

FSA publishes final Remuneration Code of Practice

Financial services compensation

12 August 2009

Earlier today the Financial Services Authority (FSA) published its final remuneration Code of Practice, thereby becoming the first regulator to implement final guidance in this area.

Feedback on the consultation process and the final Code of Practice is available on the FSA website:

http://www.fsa.gov.uk/pages/Library/Policy/Policy/2009/09_15.shtml

Introduction

The FSA's journey towards reforming financial services remuneration practices, which started in May 2008, has reached an important stage with the publication of a final Code of Practice and associated Handbook changes. The final Code Principles are set out in the Appendix.

This represents a major development in financial services remuneration. It is easy to forget that as recently as the summer of 2008, when we carried out our major research study into the role of remuneration in the financial crisis *Reward: A New Paradigm?*, only 13% of respondents identified regulation as a key force for change.

FSA Policy Statement and Code of Practice

- The scope is initially limited to around 26 banks, building societies and broker dealers with significant UK regulatory capital. A progress report on extending the Code will follow in October 2009.
- Compliance with the Handbook rule for remuneration arrangements will be required from 1 January 2010.
- The general requirement is unchanged from the draft code: "A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with effective risk management."
- Principles relating to governance, risk adjustment and performance measurement are virtually unchanged from the draft code and will apply to the remuneration for all employees.
- A single principles-based requirement that the structure of remuneration is consistent with and promotes effective risk management is established. This principle is to apply to employees performing a significant influence function or who could have a significant material impact on the firm's risk profile and replaces the previous principles 8 to 10 of the draft Code.
- Explicit guidance has been added that guaranteed bonuses of more than one year are likely to be inconsistent with the Code.
- Firms must amend or terminate non-compliant binding agreements with employees by 31 December 2010 and adopt specific risk-mitigation mechanisms in the meantime.
- By 1 January 2010, firms must initiate a review of how risk is taken into account in long-term performance measures.
- Remuneration committee chairs will be required to report to the FSA, by the end of October 2009, on how the firm will comply with the Code. Firms will also be expected to assess their exposure to remuneration risk.

No real surprises

It is widely accepted that the role of compensation in risk management needs to be taken seriously. Therefore, it is no surprise that the general requirement, which will form the new Handbook Rule relating to remuneration, is unchanged from the draft Code: "A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management."

There are a few minor amendments (generally sensible clarifications) of the seven principles on governance, performance measurement and risk-adjustment. However, the provisions relating to compensation structure and deferral may be perceived as having been diluted, with a principles-based requirement adopted into the Code. However, we agree this is the appropriate approach given the different rates of progress by regulators globally.

At over 60 pages including appendices, the Policy Statement is not short. In addition to setting out the Code's Principles it also provides extensive commentary which gives insight into the FSA's thinking and, therefore, how they might approach discussions and enforcement with firms.

For example, there is some interesting commentary relating to shareholders. The FSA states that shareholders should challenge the model whereby firms accrue bonus pools ahead of making an economic profit for shareholders. In addition, the commentary gives some indication of what the FSA will consider to be an acceptable funding policy. The FSA indicates that allowing bonuses to result in negative economic profit for shareholders will limit a bank's ability to attract new investment and so imperil their resilience. This indicates that risk adjustment goes beyond taking economic profit into account, and extends to fundamental redrawing of funding policy, basing funding ratios directly on economic profit rather than revenues.

The commentary on long-term performance measures is interesting. The FSA clearly still feels uncomfortable about the widespread use of earnings per share (EPS) and total shareholder return (TSR) in the banking sector. In our opinion, they are right to do so. Our analysis has shown that neither measure is effective at aligning remuneration with sound risk management. Given the overlap with shareholder approval requirements the FSA has proceeded more cautiously in this area than others. The FSA is requiring firms to "initiate a review" of their long-term measures and to discuss timetables for change with the FSA. In the meantime, the FSA will continue to discuss the issue with bodies such as the Association of British Insurers.

Even with the more principles-based approach to compensation structures, implementation of the Code in full will cause significant change in practices in the industry. Key to this change will be how rigorously the FSA enforces the provisions - the FSA states that they will "follow this through with determination" during the supervisory process.

Outlook

The FSA has moved to become the first major regulator to implement new rules on remuneration following the credit crisis. At least the waiting is now over, and firms have a clear framework against which to plan. Most firms, who will initially be subject to the Code, are already far advanced in their scenario planning. Those that have yet to start now need to move rapidly given that submission of the first Remuneration Policy Statement is little more than ten weeks away. All other financial services organisations have a clear benchmark against which remuneration arrangements will be measured. For many FSA regulated organisations they can expect this benchmark to be used when assessing remuneration risk as part of the advanced risk response operating framework (ARROW) process. In any case, the extension of the Code is likely to be just a matter of time.

The case for change

In the Policy Statement the FSA reiterates the fundamental case for regulation. While remuneration is cited as a contributory, rather than dominant, factor behind the market crisis, the FSA continues to believe that fundamental change in compensation structures is necessary to avoid future crises. They report little dissent to this view from the consultation process.

It is worth recalling the issues identified with current practice by the FSA, as they are an indication of the areas the FSA will focus on when reviewing firms' arrangements.

Example of problems observed with current practice

- Remuneration is too short term and not risk adjusted
- Bonus accrual not allowing for generation of economic profit for shareholders
- Reliance on non risk-adjusted metrics such as EPS
- Conflicts of interest in remuneration of risk and compliance
- Insufficient weight to non-financial measures of performance
- Bonuses paid almost entirely in cash with little deferment
- Few examples of linking deferred bonus to performance

The FSA notes that in the consultation responses nearly all institutions maintained that they were already broadly compliant with the Code. However, the FSA makes an interesting comment which perhaps should give cause to resist complacency: "in our experience ... the policies and practices of many firms exhibit significant weaknesses and are inconsistent with effective risk management". This suggests that many firms may be subject to challenging discussions with the FSA.

Scope of the Code

The scope of the Code has been altered in respect of both the firms and employees covered.

The definition of firms has been amended broadly to exclude small UK operations of large overseas banks and broker dealers. A firm now has to have a large UK-regulated presence in its own right to fall within the remit of the Code. A firm will be covered by the Code if it:

- Is a UK bank or building society that had capital resources exceeding £1 billion on its last accounting reference date; or
- Is a BIPRU 730k firm that had capital resources exceeding £750 million on its last accounting reference date; or
- Is a full credit institution, a BIPRU 730k firm or a third country BIPRU 730k firm, which is part of a group and on the last accounting reference date capital resources held within the group exceeded £1 billion by UK banks or building societies or £750 million by BIPRU 730k firms

The rule was originally drafted to prevent small subsidiaries of large overseas parents gaining competitive advantage by not being subject to the rules. The FSA now feels that the amendments to the Code reduce the competitive disadvantage that would apply. The effect is to reduce the organisations covered from over 40 to an estimated 26.

The FSA has reiterated that they will increase the focus on remuneration within their supervisory programmes for all FSA-authorized firms by incorporating remuneration risk into the ARROW process, albeit with a risk-based and proportionate approach. The Code provides the benchmark against which remuneration risk will be measured. In addition, those organisations not immediately covered by the Code should note that the FSA will announce in October 2009 its progress towards extending the Code.

The final Code has clarified the employees covered. In line with the Financial Stability Board's principles, the FSA has stated that Principles 1 to 7 (covering governance, risk-adjustment, and performance measurement) should apply to all employees. By contrast, Principle 8 (covering remuneration structure) applies only to: persons performing a significant influence function for a firm and employees whose activities have, or could have, a material impact on the firm's risk profile.

The implication of this requirement is potentially far-reaching. It will require organisations to take account of these Principles in relation to policy and governance across the entire organisation. There is likely to be greater onus on companies (and remuneration committees) to demonstrate that appropriate controls are in place to ensure remuneration across the firm is consistent with sound risk management.

International alignment

Throughout the consultation process concerns were raised about precipitate action on remuneration putting the UK at a competitive disadvantage. The FSA acknowledges that progress towards internationally consistent implementation is slow, and that the FSA (plus perhaps one or two other countries) will be implementing at least a year ahead of others. The FSA will report in Q3 2010 on an assessment of the effectiveness of the Code and with an update on international implementation. The Code may be amended to take account of this progress and any future market developments.

Lack of international alignment has caused the one major shift in the Code of Practice, relating to Principles 8 to 10 of the draft Code. In summary these principles required that:

- firms should operate a fully flexible bonus policy (i.e. be able to pay zero bonus);
- the majority of any significant bonus should be deferred; and
- deferred bonus should be linked to the performance of the firm and division or business unit

The FSA has acknowledged that retaining these requirements would put the Code out of line with international practice, and out of line in areas that could have a significant impact on competitiveness of the UK. Therefore, they have replaced all three principles by a single principle that:

“A firm should ensure that the structure of remuneration for a person to whom this evidential provision applies is consistent with and promotes effective risk management.”

As mentioned above, this Principle only applies to individuals in a role associated with significant influence or material risk.

Given the possibility of the FSA being out of line with other major regulators the move to a more principles-based approach on this issue is sensible. From a UK perspective, however, it is striking that the FSA has become more principles-based just a few weeks after a very prescriptive recommendation on deferrals arising from the Walker Review.

The original prescriptive wording on the amount of deferrals has been retained, but now forms part of the Guidance to the new Principle 8. Guidance is not legally enforceable, but it will be interesting to see how much weight the FSA attaches to it in its discussion with firms.

Implementation of policies to support effective risk management

The FSA has set out what it expects from enactment of a remuneration policy that supports effective risk management:

- Identify incentives created by remuneration policies at firm and individual level.
- Consider risks (across all risk categories) created by behaviours incentivised.
- Consider whether those risks fall within the firm's overall risk tolerance.
- Redesign if incentives contribute to firm exceeding risk tolerance.
- Set up procedures and controls to ensure that policies are implemented in practice.
- Communicate incentives to employees to reinforce desired behaviours.
- Set up management information systems to ensure effective monitoring of outcomes.
- Check that remuneration policies have delivered the desired behaviours and outcomes.

This is mostly self-evident, although a couple of points of interest stand out.

First is the idea, which we have long-argued for, that risk-adjustment needs to be viewed in the context of the firm's risk strategy and appetite. There is a danger in the current environment leading to a climate of risk-eradication. Risk is an integral part of financial services businesses - the aim must be to ensure that the *right* risks are being taken.

Second, the steps emphasise that remuneration committees must monitor and review the effectiveness of policies.

Third, the explicit mention of communication is interesting. The FSA rightly identify that the best designed compensation plans will fail in the absence of appropriate communication.

Transition

The original implementation date of 6 November has been pushed back to 1 January 2010. This is helpful, since the original date introduced confusion about exactly what was required in relation to which year's compensation.

The FSA accepts that firms may have entered into binding contracts with employees that are not consistent with the Code's general requirement, and which will extend beyond the implementation date of 1 January 2010. The Code distinguishes between:

- arrangements where the firm has the ability to amend the commitment, in which case it must do so by March 2010; and
- other arrangements, in which case the firm must:
 - take reasonable steps to amend the obligation or terminate the arrangement at the earliest opportunity and in any case no later than 31 December 2010; or
 - adopt specific and effective arrangements, processes, and mechanisms to manage the risks raised by the obligation.

The easement only applies to contracts entered into prior to 18 March 2009. By implication any non-compliant commitment entered into after 18 March will give rise to an immediate breach from 1 January 2010. This has an important consequence. The Guidance relating to the new Principle 8 states that guaranteed bonuses in excess of one year are likely to be inconsistent with that Principle. Therefore, any multi-year guarantee entered into after 18 March will, on the face of it, cause an immediate failure to comply with the general requirement of the new Handbook rule immediately on 1 January 2010.

It remains open to firms to explain how they comply with the general requirement even if they are not complying with individual Evidential Principles. However, the onus will be on firms to explain the mitigating factors that enable them to meet the general requirement notwithstanding the existence of multi-year guarantees.

Finally, the transition arrangements require that by 1 January 2010 a firm should at least have initiated a review of the extent to which the measurement of performance for any existing long-term incentive plans takes account of future risks. The FSA may discuss the timing of that review and any remedial action with the firm.

The extent of required compliance by 1 January 2010 is summarised below for each of the principles:

Principle	Compliance Requirement
1. Role of remuneration committees	Evidence of plan to implement by 1 Jan 2010
2. Procedures and risk and compliance input	Full compliance from 1 Jan 2010
3. Remuneration of risk and compliance	
4. Risk adjustment	
5. Long-term performance measurement	
6. Non-financial performance metrics	
7. Performance measurement for long-term incentives (LTIs)	Review initiated by 1 Jan 2010
8. Remuneration structures	Full compliance from 1 Jan 2010

Reporting

As expected the Code enables the FSA to ask for a remuneration Policy Statement. This is likely to be the primary vehicle by which pressure is initially brought to bear to ensure compliance with the Code for 2010.

The request for a first remuneration Policy Statement will be issued at the end of August, with a requirement for submission by the end of October. The FSA will issue more detail on what is required in this report, but they have indicated outline contents in the Policy Statement.

During November to February, the FSA will meet with remuneration committee member(s) (most likely the chair) together with senior representation from HR and risk. For overseas parented organisations this may either refer to the parent company remuneration committee or, if one is in place, the UK remuneration committee. There is likely to be a follow-up request for a statement covering what was actually done by the firm in 2009 at some point towards the end of the first quarter of 2010 before moving to a Q1 annual reporting cycle to obtain timely information on firms' policies.

.Outline contents of remuneration Policy Statement

Principles of remuneration policy and assessment of implications for the firm's risk profile

- Principles of the remuneration policy and how it is applied to employees according to seniority, business line, and function
- Intended impact on employee behaviours and on the risk profile of the firm. Link to and consistency with firm's strategy and business plan
- How remuneration policies are communicated to staff

Remuneration practices in 2009

- Selected data on remuneration practices in the year to end-September 2009

Remuneration policies, procedures and practices in 2010: compliance with the Code

- Information on proposed remuneration policies in 2010, referenced to each of the Evidential Provisions and associated guidance in the Code
- In presenting the information, a firm should include a statement stating whether it expects to comply with the General Rule through compliance with each of the Principles of the Code. If it does not intend to comply with one or more of the principles, the remuneration statement should state what the firm intends to do in lieu of compliance, and why this course of action is consistent with and promotes effective risk management

We expect the FSA to ask specific questions under each of these headings. In particular, firms will need to have a good assessment of how all material risks are reflected in compensation and, where they are not, what mitigating factors are in place.

The contents of the report will be subject to confidentiality arrangements, and the FSA has clarified that it was not the intention that this report be made public. However, firms are encouraged to consider how their reporting to shareholders could be enhanced in relation to risk.

Interaction with Walker Review

The Walker Review is referred to on several occasions in the Policy Statement. In several areas the two documents are complementary, in particular they agree on:

- focus on structure of remuneration rather than quantum;
- wider remit for remuneration committees;
- enhanced expectations on involvement and experience of non-executive directors;
- interaction between remuneration committee, risk and audit committees; and
- role for increased deferral in compensation systems.

Of course, there are areas of the Walker Review relating to disclosure and accountability to shareholders which are not specifically within the FSA's remit. However, the Walker Review is referred to in generally supportive terms, and indeed it is stated that the FSA will in due course review whether to incorporate the Walker recommendations on remuneration in some way into a revised Code of Practice.

In practice we think this is unlikely. There is already significant overlap in the areas that the FSA will view as central to its remit. In other areas – such as for example disclosure and relations with shareholders – the FSA is unlikely to see itself as having a locus.

One area of particular interest is that of deferral. At just the time when the FSA has reduced the level of prescription in the Code in relation to deferral, the Walker Review has gone to the opposite extreme with a very prescriptive recommendation.

Overall we believe that, in the area of remuneration design and oversight, the FSA Code will be the dominant force shaping requirements for UK banks. The Walker Review will be most influential in areas of overall governance and relations with shareholders.

Appendix – Changes from the draft Code and a summary of the eight principles

A number of other changes have been made to the Evidential Principles which are worth noting. They are summarized below. Changes can be viewed in detail in Appendix 1 where we present a line-by-line comparison of the Final and Draft Codes.

Principle	Noteworthy modifications
1. Role of remuneration committees Risk experience of committee can be increased by have a member of risk or audit committee sit on remuneration committee	For overseas entities, remuneration committee can be that of overseas parent Risk experience of committee can be increased by having a member of risk or audit committee sit on remuneration committee
2. Procedures and risk and compliance input	Role of risk now to be “appropriate” rather than “significant” – although Guidance makes clear that in some cases it will be appropriate for the involvement of risk to be significant
3. Remuneration of risk and compliance	Performance metrics now to be based “principally” on functional objectives to allow some participation in business results of their business unit or division, recognizing the importance of risk and compliance being an integral part of the team
4. Risk adjustment	No material change
5. Long-term performance measurement	Principle restricted to cases where performance-related component of compensation is a significant part of the total (i.e. no need to smooth performance for lower-paid staff)
6. Non-financial performance metrics	No material change
7. Performance measurement for LTIs	No material change, although slight nuance introduced to differentiate between EPS and TSR
8. Remuneration structures	Three principles collapsed into one general principle – see earlier discussion

Below is a summary of the Code's Principles and evidential provisions.

Principle	Evidential provisions
1. Role of bodies responsible for remuneration policies and their members	<p>A remuneration committee should:</p> <p>(a) exercise, and be constituted in a way that enables it to exercise, independent judgment;</p> <p>(b) be able to demonstrate that its decisions are consistent with a reasonable assessment of the firm's financial situation and future prospects;</p> <p>(c) have the skills and experience to reach an independent judgment on the suitability of the policy, including its implications for risk and risk management; and</p> <p>(d) be responsible for approving and periodically reviewing the remuneration policy and its adequacy and effectiveness</p>
2. Procedures and risk and compliance function input	<p>Procedures for setting remuneration within a firm should be clear and documented, and should include appropriate measures to manage conflicts of interest.</p> <p>A firm's risk management and compliance functions should have appropriate input into setting the remuneration policy for other business areas. The procedures for setting remuneration should allow risk and compliance functions to have significant input into the setting of individual remuneration awards where those functions have concerns about the behaviour of the individuals concerned or the riskiness of the business undertaken.</p>
3. Remuneration of employees in risk and compliance functions	<p>Remuneration for employees in risk management and compliance functions should be determined independently of other business areas.</p> <p>Risk and compliance functions should have performance metrics based principally on the achievement of the objectives of those functions.</p>
4. Profit-based measurement and risk-adjustment	<p>Assessments of financial performance used to calculate bonus pools should be based principally on profits.</p> <p>A bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required</p>

5. Long-term performance measurement	Where the performance-related component of an employee's remuneration is a significant part of his total remuneration, the assessment process should be designed to ensure assessment is based on longer-term performance.
6. Non-financial performance metrics	Non-financial performance metrics should form a significant part of the performance assessment process. Non-financial performance metrics should include adherence to effective risk management and compliance with the regulatory system and with relevant overseas regulatory requirements.
7. Measurement of performance for long-term incentive plans	The measurement of performance for long-term incentive plans, including those based on the performance of shares, should take account of future risks.
8. Remuneration structures	A firm should ensure that the structure of remuneration for a person to whom this evidential provision applies is consistent with and promotes effective risk management.

Contacts

We have extensive experience in helping clients in all of these areas referred to in this briefing. If you would like assistance in planning or executing your thinking then please contact your usual PricewaterhouseCoopers adviser or alternatively one of the people listed below:

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