefore entirely those of Towers Perrin.

Recommendation 29

The Recommendation presents a fundamental shift in the relationship between the remuneration committee and executive management, possibly diluting the mandate of executives to manage the business and potentially undermining executive management's authority to run the company.

In some firms the proposed oversight might prove onerous to committee members in terms not only of the multiplicity of plans but also in relation to the number of individuals that may fall under the definition of high-end executive.

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Recommendation 31

In our view, greater disclosure and transparency about executive pay levels and structures as set out in companies' Directors' Remuneration Reports has exerted upward inflationary pressures on pay levels. It is difficult to come to any other conclusion than that further disclosure of pay levels (even within bands) will lead to the same outcome in relation to high-end executives.

We are not convinced that the disclosure of pay levels within banks will lead to lower levels of variable or total compensation, especially in what is an extremely competitive international labour market. Nor do we see how further disclosure would improve governance in any significant way.

Perhaps an alternative and more appropriate approach would be for BOFIs (whether UK listed or UK domiciled subsidiaries of non-resident entities) to disclose details on broad based compensation policies and details on high end executives in confidence to the FSA. In this way the potential upward ratchet on pay levels might be avoided and all major firms would be disclosing similar information within a confidential environment.

Recommendation 33

We would broadly agree that there should be less emphasis on short-term recognition via annual bonus and that the ability of a company to adjust non-vested deferred cash or equity-based awards would help address some of the perceived issues over "short-termism".

That said, we suggest that many institutions will find Recommendation 33 to be overly prescriptive in nature for various reasons. UK listed, international, banks with large capital markets businesses may find it difficult to recruit and retain globally mobile talent. This is because in many major markets and global firms, performance-based vesting of long-term incentives is not common. Deferral of a portion of bonus into equity or other similar vehicle with no further performance testing is much more widespread for high-end executives. Implementing Recommendation 33 for BOFIs may well lead to:

- *uncompetitive pay structures in the UK (if similar changes are not made in other major markets); and*
- *the emergence of multiple variations of pay structure within a single firm; for example, UK pay might be subject to performance-based vesting requirements but pay outside the UK might not, thus causing issues over internal pay relativities for firms.*

Our sense is that, when viewed from a global perspective, we are seeing the following broad consensus emerging for high-end pay structures:

- *some increase in base pay levels offset by an equal reduction in variable pay so the overall effect is cost neutral;*
- *annual bonus determined from a risk-adjusted, profit driven, bonus pool with a stronger role for the risk function in qualifying the quality or sustainability of that profit figure;*
- *greater deferral of annual bonus into equity or similar vehicles for a minimum of three years (and perhaps longer) subject to adjustment of the final value by reference to financial performance during the deferred period;*
- *clawback of deferred awards if key performance measures on risk and compliance are not adhered to; and*
- *longer deferral or shareholding periods, which may continue after termination of employment, so that some element of compensation retains a link to company performance through the share price over a much longer time horizon.*

To address a number of concerns raised by regulators and politicians and, given this emerging consensus, we wonder whether Recommendation 33 is overly prescriptive.

Recommendations 38 and 39

We are of course relatively content with the draft code as set out in Annex 11 of the review having been one of the seven firms involved with its drafting and the suggestions you make for its on-going development and management.

Sir David Walker
1 October 2009
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We will comment no further as representatives of this group are hoping to meet with you in the near future in connection with both governance issues and any other changes to the code itself that may be appropriate.

Sir David, I trust that you find our comments and thoughts helpful input to your review and naturally we would be happy to clarify any points that you might like to raise.

Yours sincerely

Towers Perrin

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Walker Report

If you would like any further information on the items covered below, please contact your regular Towers Perrin consultant [or Tamsin Sridhara (020 7170 2914, tamsin.sridhara@towersperrin.com)].

Sir David Walker last week produced his Review of corporate governance in UK banks and other financial institutions (BOFIs). It contains a whole chapter (7) on remuneration. Although Sir David eschews any recommendations on pay caps or pay differentials, the Review does contain a number of quite specific recommendations, one or two of which might be considered overly prescriptive.

In this note, we identify and provide our initial thoughts on the main recommendations and also their possible impact if adopted outside the financial sector – as might happen if some of the recommendations are taken on board by the FRC and incorporated into the Combined Code.

It is to be noted that Sir David invites comments upon the proposals contained in his Review up to October 1st: a final paper is then to be produced in November.

Reach of Remuneration Committee Oversight

In this area, there are two recommendations (28 and 29). They are as follows:

Recommendation 28

“The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.”

Recommendation 29

“The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration...exceeds or might be expected to exceed the median compensation of executive board members on the same basis.”

In line with the FSA's own consultation paper and Code, Sir David emphasises both here and in other sections of his Review, the importance of remuneration arrangements taking risk into account. He includes a strong recommendation for the Remuneration Committee to be advised by a Chief Risk Officer and for significant portions of pay to be deferred into shares (see later) as a means of reflecting the longer term consequences of both individuals' and groups' activities.

Our main comment here is that risk cannot simply be taken into account via a pay formula. And, at the extreme, applying a risk adjusted rate of return before any performance related bonus pool is generated may, perversely, encourage higher levels of risk taking.

The issue of risk management is, as Sir David and others acknowledge, much more complex and is more a matter of governance, management control and informed judgement.

With regard to Recommendation 29, if there is a need for greater oversight (and disclosure) of pay for higher paid executives who are not Board members, the definition of those to whom it should apply – i.e. those whose total remuneration exceeds the median total remuneration of executive directors, seems to us to be quite a neat one. Sir David refers to this group as “high end” executives.

As well as covering all aspects of remuneration policy on a firm-wide basis, this “oversight” requirement may, however, require the Committee’s involvement in the specifics of individual executives’ remuneration if they fall in the high end category. This may prove quite onerous in some financial institutions where there may well be a multiplicity of plans in place. As a matter of principle, there are also some commentators who feel quite strongly that the remit of the Committee should not extend beyond the executive directors, because pay below the board is a matter for the CEO and his team.

Whatever practice is adopted in BOFIs, we do not believe that the extension of Sir David’s recommendation to companies outside the financial sector would present any significant difficulties. The terms of reference adopted by many remuneration committees already extend to plans and policies that apply below Board level and they often also include notification, or sometimes approval, of pay for executives at the level immediately below the Board or whose earnings exceed a certain threshold level.

Disclosure of “high end” remuneration

Here there are three recommendations, as follows.

Recommendation 30

“In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members”

Recommendation 31

“The remuneration committee report should disclose for “high end” executives whose total remuneration exceeds the executive board median total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term award and pension contribution.”

Recommendation 32

“Major FSA-authorized BOFIs that are UK-domiciled subsidiaries of non-resident entities should include in their reporting arrangements with the FSA disclosure of the remuneration of “high end” executives broadly as recommended for UK-listed entities but with detail appropriate to their governance structure and circumstances agreed on a case by case basis with the FSA. Disclosure of “high end” remuneration on the agreed basis should be included in the annual report of the entity that is required to be filed at Companies House.”

As far as Recommendation 30 is concerned, capital markets or trading incentive plans are often quite different from those which apply to executive directors, so this recommendation seems intended to expose non-board incentive plans which may encourage excessive risk taking. In that context and provided it does not discourage the implementation of incentive plans which are properly different from board incentives, this recommendation again looks reasonable.

But it seems to be a recommendation which would not normally have significance outside financial services. In general industry, the problem of risk in incentives does not arise in the same way and risk factors in incentive plans would not, generally, need to be disclosed to shareholders. Also, in practice, the structures of incentives in companies outside the financial sector are normally quite homogeneous.

Turning to Recommendation 31, Sir David rejects disclosure on an individual basis for high end executives, recommending instead that this be on a basis of total remuneration bands – reminiscent of the basis that applied pre-Cadbury to executive directors. This is consistent with a practice already adopted voluntarily by some financial institutions and other companies (and encouraged by institutional investors). However, the stipulation that the main elements of remuneration should also be identified might add a very high degree of complexity given that these might be very different for the individuals within the high end

category – including those falling within the same total remuneration band. For this reason, if it is retained in the final paper, we would suggest that an indication of the breakdown of total remuneration might be better provided via accompanying text rather than in tabular form.

Time horizons, performance conditions and risk adjustment of performance incentives

This part of the review is concerned with the impact of objectives in incentive plans which encourage excessive risk taking. The Review quotes the FSA as follows “It is of vital importance that these objectives are appropriately risk-adjusted to take account of the incremental capital, liquidity, franchise or other risk that would be entailed in vigorous pursuit of, for example market share or revenue.” This analysis has led to the single most prescriptive recommendation in the chapter.

Recommendation 33

“Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three-year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.”

Recommendation 34

“Executive board members and executives whose remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.”

Recommendation 35

“The remuneration committee should seek advice from the board risk committee on an arms-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board”

Although Sir David deliberately does not make any recommendation regarding the relationship of fixed pay to variable pay (and he recognises that the proposals contained in Recommendation 33 might result in upward pressures on base pay) his proposals in relation to the relative weight and time horizons for incentive pay plans and share ownership are in our view unduly prescriptive. If universally adopted, the recommendation that at least one half of variable remuneration be provided under a long term scheme might lead to more executives being covered by a group plan (such as a group performance share plan as currently found in most UK banks) which might be totally inappropriate for some roles **or** it might lead to a greater proliferation of business unit plans. The latter may be appropriate in some circumstances but we would note that there are enough difficulties in setting performance targets and conditions for long term incentive plans at group level; even if desirable, it is much more difficult to set such targets below group level. There are also potential problems involved with changing organisation structures affecting long term plans and performance measurement below Group level.

In Recommendation 34, Sir David seems to be covering two quite separate ideas. The first – shareholding requirements – is already widespread practice in all sectors of UK industry – though we note in passing that specifying numbers of shares works better than specifying multiples of pay and that, because of its variability, tracking a shareholding guideline against total compensation may prove troublesome.

The second idea – not normally providing for accelerated vesting – is also majority practice and unexceptional.

And, finally, Recommendation 35 is a recommendation which is commendably free of prescription; both risk adjustment and incentive target setting are difficult decisions in their own right and it is helpful that – within the prescriptive confines of recommendation 33 – this recommendation leaves committees and boards to resolve the issues in their own way.

Again we note that the problem of risk does not arise in the same way outside financial services (where there are relatively few board risk committees) so it is not clear how far this recommendation would or should be applied outside the financial services sector.

Voting on the remuneration committee report and the committee chairman

The Review notes that it can be difficult in practice to change contractual remuneration packages even if the advisory AGM resolution is not passed. It does however express sympathy with the view, doubtless occasioned by recent experience both in the financial sector and elsewhere, that there needs to be a more meaningful way for shareholders to express their disapproval than that which is afforded by the advisory vote on the Directors Remuneration Report. Therefore, the review says “...influence should be capable of being exerted through the board election process...”

Recommendation 36

“If the non-binding resolution on a remuneration committee [report] attracts less than 75% of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.”

Although entirely understandable, we have some difficulty with this recommendation, partly because it is likely to be a recommendation which is adopted outside financial services but more particularly because a remuneration report might attract less than 75% of the votes cast for many reasons by no means all of which resulting from faulty remuneration practice.

This Recommendation may be superseded by a requirement that all directors have to be re-elected each year. But whether or not this requirement does come into force, we think that annual re-election of all committee chairmen might be a better check on poor practice than reliance on the achievement of an arbitrary percentage of a shareholders’ vote.

The scope of further disclosure in remuneration committee reports

Against the background of the public debate about executive pay levels and relativities, the review notes that its recommendations “...explicitly do not extend to any cap on earnings or on the ratio of earnings of the highest paid to the lowest paid.” But the report does comment on “exceptional pension or other arrangements to encourage or facilitate departure...” again about certainty occasioned by recent cases – and any in particular which have attracted high levels of adverse comment.

Recommendation 37

“The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.”

Generally, we think that this recommendation may not result in substantial changes of practice although it may become necessary to disclose some pension provisions in more detail.

Best practice standards for remuneration consultancy

The review discusses at some length current perceptions about the role of remuneration consultants and

appends a draft code of conduct for remuneration consultants. There are two recommendations.

Recommendation 38

“The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.”

Recommendation 39

“The code and an indication of the consulting firms committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.”

Towers Perrin was one of the firms which took the lead in developing the draft Code of Conduct which was submitted to Sir David Walker. In total, seven of the major consulting firms were signatories to this Code when it was submitted. It was developed partly in response to pressures from some institutional investors but more particularly to correct some misperceptions and set out some best practice guidelines which should be helpful both to companies and consultants providing advice on executive remuneration.

Although most consulting firms have their own codes of conduct and in spite of the fact that many practitioners are lawyers, accountants or actuaries (and thus covered by their own professional codes), consulting on executive remuneration – which is defined by the Code as those aspects of remuneration which fall within the remit of the Remuneration Committee – is always sensitive and can give rise to perceptions of conflict of interest. This is particularly the case where a consulting firm provides services that extend beyond advice to the Remuneration Committee.

In his Review, Sir David recognises that consultants might be engaged by companies in a number of different ways to advise on executive remuneration. However, key criteria to foster confidence in their advice are integrity of process and total clarity as to the nature of the remit, the identity of the client within the company and the protocols to be observed.

At the very least it is hoped that the Code will provide a framework for companies and consultants to minimise any perceived or real conflicts of interest and establish reporting requirements, processes and standards against which the conduct of any engagement can be judged.

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