Institute of Business Ethics

Nigel Wilson
Chairman
Executive Remuneration Working Group
The Investment Association
Camomile Court
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Dear Mr Wilson

We are writing to comment on the Interim report of your group. We strongly welcome the initiative of the Investment Association in opening up the discussion on executive remuneration. Our annual surveys of trust in business show that the level and structure of executive remuneration consistently figures among the top concerns of the public. Clearly, it is important for business to address this if it is to restore its standing and preserve its licence to operate. Moreover, your own report describes the present system as being "widely seen as broken," while pointing out that the level of executive pay has more than trebled over the past 10 years even though the FTSE is at broadly the same levels and 10% below its peak.

Against this background we consider the debate needs to encompass more radical changes than those discussed in your report. While we agree that transparency, shareholder engagement, accountability and flexibility are all important, we believe that the discussion should give more weight to simplicity. Executive pay is unnecessarily complicated. It is very difficult indeed, if not impossible to set a clear value on many of the leveraged share arrangements nowadays routinely awarded to directors. Outcomes can fluctuate wildly in ways that are out of the control of recipients. For example, a strong stock market or a calamity at one or more comparator group companies can boost the reward for a less than outstanding individual performance.

We therefore question the assertion in the interim report that Long Term Incentive Plans based around three to five year performance measures remain appropriate for some companies. Although you propose a suite of different approaches this statement is likely to be taken as meaning that LTIP's are generally OK. In fact they present real operational difficulties because it is so hard to set meaningful performance conditions. It is very difficult for an executive to know how to deliver some performance criteria like TSR, but executives will often try to game performance criteria over which they feel they do have some control.

We note that the group has proposed a range of options which do not involve upfront performance conditions but therefore feel it should be bolder in promoting these as long as they are aligned to the long term performance of the company. This is not just a question of share price performance but also of the management's achievement in delivering a sustainable and growing cash flow. For many companies it would therefore be sensible to reduce the emphasis on annual bonuses, which often appear rather arbitrary and increase the emphasis on payment of dividends on accumulated long term holdings of shares, always subject, of course, to appropriate cover conditions.

From this perspective five years should be a minimum, not a maximum time frame for holding shares regardless of whether or not the executive has left the company. At any event the time frame and the holding requirement should provide a strong incentive to give careful thought to succession planning.

In every case the remuneration committee should be able to answer the following simple questions. Why have we chosen the level of quantum proposed and can it really be justified? Can everybody – boards, executives and shareholders – clearly see the value of what is being handed over? Will the award stimulate the executives to pursue a long term strategy that is in the interest of the shareholders and the company? And, finally, will the broader public be able to see a clear connection between performance and the eventual outcome?

Until remuneration committees can always answer these questions, we will continue to have problems with executive remuneration which feed into rising voter concern with inequality on both sides of the Atlantic. We believe the problem is urgent and more serious than your report suggests.

Yours sincerely
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