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Executive summary

Executive remuneration was once again in the spotlight in 2011, and we expect this focus to continue throughout 2012. Our survey suggests that the headlines oversimplify the true position, and that, in reality, remuneration trends for FTSE 250 and smaller company directors are conservative.

The area of executive remuneration is becoming increasingly political, leading to discussions around increasing transparency in remuneration arrangements through enhanced disclosure. However, there is limited consensus on the extent of regulation needed and the precise form it should take, thus leading to a lack of clarity in the agenda.

Regulation and change across all aspects of remuneration is affecting executive pay across different sectors in different ways. However, the precise impact of the changes on the design of executive remuneration structures remains unclear, as detail of some of the changes is still emerging. It is likely that, despite calls for simplification, the inherent complexity in remuneration structures will be difficult to overcome.

Regulatory developments, in particular, the UK Government’s proposed reforms, and shareholder activism present significant challenges for remuneration committees in designing director pay policy.

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1. This includes FTSE SmallCap, FTSE Fledgling and companies listed on the Alternative Investment Market (AIM).
Key remuneration trends in 2011

**Total remuneration**

Total cash for FTSE 250 executives accounted for the majority of take home pay, with relatively low levels of long term incentive vesting compared with previous years. For smaller company executives, the picture was more mixed, with little or no bonuses for many and few enjoying value from vesting long term incentive awards.

The chart below presents actual remuneration mix for lead executives. The long term incentive analysis includes only those executives that have received any value from vesting long term incentive awards during the year.

**Chart 1: Pay components for the lead executive as a percentage of actual pay in 2010/11**

Source: Ernst & Young

**Base salary**

**Chart 2: Increases in base salary for FTSE 250 directors between 2009/10 and 2010/11**

Evidence of base salary increases was limited, and, where made, modest at between 2% and 3% for FTSE 250 executives. For smaller company executives, increases were even more isolated, with most base salaries frozen at 2010 levels. A similar theme is expected in 2012.

Source: Ernst & Young
Annual bonus

Although many FTSE 250 executives enjoyed an annual bonus, deferral is now common practice, with claw back provision creeping into mainstream remuneration policy. In contrast, only a handful of smaller companies have adopted a deferral policy, although annual bonuses for executives in this group have largely been nil.

Table 1 maximum and actual bonuses paid to lead executives in smaller companies

<table>
<thead>
<tr>
<th></th>
<th>Smalcap</th>
<th>Fledgling</th>
<th>AIM</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of base salary</td>
<td></td>
<td></td>
<td>% of base salary</td>
</tr>
<tr>
<td>Maximum annual bonus</td>
<td>UQ</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Median</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>LQ</td>
<td>75</td>
<td>100</td>
</tr>
<tr>
<td>Actual annual bonus</td>
<td>UQ</td>
<td>68</td>
<td>82</td>
</tr>
<tr>
<td></td>
<td>Median</td>
<td>30</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td>LQ</td>
<td>0</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Ernst & Young

Bonus measures continue to be dominated by profit and cash flow targets, with personal targets often making up a weighted basket of measures at around 20% of the total target. There is some evidence of increased use of non-financial measures.

Long term incentives

The homogenous approach to long term incentive design continues in larger companies, with nil-cost options and TSR/EPS performance conditions the dominating features. Amongst smaller companies, market value options remain popular. However, there is increased evidence of design innovation, particularly in the use of value creation plans.

Most long term incentive awards failed to vest in 2011, with only around a third of FTSE 250 and less than 10% of smaller company executives deriving any value.

Table 2: Long term incentive plans operated for executives

<table>
<thead>
<tr>
<th>FTSE 250 companies</th>
<th>Smaller companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of companies with type of plan</td>
<td>% of companies with type of plan</td>
</tr>
<tr>
<td>Share matching plan</td>
<td>18</td>
</tr>
<tr>
<td>LTI</td>
<td>86</td>
</tr>
<tr>
<td>Share option plan</td>
<td>29</td>
</tr>
<tr>
<td>Value creation plan</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Ernst & Young
Executive pensions
Within FTSE 250 companies, there is a complex mix of legacy defined benefit / contribution scheme, with some evidence of growing use of personal schemes. Defined contribution schemes were by far the most common form of executive pension in smaller companies.

Non-executive director fee policy
Base fee policy remained broadly static, with any increases modest and largely limited to the top FTSE 250 companies. Audit committee chairs continue to receive a premium fee, although many companies now pay a comparable fee to the remuneration committee chair. Practice amongst smaller companies remains fragmented, with limited evidence of adoption of a formal non-executive director fee policy.

Table 3: Non-executive director annual fee policy

<table>
<thead>
<tr>
<th></th>
<th>FTSE 250</th>
<th>FTSE 250 - top</th>
<th>FTSE 250 - bottom</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£</td>
<td>£</td>
<td>£</td>
</tr>
<tr>
<td>NED base fee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UQ</td>
<td>47,500</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Median</td>
<td>40,000</td>
<td>42,750</td>
<td>44,000</td>
</tr>
<tr>
<td>LQ</td>
<td>38,000</td>
<td>38,675</td>
<td>40,000</td>
</tr>
<tr>
<td>Additional Senior NED fee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UQ</td>
<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Median</td>
<td>5,000</td>
<td>5,200</td>
<td>6,250</td>
</tr>
<tr>
<td>LQ</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Source: Ernst & Young
Trends for 2012

Remuneration trends in 2012 will be influenced by continuing regulatory change and economic challenges. Over the course of 2012, we expect to see:

**Greater regulation of remuneration policies and practices**

The UK corporate governance framework will continue to evolve. On 23 January 2012, the Government responded to the Department of Business Innovation and Skills (BIS) reviews of executive remuneration and narrative reporting. During the course of the year, further details will be released regarding the Government’s proposed changes.

**Continued pressure on remuneration quantum**

Relatively low inflation combined with the current economic challenges facing the UK and the Eurozone more broadly will continue to constrain remuneration quantum. We expect fixed remuneration increases in FTSE 250 and smaller companies to be minimal, with a greater focus on performance based pay.

**Increased focus on incentive plan design**

We expect an increased focus on aligning incentive plans with business strategy. Given the focus of BIS and the Association of British Insurers (ABI) on long term shareholder value creation, companies will look to review the appropriateness of performance measurement. We expect:

**Annual bonus**

Bonus payments likely to be challenged where financial performance is unsatisfactory. Claw back to become a mainstay of remuneration policy.

**Long term incentives**

Further examples of bespoke incentive design to emerge, particularly where shareholder value creation is being prioritised and directors need re-incentivising.

Media interest in directors’ pay often focuses on ways in which remuneration can be controlled or limited - views differ on whether this is desirable and on how this can be achieved
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