

Inspired thinking



Inflated Pensions – rewards for failure?

Introduction

Insight has become increasingly concerned about two issues relating to directors' pensions on their departure – voluntary or otherwise – from companies. First, we are concerned that current contracts may entitle directors to big boosts to their pension pots as part of their severance packages. While boards may defend their payments by stating that the entitlements are part of agreed contracts, in our view, these payments could be seen as rewards for failure and Insight and other active shareholders should not condone them. Second, when agreeing executive directors' contracts, boards should consider additional costs to the company if a director were to retire early. We acknowledge it is difficult for companies to put a value on such costs, but we believe that remuneration committees should consider the potential hidden costs associated with early retirement. Our view is in line with a joint statement entitled 'Principles and Guidelines of Executive Remuneration' published in 2004 by the National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI), which states that when executives are hired, their contracts should be written in such a way as to not commit the organisation to excessive severance arrangements.

ABI action

Britain's most influential investor group, the ABI, whose members represents almost 20 per cent of investments in the London stock market, has also recently voiced its concern about these issues. In a letter to the chairs of the remuneration committees of FTSE 350 companies (and their remuneration consultants), it has warned that companies risk damaging the reputation of business unless they clamp down on inflated pension packages

for former directors. Specifically, the ABI urges non-executive directors on remuneration committees to review pension arrangements attached to executive contracts to ensure they are in line with UK best practice. The TUC echoes the views of the ABI on this issue, 'It is damaging to the reputation of business if companies pay extremely generous pensions – which are not related to performance – when most of the workforce is seeing their pension expectations reduced.'

Case study: Scottish Power

The ABI's action was triggered by the recent payout to the former Chief Executive of Scottish Power, Ian Russell. He left the group in January 2006 with a compensation payment of £2.3 million and the value of his pension doubled on termination of his contract from £3.4 million to £6.8 million. His contract enabled him to retire early on the same pension he would have received had he stayed until normal retirement age. Although he was only 53 when he left the company, he was contractually entitled to retire on a full pension at 50. This arrangement was not unique, as the pensions of three other directors at Scottish Power who recently left the company also rose substantially. The company has confirmed in a letter to the ABI that 'it was contractually obliged to make these payments and it is committed to providing the fullest disclosure possible and that it will seek to make further improvements in the next Annual Report and Accounts.' Scottish Power's Remuneration Committee has reviewed its policy on the provision of pensions for future executive director appointments. It has decided that in the future it will offer a defined contribution or salary supplement, having closed all of its defined benefit schemes to new members.

Insight's view

It is Insight's view that it is no longer appropriate for newly appointed directors and senior executives to be given special deals within defined benefit pension schemes. For example, Insight does not believe that contractual provision of enhanced early retirement benefits is in the interest of shareholders. This is particularly important in the case of involuntary departures where any contractual pensions obligations are likely to increase the cost of the compromise agreement. (Please refer to the article published in our Spring 2004 bulletin on page 10 which provides more detail on compromise agreements). For example, one of the few departing executive directors to go to court was Neil Davidson, the former Chief Executive of Arla Foods UK, who lost his appeal over the pension provision in his compromise agreement. He argued that he should have been entitled to a £5.2m pension pot as opposed to the £4.45m one that the company had put forward.

Pension provisions that allow an executive to retire early on a full pension are not an effective means of retaining executives. And they are clearly not in the interest of shareholders.

When existing directors have enhanced pension provisions including early retirement options, remuneration committees should be diligent in including costs (or at least estimating potential costs) when assessing the size of a director's overall package.

Insight believes that boards should be moving towards best practice executive pension arrangements. We encourage boards to fully disclose pension arrangements to shareholders and to take account of any non-standard arrangements in determining the overall level of reward packages. We welcome the ABI's role in facilitating discussion between companies and their shareholders on this issue.

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