



Association of British Insurers

EXECUTIVE REMUNERATION – ABI GUIDELINES ON POLICIES AND PRACTICES

14 December 2006

Foreword

The Guidelines are now in a clearer format with over-arching Principles, Main Provisions and more detailed Guidance. We have not introduced any significant changes. The substance of the Guidelines is largely unchanged and they are not more prescriptive.

The Guidelines are for companies with a main market listing, but are useful for others too. All companies are encouraged to observe the Guidelines in the spirit of best practice.

The Guidelines incorporate issues dealt with in more detail in the ABI/NAPF Statement on Executive Contracts and Severance. This document can be found on the IVIS website: www.ivis.co.uk. ABI and NAPF will be considering in due course whether any revisions to this paper would be appropriate.

We hope that the revised presentation of the Guidelines will help companies to anticipate the likely response of shareholders to remuneration proposals. The ABI and its members are always willing to discuss any cases where there may be doubt as to how these Guidelines should be applied.



Stephen Haddrill
Director General

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PRINCIPLES

Boards are responsible for adopting remuneration policies and practices that promote the success of companies in creating value for shareholders over the longer term. The policies and practices should be demonstrably aligned with the corporate objectives and business strategy and reviewed regularly.

Remuneration Committees should be established in accordance with the provisions of the Combined Code. They should comprise independent directors who bring independent thought and scrutiny to all aspects of remuneration. It is important to maintain a constructive and timely dialogue between boards and shareholders regarding remuneration policies and practices.

Executive remuneration should be set at levels that retain and motivate, based on selection and interpretation of appropriate benchmarks. Such benchmarks should be used with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.

Executive remuneration should be linked to individual and corporate performance through graduated targets, that align the interests of executives with those of shareholders. The resulting arrangements should be clear and readily understandable.

Shareholders will not support arrangements which entitle executives to reward when this is not justified by performance. Remuneration Committees should ensure that service contracts contain provisions that are consistent with this principle.

Section I

REMUNERATION COMMITTEES AND THEIR RESPONSIBILITIES

Main Provisions

Remuneration Committees are responsible for ensuring that the mix of incentives reflects the company's needs, establishes an appropriate balance between fixed and variable remuneration, and is based on targets that are stretching, verifiable and relevant. They should satisfy themselves as to the accuracy of recorded performance measures that govern vesting of variable and share-based remuneration.

They should establish effective procedures for disclosure and communication of strategic objectives, which enable shareholders to take an informed and considered view of remuneration policy and its implementation.

They should ensure that remuneration levels properly reflect the contribution of executives and be rigorous in selecting an appropriate comparator group. They should guard against unjustified windfalls and inappropriate gains arising from the operation of share incentive schemes and other associated incentives.

They should consider legal redress where performance achievements are subsequently found to have been significantly misstated so that bonuses and other incentives should not have been paid.

They should also pay particular attention to arrangements for senior executives who are not board members but have a significant influence over the company's ability to meet its strategic objectives.

Section II

GUIDANCE FOR BASE PAY, BONUSES, PENSIONS AND CONTRACTS AND SEVERANCE

1. BASE PAY AND BONUSES

Main Provisions

Remuneration Committees should ensure that base pay reflects the contribution of the executives concerned and be robust in setting and monitoring targets for bonuses. They should ensure that bonuses reflect actual achievements against these targets.

Any material payments that may be viewed as being ex-gratia in nature should be fully explained, justified and subject to shareholder approval prior to payment. Shareholders are not supportive of transaction bonuses that reward directors and other executives for effecting transactions irrespective of their future financial consequences.

Remuneration Committees should scrutinise all other benefits, including benefits in kind and other financial arrangements to ensure they are justified, appropriately valued and suitably disclosed.

Guidance

Base Pay

- 1.1 Remuneration Committees should ensure their policy on base pay is fully communicated to shareholders. Where a company seeks to pay salaries at median or above, justification is required.

Bonuses

- 1.2 Annual bonuses should be demonstrably related to performance. Both individual and corporate performance targets are relevant and should be tailored to the requirements of the business and reviewed regularly to ensure they remain appropriate.
- 1.3 Any share matching arrangements should be treated in accordance with relevant provisions under the Guidance for Share-Based Incentive Schemes. (see Paragraph 4.6)
- 1.4 Where consideration of commercial confidentiality may prevent a fuller disclosure of specific short-term targets at the start of the performance period, shareholders expect to be informed of the main performance parameters, both corporate and personal, for the financial year being reported on.

- 1.5 Following payment of the bonus, shareholders will expect to see a full analysis in the Remuneration Report of the extent to which the relevant targets were actually met.
- 1.6 Maximum participation levels should be disclosed and any increases in the maximum from one year to the next should be explicitly justified. Shareholders will expect increases to be subject to correspondingly more stretching performance.
- 1.7 Annual bonuses should not be pensionable.
- 1.8 Remuneration Committees should retain discretion to reduce or reclaim payments if the performance achievements are subsequently found to have been significantly misstated. Where there is doubt Remuneration Committees should work with the Audit Committee to ensure the basis of their decision is correct.

2. PENSIONS

Main Provisions

Remuneration Committees should recognise the impact that pension arrangements can have on the mix between fixed and variable pay. In setting an appropriate balance, they should bear in mind that pension entitlements may represent a significant and potentially costly item of remuneration that is not directly linked to performance.

Guidance

- 2.1 Shareholders expect there to be full disclosure of the extent to which actual and potential liabilities, such as pension promises or early retirements, are funded together with any aggregate outstanding unfunded liabilities.
- 2.2 There should be informative disclosure identifying incremental value accruing to pension scheme participation and any other superannuation arrangements. Pensions paid on early retirement should be subject to abatement.
- 2.3 Changes to transfer values, discretionary increases in pension entitlement, and significant changes in actuarial and other relevant assumptions, should be fully explained and justified.
- 2.4 Companies should recognise the risks of changes to future mortality rates and investment returns and consider how to limit the potential liability created by pension commitments.
- 2.5 Companies should not compensate individuals for changes in personal tax liabilities arising from changes to pensions taxation. Companies

may wish to consider whether there may be ways of delivering remuneration that are more cost-effective than a pension fund and more aligned with shareholder value creation.

3. CONTRACTS AND SEVERANCE

Main Provisions

Remuneration Committees should ensure that contracts protect the company from being exposed to the risk of payment in the event of failure.

The treatment of bonuses should be clear and a contractual link established between variable pay and performance. In the event of early termination there should be no automatic entitlement to bonuses or share-based payments.

Guidance

- 3.1 Remuneration Committees should ensure that the policy and objectives on directors' contracts are clearly stated in the Remuneration Report.
- 3.2 When drawing up contracts, Remuneration Committees should calculate the likely cost of any severance and determine whether this is acceptable. All payments made should be based upon performance in relation to objectives and take account of the overall financial circumstances of the company.
- 3.3 Companies should justify their policies on contractual protection. Contracts should commit companies not to pay for failure.
- 3.4 Phased payments are generally appropriate for fulfilling compensation on early termination.
- 3.5 Shareholders are less supportive of the liquidated damages approach which involves agreement at the outset on the amount that will be paid in the event of severance.
- 3.6 Remuneration Committees should ensure that full benefit of mitigation is obtained. This includes the legal obligation on the part of the outgoing director to mitigate the loss incurred through severance by seeking other employment and reducing the need for compensation.
- 3.7 Contracts should make clear that if a director is dismissed as a result of a disciplinary procedure, a shorter notice period than that given in the contract would apply.
- 3.8 Contracts should not provide additional protection in the form of compensation for severance as a result of change of control.

- 3.9 Pension entitlement on severance can represent a large element of cost to shareholders. Remuneration Committees should identify, review and disclose in their report any arrangements that guarantee pensions with limited or no abatement on severance or early retirement. These would not be regarded as acceptable if included in new contracts. Remuneration Committees should demonstrate that the route taken on severance represents the lowest overall cost to the company.

Section III

GUIDANCE FOR SHARE-BASED INCENTIVE SCHEMES

Main Provisions

Share-based incentives should align the interests of executive directors with that of shareholders and link reward to performance over the longer term. Vesting should therefore be based on performance conditions measured over a period appropriate to the strategic objectives of the company. This will not be less than, and may exceed, three years.

All new share-based incentives or any substantive changes to existing schemes should be subject to prior approval by shareholders by means of a separate and binding resolution. Their operation, rationale and cost should be fully explained so that shareholders can make an informed judgment.

The operation of share incentive schemes should not lead to dilution in excess of the limits acceptable to shareholders.

Executive share options should not be granted at a discount to the prevailing market price.

It is desirable to align the interests of chairmen and independent directors with those of shareholders, for example through payment in shares bought at market prices. However, shareholders consider it inappropriate for chairmen and independent directors to receive incentive awards geared to the share price or corporate performance that would impair their ability to provide impartial oversight and advice.

Shareholders encourage companies to require executive directors and senior executives to build up meaningful shareholdings in the companies for which they work.

Guidance

1. SCOPE

- 1.1 This Guidance applies to all share-based schemes whether option-based or involving conditional awards of shares, and including any arrangements whereby the value of an option gain will be paid either in the form of cash or shares (cash or share-settled share appreciation rights respectively).

2. REVIEW AND DISCLOSURE

- 2.1 Remuneration Committees should:

- regularly review share incentive schemes to ensure their continued effectiveness, compliance with the current Guidance and contribution to shareholder value;
- provide a statement in the Remuneration Report as to whether a review of the current share incentive schemes has been undertaken both as regards their operation, including how discretion has been exercised, and whether grant levels, performance criteria and vesting schedules which have been previously approved by shareholders remain appropriate to the company's current circumstances and prospects; and
- obtain prior shareholder authorisation for any substantive or exceptional amendments to scheme rules and practice including changes to limits and changes which make it easier to achieve performance targets, and where significant exercise of discretion is proposed by the Remuneration Committee.

- 2.2 Scheme and individual participation limits must be fully disclosed in share incentive schemes. Disclosure should, *inter alia*, cover performance conditions and related costs and dilution limits as set out in the relevant sections below. The reasons for selecting the performance conditions and target levels, together with the overall policy for granting conditional share or option awards, should be fully explained to shareholders.

3. GRANT POLICY

Phasing of Awards and Grants

3.1 The regular phasing of share incentive awards and option grants, generally on an annual basis, is strongly encouraged because:

- it reduces the risk of unanticipated outcomes that arise out of share price volatility and cyclical factors;
- it eliminates the perceived problem that a limit on subsisting options encourages early exercise;
- it allows the adoption of a single performance measurement period; and
- it lessens the possible incidence of ‘underwater’ options, where the share price falls below the exercise price.

The phased vesting of awards in specific tranches following the minimum three year performance measurement period is not an alternative to phased grants. However, it can help to enhance the linking of vesting of awards to sustained performance and maintain incentivisation.

4. PERFORMANCE

4.1 The desired alignment of interests is best achieved through the vesting of awards under share incentive schemes being conditional on satisfaction of performance conditions. Performance measures should be fully explained and be clearly linked to the achievement of challenging and stretching financial performance which will lead to enhancement of shareholder value.

Remuneration Committees should satisfy themselves that vesting of awards accord with these objectives.

4.2 Challenging performance conditions should:

- relate to overall corporate performance;
- demonstrate the achievement of a level of financial performance which is demanding and stretching in the context of the prospects for the company and the prevailing economic environment in which it operates;
- be measured relative to an appropriate defined peer group or other relevant benchmark; and
- be disclosed and transparent.

4.3 Threshold vesting amounts should not be significant by comparison to annual base salary. Furthermore, award structures with a marked ‘cliff-edge’ vesting profile are considered inappropriate, particularly where there may be clustering of performance outcomes around the average.

- 4.4 The vesting of awards with high potential value should be linked to commensurately higher levels of performance. Full vesting should be dependent upon achievement of significantly greater value creation than that applicable to threshold vesting. Companies should explain clearly how this is achieved, especially when annual grants of options in excess of one times salary, or equivalent long term share incentive awards, are made.
- 4.5 Sliding scales are a useful way of ensuring that performance conditions are genuinely stretching. They generally provide a better motivator for improving corporate performance than a 'single hurdle'.
- 4.6 Awards of matching shares arising from annual bonuses payable in the form of shares where these are held for a qualifying period, should be subject to the satisfaction of performance criteria prior to the vesting of the matching element. (see Paragraph 1.3 – Guidance for Base Pay, Bonuses, Pensions and Contracts and Severance)
- 4.7 Comparator groups used for performance purposes should be both relevant and representative. Where only a small number of companies are used for a comparator group, Remuneration Committees should satisfy themselves that the comparative performance will not result in arbitrary outcomes which are inconsistent with this Guidance. Awards should not vest for less than median performance.

Performance Criteria

- 4.8 Total Shareholder Return (TSR) relative to a relevant index or peer group is one of a number of generally acceptable performance criteria. However, Remuneration Committees should satisfy themselves prior to vesting that the recorded TSR or other criterion is a genuine reflection of the company's underlying financial performance, and explain their reasoning.
- 4.9 Where TSR is used as a performance criterion and the chosen comparator group includes companies listed in overseas markets, it is essential that TSR be measured on a consistent basis. The standard approach should be for a common currency to be used. Where there are compelling grounds for the calculation to be based on local currency TSR of comparator group companies, then the reasons for choosing this approach should be fully explained.
- 4.10 The definition of Earnings Per Share (EPS) or any other financial measure should fully reflect the performance of the business on a consistent basis in respect of the measurement period.
- 4.11 Shareholders need to have sufficient data to judge the appropriate size of the award for any given performance level. They also expect a maximum level of grant to be disclosed.

- 4.12 The setting of a premium exercise price is not of itself a substitute for the adoption of relative performance conditions in accordance with this Guidance.

Retesting

- 4.13 It is recognised that any retesting of performance conditions for all share-based incentive schemes is unnecessary and unjustified.

5. COST AND BASIS OF PARTICIPATION

Cost

- 5.1 The following information should be disclosed in order that shareholders can make a judgment about total cost:

- The potential value of awards (see Appendix) due to individual scheme participants on full vesting. This should be expressed by reference to the face value of shares or shares under option at point of grant, and expressed as a multiple of base salary.
- The expected value (see Appendix) of the award at the outset, bearing in mind the probability of achieving the stipulated performance criteria.
- The maximum dilution which may arise through the issue of shares to satisfy entitlements.

- 5.2 There should be prudent and appropriate arrangements governing acquisition of shares, and financing thereof, to meet contingent obligations under share-based incentive schemes.

- 5.3 The use of phased grants of share options and restricted shares, and utilisation of both new and purchased shares to satisfy the vesting of awards, requires a comprehensive approach to valuation. Assessment should focus on expected value, which should be disclosed, and it should take account of the performance vesting schedule which is adopted as well as the existence of any 'retesting' and 'replacement option' facilities such as have been prevalent under traditional schemes. Shareholders are helped in this task by disclosure of face value of any share award or option grant as well as of expected value.

Vesting of Awards

- 5.4 Remuneration Committees should consider the use of performance measurement periods of more than 3 years and deferred vesting schedules, in order to motivate the achievement of sustained improvements in financial performance.

- 5.5 Where LTIP awards are made over whole shares¹, a better alignment of interest with shareholders will be achieved if, in respect of those shares that do vest, equivalent value to that which has accrued to shareholders by way of dividends during the period from date of grant also vests in the hands of LTIP recipients. To the extent that the shares conditionally awarded do not vest then nor should any scrip or cash amounts representing the rolled-up dividends.
- 5.6 Remuneration Committees should ensure that the size of grants made on this basis takes into account reasonable expectations as to the value of the dividend stream on the company's shares over the period to vesting. Where the facility for rolled-up dividends is introduced a smaller initial grant size is required in order to target a similar level of value in the conditional share award.

Performance on Grant

- 5.7 Shareholders expect that future performance should govern the vesting of options or share awards. Performancing at point of grant is generally not considered a suitable alternative.

Change of Control Provisions

- 5.8 Scheme rules should state that there will be no automatic waiving of performance conditions either in the event of a change of control or where subsisting options and awards are 'rolled over' in the event of a capital reconstruction, and/or the early termination of the participant's employment. Remuneration Committees should use best endeavours to provide meaningful disclosure that quantifies the aggregate payments arising on a change of control.
- 5.9 Shareholders expect that the underlying financial performance of a company that is subject to a change of control should be a key determinant of what share-based awards, if any, should vest for participants. Remuneration Committees should satisfy themselves that the performance criterion genuinely reflects a robust measure of underlying financial achievement over any shorter time period. They should explain their reasoning in the Remuneration Report or other relevant documentation sent to shareholders.
- 5.10 Where share incentive awards vest early as a consequence of a change of control, awards should vest on a time pro-rata basis i.e. taking into account the vesting period that has elapsed at the time of change of control.

¹ This term covers awards structured in the form of either 'restricted shares' or 'nil-cost options'.

Participation

- 5.11 Participation in share incentive schemes should be restricted to bona-fide employees and executive directors, and be subject to appropriate limits for individual participation which should be disclosed.
- 5.12 There should be no absolute right of participation in share incentive schemes. Grant policy should be disclosed and consistently applied and, within the limits approved by shareholders, reflect changing commercial and competitive conditions. In the event of declining share price levels it is particularly important to avoid unjustified increases in the actual number of shares or options awarded.
- 5.13 Participation in more than one share incentive scheme must form part of a well-considered remuneration policy, and should not be part of a multiple arrangement designed to raise the prospects of payout.

6. PRICING AND TIMING

Pricing of Options and Shares

- 6.1 The price at which shares are issued under a scheme should not be less than the mid-market price (or similar formula) immediately preceding grant of the shares under the scheme.
- 6.2 Options granted under executive (discretionary) schemes should not be granted at a discount to the prevailing mid-market price.
- 6.3 Repricing or surrender and regrant of awards or 'underwater' share options is not appropriate.

Timing of Grant

- 6.4 The rules of a scheme should provide that share or option awards normally be granted only within a 42 day period following the publication of the company's results.

7. LIFE OF SCHEMES AND INCENTIVE AWARDS

- 7.1 No awards should be made beyond the life of the scheme approved on adoption by shareholders, which should not exceed 10 years.
- 7.2 Shares and options should not vest or be exercisable within three years from the date of grant. In addition, options should not be exercisable more than 10 years from the date of grant.
- 7.3 Options or other conditional share awards are normally granted in respect of the year in question and in expectation of service over the performance measurement period of not less than 3 years.

- 7.4 Where individuals choose to terminate their employment before the end of the service period, or in the event that employment is terminated for cause, any unvested options or conditional share-based award should normally lapse.
- 7.5 In other circumstances of cessation of employment¹, it is to be expected that some portion of the award will vest, to the extent of the service period that has been completed but subject to the achievement of relevant performance criteria. In general the originally stipulated performance measurement period should continue to apply. However, where in the opinion of the Remuneration Committee, early vesting is appropriate, or where it is otherwise necessary², awards should vest by reference to performance criteria achieved over the period to date.
- 7.6 Where options vest, in the event of death or cessation of employment of the option holder or where a company is taken over (except where arrangements are made for a switch to options of the offeror company), or where they have already vested at the time of such event, they must be exercised (or lapse) within 12 months. Where the performance measurement period applicable to an option extends beyond the point of cessation of employment as provided for by Paragraph 7.5 above, options must be exercised within 12 months of vesting following the end of the performance measurement period.
- 7.7 Any shares or options that a company may grant in exchange for those released under the schemes of acquired companies should normally be taken into account for the purposes of dilution and individual participation limits determined in accordance with this Guidance.

8. DILUTION

- 8.1 The rules of a scheme must provide that commitments to issue new shares or re-issue treasury shares, when aggregated with awards under all of the company's other schemes, must not exceed 10% of the issued ordinary share capital (adjusted for share issuance and cancellation) in any rolling 10 year period. Remuneration Committees should ensure that appropriate policies regarding flow-rates exist in order to spread the potential issue of new shares over the life of relevant schemes in order to ensure the limit is not breached.
- 8.2 Commitments to issue new shares or re-issue treasury shares under executive (discretionary) schemes should not exceed 5% of the issued ordinary share capital of the company (adjusted for share issuance and cancellation) in any rolling 10 year period. This may be exceeded

¹ Such circumstances may include disability, ill health, redundancy, retirement or analogous reasons for departure of a 'good leaver' nature.

² Such circumstances may include death and also occasions such as takeover of the company or sale or transfer of the business undertaking where awards are not being rolled over into equivalent awards in the successor entity or new employer.

where vesting is dependent on the achievement of significantly more stretching performance criteria.

- 8.3 The implicit dilution commitment should always be provided for at point of grant even where, as in the case of share-settled share appreciation rights, it is recognised that only a proportion of shares may in practice be used.
- 8.4 For small companies, up to 10% of the ordinary share capital may be utilised for executive (discretionary) schemes, provided that the total market value of the capital utilised for the scheme at the time of grant does not exceed £1,000,000.

9. JOINT VENTURE COMPANIES AND SUBSIDIARY COMPANIES

- 9.1 Shareholders generally consider it undesirable for options and other share-based incentives to be granted over the share capital of a joint venture company.
- 9.2 Discretionary grants over shares of a subsidiary company should only be made in exceptional circumstances. Where companies can justify doing so in terms of contribution to overall value creation, shareholders may consider exceptions subject to the following:
- Participation in subsidiary company schemes is restricted to those whose time is fully allocated to that subsidiary. Parent company directors should not participate in such schemes.
 - There is full disclosure of the accounting treatment used when recognising the cost of option or share awards.
 - Grants of options or share awards are subject to appropriately challenging performance criteria.
 - Dilution limits relating to the subsidiary company should be disclosed in the context of parent company dilution limits.
 - The methodology for valuing the subsidiary company shares and in the case of option awards the measurement of volatility of those shares should be disclosed. The party responsible for the valuation process should also be disclosed.
 - Any entitlement or obligation to convert subsidiary company shares to parent company shares should be disclosed.
- 9.3 Shareholders may consider further exceptions where the condition of exercise is subject to flotation or sale of the subsidiary company. In such circumstances, grants should be conditional so that vesting is dependent on a return on investment that exceeds the cost of capital and that the market value of the shares at date of grant is subject to external validation.
- 9.4 Exceptions will apply in the case of an overseas subsidiary company where required by local legislation, or in circumstances where at least

25% of the ordinary share capital of the subsidiary company is listed and held outside the group.

10. ESOTs AND ALL-EMPLOYEE SCHEMES

Employee Share Ownership Trusts - ESOTs

- 10.1 ESOTs should not hold more shares at any one time than would be required in practice to match their outstanding liabilities, nor should they be used as an anti-takeover or similar device. Furthermore an ESOT's deed should provide that any unvested shares held in the ESOT shall not be voted at shareholder meetings. The prior approval of shareholders should be obtained before 5% or more of a company's share capital at any one time may be held within ESOTs.
- 10.2 Where companies have provided for an ESOT to be used to meet scheme requirements, they should disclose the number of shares held by the ESOT in order to assist shareholders with their evaluation of the overall use of shares for remuneration purposes. The company should explain its strategy in this regard.

All-Employee Schemes

- 10.3 All-Employee schemes, such as SAYE schemes and Share Incentive Plans (SIPs) - (formerly known as AESOPs), should operate within an appropriate best practice framework. If newly issued shares are utilised, the overall dilution limits for share schemes should be complied with. The Guidance relating to timing of grants (except for pre-determined regular appropriation of shares under SIPs) applies.

APPENDIX

Potential Value of the Award

Shareholders are likely to have regard to the potential value of the award assuming full vesting. This should be expressed on the basis that a conditional award is made of shares, or options over shares, with a face value, at current prices, equal to a given percentage of base salary. However the potential value will also be a function of share price at the time of vesting and of illustrative disclosures of potential outcomes may also be helpful. Full vesting of awards of higher potential value should require the achievement of commensurately greater performance.

Expected Value

The concept of Expected Value (EV) should be central to assessment of share incentive schemes. Essentially, EV will be the present value of the sum of all the various possible outcomes at vesting or exercise of awards. This will reflect the probabilities of achieving these outcomes and also the future value implicit in these outcomes. The calculation of the EV of share schemes relies on a range of assumptions, and reliance on this concept by Remuneration Committees will require a sufficient measure of disclosure to enable shareholders to make informed judgments about such arrangements.

The nature of performance hurdles governing exercise is also crucial to calculations of EV and it must also be recognised that any facility for 'retesting' will also increase the EV of the award whereas in contrast if the exercise price is set at a premium to the share price at the outset, this will reduce the value of the EV of the instrument.

Shareholders welcome efforts towards ensuring that accounting for share options and other share-based payment awarded under incentive schemes fully reflects the true cost to shareholders.

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