



**Local Authority
Pension Fund
Forum**

**Reforming remuneration practices in financial
services**

***Response by the
Local Authority Pension Fund Forum***

18 May 2009

David Sellors
Chief Operating Officer
LAPF Forum
Email: David.Sellors@lapforum.org

Reforming remuneration practices in financial services

1. Background

LAPFF, which was set up in 1991, is a voluntary association of 49 local authority pension funds based in the UK. LAPFF exists 'to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of about £75 billion. PIRC is the Research and Engagement Partner to LAPFF.

The Forum has taken the opportunity below to provide our view on those consultation questions, which we consider relevant to our activities.

2. Responses to specific questions

Question 1: Do you agree with our analysis on the need for change and the gaps in the current regulatory approach?

We agree that certain remuneration practices were a 'contributory factor' and in our view only sought to exacerbate excessive risk-taking within financial institutions. We consider that company remuneration policies must align with the strategy, risk appetite and ethos behind the department/firm. This alignment is only effective when it is explicitly evident, and therefore we do not consider implicit constraints, as present in the current FSA requirements, to be sufficient in achieving this.

A good example of this is the disclosure of remuneration policies for executive directors of listed companies, which is currently required under the Listing Rules and to an extent the Companies Act 2006. Even in some large FTSE100 companies, remuneration committees fail to demonstrate how their remuneration policies are aligned with the company's unique position, including its risk profile, often only stating that remuneration policies are aligned, not how they are aligned.

On a similar note although current FSA guidelines require that companies do not take actions or commit to policies that will jeopardise their internal control mechanisms, there is no explicit reference to remuneration policies within this context. This means companies are able to state in a blanket fashion that no risks to the internal control are in place, rather than actually addressing the risk of remuneration. In light of its importance, we welcome the proposal to put additional requirements in place that explicitly address this area.

Question 3: Do you agree with this analysis of market failure?

LAPFF, as an organisation composing long-term pension fund investors, shares the FSA's concerns about short-termism in the behaviour and influence of investors. We consider it important that long-term investors communicate their long-term intentions to companies, either themselves, through their representatives or their fund managers. Regarding remuneration, LAPFF has been engaging with FTSE100 companies to encourage them to include non-financial performance measures within their long-term incentive arrangements, which we consider to be central to ensuring the long-term success and reducing overall risk.

Regarding the role of remuneration committees, we consider that they should go beyond their normal boundaries and play a significant role in overseeing the remuneration culture within a company and the overall Group wide structure in place. Currently committees dedicate the vast majority of their time devising and monitoring the remuneration of executive directors and senior management, largely due to the fact that there is no requirement for them to disclose discussions regarding overall remuneration policies for all employees in their remuneration report. However we note that going forward there are signs of favourable trends in this area.

An explicit requirement to disclose 'how pay and employment conditions of employees of the company and of other undertakings within the same group as the company were taken into account when determining directors' remuneration for the relevant financial year' will come into effect under the Companies Act 2006. In addition, this year, in light of the increased interest by investors in this subject, several remuneration reports for UK-listed banks went beyond the norm and disclosed more extensively on this subject, most notably at Royal Bank of Scotland and HSBC.

A gap in the analysis may lie in the role played by context in determining individual behaviour. Outside observers have a tendency to attribute behaviour to individual characteristics, traits and motivations. Behavioural economics (see, for example, the Stanford Prison Experiment) has established that the situation a person finds him or herself in plays a large part in determining behaviour. It is possible that particular remuneration arrangements help to shape corporate cultures, which would imply that remuneration arrangements have indeed contributed to questionable behaviours in the past. However, it is also possible that causation runs in the other direction and that corporate culture (the situation or context) is the determining factor in individual behaviour. In light of this the FSA should be aware that remuneration arrangements do not exist in isolation of other factors that may contribute to market failure and it should analyse the role played by remuneration along side other factors that may shape the context that determines individual behaviour.

Question 4: Do you have comments on the content or the scope of the draft Code?

We agree with the sentiment behind the proposed rule that firms must establish, implement and maintain remuneration policies that are consistent with effective risk management. In addition we welcome that the general rules cover all aspects of remuneration, including variable pay, hiring policies, severance packages and pension arrangements.

We welcome greater emphasis upon bonus deferral as a method of ensuring that sustainable long-term performance is considered in rewarding short-term performance, although we consider that the Code should be more specific in how any deferred element should be linked to the future performance of the firm.

Currently several FTSE-listed financial companies have in place bonus matching plans which have a positive multiplier to deferred bonuses if long-term performance is sustained or improved, but most fail to apply a negative multiplier when company performance over the long-term deteriorates. In addition, although many schemes contain a clause which allows the Remuneration Committee to use its discretion to ensure that no awards are matched if there is poor overall performance, once bonuses have been deferred there is little that can be done to reduce this amount. Such systems devalue the usefulness of deferred bonuses in encouraging sustainable performance, as recipients have everything to win and little to lose, which is the very behaviour that the FSA does not wish to persist. We would suggest that in promoting bonus deferral that the Code make specific reference to systems of *bonus malus*, similar to that recently introduced at UBS., which can apply both a positive and negative multiplier to deferred bonuses, in order to reward good sustainable performance and penalise poor long-term performance.

In addition, experience suggests that encouraging companies to defer at least two-thirds of bonuses (where the bonus forms a significant proportion of the fixed component) will also encourage them to manage target levels of performance down so as to compensate recipients for the effect. The FSA may wish to manage against such unintended consequence by encouraging companies to improve disclosure in respect of the degree to which performance targets are stretching and how they compare to prior years.

Regarding non-financial performance metrics, LAPFF agrees that non-financial performance measures should form a significant part of the performance assessment process, and agrees that poor management of non-financial areas such as risk management, can be detrimental to the performance of the company. In addition we would add, as previously stated, that we consider that companies should take account of non-financial measures in their long-term incentives, rather than simply their bonuses, because poor management of non-financial areas can also be detrimental to sustained long-term performance. We

consider that in its current form, most people will interpret principle 6 of the Code to refer exclusively to annual bonuses, as this is a more common practice.

We support the FSA's desire to encourage firms to adjust profits and capital for risk. We also feel that the FSA should not underestimate the resources required at the company level to make this work. Experience of companies adopting an Economic Profit model of performance measurement and management suggests this can be a time consuming process that requires significant configuration of management information systems.

More importantly, if such an approach is to work in changing firm wide behaviours, it is generally believed that performance measurement and management based on risk adjusted measures has to be relentlessly championed from the top of the organisation and has to be reflected in the strategic planning process. It is not clear how or whether the FSA has considered this in its analysis.

Question 7: Do you have any comments on the suggestions that firms publish an annual remuneration statement?

We welcome the suggestion that firms publish an annual remuneration statement which states how the Code is applied to all employees. Current disclosure regarding remuneration in the context of risk management is generally very poor and at the very best generic. A survey of UK-listed bank remuneration reports last year would show that only three of the nine banks made specific reference to risk in establishing their remuneration practices, all of which were only generic in nature. In particular we would welcome a requirement for listed-companies that the statement is disclosed in the company's remuneration report in order that shareholders are able to take it into consideration when determining their voting stance on the remuneration report. As is the case with executive pay, this would better facilitate shareholders to express their consideration of how the company has acted in response to the Code.

It is critical that annual remuneration statements are informative and meaningful. Disclosure of remuneration policy is riddled with boilerplate statements, the most notable of which is the need to 'attract, retain and motivate', which does not provide shareholders with an informative insight. A good further example of this is the guideline by the ABI which states that the companies must disclose:

'Whether the remuneration committee has ensured that the incentive structure for senior management does not raise ESG risks by inadvertently motivating irresponsible behaviour.'

Although the intention of this guideline is clear, companies that actually respond to it only do so in a generic manner. HSBC, for example, states year on year that:

“The [Remuneration] Committee also considers corporate performance on environmental, social and governance factors when determining the executive Directors’ remuneration. In addition, the Remuneration Committee has oversight that the incentive structure for senior management does not raise environmental, social and governance risks by inadvertently motivating irresponsible behaviour” (HSBC Annual Report 2007, p.322).

In requiring companies to disclose a statement regarding the Code, the FSA must remain cautious that a similar attitude of generic compliance reporting could develop, and that it should continually push for high standards of informative reporting, in order that disclosure is useful to shareholders.