

FSA CODE OF PRACTICE ON REMUNERATION POLICIES

August 2009

In February, the FSA issued a draft version of its Code of practice on remuneration policies (the 'Code') for the largest banks, building societies and broker dealers. Now following a period of consultation, the finalised version of the Code has been issued.

The basic structure of the finalised Code remains unchanged from the original draft, consisting of a general requirement for firms to establish remuneration practices that "promote effective risk management" which is underpinned by a series of 'evidential provisions' (i.e. principles) and some more general guidance. There have though been a number of changes in the Code's detail since the original draft:

- **Scope of the Code.** The scope of the Code has been significantly narrowed by the exclusion of many non-UK firms – only 26 firms (compared to the originally proposed 47) will now be directly impacted by the Code. However, the FSA is still considering a possible wider extension of the Code to other FSA-authorized firms and will report further in October on this issue.
- **Structure of Pay Packages.** The original draft contained a number of detailed proposals in relation to the appropriate structure of remuneration packages including that fixed pay should be a significant proportion of the total package and that there should be significant (not less than two-thirds) deferral of bonus.

These proposals remain in the Code but now only apply to senior management and employees in roles that could have a significant impact on the firm's risk profile. Given what the FSA describes as the absence of a "satisfactory level of international alignment", the proposals have also been 'downgraded' to guidance rather than principles which creates the potential for tension between the FSA and firms depending upon the extent to which the guidance is adhered to in practice.

- **Guaranteed bonuses.** Guaranteed minimum bonuses that run for a period of more than one year are criticised as being "unlikely to be consistent with effective risk management". Their general merits can be debated but we are not entirely clear as to exactly why the FSA regards guaranteed bonuses (which are not linked to performance) as being at odds with effective risk management. We also cannot see why a distinction is being drawn between a guaranteed bonus and the likely alternative that many firms will adopt, namely an enhanced salary.
- **Implementation Date.** The implementation date for the Code has been put back from November 2009 to 1 January 2010, although firms will be required to communicate a remuneration policy statement to the FSA by the end of October 2009.
- **Long-Term Incentive Review.** By 1 January 2010, a firm must have initiated a review of the extent to which performance measurement for its long-term incentive plans takes account of risk.

The general press reaction to the Code has not been entirely favourable with widespread criticism that bankers have "got off lightly". Our view is that this is slightly unfair as the Code viewed as a whole, including its extensive guidance, does provide a considerably more detailed framework for remuneration in the financial sector than has existed to date and should pressure remuneration committees into ensuring that remuneration arrangements going forward are more consistent with the promotion of effective risk management.

That said, the shift of the more prescriptive proposals on remuneration structure from the headline 'evidential provisions' into mere guidance may, depending on the attitude of the FSA, leave more scope for firms to ignore these details. Accordingly, focus now switches back to the Walker Review, the initial draft of which contained a significant number of detailed recommendations on pay structures such as longer vesting periods for share awards and phased bonus payments. Will these recommendations survive its consultation process and potentially end up in the Combined Code or will they too be 'downgraded' to guidance status?

A more detailed summary of the provisions of the Remuneration Code is set out below

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

One key point to emphasise is that the Code is concerned with the risks created by the structure of remuneration arrangements and not with the absolute amount of remuneration itself.

Evidential Provision 1 **A remuneration committee should:**

Role of bodies responsible for remuneration policies and their members

- (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.**

The scope of a remuneration committee's remit is less extensive here than that outlined in the Walker Review. That said, the accompanying guidance to this provision envisages the committee producing a statement on the firms' remuneration policy for the FSA which, amongst other things, assesses the impact of its remuneration policies on its risk profile and employee behaviour. By implication, this would necessitate a general understanding by the committee of firm-wide remuneration policy (as recommended in the Walker Review).

Evidential Provision 2 **Procedures for setting remuneration within a firm should be clear and documented, and should include appropriate measures to manage conflicts of interest.**

Procedures and risk and compliance function input

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.

This provision illustrates the theme that runs through the whole of the Code of the need for significantly greater account to be taken of risk in every aspect of remuneration structures.

Evidential Provision 3 **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 principally on the achievement of the objectives of those functions.**

Remuneration of employees in risk and compliance functions

An interesting aspect of the accompanying guidance to this provision is that whilst employees in risk management are expected to have a lower portion of their pay linked to performance than other employees, it is stressed that firms should still ensure that the total package is sufficient to attract and retain sufficiently talented staff to this area. It is difficult to see how this balance will be achieved without significant upward adjustments to the salaries of employees in risk management and compliance roles.

**Evidential
Provision 4**

*Profit-based
measurement
and risk-
adjustment*

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.

The shift to profits rather than revenues as the basis for bonus pools is an attempt to enhance focus on the quality of business undertaken (and would bring the financial sector more into line with the wider economy where profits have traditionally been the key performance metric). The use of risk-adjusted measures such as economic profit is likely to be the more complex aspect of this advice to implement and, in this regard, it is telling that the FSA emphasises that "the results of risk-adjustment are not foolproof" and that "judgment and common sense" should still be applied.

**Evidential
Provision 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.

'Significant' in this context is defined in the accompanying guidance as being a judgment based on both the proportion of the package which is performance-related and the absolute value of the performance element of the package. This leaves scope for the payment of proportionately large bonuses (without taking long-term performance into account) to relatively low-paid, junior employees and illustrates the tighter focus of this finalised version of the Code on more senior employees.

**Evidential
Provision 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.

The traditional concern with the use of non-financial performance metrics in incentive schemes is that they can trigger bonus payments even when financial metrics are failed, to the chagrin of shareholders. The accompanying guidance suggests that the FSA aims to avoid this by firms using non-financial metrics as "override metrics of financial performance" (i.e. with the potential to reduce bonus payments only) rather than as part of a more traditional "balanced scorecard" (where non-financial metrics can trigger bonus payments in their own right).

**Evidential
Provision 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.

The original draft of the Code criticised both EPS and TSR performance measures as being not adjusted for long-term risk factors. In light of the Walker Review's more measured view of TSR, it is noticeable that the guidance to this provision in the final version of the Code draws a distinction between EPS (criticised as before) and TSR (where the criticism is more tangential).

That said, the FSA's observation that TSR is sub-optimal as a measure because it includes in its measurement "dividend distributions, which can be based on unadjusted earnings data" is, in our view, a slightly odd one particularly as the impact of dividends on TSR is usually limited in comparison to the impact of share price movements (where the market's view of 'risk' is clearly incorporated). Also, investors generally prefer the use of TSR to a share price measure because it removes any potential benefit from manipulating dividend policy.

**Evidential
Provision 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.

*** a person who performs a significant influence function for a firm and an employee whose activities have, or could have, a material impact on the firm's risk profile**

As discussed at the start of this note, the original draft of the Code contained three specific provisions relating to remuneration structures that have now been 'downgraded' in the final version of the Code to being guidance to this more general provision. The provision is also now focussed on a narrower group of employees than was envisaged in the draft Code (and it is worth noting in passing that this proposed group of 'high-risk' individuals appears slightly more appropriate than the group of 'high-end' executives which the Walker Review focussed upon).

The guidance to this provision is the most extensive in the Code and may well be a key area of tension between the FSA and firms as to the extent of its application. The key aspects of the guidance are:

- Good practice would be for fixed pay to be a significant enough proportion of an employee's pay package to allow the firm to operate "a fully flexible bonus policy".

The FSA does point out that they want "to avoid the impression that [they] want to see higher fixed components of pay" although anecdotal evidence is that this is a trend that is already being seen in many financial institutions, particularly in the US.

- A firm should have the ability not to pay a bonus in a year when it makes a loss (although the guidance does acknowledge that this does not mean that making a loss automatically results in no bonuses).
- Good practice would be for a significant proportion of any bonus to be deferred for at least three years. If the bonus is significant compared with an employee's fixed pay, then "a reasonable starting point would be to defer at least two-thirds".
- Good practice would be for a significant proportion of variable pay to be linked to future performance of the firm and the employee's division or business unit.
- Bonuses should be based on a mixture of firm and business unit performance in the year under review and there should also be linkage to the future performance of the firm and business unit.

Whilst this may be appropriate for large banking bonuses where sometimes there are few long-term incentives to act as a counterweight, we do not regard it as necessarily appropriate for those firms with more typical listed company incentive arrangements where the value of stand-alone long-term incentive awards already typically exceeds that of the annual bonus.

- Guaranteed minimum bonuses running for a period of more than one year that are not based on performance during the performance period under review are "likely to be inconsistent" with the Code.

Irrespective of the general merits or otherwise of such arrangements, we are unclear as to precisely why they are being criticised as being inconsistent with risk management. Seeing as the alternative to paying guaranteed bonuses to certain recruits is likely to be paying them higher base salaries, it is also difficult to see how this is in the best interests of shareholders.