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By email:

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Date: 3 November 2014

Dear Rachel,

Re: Consultation on changes strengthening the alignment of risk and reward: new remuneration rules

I am responding on behalf of Aviva Investors. Aviva Investors is the global asset management business of Aviva plc. The business delivers investment management solutions, services and client-driven performance to clients worldwide. We operate in 14 countries in Asia Pacific, Europe, North America and the United Kingdom and have assets under management of £246bn at September 2014.

Aviva Investors is a committed long term investor. We aim to work with companies towards promoting a profitable, sustainable, long term future for them, our clients and ultimately the capital markets. Out voting policy provides guidance for the Boards of Directors of UK companies on how we exercise our voting rights and is available online here.

In general, we look for pay arrangements that are aligned with strategy and shareholder interests. We look to remuneration committees to hold management to account and only reward value creation. We also look for remuneration arrangements that are not excessive, well structured and, of course, understandable. Pay arrangements should have a sufficient focus on the long-term and have adequately challenging performance conditions that align the directors' interests with those of shareholders.

We welcome the opportunity to respond to this consultation with respect to proposals to extend the Remuneration Code to ensure greater alignment between risk and individual reward, to discourage excessive risk-taking and short-termism and encourage more effective risk management.

Reservations

We understand the need for appropriate bank regulation over pay given the financial crisis. While generally supportive of the suggestions proposed in the consultation paper, these changes are not without risk. Risks include the possibility that these proposals might impact on the competitiveness of the UK financial sector and also, lead to structures in pay that are not optimal. As we have seen with the introduction of CRD IV, there has been a significant shift from performance-related to fixed pay. We believe that this is an unwelcome development and are concerned that these proposals, without due consideration, may fuel this shift. The proposals may also have an impact on the risk appetite of banks so we need to clear that banks will not become too risk averse but will take appropriate decisions understanding the risks involved. Lastly, we also have to be careful that implementation of these proposals is not accompanied with an upward ratcheting of pay, particularly for banks, when expected values decrease with the additional conditions proposed. However, we are encouraged by RBS saying that so far there has been no material damage to RBS from a competitive point of view of having restricted bonuses to once times salary[1]

When the PRA/FCA's final proposals are produced it may be helpful to say that it is not expected that pay should increase to accommodate these proposals.

Bearing these reservations in mind, our answers to the specific questions are as follows:

Question 1 Do you agree with the principle of introducing a two-level approach for deferral, with longer deferral for senior managers?

Given the strategic overlap between senior managers and material risk-takers (MRTs) we suggest further alignment between senior management and MRTs deferral periods. Specifically, we suggest the deferral period be the same. It is likely that the MRTs will understand the risks better than the Senior Managers and Directors. This is another reason why we believe they should be subject to the same deferral requirements, as the risks originate from the MRTs.

We believe the development of a consistent remuneration approach should be a priority of the remuneration committee. The ultimate aim being achieving synergy between managing risk (with a view to the time horizon in which such risks may materialise) and incentivising.

Question 2 Do you agree with extending the deferral period to seven years for senior managers?

Although we agree that companies should be encouraged to defer a larger proportion of pay over a longer period, we would like to see a minimum of five years. It has been our long held view that where the long term vesting period is three years or less, there should be a longer deferral or holding period at the end of the vesting period in order to encourage Boards to look through to a longer period and through their business cycle.

In very exceptional circumstances, there may be good reason for shorter deferral periods but these should be very exceptional and explained to shareholders.

Question 3 Do you agree with introducing an additional requirement that no deferred variable remuneration should vest earlier than the third anniversary of award for senior managers?

Yes and this should apply to MRTs too. Our observation is that for remuneration reform to be effective it also needs to consider how to factor in the level of pay as well as its links with performance. For example, we have seen banks doubling base pay to make up for bonuses because the regulatory approach has focused on bonuses

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[1] Independent: The (fat) cat is out of the bag. RBS is thriving despite caps on bonuses. Reference to Leigh-Pemberton's answer to the question about the impact of the bonus restrictions on the business

Question 4 Do you agree that five years is an appropriate minimum requirement to apply to all other MRTs, bearing in mind the range of roles covered?

Yes and please see our answer to question one.

Question 5 Do you agree with the FCA's proposal to introduce a requirement for a minimum clawback period of seven years for all MRTs, in line with the PRA rule?

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Question 6 Do you agree with the proposal to introduce a requirement to provide for a possible extension of the clawback period of up to three years for Senior Managers if there are outstanding investigations underway at the end of seven years?

Yes this seems sensible alongside the proposition that companies should provide for an option to extend the clawback period by an further three years at the end of the period in the situations detailed in 3.5 (a & b). Furthermore, we would like to see consideration given to how long the long-term is dependent upon the sector.

Additionally, **w**e believe that claw-backs should be in relation to net and not gross reward given the complications involved in recovering taxable elements. It should be ensured that the use of claw-back mechanisms is not overly restrictive (i.e. they will be virtually unusable) and that remuneration committees have some discretion as to how and when to invoke them, with shareholders holding remuneration committees responsible for using or not using their discretion as appropriate. We would expect clawback to be used only in exceptional cases where malus is not available. Ideally, a healthy corporate culture would negate the need to utilise such provisions.

Question 7 Do you agree with the proposal to make explicit in the remuneration rules the presumption against payment or vesting of any discretionary payments, including entitlements to payment for loss of office and discretionary pension benefits?

Yes, in cases where the public are supporting banks this is an important principle. It is not difficult to understand the public's ire when bankers are paid significant amounts when the public are bailing them out. This will further reinforce the need for bankers to take appropriate risks that are understood.

Question 8 What do you see as the advantages and disadvantages of the approaches identified above?

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Question 9 What views do you have on the potential options for addressing the disadvantages of particular approaches?

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Question 10 What are the relative merits of pursuing the different approaches and any alternative approaches that might be identified?

We agree that this is a difficult area where none of the options is perfect.

If we were to start with a clean slate, we would favour banning buy-outs (option 1). However, buy-outs have become accepted practice in the market and banning buy-outs may compromise UK banks from competing with overseas competitors. Unless we are not concerned with competitiveness, the issue for us is how to ensure buy-outs are fair and appropriately structured.

Option 3, applying malus to bought-out awards, is our preferred option. We support the option for the awards to be held in trust with the former employer being able to reduce them if a malus event is found to have occurred. We also support the involvement of the regulator in any malus centric disciplinary procedure.

We see merit in option 4 too, in tandem to option 3. Given that the new robust clawback regime is only just being introduced this should be allowed to bed in before an assessment is given to introducing significant additional requirements. However, the potency of option 4 relies on sufficient remuneration having already been paid out and clarity that legal processes around clawback do not prevent this option from working effectively.

We should follow developments from the Netherlands where not only are they proposing bonus caps of 20% (not 100% under EU proposals) but also severance payments caps of 100% of base salary. Such rules would greatly reduce the excessive buy-out payments that we have seen in the past. Hopefully with the constraints on bank incentives future buy outs should be less egregious. There should be a principle that the new employer should not pay more than what is being given up at the previous employer.

Question 11 Do you agree with the proposal to require firms to use the above approach to ensure that the measure of profit used for determining variable remuneration is based on prudent valuation?

Prima facia we agree with the proposal. The fair value model has the potential to disproportionately overstate banks profitability and in turn overstating profit enabling excessive dividends to be paid. As the banks already have to report under the PRA's valuation regime it seems appropriate for remuneration calculations to be based on the same terms.

Question 12 Do you agree that there should be a rule that simple revenue or profit-based measures may not be relied on to determine variable remuneration at aggregate or individual level, except as part of a balanced and risk-adjusted scorecard?

We agree that the use of Return on Equity alone was not an appropriate incentive although we disagree that TSR need necessarily be a short term measure. TSR can be measured over the long term and it is over the long term that we believe TSR has the greatest value. Our preference is that long term TSR forms some part of the overall pay arrangements. We believe that over the longer term this is the least manipulable measure and takes into account operational performance including softer issues such as corporate governance and trust in the company. We also believe that no one measure is perfect . Importantly, it is the measure that most aligns company performance with shareholder returns and this is ultimately how all companies will be measured.

Subject to the above, we agree with the use of balanced scorecards so long as they are well structured. However, remuneration committees should have some flexibility to choose the measures and targets that are best suited to their company. These measures should be closely associated with the stated long term KPIs and objectives of the company. Our engagement and voting activities have long encouraged remuneration committees to use long-term strategic and sustainable KPIs as the basis of the composition of rewards.

Our view is that TSR is least manipulable over the longer term and will take into account operational performance. We also welcome the inclusion of material ESG (environmental, social and governance) performance measures, particularly for companies in high risk sectors. As with all performance measures these should be material to the business, clear and transparent with specified metrics and targets and measurable. However, we are mindful that performance on corporate ethics and corporate culture is often subjective. and may be hard to quantify as a KPI.

ESG considerations may be introduced via malus mechanisms, for example, if an individual has damaged the company's reputation through unethical behaviour, or if the company has poor health and safety records or customer complaints). ESG considerations may also be incorporated as a form of underpin whereby certain ESG standards need to have been met before payout, even if all the financial targets have been met.

To summarise, for banks we are not opposed to using a single balanced scorecard of metrics based on KPIs, over which (for executives) the remuneration committee may use its discretion, and which pays out predominantly in shares which must be held for the long term. However, long term TSR should have a material influence on overall long term performance outcomes.

Question 13 Do you agree that there should be an explicit rule that non-executive directors should not receive variable remuneration in respect of activity carried out in their roles as non-executives?

Yes we agree.

We would be delighted to discuss our submission further.

Yours Sincerely

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