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FSA draft code on remuneration practices

This draft Code sets out the main rules, evidential provisions and guidance on remuneration which the FSA is proposing to incorporate into its Handbook. It is a revised version of the Code originally published on 26 February 2009. It will not apply until the FSA's final Code is approved and implemented. If the proposal goes ahead, we currently plan to publish the final version in late July 2009 with the Code in force from November 2009. Until then, firms should regard the code as a benchmark for good practice, building on our October 2008 'Dear CEO' letter.

This Code applies directly to the larger banks and broker dealers (for a full definition of the scope please see CP 09/10, Appendix 1, SYSC 19.1.1R). The FSA encourages all firms to review their compensation policies against the general requirement and the principles in this Code.

Glossary

General requirement: A rule that must be complied with by firms to which the Remuneration Code applies. Breach of a rule can lead to enforcement action.

Remuneration principles: Each remuneration principle is an *evidential provision*, a type of rule that has evidential value in showing that another rule has been breached or complied with. Compliance with evidential provisions in the Remuneration Code tends to show compliance with the general requirement. Non-compliance with an evidential provision in the Remuneration Code tends to show non-compliance with the general requirement. Each remuneration principle is highlighted and followed by guidance on that principle.

Rules and evidential provisions are highlighted and are followed by *guidance*.

Guidance: Guidance may be used to explain the implications of other provisions, to indicate possible means of compliance, to recommend a particular course of action or arrangement and for other purposes. Guidance is generally designed to throw light on a particular aspect of regulatory requirements, not to be an exhaustive description of firms' obligations.

Remuneration committee: a committee or other body responsible for a firm's remuneration policy.

Remuneration policy: the policy, procedures and practices established, implemented and maintained in accordance with the Remuneration Code's general requirement

General requirement

Remuneration policies must be consistent with effective risk management

Proposed Rule:

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A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management

Proposed Guidance:

If a firm's remuneration policy is not aligned with effective risk management it is likely that employees will have incentives to act in ways that might undermine effective risk management

The aim of the Remuneration Code is to ensure that firms have risk-focused remuneration policies, which are consistent with and promote effective risk management and do not expose them to excessive risk. It expands upon the general organisational requirements in SYSC 4.

The Remuneration Code covers all aspects of remuneration that could have a bearing on effective risk management including wages, bonus, long term-incentive plans, options, hiring bonuses, severance packages and pension arrangements. In applying the Remuneration Code, a firm should have regard to applicable good practice on remuneration and corporate governance, such as guidelines on executive contracts and severance produced by the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF).

As with other aspects of a firm's systems and controls, what a firm must do in order to comply with the Remuneration Code will vary according to the nature, scale and complexity of the firm and its activities.

The principles in the Remuneration Code will be used by the FSA to assess the quality of a firm's remuneration policies and whether they encourage excessive risk-taking by a firm's employees.

The FSA may also ask remuneration committees to provide the FSA with evidence of how well the firm's remuneration policies meet the Remuneration Code's principles, together with plans for improvement where there is a shortfall. The FSA will also expect relevant firms to use the principles in assessing their exposure to risks arising from their remuneration policies as part of the internal capital adequacy assessment process (ICAAP).

The Remuneration Code is concerned with the risks created by the way remuneration arrangements are structured, not with the absolute amount of remuneration, which is a matter for firms' remuneration committees.

Remuneration principles

Principle 1: Role of bodies responsible for remuneration policies and their members

Proposed Evidential Provisions:

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A remuneration committee should:

- (a) exercise, and be constituted in a way that enables it to exercise, independent judgment;**
- (b) be able to demonstrate that its decisions are consistent with a reasonable assessment of the firm's financial situation and future prospects;**
- (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**
- (d) be responsible for approving and periodically reviewing the remuneration policy and its adequacy and effectiveness.**

Proposed Guidance:

Remuneration is usually the largest cost incurred by firms after funding costs. The risks arising from the way employees are recruited and managed, including the risks posed by remuneration policies, constitute some of the most important risks faced by firms. Remuneration committees should pay specific attention to these risks.

While industry comparators may be relevant in setting remuneration they should not override the need for independent decisions that are consistent with the firm's financial situation and prospects.

Remuneration committees should normally include one or more non-executive directors with practical skills and experience of risk management, and should receive regular reports directly from the firm's risk management function on the implications of the remuneration policy for risk and risk management.

The FSA may ask a remuneration committee to prepare a statement on the firm's remuneration policy, including the implications of the policy for the firm. The FSA will expect the statement to include an assessment of the impact of the firm's policies on its risk profile and employee behaviour. In drawing up this assessment, the remuneration committee should exercise its own judgment and not rely solely on the judgment or opinions of others. The FSA may seek a meeting with members of the remuneration committee to discuss the statement.

It is good practice for a statement from a firm's governing body or the remuneration committee on a firm's remuneration policy to be available to the firm's shareholders ahead of any vote by them on directors' remuneration.

Principle 2: Procedures and input of the risk and compliance functions

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Proposed Evidential Provisions:

Procedures for setting remuneration within a firm should be clear and documented, and should include appropriate measures to manage conflicts of interest.

A firm's risk management and compliance functions should have significant input into setting remuneration for other business areas.

Proposed Guidance:

Conflicts of interest can easily arise when employees are involved in the determination of remuneration for their own business area. Where these could arise they need to be managed by having in place independent roles for control functions including, notably, risk management departments. It is good practice to seek input from a firm's human resources function when setting remuneration for other business areas.

Remuneration Principle 4 stresses the importance of risk-adjustment in measuring performance, and the importance within that process of applying judgment and common sense. It is good practice for a remuneration committee to ask the risk management function to validate and assess risk adjustment data, and to attend a meeting of the remuneration committee for this purpose.

Documenting procedures for setting remuneration includes documenting all performance appraisal processes and decisions.

Principle 3: Risk and compliance function remuneration

Proposed Evidential Provisions:

Remuneration for employees in risk management and compliance functions should be determined independently of other business areas.

Risk and compliance functions should have performance metrics based on the achievement of the objectives of those functions.

Proposed Guidance:

Remuneration Principle 3 is designed to manage conflicts of interest, such as might arise if other business areas had undue influence over the remuneration of employees within control functions.

The need to avoid undue influence is particularly important where employees from the control functions are embedded in other business areas. Remuneration Principle 3 does not

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prevent the views of other business areas being sought as an appropriate part of the assessment process.

We would generally expect the ratio of the potential variable component of *remuneration* to the fixed component of *remuneration* to be significantly lower for *employees* in risk management and compliance functions than for *employees* in other business areas whose potential bonus is a significant proportion of their *remuneration*. *Firms* should nevertheless ensure that the total *remuneration* package offered to those *employees* is sufficient to attract and retain staff with the skills, knowledge and expertise to discharge those functions. The requirement that the method of determining the remuneration of *relevant persons* involved in the compliance function must not comprise their objectivity or be likely to do so (see SYSC 6.1.4R(4)) also applies.

Principle 4: Profit-based measurement and risk-adjustment

Proposed Evidential Provisions:

Assessments of financial performance used to calculate bonus pools should be based principally on profits.

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.

Proposed Guidance:

Measuring performance based wholly or mainly on revenues or turnover can provide an incentive for employees to pay insufficient regard to the quality of business undertaken or services provided, or their appropriateness for the client.

Profits are a better measure, but they should be adjusted for risk, including future risks not adequately captured by accounting profits.

Management accounts should provide profit data at such levels within the firm's structure as enables a firm to see as accurate a picture of an employee's contribution to a firm's performance as is reasonably practicable. If revenue or turnover is used as a component in performance assessment, processes should be in place to ensure that the quality of business undertaken or services provided and their appropriateness for clients is taken into account.

A number of techniques are available to adjust profits and capital for risk, and a firm should choose those most appropriate to its circumstances. Common techniques include those based upon a calculation of economic profit or economic capital. Whichever technique is chosen, the full range of potential risks (including, for example, liquidity risk) should be covered. The FSA expects a firm to be able to provide information relating to the workings of the calculations. The results of risk-adjustment are not foolproof, and accordingly a firm should

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apply judgment and common sense in the final decision about the performance-related component of remuneration.

Principle 5: Long-term performance measurement

Proposed Evidential Provisions:

The assessment process for the performance-related component of an employee's remuneration should be designed to ensure assessment is based on longer-term performance.

Proposed Guidance:

Profits from a firm's activities can be volatile and subject to cycles. The financial performance of firms and individual employees can be exaggerated as a result and so the performance-related component of remuneration should not be assessed solely on the results of the current financial year. Effective adjustment for current and future risks in line with Remuneration Principle 4 may also be relevant to compliance with Remuneration Principle 5.

Performance assessment on a moving average of results can be a good way of meeting Remuneration Principle 5. However, other techniques such as good quality risk adjustment and deferment of a sufficiently large proportion of remuneration may also be useful (see Remuneration Principles 4 and 9).

Principle 6: Non-financial performance metrics

Proposed Evidential Provisions:

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.

Proposed Guidance:

Poor performance in non-financial metrics such as poor risk management or other behaviours contrary to firm values can pose significant risks for a firm and should, as appropriate, override metrics of financial performance.

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The performance assessment process and the importance of non-financial assessment factors in the process should be clearly explained to relevant employees and implemented. A 'balanced scorecard' can be a good way to do this.

Principle 7: Measurement of performance for long-term incentive plans

Proposed Evidential Provisions:

The measurement of performance for long-term incentive plans, including those based on the performance of shares, should be risk-adjusted.

Proposed Guidance:

Common measures of share performance, such as earnings per share (EPS) and total shareholder return (TSR), are not adjusted for longer-term risk factors. If incentive plans mature within a two-four year period and are based on EPS or TSR, strategies can be devised to boost EPS or TSR during the life of the plan, to the detriment of the true longer-term health of a firm. For example, increasing leverage is a technique which can be used to boost EPS and TSR. Firms should take account of these factors when developing risk-adjustment methods.

Principle 8: Fully flexible bonus policies

Proposed Evidential Provisions:

The fixed component of remuneration should be a sufficient proportion of total remuneration to allow a firm to operate a fully flexible bonus policy.

Proposed Guidance:

If the fixed component (typically, base salary) of employee remuneration is low a firm will find it difficult to cut or eliminate a bonus in a poor financial year.

One measure of the effectiveness of this principle would be the ability of a firm (or part of it) not to pay a bonus in a year in which the firm (or part of it) makes a loss.

Principle 9: Deferment of the majority of any significant bonus

Proposed Evidential Provisions:

The majority of any bonus should be deferred with a minimum vesting period if, when compared with the fixed component of an employee's remuneration, the bonus is a significant proportion of that fixed component.

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Proposed Guidance:

Remuneration Principle 9 is aimed at aligning the interests of those receiving significant amounts of bonus with the longer-term interests of the firm, while still providing flexibility for firms to devise attractive remuneration structures.

In the FSA's view an example of good practice would be for at least two-thirds of the bonus to be deferred. The vesting period of the deferred element should be appropriate to the nature of the business and its risks.

Principle 10: Linking deferred elements to the firm's future performance

Proposed Evidential Provisions:

Any deferred element of the variable component of remuneration should be linked to the future performance of the firm as well as the employee's division or business unit.

Proposed Guidance:

A firm's business is often subject to future risk and uncertainty. If variable remuneration is paid out without any link to future performance, employees have less incentive to take future risk into account, and firms are exposed to the risk of paying out variable remuneration which proves not to be justified by results.

Deferred remuneration paid in shares can meet Remuneration Principle 10 provided that the scheme meets appropriate criteria, including risk-adjustment of the share performance measure as described in Remuneration Principle 4.

Deferred remuneration paid in cash should also be subject to performance criteria.

Linkage to the future performance of the firm is important as well as linkage to the future performance of a division or business unit. The former promotes teamwork, while the latter assures that the risks which the employee had a role in assuming continue to have a bearing on his remuneration.