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Financial Services Authority

Reforming remuneration practices in financial services

March 2009



Contents

1	Overview	3
2	Why change is necessary	9
3	Feedback and findings from our review of remuneration practices in the London market	14
4	Market failure analysis	21
5	The Code of practice and the proposed new framework	27
6	Questions for discussion about extending the code to all FSA-authorised firms	37

Annex 1: List of the consultation questions and questions for discussion

Annex 2: Draft code on remuneration practices

Annex 3: Current regulatory requirements

Annex 4: Cost benefit analysis of the proposals under consultation

Annex 5: Compatibility statement

Appendix 1: Draft Handbook text

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 18 May 2009 for the consultation questions and by 18 June 2009 for the questions for discussion.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/CP/2009/cp09_10_response.shtml).

Alternatively, please send comments in writing to:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

1 Overview

Purpose

- 1.1 We published a draft Code of practice on remuneration policies on 26 February. In this Consultation Paper (CP), we set out our proposals to implement that Code. It proposes, and formally consults on, incorporating the Code into the Handbook and applying it to large banks, building societies and broker dealers. Details of firms to which it applies are given in paragraph 1.12.
- 1.2 We also report here on the findings of our review of remuneration practices in a group of major UK-incorporated banks and building societies, which we undertook between November 2008 and January 2009.
- 1.3 Finally, we are inviting general discussion and feedback on whether the Code should be extended to other FSA-authorised firms. We are not consulting on this question at this stage.
- 1.4 We are grateful to the group of banks and building societies that helped with our research; also to other industry professionals, including consulting firms and commentators, for their ideas and views. Our analysis has also benefited greatly from the discussions that we have had with supervisory colleagues from other financial centres, conducted within working groups of the Financial Stability Forum (FSF) and the Committee of European Banking Supervisors (CEBS).

Background

- 1.5 Although it is hard to prove a direct causal link, there is widespread consensus that remuneration practices may have been a contributory factor to the market crisis. Practices in common use during the period leading up to the crisis, mainly but not exclusively in investment banking, tended to reward short-term revenue and profit targets. These gave staff incentives to pursue unduly risky practices, for example by undertaking higher risk investments or activities which provided higher income in the short run despite exposing the institution to higher potential losses in the longer run. In many cases, remuneration practices were running counter to effective risk management, in effect undermining systems that had been set up to control risk.

The market failure analysis in Chapter 4 provides a more detailed description on why current remuneration practices are problematic from a regulator's perspective and how regulation can address these problems.

- 1.6 We began to consider the extent to which remuneration practices may have contributed to the current crisis during the summer of 2008 – in common with other regulatory authorities, as discussed in Chapter 2. In October 2008 we issued a 'Dear CEO' letter asking firms to review their remuneration policies against a set of criteria of good and poor practice. We sent this to around 20 of the larger UK-based banks (including both investment banks and retail banks, and some building societies) indicating that we would follow the letter up by seeking further information about their remuneration practices, as well as inviting comments on the criteria themselves. We also sent the letter to a number of other FSA-regulated firms, for information.
- 1.7 Further information was obtained from the UK-based banks via a questionnaire and a series of bilateral meetings, with the aim of putting together a review of remuneration practices in the London markets. We summarise the findings of this review in Chapter 3.
- 1.8 Our October letter indicated that we would publish a further statement in early 2009 reporting on the findings of our review and on the feedback received on the criteria, and indicating also how we intended to take forward FSA policy in this area. We decided that we would do this by upgrading the criteria to a Code of practice, and that furthermore, we needed to consult on the proposal that we should give effect to the Code by incorporating it into our Handbook.
- 1.9 The Code was first published in draft form on 26 February, alongside the government's publication of the details of the Asset Protection Scheme (APS). We have since made some significant revisions to the Code and the new version is attached as Annex 2. For the time being, we encourage firms to use it to benchmark their remuneration practices against it. However, we are proposing in this CP that the Code should be incorporated into our Handbook in a way that would enable us to enforce the Code directly. If we decide to go ahead with the new Handbook rules we may need to make some further changes to the Code in taking account of responses to the consultation.

Summary of our proposals

- 1.10 **We are consulting on the proposal that the Code's general requirement should become a Handbook rule.** This requires firms to establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management. Effective risk management arrangements are already required under our rules.
- 1.11 **We are consulting also on the proposal that the remaining ten principles should be put into the Handbook as 'evidential provisions' to support the general requirement.** An evidential provision is a type of rule that has evidential value in showing that another rule (in this case, the Code's general requirement) has been breached or complied with. We have set out guidance on how firms can comply with the rule and evidential provisions (this is contained in Chapter 5, in Annex 2 and in Appendix 1).

- 1.12 The Code's rule and evidential provisions would apply to certain large banks, building societies and broker dealers, defined as follows:
- FSA-regulated banks and building societies which meet either of these criteria:
 - o total regulatory capital in the UK banking entities in excess of £1 billion;
 - o are part of a financial group (UK or international) whose regulatory capital is in excess of £20 billion or the equivalent amount in another currency.
 - FSA-regulated BIPRU 730k firms which meet either of these criteria:
 - o total regulatory capital in the UK authorised entity is in excess of £750 million or its equivalent amount in another currency;
 - o are part of a financial group (UK or international) whose regulatory capital is in excess of £5 billion or its equivalent amount in another currency.
- 1.13 This would exclude UK branches of EEA firms since responsibility for systems and controls is reserved to home competent authorities, but include the overseas branches of UK firms (both EEA and non-EEA).
- 1.14 The draft handbook text for these changes is set out in Appendix 1. We discuss the provisions of the Code and the rationale for applying it to these firms in Chapter 5 and provide a cost-benefit analysis in Annex 4.
- 1.15 We are also inviting discussion and feedback on the idea that the code should be applied to all other FSA-authorised firms, in the same way as proposed for banks, building societies and large broker dealers. This is discussed in Chapter 6.
- 1.16 It is important to emphasise that if we were to go ahead with this, the Code of practice would be implemented in a principles- and risk-based way. We recognise that not every principle would apply in the same way to every firm. For example, smaller firms often do not have separate remuneration committees, and proposed references in guidance to shareholders do not apply to building societies or other mutual firms.
- 1.17 **We will also be taking steps to increase our focus within our supervisory programmes on the potential risks posed by inappropriate remuneration practices in all FSA-authorised firms.** These steps, which do not require consultation, will be implemented as soon as possible and will include:
- follow-up visits to a number of major banks and broker dealers during April and May to review their progress in aligning remuneration practices with effective risk management; and

- incorporation of remuneration risk into ARROW¹ programmes, and also into ICAAPS² and SREPs³ as part of the Pillar 2 process.⁴
- 1.18 In line with our overall regulatory philosophy we will continue to take a principles-based and proportionate approach. Our primary focus will be with the high impact UK – incorporated banks and broker dealers, i.e. the group of firms which are the subject of this consultation. However, all firms should expect greater supervisory focus and potentially supervisory action if their remuneration practices pose unacceptable risks.
- 1.19 Our primary focus in this consultation will be on the employees of firms whose activities have a significant impact on the risk profile of the firm.
- 1.20 As noted in Chapter 2, much work has been done internationally in developing principles for sound remuneration policies. In putting forward our proposals now we are signalling how these might be put into practice. We fully recognise the need for the financial services industry to attract and to retain highly talented staff, and the need also not to undermine London’s position as an international financial centre. Other countries will be implementing regulatory changes to improve remuneration policies, and in deciding whether to go ahead with these plans we will take into account progress with implementation at the international level.
- 1.21 As we will explain in more detail our focus is on remuneration policies and practices. We are not concerned with the levels of remuneration, which we regard as a matter for firms’ boards and shareholders. None of the principles in our Code will prevent firms providing large remuneration packages to employees if such packages can be justified by their contribution to the success of the firm, adjusted appropriately for risk.

Structure of the paper

- 1.22 The rest of this paper is set out as follows:
- **Chapter 2** considers why change to the status quo is necessary. It notes the gaps in the current regulatory requirements which we are seeking to fill. It also includes a section on international developments on remuneration, how our proposals tie into these developments and the implications of our proposals for London’s competitive position.
 - **Chapter 3** sets out our findings from our review of practices in the UK market.
 - **Chapter 4** analyses the failure in the current market and, in particular, why current practices pose a problem and why regulation can help address the problem.

1 Advanced risk responsive operating framework- the FSA’s principal risk assessment process.

2 Internal capital adequacy assessment process – a report that firms are required to prepare with their own assessment of capital adequacy. We will expect firms to give appropriate emphasis to remuneration risk in these reports.

3 Supervisory review and evaluation process – the FSAs response to an ICAAP.

4 We already have the option to use Pillar 2 capital requirements as a supervisory tool to deal with risk not covered by Pillar 1. It is likely that this tool would, however be used only for extreme cases of remuneration risk. Our first objective will be to persuade firms to improve their remuneration policies.

- **Chapter 5** describes the new framework we are proposing and the Code of remuneration practices. It sets out the firms which would be affected by the Code: the principles of the Code, and how we expect firms to follow them: and some transitional arrangements.
- **Chapter 6** contains the Discussion Paper section of this document. It addresses the question whether the Code of remuneration practices should extend to all FSA-regulated firms.
- Annex 1 lists the consultation questions.
- Annex 2 includes our proposed Code on remuneration practices as extracted from the draft Handbook text. This will replace the Code that we first published on 26 February.
- Annex 3 expands on Chapter 2 by setting out the current national regulatory requirements on remuneration issues.
- Annex 4 contains a cost benefit analysis of our proposals.
- Annex 5 analyses the compatibility of our proposals with our statutory objectives and the principles of good regulation.
- Appendix 1 contains the draft text that is proposed should be used to incorporate the draft Code (as described in Annex 2) into our Handbook.

Next steps

- 1.23 This paper specifies a two-month consultation period on implementing the Code for the larger banks and broker dealers, and a three-month period for feedback on the issues raised in Chapter 6 on the possibility of extending the Code to other firms regulated by the FSA. We are consulting for two months as we want to be ready to bring the Code into effect from early November, in time for firms' 2009 remuneration reviews. To do this and give firms adequate time to prepare, we propose to provide feedback and publish the new rules, if we decide to go ahead, by early August. We think that a two-month consultation period will be sufficient to enable potential respondents to provide feedback.
- 1.24 However, it is evident that to be most effective, policies on remuneration should be implemented globally and in a consistent manner. In deciding whether to implement our plans we will therefore take into account whether we consider there is satisfactory alignment of implementation plans by the authorities in the major financial centres. As explained in Chapter 2, international bodies such as the FSF and CEBS are issuing sets of high-level principles for sound remuneration practices. The EU Commission has also announced that it proposes to bring forward a new recommendation on remuneration in the financial services sector in April. We have worked closely with the FSF and CEBS groups in formulating their sets of principles, and we will work closely with our supervisory colleagues to ensure consistent implementation.

Who should read this paper and to whom do our proposals apply?

- 1.25 This paper should be read by all FSA-authorised firms since, besides consulting on proposals affecting large banks and broker dealers, we are inviting discussion on the idea that the Code might be extended to all authorised firms.
- 1.26 This paper will also be of interest to trade bodies and consumer groups.

2 Why change is necessary

- 2.1 There is now a consensus amongst both regulators and industry practitioners that inappropriate remuneration practices contributed to significant losses at major firms and therefore to the severity and duration of the current market turmoil. Industry practitioners have prepared analyses such as the report by UBS to its shareholders⁵ and have prepared recommendations, for example those in the report from the Institute of International Finance⁶. Reports from regulators have included the Senior Supervisors Group⁷, high level principles prepared by the Committee of European Banking Supervisors⁸ and a report from the Financial Stability Forum which will be published in the next few days.
- 2.2 In substantial parts of the banking industry variable compensation has a short-term focus and is not adjusted for risk. These remuneration structures persist as the banking industry is constrained by pressures on the labour market.
- 2.3 There is powerful circumstantial evidence to demonstrate that control systems have failed to deal with the risks created by inappropriate incentives. Two recent trends may have caused this to happen. The first is that the controls themselves have struggled to cope with the increasing complexity of the risks, and the methods by which employees may take risk. This is reflected in the growing size and complexity of trading books. This is a general problem which extends beyond the question of remuneration practices and for which a range of actions are being proposed.⁹ The second trend is that remuneration practices have evolved to provide stronger incentives, as firms realised the potential to grow profits (unadjusted for risk) during the boom. Hence the need to make rules about remuneration practices directly.
- 2.4 The balance of risk and reward offered by poor remuneration practices is unequal. Our market failure analysis, set out in Chapter 4, notes that higher profits translate into higher bonuses for the employee, whereas bonus payments cannot be lower than zero. Therefore, losses are borne by long-term shareholders and society, but

5 *Shareholder Report on UBS's Write –Downs*, 18 April 1008

6 *Interim Report of the IIF Committee on Market Best Practices*, April 2008.

7 *Observations on Risk Management Practices during the Recent Market Turbulence*, Senior Supervisors Group, March 2008.

8 Available at www.c-ebs.org/Publications/Consultation-Papers/CP21-CP30/CP23.aspx.

9 See DP09/2 *A regulatory response to the banking crisis*, also published on 18 March 2009.

only to a small extent by employees and short-term shareholders. In this sense remuneration is a driver for excessive risk-taking and can have wider ramifications as employees in the banking sector do not take fully into account the potentially negative consequences of their decisions on their firms and society.

- 2.5 Another way of looking at this is that risk takers are in effect buying options which can generate either profits or losses, but the option premium is being funded by the capital of the firm, i.e. by the firm's shareholders. There is a two-fold challenge. First, to calculate accurately the cost of the capital and liquidity being used to fund the option and to deduct it from the estimate of future profit; secondly, to ensure that there is a better symmetry in the pay out of gains and losses between shareholders and the risk takers.

Gaps in the current regulatory requirements

- 2.6 Annex 3 sets out the existing Handbook provisions that are relevant to the risks posed by remuneration practices, and which cover most FSA-regulated firms. Each of these provisions is relevant to the remuneration of staff in so far as it poses a risk to the firm which needs to be managed to comply with other regulatory requirements.
- 2.7 However a firm's ability to deal with a situation where inappropriate remuneration policies are leading or could lead to excessive risk taking is limited, since there is no express requirement to ensure that a firm's remuneration strategy is consistent with sound risk management. Firms may therefore seek to argue that they mitigate risks that arise from their remuneration policy through other internal control mechanisms and it would be for us to show in each case that those mechanisms did not sufficiently mitigate the risks. Depending on the circumstances this may be a difficult case to make in practice.
- 2.8 Annex 3 also sets out other legislative requirements, codes and guidelines on remuneration. All of these provide valuable benchmark tools for firms' behaviours in the area of remuneration. However, they are either voluntary and /or their scope is limited to executive directors. So there are gaps in the existing body of material on remuneration which this Code aims to fill.

Consultation Q1: Do you agree with our analysis on the need for change and the gaps in the current regulatory approach?

International work on remuneration

- 2.9 Policy work on remuneration issues has been taken forward in two main fora – the Financial Stability Forum (FSF) and the Committee of European Banking Supervisors (CEBS).
- 2.10 In April 2008 the **Financial Stability Forum** published a report on the market crisis and a list of recommendations for action. One of these was for regulators

to work with market participants to mitigate the risks arising from remuneration policies¹⁰ A Compensation Workstream Group was formed in late 2008 with a mandate to draft sound practice principles for large financial institutions. The Group commissioned a survey of remuneration practices (in conjunction with the private sector group the Institute for International Finance), and held a series of meetings with industry practitioners and other experts in the US, London, and other major financial centres.

- 2.11 The FSF has now prepared a set of Principles for Sound Compensation Practices, within a document which also discusses issues such as the need for change by the industry and the rationale for regulatory intervention. The document will form part of the report of the FSF on the market crisis which it will be presenting to the G20 summit meeting on 2 April. The FSF will publish it shortly.
- 2.12 A CEBS working group has also been preparing a set of high-level principles on remuneration, as part of a project on internal governance guidelines for the application of Pillar 2. These were published by CEBS on Friday 5 March.¹¹ The intention is that risks arising from remuneration practices should be incorporated into the Pillar 2 process of the Basel capital accord and, within the EU, the Capital Requirements Directive. The risks will need to be reviewed in both the ICAAP (the individual capital adequacy assessment process, undertaken by the firm) and the SREP (the supervisory risk evaluation process undertaken by supervisors in response to the ICAAP).
- 2.13 The EU Commission has also announced that it proposes to bring forward a new recommendation on remuneration in the financial services sector in April.
- 2.14 We have been closely involved in the preparation of both the FSF and CEBS sets of Principles. The sets of Principles and the FSA's Code are all broadly consistent. They have the same objectives, and cover the same key areas: governance, the measurement of performance including risk adjustment, and the composition and structuring of bonuses.
- 2.15 Our Code goes further in some respects. For example:
 - it is more explicit about the need for remuneration committees to prepare an annual remuneration policy statement for the FSA if asked to do so;
 - it calls for risk adjustment to be applied to performance metrics for long term incentive share plans as well as yearly bonuses; and
 - it calls for the major part of significant bonuses to be deferred, and also for the deferred element to be linked to the future performance of the firm.
- 2.15 We are consulting now on the proposal that the Code should be incorporated into our Handbook because we believe that it is important for us and for firms to have agreed changes to our regulatory regime before decisions need to be taken about remuneration practices for the 2009 remuneration reviews, typically starting in

10 Report of the Financial Stability Forum on Enhancing market and institutional resilience, April 2008.

11 Available at www.c-ebis.org/Publications/Consultation-Papers/CP21-CP30/CP23.aspx.

November/December each year. In doing so, we are moving faster than our colleagues in other major financial centres.

2.16 The effectiveness of our approach in achieving real change will depend on our ability to gain international agreement to enforce similar principles in all major financial markets. Acting alone, the FSA cannot influence the group-level practices of foreign firms operating in the UK market, nor the practices followed in other financial centres where UK banks have activities. Achieving international agreement on mechanisms to ensure all major supervisory authorities apply the principles will be a crucial subsequent step. In deciding whether to implement our plans we will therefore take into account whether we consider there is satisfactory alignment of implementation plans by the authorities in the major financial centres. We will work closely with our supervisory colleagues over the next few months to ensure consistent implementation.

2.17 **Implications for the UK's competitive position**

2.18 The statement in Annex 5 on the compatibility of this CP with the Principles of Good Regulation includes a reference to the implications for the UK's competitive position. This section considers the issues in a little more detail.

2.19 The case for saying that the implications for the UK would be at worst neutral, and may be positive is as follows:

- We have made clear (paragraph 2.16) that our implementation of the Code is subject to satisfactory alignment of implementation plans by the authorities in the major financial centres.
- Many firms are already in line with the principles in the Code, and others have already started to change their remuneration policies and practices in ways which will make them better aligned.
- We believe that firms will benefit from aligning their remuneration policies and practices with the principles of the Code. Alignment will improve their relationships with stakeholders – including shareholders, regulators, the government and market counterparties.
- In making concrete proposals for reforming remuneration policies ahead of other centres the UK is signalling how the general principles advocated by the FSF and CEBS might be put into practice,

2.20 On the other hand, the Code could have adverse implications for the UK's competitiveness:

- International alignment of implementation plans may not be complete. National differences will not be eliminated.
- Even if we get alignment with the other major financial centres we are unlikely to get global alignment. Other centres may offer an unregulated environment.
- As noted in the cost benefit analysis in Annex 4, the costs of implementing the Code may be significant for some firms.

Consultation Q2: Do you think that introducing this Code into the Handbook as proposed would have adverse implications for the UK as a financial centre? Or do you think its introduction might have neutral or positive implications?

3 Feedback and findings from our review of remuneration practices in the London market

- 3.1 In November and December last year we asked 22 firms (9 investment banks, 6 major UK banks, 5 smaller UK banks and 2 building societies) to provide us with information about their remuneration practices, alongside feedback on the criteria of good and bad practice set out in Hector Sants' Dear CEO letter of 13 October.
- 3.2 We followed this up with a series of bilateral meetings, with the aim of benchmarking current practices against the criteria. We found good practice in many firms, and instances also where firms were changing their practices in response to the crisis, generally in the right direction. However we also found significant weaknesses around a number of areas, discussed in more detail below.
- 3.3 It is not possible to prove a direct causal link between remuneration practices and the market crisis. Other factors such as over-ambitious strategies, over-reliance on third party risk assessment, and herd-like behaviour by firms, are likely to have been more important. But there is plenty of circumstantial and anecdotal evidence of such a link. We found evidence of poor remuneration practices in a number of the firms which have suffered badly in the crisis. Further research to establish correlations between remuneration practices (good and bad) and performance could be interesting and worthwhile.
- 3.4 We received valuable feedback from firms about the criteria, as set out below. It was striking that in all our visits no one challenged the basic premise that remuneration practices were a contributory factor, and the overwhelming majority supported our involvement in the subject.
- 3.5 Our meetings with firms were mainly conducted as firms' preparations for their 2008 review of remuneration practices and awards were in progress, and many firms were able only to give us general indications of what was going to emerge from the reviews. Subsequent reports have confirmed that remuneration practices are changing, in response to market conditions, and possibly in response to the interest shown by us and other regulators. The speed and extent of change differs across firms: some players have announced wide ranging reviews of their remuneration structures, extending in some cases over the course of 2009, whilst others are targeting changes to specific elements of their existing remuneration policy.

Feedback from firms on the criteria in the Dear CEO letter

3.6 This can be summarised as follows:

General feedback

- Nearly all firms welcomed the FSA's criteria of good and poor practice and thought that they captured the key issues.
- There was concern that regulators should not try to make 'one size fit all'. Firms pointed to the substantial differences in business practices as between investment banking and retail banking (and to differences within those two broad categories). Retail banks were concerned not to be put into the same category as investment banks, and a few of them questioned why we were not restricting the scope of our review to the latter.
- Firms emphasised the importance of the FSA (and other regulators) avoiding a formulaic approach. Judgment would always be needed in determining remuneration policies, and individual awards.
- There was concern from international banks and from UK-owned banks with overseas operations that regulators should adopt a common approach, and that the FSA should not go too far ahead of other regulators in implementing regulatory solutions. Firms would face difficulties and costs in implementing different regulations in different countries: regulatory arbitrage would not be difficult to construct: and in consequence London could suffer as a financial centre.
- Regulators should focus on ensuring good governance in remuneration policy, rather than on the design of remuneration structures. They should be aware of some of the practical difficulties for firms (eg, changing current employment contracts, implications for tax), and the risk of unintended consequences.

Comments on individual criteria

- 3.7 Firms generally welcomed the idea that there should be a dialogue between the FSA and remuneration committees, and that remuneration committees should take more account of the implications of remuneration policies and practices for risk.
- 3.8 There was some scepticism about the usefulness of risk adjustment models in determining bonus pools (see comments above about avoiding a formulaic approach), but many firms also acknowledged that risk adjustment of performance criteria was a key issue which needed further thought and discussion.
- 3.9 Few firms supported the idea of performance measurement based on a moving average of performance – pointing to the complications eg if staff moved jobs, and the loss of a 'line of sight' between performance and reward. Firms felt that assessments of performance over a longer time period than one year could be made through exercising judgement.

- 3.10 There was acceptance by at least some firms that low base salaries coupled with bonuses which were a significant multiple of that base had implications both for the flexibility of bonus policies and for employee behaviour.
- 3.11 Most firms argued that equity compensation schemes met the criteria for performance adjusted deferred compensation. At the same time, practical arguments were used to argue against schemes for performance adjustment of deferred cash compensation.
- 3.12 We have taken account of this feedback in the design of the Code of practice now being proposed in this CP.

Summary of our findings

Measurement of performance

Profits, revenues and risk adjustment

- 3.13 Profits are a key metric for most firms when measuring performance at group/company level. However many investment banks take net revenue (typically, revenues after deduction of interest expenses) and then determine bonus pools by reference to a revenue to compensation ratio (typically in the range of 40-50%). Other factors such as cost (eg cost income ratios) can be components for bonus pool calculations for the CEO or other senior executives.
- 3.14 The use of unadjusted revenue or net revenue is a particularly poor metric for measuring performance since it can provide an incentive for employees to pay insufficient regard the quality of the business undertaken or the services provided. Profit is a better measure, but only a few firms risk adjust profit by using economic capital models or systems at the moment. More firms reported that they were under consideration. The range of risks for which firms are adjusting performance measures is limited: for example, few firms are making adjustments for market liquidity risk and virtually no firms are adjusting for funding liquidity risk.
- 3.15 Cost of capital adjustments are more frequent, for example when allocating bonuses pools to divisions or to business units. As performance is measured further down the organisation risk adjustment seems to become less common and less sophisticated in many firms. In some cases this may reflect actual practical difficulties in doing so, in other cases a failure to collect the necessary management information and other data (eg through the cycle or forward looking market price data).
- 3.16 We found insufficient use of risk adjustment in both investment banking and retail banking. Recent events point to the need for such techniques in both of these activities, and many firms are looking actively at how to introduce them. Our code recognises, first that different risk adjustment techniques suit different types of business, and second, that no technique is foolproof. However we are expecting all large banks and broker dealers to undertake risk adjustment of profit measures.

Long term performance measurement.

- 3.17 Moving averages for performance measurement are not generally used and firms point to the practical complications of relying on them.
- 3.18 We recognise the practical difficulties at the level of the individual employee. However in our view the need to reduce the incentive to maximise current year revenues or profits without regard to the implications for future years is crucial. Moving averages may be easier to construct for a department or business unit. Our code notes that other techniques such as good quality risk adjustment or a sufficiently large proportion of deferred compensation to influence behaviour may also help to achieve this objective.
- 3.19 Most deferred compensation schemes defer the compensation for between 2 and 4 years. It is argued that if the deferment is for a longer period the recipient discounts the present value of the award to such a low amount that its value (either as an award or to influence behaviour) is lost.
- 3.20 We have some significant concerns about the metrics used to measure the performance of shares in most share incentive schemes. The focus on measures such as earnings per share, and total shareholder return, which are not risk-adjusted and can easily be used to drive short-term performance targets, seems to have increased in recent years. As a result strategies can be devised to boost these metrics during the life of an incentive plan, to the detriment of the longer term health of a company. It can be argued that this focus may have contributed to the build up of leverage.
- 3.21 Our proposed Code says that the measurement of performance for long term incentive plans, including those based on the performance of shares, should be risk adjusted.

Non-financial measures of performance

- 3.22 Non-financial measures of performance are taken into account to some degree in all firms, but in some cases we felt that they had been given insufficient weight and in others we found a lack of clarity in the processes that had been followed. We suspect that procedures may have not been conscientiously followed in certain firms and at certain times during the boom years.

Composition of remuneration

The fixed component of remuneration and 'bonus leverage'

- 3.23 The fixed component of remuneration remains low relative to the total package of remuneration in investment banking. . The gearing of bonuses to fixed salary can be ten-fold or more for many front office staff. Firms claim that this high leverage of bonuses enables them to operate with a flexible cost base, but the evidence for this is weak, as can be seen by the difficulties that firms have had in operating a fully flexible bonus policy in the current market conditions. Concern also remains about the implications of highly geared bonus structures for attitudes to risk.

- 3.24 The proposed Code calls on firms to have remuneration structures which allow them to operate a fully flexible bonus policy.

Bonus deferment

- 3.25 We found that the proportion of deferred bonus in the total bonus package for middle ranking to senior executives in investment banking typically varied between 25% and 55%, with the higher proportion generally for senior executives. There were firms with higher deferred proportions but they were in a minority. One firm, notably, did not defer any of its bonus payouts. The remainder of bonus payments was usually paid in cash upfront at the end of the year.
- 3.26 We concluded that in most cases the cash payout (which is in any event going to have a greater present value to the recipient than deferred compensation) is likely to be the dominant incentive for employees. The deferred element may be regarded as ‘icing on the cake’, and as such less likely to influence behaviour towards a longer term focus. This may be the case especially where the line of sight between an individual’s performance and the performance of the share price is weak. Correlation between firm overall performance and the person’s individual contribution is often only evident at the very top of the larger firms. Even where the deferred element is above 50%, and the recipient a senior member of the firm, the cash element could be sufficiently big as to overshadow the deferred element as a motivational factor.
- 3.27 Firms have announced increased proportions of deferred bonus in recent weeks, including some schemes for the deferment of cash bonuses – hitherto rare. In our Code we give guidance to the effect that for us an example of good practice would be for at least two-thirds of the bonus to be deferred, where the bonus forms a significant proportion of the fixed component. The vesting period of the deferred element should be appropriate to the nature of the business and its risks.

Linking deferred elements to the firm’s future performance

- 3.28 Firms argued that the equity based components in a bonus scheme were examples of performance adjusted deferred compensation, with the current weakness in share prices providing powerful evidence of performance adjustment. We accept that this is valid for shares issued at current market valuations, although not usually for share options.
- 3.29 Our concern in our review was, however, as much with the treatment of cash bonuses, which as noted above remain a significant proportion of total bonuses and typically not deferred. Firms have argued strongly that such schemes to defer and performance adjust cash bonuses have a range of practical problems, including legal questions about how to operate ‘clawback’ mechanisms, complexity of operation, difficulties for staff that move jobs within the firm, and poor ‘line of sight’ between performance and award in any one year. Schemes were however in operation in the 1990’s and were abandoned, we understand, partly because of their complexity and partly because of competition from firms without such schemes.

- 3.30 Alongside other regulators, the FSA is pressing for such schemes to be reconsidered and reintroduced. We believe that simpler schemes can be devised, and that the competition issue can be less acute given the greater scrutiny of remuneration practices that will be undertaken by regulators in the major financial centres.

Governance

The role of Remuneration Committees

- 3.31 All firms visited have Remuneration Committees (RemCos) - or their equivalent - in place as subcommittees of the Board. They are fully or majority staffed with non executive directors, and they see their principal responsibility (a statutory responsibility in the UK and most other countries) as to advise the main Board on the remuneration of the executive directors. Many of them approve the remuneration of other staff above a certain level.
- 3.32 In other respects, practices vary. Some have up to now had little involvement in determining the remuneration policies across the firm as a whole. Some are independent minded: others, we feel, tend rely to an undue extent on the advice provided to them, whether by independent advisers or by the management of the firm. There is evidence that some overseas-based RemCos have had only limited oversight of remuneration practices in UK subsidiaries below top-level management.
- 3.33 A more common theme however is that RemCos have not regarded an assessment of the implications for risk of remuneration policies and practices as a significant part of their terms of reference. As noted above, there is an emerging consensus that this should change.
- 3.34 In our Code we are proposing that RemCos should increase their focus on risk, ensuring that there are within the committee members with the necessary skills and experience to do so. We also state that it would be good practice for RemCos to increase their engagement with the risk management function within a firm, for example by inviting them to assess risk adjustment data used in performance assessment.

Independence of the risk and compliance functions and procedures for determining their remuneration

- 3.35 Under this heading we raised three questions. First, did risk and compliance functions have sufficient input into remuneration decisions? Second, did they have sufficient independence to challenge views and decisions taken by front line decisions? Third, was the remuneration of employees in these functions determined independently of other business areas?
- 3.36 Compliance functions had an input to remuneration decisions in nearly all firms, although the procedures were more formalised in some than in others. In contrast, risk management functions had less input – in some cases, no formal role at all – and most firms agreed that this was an issue that needed to be addressed.

- 3.37 The majority of firms were able to demonstrate that their risk and compliance functions were sufficiently independent from front line units, both in their ability to challenge decisions and in the way in which they were remunerated, but there were some exceptions. It was apparent that in a few firms risk and compliance staff embedded in front line units had lost some of their ability to challenge decisions. Reporting lines were principally to senior staff in the front line unit, rather than to independent units. In some firms, and notably in some investment banks, bonuses for risk and compliance staff embedded in business units were being paid from the same pot as for other staff in the business unit. This creates conflicts of interest.
- 3.38 Our proposed Code requires firms to have measures to manage and where possible avoid conflicts of interest. It also says that the ratio of the variable to the fixed components of remuneration for risk and compliance staff should be significantly lower than for employees in the business areas, but that firms should nevertheless ensure that the overall package for risk and compliance staff is sufficient to attract qualified and talented staff.

4 Market failure analysis

Why are current remuneration structures a problem?

- 4.1 A discussion about setting a framework for remuneration policies in the banking industry first needs to consider whether there is a market failure related to remuneration structures and the way they are set. We then need to establish whether regulatory intervention can in principle help to address this market failure.
- 4.2 Excessive risk-taking in the banking industry has led to the failure of firms and to systemic problems in both the UK and globally. The causes of this excessive risk taking are numerous and complex. However, inappropriate remuneration structures can contribute to excessive risk taking and the findings of our review of practices in the London market provided evidence of such inappropriate structures in current market practice.
- 4.3 In substantial parts of the banking industry variable compensation has a short-term focus and is not adjusted for risk. These remuneration structures persist as the banking industry is constrained by pressures on the labour market. The unilateral introduction of a longer-term focus in variable remuneration could put a firm at a first-mover disadvantage as key staff will switch to competitors. Remuneration structures also persist because they are in the interest of shareholders with a short-term perspective. In this sense remuneration geared towards the short-term is a mechanism for shareholders with a short-term focus to align their interest with the interest of employees.
- 4.4 Higher profits translate into higher bonuses for the employee, whereas bonus payments cannot be lower than zero. Therefore, losses are borne by long-term shareholders and society, but only to a small extent by employees and short-term shareholders. In this sense remuneration is a driver for excessive risk-taking and can lead to an externality as employees in the banking sector do not take fully into account the potentially negative consequences of their decisions on their firms and society.

- 4.5 On a firm level there have been numerous examples where excessive risk-taking by individual employees has led to substantial losses which have to be borne by shareholders.
- 4.6 On an economy-wide level it is obvious that over the last 18 months problems in the banking sector have led to high costs for society as the costs for bank assistance programs are borne by the taxpayer. We have also seen the problems in the financial sector spreading out to the rest of the economy as banks are de-leveraging their balance sheets and provide less credit than is needed for welfare-improving investments. But it has to be acknowledged that banks also import problems from the wider economy. Initially low risk loans may become bad loans as a result of a deterioration in the macro-economic environment. So it is important to bear in mind that not all macroeconomic problems are caused – or can be solved – by financial regulation.
- 4.7 However, excessive risk-taking has been one of the main drivers of the current problems in the banking sector and incentives created by variable remuneration have been a contributing factor.

Why can regulation help to address the problem?

- 4.8 The economic rationale for regulation when systemic issues come into play has been explained in our Occasional Paper 1: “Regulation for systemic reasons is warranted when the social costs of failure of financial institutions (particularly banks) exceed private costs and such potential social costs are not incorporated in the decision making of the firm. Banks may, therefore, be induced into more risky behaviour than they would if all risks (including those for the system as a whole) were incorporated in their pricing.”¹²
- 4.9 Current remuneration structures that encourage excessive risk-taking have evolved in the market over a long time. Chapter 3 of this Consultation Paper gives a summary of the key issues we have observed in our survey of the UK banking industry. The most important concerns are:
- Remuneration committees have generally low levels of engagement in remuneration policies below those for executive members of the board. However, inappropriate remuneration structures at other senior management levels (and sometimes for more junior staff in the trading environment) can be key drivers for excessive risk taking. In most cases members of remuneration committee members lack expertise in risk assessment. We have also seen cases where remuneration committees may have acted with less independence from the executive members of the board than would be desirable.
 - Problems have largely been observed in large banks with significant investment banking operations and large broker dealers. There have been fewer remuneration-related issues in smaller, predominantly retail banks and building societies.

12 Llewellyn, D. (1999), The Economic Rationale for Financial Regulation, FSA Occasional Paper 1, www.fsa.gov.uk/pubs/occpapers/OP01.pdf

- Cash is the dominant element in variable compensation packages. As deferred compensation is often only a small proportion of the total remuneration package and is in many cases imperfectly structured, it is unlikely to be effective in promoting an adequate focus on longer term perspectives.
 - Deferred compensation which is adjusted to reflect the future performance of the firm or a business unit is rare for cash compensation. Compensation in the form of equity provides some element of performance adjustment provided it is appropriately structured.
- 4.10 It seems unlikely that the market will come up with a sustainable solution that addresses the problem of externalities which can result from remuneration structures in the banking sector. The main reasons why the market is unlikely to provide sustainable solutions for appropriate remuneration policies are:
- shareholder short-termism;
 - market standards for remuneration and competition in the labour market
 - cyclical risk-taking behaviour; and
 - corporate governance issues.
- 4.11 Imposing constraints on remuneration policies can mitigate excessive risk-taking and the resulting negative externalities. The key mechanisms are that regulation of remuneration policies is a countervailing force to shareholder short-termism and to pressures in the labour market for short-term variable remuneration.

Shareholder short-termism

- 4.12 The interests of shareholders with a focus on short-term profits are not aligned with those of long-term shareholders. They are further not aligned with the interests of society as a whole, as they do not take into account the wider consequences of excessive risk-taking. Shareholders with a focus on short term profits can include employees of the firm who are participants in share incentive schemes, which often mature in a relatively short period of time. Pressure from shareholders with short-term perspectives is one factor why remuneration packages geared towards the short-term and leading to excessive risk-taking are offered to employees in the banking industry.
- 4.13 Standard economic theory on how executive compensation should be set is based on two assumptions:
- incentive schemes are an effective trade-off between risk-sharing and incentives for executives; and
 - share prices correctly reflect the fundamental value of a firm and can therefore be used as a basis to determine incentive-based executive pay.
- 4.14 Bolton et al. (2006) analyse managers' incentives when share price can temporarily deviate from their fundamental value. This can lead to short investment horizons of institutional shareholders. They show that in this case optimal remuneration packages

may give emphasis on boosting stock values in the short-term at the expense of the long-term value of the firm.¹³

- 4.15 Several studies indicate average holding periods by institutional investors between one and two years.¹⁴ This raises the question whether the time horizon of institutional investors is long enough to exert long-term discipline on firms or whether it creates incentives for the management to increase short-term value.
- 4.16 There are indications in the academic literature that a short investment horizon (measured by higher share turnover) of institutional shareholders is related to short-term behaviour. Bushee (1998) shows that firms where institutional investors have a high portfolio turnover tend to focus less on long-term investments, and Bushee (2001) demonstrates that institutional investors with a short-investment horizon do place undue weight on near-term expected earnings.¹⁵
- 4.17 Graham et al. (2005) conducted a survey of 400 CFOs (Chief Financial Officers) of US-listed companies. In their view there is a trade-off between the long-term goal to maximize firm value and the short-term goal to meet or exceed earnings benchmarks. Graham et al. find that a significant proportion of respondents would forgo profitable investments to meet a short-term earnings target. They also find that 78% of CFOs would sacrifice long-term firm value to smooth quarterly earnings.¹⁶ This is a rational strategy as there is evidence that missing quarterly earnings benchmarks is associated with a higher chance for executives of being dismissed as well as getting lower bonuses and lower equity-based compensation.¹⁷
- 4.18 Regulation of remuneration structures is a countervailing power to the influence of shareholders with a short-term focus and reduces the negative impacts of shareholder short-termism. It removes the power of shareholders with a short-term focus to impose remuneration structures which are in their interest, but not in the interest of long-term shareholders and society.

Market standards for remuneration and competition in the labour market

- 4.19 The labour market in parts of the banking industry (e.g. in investment banking) is highly competitive due to highly mobile employees. In these parts of the industry remuneration policies with short-term and non-risk adjusted incentives are market standard (see Chapter 3 for an overview). Introducing a remuneration policy which takes into account risk and has a stronger focus on long-term incentives may put a firm into a first-mover disadvantage, as key staff will switch to competitors.

13 See Bolton, P., Scheinkman, J. and Wei Xiong (2006): *Executive compensation and short-termist behaviour in speculative markets*, Review of Economic Studies, 73, pp. 577-610.

14 See e.g. Gaspar, J.-M., Massa, M. and P. Matos (2005), *Shareholder Investment Horizon and the Market for Corporate Control*, Journal of Financial Economics, Vol. 76, pp. 135-165 and Froot, K., Perod, A. and J. Stein (1992), *Shareholder Trading Practices and Corporate Investment Horizons*, Journal of Applied Corporate Finance, Vol. 5, pp. 42-58.

15 See Bushee, B. (1998), *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, The Accounting Review, Vol. 73, pp. 305-333 and Bushee, B. (2001), *Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value*, Contemporary Accounting Research, Vol. 18, pp. 207-246.

16 See Graham, J., Harvey, C. and S. Rajgopal (2005), *The Economic Implications of Corporate Financial Reporting*, Journal of Accounting and Economics, Vol. 40, pp. 3-73.

17 See e.g. Mergenthaler, R., Rajgopal, S. and S. Srinivasan (2008), *CEO and CFO Career Consequences to Missing Quarterly Earnings Benchmarks*, Available at SSRN: <http://ssrn.com/abstract=1152421>.

- 4.20 We currently observe several market players moving their remuneration policies towards more risk adjustment and longer-term incentives. However, there is a question whether this will apply across the market and whether a market-led solution can be sustainable in the next market upturn.
- 4.21 Creating remuneration standards that apply across the banking sector removes the threat of key staff switching to competitors as all firms have to behave the same way. This underlines the importance of consistency in the implementation of policies on remuneration practices at the international level, discussed in Chapter 2.

Cyclical risk-taking behaviour

- 4.22 Chen et al. (2006) observe procyclical risk-taking behaviour of CEOs in the US banking industry. They analyse the impacts of option-based compensation on risk taking. They find that the level of option-based ‘wealth’ of CEOs affects risk taking, with a higher level of stock-option wealth associated with higher firm risk. As this relationship in their study also holds in the opposite direction, this points to procyclical risk-taking behaviour by executives in the banking industry.¹⁸
- 4.23 Behavioural economics provides some explanation for procyclical risk-taking behaviour by decision-makers. For example, decision makers tend to rely too much on recent events / information and pay too little attention to events that they believe to be very unlikely. The latter is especially critical, as low-probability, high-impact events might not be appropriately considered (Disaster myopia¹⁹).
- 4.24 According to the arguments above, risky decisions are influenced by prior success in similar situations. Therefore in benign markets with no recent history of negative events managers will potentially take high risks, as they essentially underestimate low-probability, high-risk events. This mechanism works in the opposite direction during market downturns.
- 4.25 These effects can be exacerbated by herding behaviour. Mimicking the actions of other players in the market can be a rational strategy in two ways. Employees can ‘hide in the herd’ in order to conceal their performance or they can ‘ride the herd’ to prove the quality of their decisions. Variable compensation which is determined relative to peer performance may play a part in this behaviour.
- 4.26 However, in downturns there can be a countervailing mechanism which can lead to increased risk-taking in these situations. In order to avoid bankruptcy managers may engage in highly risky strategies in a ‘gamble for resurrection’.
- 4.27 The reward structures currently observed in the banking and investment industry can play their part in cyclical risk-taking behaviour because they exacerbate the short-term focus and provide incentives for disaster myopia. Regulating variable remuneration sets incentives for employees to take a longer-term and risk-based perspective and can therefore mitigate the behavioural issues leading to excessive risk-taking in boom markets.

18 See Chen, C.R., Steiner, T.L., Whyte, A.M. (2006), *Does stock option-based executive compensation induce risk-taking? An analysis of the banking industry*, Journal of Banking and Finance 30, 915-945.

19 See L. Bebhuk and J. Fried (2003), *Executive compensation as an agency problem*, Journal of Economic Perspectives, 17(3), pp. 71-92.

Corporate governance issues

- 4.28 Company boards, assisted by remuneration committees, should work in the interests of shareholders and set appropriate remuneration policies that provide banking employees with suitable long-term incentives. However, as Bebchuk and Fried (2003) point out, there is no reason to believe that this automatically happens in practice.²⁰ Pressure by short-term shareholders to adopt a short-term focus may obviously also affect the board.
- 4.29 Our survey of remuneration policies in the UK (see Chapter 3) points to other problematic issues. It shows that remuneration committees generally have minimal engagement in remuneration policies below the top management level. In some cases we have also seen a lack of expertise by members of remuneration committees.
- 4.30 Annex 3 provides an overview of regulations and market-led initiatives which are in place. These initiatives provide some valuable benchmarks for firms' behaviour, but they do not fully address the issues raised in this market failure analysis. For example, although the UK Combined Code²¹ includes important provisions on how remuneration policies should be determined, including on the independence of remuneration committees, the Code only applies to executive compensation and to listed companies.
- 4.31 Regulation clarifies the scope of the responsibilities for remuneration and ensures necessary independence and competence to set adequate remuneration policies. In combination with a framework how remuneration structures should be set this will also improve the quality of remuneration policies.

Consultation Q3: Do you agree with this analysis of market failure?

20 The Financial reporting Council's Combined Code on Corporate Governance, <http://www.frc.org.uk/CORPORATE/COMBINEDCODE.CFM>.

21 The Financial reporting Council's Combined Code on Corporate Governance, <http://www.frc.org.uk/CORPORATE/COMBINEDCODE.CFM>.

5 The Code of practice and the proposed new framework

The scope of the Code

- 5.1 As we have emphasised, in our original ‘Dear CEO’ letter of last October and subsequently, the FSA’s focus is on the extent to which remuneration practices may pose risks to a firm and be inconsistent with effective risk management. We are not concerned with the absolute amount of remuneration. This is a matter for the Boards of firms, which should ensure that their firms have the structures in place to set appropriate remuneration levels throughout the firm.
- 5.2 The FSA published a draft Code on 26 February, alongside the government’s announcement of the details of the Asset Protection Scheme. This proposed that the Code should apply to all FSA-authorised firms. However, we have now decided that we should consult only on a more limited scope, as set out below, and invite discussion on extending the code to all FSA firms.
- 5.3 There are two main reasons for this. First, the focus of our concern in this CP is on the extent to which inappropriate remuneration practices may have contributed to the market crisis and on ways in which we can address this risk for the future. This risk is concentrated in the practices of a relatively small number of large firms, rather than in the general body of FSA authorised firms.
- 5.4 Secondly, if it was therefore decided to extend the scope of the Code to all FSA firms, the objectives may need to be different – focusing for example on the risk of conflicts of interest between an employee and customers. This needs further thought and research before we produce firm proposals. This is discussed in further detail in Chapter 6.
- 5.5 We are therefore consulting on the proposal that the Code’s rule and evidential provisions would apply only to certain large banks and broker dealers, defined as follows:
- FSA regulated banks and building societies which meet either of these criteria:
 - o total regulatory capital in the UK banking entities in excess of £1 billion;
 - o are part of a financial (UK or international) group whose regulatory capital is in excess of £20 billion or the equivalent amount in another currency.

- FSA-regulated BIPRU 730k firms which meet either of these criteria:
 - o consolidated regulatory capital in the UK authorised entity is in excess of £750 million or the equivalent amount in another currency;
 - o are part of a financial group (UK or international) whose regulatory capital is in excess of £5 billion or the equivalent amount in another currency.
- 5.6 This would exclude UK branches of EEA firms since responsibility for systems and controls is reserved to home competent authorities, but include the overseas branches of UK firms (both EEA and non-EEA).
- 5.7 We estimate that on this basis around 48 firms would be covered. This would include around 24 UK banking entities, ten other banks in the UK which are part of bigger banking groups, three building societies, and 11 UK authorised BIPRU firms with capital in excess of £750 million. There are currently no BIPRU firms in the UK which are part of an international financial group with capital in excess of £5 billion, but the criterion is kept in case market structures were to change.

The contents of the Code

The general requirement

- 5.8 The Code has one general requirement, which we propose should be incorporated into the Handbook as a rule:

Proposed rule:

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

- 5.9 Although we are for the moment consulting on the proposal that this should be incorporated into the Handbook as a rule for the large banks and broker dealers described above, it is self evidently a high-level requirement which should be followed by all firms.
- 5.10 Our guidance on this rule explains that what a firm must do to comply with the Code will vary according to the nature, scale and complexity of the firm and its activities. For example, references in the code to shares and shareholders, do not apply to building societies.
- 5.11 The guidance on the general rule notes that the Code covers all aspects of remuneration that could affect risk and risk management, including fixed and variable compensation elements, hiring policies, severance packages and pension arrangements. Firms should

have regard to applicable good practice on remuneration and corporate governance produced by other bodies such as the Association of British Insurers and the NAPF.²²

- 5.12 We may ask a firm's remuneration committee to give us evidence of how well its policies meet the Code's principles, together with plans for improvement where there is a shortfall. As explained in further guidance, this may take the form of a statement on a firm's remuneration policy, including the implications for risk and risk management.

The Evidential Provisions

- 5.13 The draft Code also has 10 principles, which we propose should be incorporated into the Handbook as 'evidential provisions'. Where specified in the Handbook, we can use compliance with an evidential provision as tending to establish compliance with another rule, in this case the Code's general requirement. Also where specified, we can use contravention of the evidential provision as tending to establish contravention of another rule. The evidential provisions help firms understand what the high-level general requirements mean in practice (although they are not exhaustive), while retaining some flexibility in complying with that requirement. The evidential nature should also assist the FSA in supervising and enforcing the Code.
- 5.14 The rule and the evidential provisions are all supported by guidance which provides the rationale and further clarification as needed. Firms can take the Guidance into account in deciding how they can meet the rule.

Remuneration principles

Principle 1: Role of bodies responsible for remuneration policies and their members²³

Proposed Evidential Provisions:

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.

²² National Association of Pension Funds.

²³ This is a subject which is being covered also by the Walker Review of Corporate Governance in the UK Banking Industry. We have consulted Sir David Walker about our draft Code, and will continue to co-ordinate our work with that of his Review.

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.

We may ask a remuneration committee to prepare a statement on the firm's remuneration policy, including the implications of the policy for the firm. We 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 judgement and not rely solely on the judgment or opinions of others. We 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

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 judgement 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 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 compromise 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. We expect 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 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.

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: Deferral 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.

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/business unit. The former promotes teamwork, whilst the latter assures that risks which the employee had a role in assuming continue to have a bearing on his remuneration.

Consultation questions:

- Q4: Do you have comments on the content or the scope of the draft Code?
- Q5: Do you agree with our proposal to make the general requirement into a rule and the specific principles into evidential provisions, so that the Code becomes enforceable?
- Q6: What parts of this Code would be implemented by your firm (or all of the larger banks/broker dealers) if this Code were voluntary rather than mandatory?
- Q7: Do you have any comments on the suggestion that firms publish an annual remuneration statement?
- Q8: Do you think that the scope of the Code should be extended to cover the remuneration policies in firms which are undertaking outsourced or contracted activities on behalf of a firm subject to the provision of the Code. If so, what should the scope of such a requirement be (for example should it just be limited to firms carrying out FSA regulated activities)?

Implementation and transitional issues

- 5.16 As noted in the 'Next steps' section of Chapter 1, this paper specifies a two-month consultation period on implementing the Code for the larger banks, building societies and broker dealers. (We are specifying a three month period for feedback on the possibility of extending the Code to other firms regulated by the FSA – see Chapter 6). The reason why we are specifying a two month period for the consultation is that we want to be ready to bring the Code into effect from early November, in time for firms' 2009 remuneration reviews. To do this and give firms adequate time to prepare we propose to provide feedback and publish the new rules, if we decide to go ahead, by early August. We think that a two-month consultation period will be sufficient to enable potential respondents to provide feedback.
- 5.17 However, it is evident that to be effective policies on remuneration should be implemented globally and in a consistent manner. So in deciding whether to implement our plans we will take into account whether we consider there is satisfactory alignment of implementation plans by the authorities in the major financial centres. We will communicate our view on progress with implementation plans internationally in our feedback on the response to the CP, which we expect to publish in late July.
- 5.18 In summary, our proposed implementation timetable is as follows:
- 18 March: publication of this CP.
 - 18 May: deadline for comments on the consultation proposals.

- 18 June: deadline for comments on the issues raised in Chapter 6.
 - Late July: publication of a Policy Statement giving feedback on response to the CP and announcing our decision on the rules. This will include an assessment of international progress.
 - 6 November 2009 (provisional date): Handbook rules come into force.
- 5.19 Some firms may have employment contracts or other arrangements with employees which provide remuneration benefits that would prevent the firms from complying with the Code's general requirement. We anticipate that some such benefits will constitute binding obligations and there we propose transitional arrangements for two types of arrangement. The first case is where the contract allows the firm to amend it in a way which enables the firm to comply with the Code, we propose the firm will need to do so as soon as possible and no later than 31 December 2009. In all other cases, the final deadline by which such contracts must be amended or terminated to ensure compliance with the Code would be 6 November 2010, and pending amendment or termination firms would need to put in place specific measures to mitigate the risks posed by the remuneration arrangements.
- 5.20 On our proposed timetable, these arrangements would allow firms five months from publication of the final rules to amend the first type of contract. Firms would have a year from the Code coming into force to amend or terminate all other types. We understand that most current remuneration obligations will not extend beyond one year.
- 5.21 The transitional arrangements would not apply to obligations entered into after 18 March 2009 (ie after the date of publication of this CP). Remuneration arrangements entered into after 18 March 2009 would therefore need to comply with the Code from 6 November 2009 on our proposed timetable.

Consultation Q9: Do you have any comments on our
proposals for the implementation of the
Code and transitional issues?

6 Questions for discussion about extending the code to all FSA-authorised firms

- 6.1 This chapter contains the Discussion Paper section of this document. It raises the question whether the Code of remuneration practices should extend to all FSA-regulated firms (subject to constraints where EU legislation reserves such matters to home state regulators).

Objectives for an extension of the scope

- 6.2 The fundamental objective of our current project is to consider the extent to which inappropriate remuneration practices may have led banks, building societies and the larger broker dealers to take excessive risks and in doing so to contribute to the present financial crisis. We do not think that there is a strong case to suggest that inappropriate remuneration practices in other firms in the financial sector played a significant role in the present crisis.
- 6.3 However, there are other ways in which inappropriate remuneration practices are a legitimate cause for concern to firms and to regulators:
- the risk that the incentives given to the employee increase the risk of material financial loss to firms even if such losses do not contribute to wider market instability or disruption;
 - risk that an employee has a financial incentive to promote one product over another to the potential detriment of a customer (for example, where a fund manager is running both a low commission long only fund and a higher commission hedge fund); and
 - risk that an employee has an incentive to maximise the quantity of output, rather than its quality. This is a risk in most commission based incentive structures, and has been the focus of much of the work in our retail distribution review.

Firms to which it might apply

- 6.4 By extending the scope to all firms, the main additional groups that would be included are:
- BIPRU 730k firms not already covered by the scope of the consultation (ie, with regulatory capital below the threshold of £750 million or its equivalent in another currency);
 - other investment firms such as asset managers (including hedge fund managers);
 - insurers, managing agents and Lloyd's;
 - mortgage and other home finance providers;
 - credit unions;
 - general insurance and home finance intermediaries; and
 - retail investment intermediaries. Whether and how the code should be applied to these firms will be discussed further alongside the work of our retail distribution review (RDR). We will therefore ask for views on this particular area in the RDR Consultation Paper to be published in June 2009.

Application of the Code

- 6.5 As emphasised in Chapter 5, our intention is to apply the Code to all firms in a proportionate and risk-based way. As with other aspects of a firm's systems and controls, what a firm must do in order to comply with the Code will vary according to the nature, scale and complexity of the firm and its activities.
- 6.6 We are proposing that the general requirement in the Code - that a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management – should become a rule. There is a good case for saying that this is a rule which should be universally applicable to all financial firms. If their remuneration practices are not consistent with effective risk management they are likely to pose risks to the financial health of the company and so to consumers.
- 6.7 The ten principles in the Code, which we are proposing should become evidential provisions in applying the Code to the larger banks and broker dealers, are also generally applicable. The basic principles behind them – good governance in making remuneration policy and implementing it effectively, sound practices in the measurement of performance for determining bonuses, and ensuring that remuneration structures do not encourage an excessively short term approach or excessive risk taking – are good practice for all firms, whatever their size or the nature of their business.

6.8 It would, however, be most important to apply flexibility in some areas. For example, smaller firms often do not have remuneration committees, and decisions about remuneration policies can be made effectively by the directors or partners of the firm within their existing management structure.

6.9 Questions relating to our issues for discussion:

Q13: Do you think that there are concerns about inappropriate remuneration practices in financial firms besides those covered by our consultation proposals? If so, what in your view are the principal causes for concern?

Q14: Do you think that the scope of the Code should be extended to all FSA-authorised firms?

Q15: If so, do you think that it should be on the same basis as for banks, building societies and the larger broker dealers, i.e. with one Handbook rule and ten Evidential Provisions?

Q16: In your view, what would be the benefits and costs of extending the Code to all FSA-authorised firms?

List of the consultation questions and questions for discussion

Note: Questions 1-9 and 13-16 appear also in the text of the consultation paper. Consultation questions 10 – 12 appear only in this annex

Consultation Questions

- Consultation Q1: Do you agree with our analysis on the need for change and the gaps in the current regulatory approach?
- Consultation Q2: Do you think that introducing this Code into the Handbook as proposed would have adverse implications for the UK as a financial centre? Or do you think its introduction might have neutral or positive implications?
- Consultation Q3: Do you agree with this analysis of market failure?
- Consultation Q4: Do you have comments on the content or the scope of the draft Code?
- Consultation Q5: Do you agree with our proposal to make the general requirement into a rule and the specific principles into evidential provisions, so that the Code becomes enforceable?
- Consultation Q6: What parts of this Code would be implemented by your firm (or all of the larger banks/broker dealers) if this Code were voluntary rather than mandatory?
- Consultation Q7: Do you have any comments on the suggestion that firms publish an annual remuneration statement?

- Consultation Q8: Do you think that the scope of the Code should be extended to cover the remuneration policies in firms which are undertaking outsourced or contracted activities on behalf of a firm subject to the provision of the Code. If so, what should the scope of such a requirement be (for example should it just be limited to firms carrying out FSA regulated activities)?
- Consultation Q9: Do you have any comments on our proposals for the implementation of the Code and transitional issues?
- Consultation Q10: Do you have any comment on our CBA of the proposals (Annex 4)?
- Consultation Q11: Do you have any comments on the compatibility statement in Annex 5?
- Consultation Q12: Do you agree that remuneration risk is part of business risk? Should remuneration risk be specified in GENPRU 1.2.30R as a separate major source of risk that firms should, where relevant, identify and manage?

Questions from the DP Chapter (Chapter 6) for comment and feedback

- Q13: Do you think that there are concerns about inappropriate remuneration practices in financial firms besides those covered by our consultation proposals? If so, what in your view are the principal causes for concern?
- Q14: Do you think that the scope of the Code should be extended to all FSA-authorised firms?
- Q15: If so, do you think that it should be on the same basis as for banks, building societies and the larger broker dealers, i.e. with one Handbook rule and ten Evidential Provisions?
- Q16: In your view, what would be the benefits and costs of extending the Code to all FSA-authorised firms?

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:

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:

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

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 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 compromise 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 it with information relating to the workings of the calculations. The results of risk-adjustment are not foolproof, and accordingly a firm should 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.

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.

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.

Current regulatory requirements

1. This annex summarises current rules and guidance in the FSA's Handbook which are relevant to the remuneration issue. It also notes other relevant codes and legal requirements.

Current FSA rules and guidance on remuneration policies

2. There are a number of existing Handbook provisions that are relevant to the risks posed by remuneration policies, and which cover all firms (subject to certain restrictions for incoming EEA firms where systems and controls issues are reserved to the home State regulator).¹ In particular:
 - Principle 3 of the Principles for Businesses applies to all firms and requires them to take reasonable care to organise and control their affairs responsibly and effectively, with adequate risk management systems.
 - SYSC 4.1.1R requires firms to have robust governance arrangements including “effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms”.
 - SYSC 6.1.1R requires policies and procedures sufficient to ensure compliance with the regulatory system.
 - SYSC 6.1.4R requires common platform firms (which include banks, building societies and investment firms) to ensure that the remuneration of compliance staff is not likely to compromise their objectivity.
 - SYSC 7.1.16R requires BIPRU firms (which include banks, building societies and certain investment firms) to implement policies and processes to evaluate and manage exposure to operational risk.
3. Where incentives created by remuneration create a conflict with a firm's duties to its clients our conflicts management requirements are also relevant. In particular, Principle 8 requires a firm to manage such conflicts fairly. SYSC 10 expands on this and requires firms to take all reasonable steps to identify conflicts of interest

¹ References are to rules as they apply from 1 April 2009 when certain ‘common platform’ requirements are extended to all firms other than insurers, managing agents and Lloyd's.

between the firm and a client that may arise when it provides services. It requires firms to manage those interests in the first instance to prevent them materially risking damage to client interests. If the arrangements are insufficient then firms must disclose the conflict.

4. SYSC 3.2.18G provides specific guidance on remuneration for insurers on managing tensions caused by remuneration policies, while for insurers SYSC 13.6.2G provides that insurers should have regard to whether employee remuneration exposes the firm to the risk that it will not be able to meet its regulatory obligations.
5. The Listing Rules, also in the FSA Handbook, have requirements for listed companies' annual reports to include disclosures of their policies on executive directors' remuneration in annual reports (LR 9.8.8R).
6. The Listing Rules also require a listed company to make a "comply or explain" disclosure against the Main Principles of the Combined Code, discussed below, (LR 9.8.6(5) and (6)).

Other codes and legal and regulatory requirements

The Companies Act 2006

7. The Companies Act 2006 (CA2006) touches upon the issue of directors' remuneration, from the perspective of corporate governance, imposing statutory requirements relating to the creation of directors' remuneration reports², and what must be disclosed in these reports via a company's annual audited accounts. The operative principle in the relevant provisions of the CA 2006 relates to transparency around remunerations or emoluments paid to or receivable by a company's directors.
8. More specifically, the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008³, require disclosure of the overall total amount of the remuneration paid to, or receivable by, directors of a company. The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008⁴ read with Schedules 5 and 8, require disclosure in the directors' statutory remuneration report, in a given financial year, of information relating, *inter alia*, to remuneration committees, performance related remuneration, and the aggregate amounts of remuneration paid to or receivable by directors in respect of qualifying services. The scope of these latter regulations covers listed companies.
9. Both sets of regulations are made under section 412 of CA2006.

The Combined Code on Corporate Governance

10. The Combined Code on Corporate Governance sets out standards of good practice in relation to board composition and development, remuneration, accountability and audit and relations with shareholders. The standards are useful for firms to use as a

2 Required by section 420 CA2008.

3 SI 2008/410.

4 SI 2008/409.

yardstick for remuneration, however, the standards are only concerned with the remuneration of Directors and not with the implementation of remuneration practices that are consistent with effective risk management for the broad population of employees.

The ABI's Guidelines on Executive Remuneration Policies and Practices

11. The ABI also publishes Guidelines on policies and practices with respect to remuneration. These are a valuable as a benchmark tool for firm's behaviour in this area. However, the guidelines are voluntary and not binding as such and their scope covers a limited population, namely the remuneration of executive directors and not the employees throughout the company.

Cost benefit analysis of the proposals under consultation

1. When proposing new rules, we are obliged (under sections 155 and 157 of the Financial Services and Markets Act 2000) to publish a cost / benefit analysis (CBA), unless we consider that the proposals will give rise to no costs or to an increase in costs of minimal significance. The CBA is an estimate of the costs and an analysis of the benefits that will arise from the proposals. It is a statement of the differences between the baseline (broadly speaking, the current position) and the position that will arise if we implement the proposals.
2. This CBA is structured as follows:
 - overview of the population of firms affected;
 - direct costs to the FSA;
 - the incremental compliance costs incurred by firms;
 - potential impact on firms' ability to attract qualified staff;
 - the benefits of the Code to firms and the wider economy.

Overview of the population of firms affected

3. The Code of practice on remuneration policies as proposed in this CP would initially apply to certain large banks, building societies and broker dealers (defined as BIPRU 730K firms), defined as follows:
 - FSA regulated banks and building societies which meet either of these criteria:
 - a) total regulatory capital in the UK banking entities in excess of £1 billion;
 - b) are part of an international financial group whose regulatory capital is in excess of £20 billion or the equivalent amount in another currency.
 - FSA- regulated BIPRU 730k firms which meet either of these criteria:
 - a) total regulatory capital in the UK authorised entity is in excess of £750 million or its equivalent amount in another currency;

- b) are part of an international financial group whose total shareholder equity is in excess of £5 billion or its equivalent amount in a another currency

The following table provides a breakdown of the population of firms affected.

Category	Approximate number of firms
Banks in category 3 a above	24
Other banks in category 3 b with a UK presence (excludes EEA firms with a UK presence)	10
Building societies	3
BIPRU 730k firms in category 4 a above	11
BIPRU 730k firms in category 4 b above	0
Total	48

Direct costs to the FSA

- As discussed in Chapter 1, the FSA will be increasing its focus on remuneration practices within our supervisory programmes in all FSA-authorised firms. This will include further follow up visits to major firms, and the incorporation of remuneration risk into Arrow programmes and ICAAPs and SREPs as part of the Pillar 2 process. However this is a step on which we do not need to consult and on which no CBA is required.
- The implementation of the Principles of the Code of practice on remuneration policies, on which we are consulting, will have additional resource implications for the FSA. Supervisors may require annual statements of remuneration policy from the larger firm, or from firms where inappropriate policies have been identified following Arrow visits or other risk identification work. These will need to be analysed and followed up as required. However the FSA will adopt a proportionate approach and the intensity of the supervision applied to firms subject to the Code will vary according to the FSA's estimate of the impact and probability scores accorded to the risks.
- We estimate that the additional supervision time can be accommodated within the increased resources allocated to supervisory teams under the Supervisory Enhancement Programme. However, additional staff will be required to monitor the implementation of the policy and to update it as required. We estimate additional costs of about £300,000.

Incremental compliance costs to firms

- The implementation of the Principles of the Code of practice on remuneration policies may lead to incremental compliance costs to firms. These costs may be incurred initially, when the new standards are set up, as well as on an on-going basis. The table below summarises the expected incremental compliance costs to firms.

8. The cost estimates provided in this CBA are based on a small survey of four firms carried out in March 2009 which asked for an indication of the costs associated with the proposed Principles of the Code. The survey covered large retail banks, wholesale-only banks and a building society.
9. The survey of remuneration practices in the London market we have carried out (see Chapter 3) indicates some of the firms subject to the Code are already generally in line with the requirements of the Principles, particularly those primarily focussed on retail banking. It also notes that a number of banks and building societies have already started changing their remuneration policies and practices which will increase their compliance with the Code. The incremental impact of the Code will therefore vary significantly across the affected firms.
10. This is confirmed by the wide variation in the estimates provided by firms in our cost survey. Due to these variations in the estimates and the small sample size, we provide cost estimates in this CBA on a per firm basis. We also provide the range of cost estimates we have received.

Table 1 – Incremental compliance costs estimates per firm

Costs in terms of	One-off	On-going (annual)
Changing the way remuneration policies are set, systems and controls, additional data collection, reporting, and record keeping requirements	£150,000 - £1.5m	£75,000 - £1m
Issuance of an annual remuneration statement*	£5,000 - £0.5m	
Senior management/board or committee time		£30,000 - £200,000
Enhanced risk management function		£60,000
Adjusting remuneration structures (as per Principles 8 and 9)	0 – £0.5m	0 – £0.5m
Total	£155,000 - £2.5m	£170,000 – £2.3m

* See paragraph 16 for explanation.

Change in procedures for setting remuneration policies

11. The implementation of the Principles of the Code of practice on remuneration policies will change the ways in which remuneration policies are set within a firm including the necessity to change the way remuneration is determined on the level of divisions or business units. This may involve changes in firms' processes, systems and controls, additional data collection, reporting and record keeping. Based on the information collected in our survey of firms, we estimate that the initial costs to make appropriate changes will be in a range of £150,000 to £1.5m and incremental annual compliance costs between £75,000 and £1m depending on the complexity of the organisation.

Annual remuneration statement

12. Principle 1 states that the FSA may require the issuance of an annual remuneration statement for the FSA which includes an assessment of the impact of the firm's remuneration policies on its risk profile and employee behaviour.
13. The incremental cost for firms will depend on the extent to which new processes have to be implemented and the additional level of detail which is required for the statement.
14. The cost estimates provided by firms vary from £5,000 up to £0.5m for the production of a remuneration statement. These costs depend on the complexity and current procedures of the organisation. We expect the costs of subsequent remuneration statements to be lower because the necessary procedures will have been implemented.
15. Principle 1 also notes that 'it is good practice for a statement ...on a firm's remuneration policy to be available to the firm's shareholders'. Many of the firms affected by the Code do already publish an annual statement on executive remuneration within their annual report. The suggestion in Principle 1 goes further, in that the statement should cover remuneration policies across the firm and consider implications for risk. .
16. One respondent to the survey mentioned a likely increase in postage costs of 30% if the FSA were to require the statement to be sent out to members or shareholders. However in our view survey respondents may have over estimated the obligations and hence the additional costs of this suggestion. We would anticipate that a communication to shareholders or policyholders should be fairly straightforward and short, and be sent out alongside other documentation.

Boards and remuneration committees

17. The Code is to strengthen the role of boards and remuneration committees in the determination of remuneration policies and their implementation as remuneration practices. Members of boards and remuneration committees may have to spend additional time to meet the enhanced regulatory requirements specified in Principle 1. Firms might also incur additional costs for external advice. All respondents to the survey mentioned that remuneration committees would need to meet more often. From the responses we received, we estimate that the related incremental internal staff costs and costs for external advice will be in the range between £30,000 and £200,000.
18. The firms responding to our survey also expressed concerns about the enhanced role of Non-Executive Directors. It may be difficult and costly for firms to recruit sufficiently qualified and experienced persons to these roles.
19. Listed firms are already subject to the UK combined code for corporate governance which includes in its Chapter B some provisions on remuneration setting and committees. However these requirements refer to remuneration at the executive level only. Nevertheless, incremental costs for firms which are compliant with the code may be lower than for firms which do not have to comply with the UK combined code.

20. Foreign firms with UK subsidiaries covered by the Code may face additional costs in complying with Principle 1 in that the requirements will fall on boards and remuneration committees located overseas. We expect these costs to be similar to UK incorporated firms, except potentially increased travel requirements for meetings with the FSA. However, the FSA would endeavour to ensure that such meetings took place as part of planned visits, either in London or overseas.

Enhanced risk management

21. Principle 2, among others, refers to a changed and enhanced role of corporate risk management. Risk and compliance functions will be required to take a more active role in remuneration policies. Based on information firms provided in our survey, we have estimated that the necessary upgrade of a firm's risk management function will increase staff cost in the area by approximately £60,000 per year.

Adjustment of remuneration structures

22. There may be costs associated with adjusting remuneration structures as required by Principles 8, 9 and 10 which refer to the composition of remuneration. This will involve, for example changing individual contracts that are not in line with the Principles of the Code.
23. Companies may be required to change employment contracts which are non-compliant with the Code. Contracts with (for example) guaranteed bonuses may need to be renegotiated, and this might involve additional costs for some firms. However firms have assured us that the number of guaranteed bonus contracts, especially with a duration of over one year, is low. We estimate initial costs for this process of up to £0.5m. Firms also reported ongoing costs of the same magnitude. However, in general, costs may be significantly lower for organisations that have few contracts with guaranteed bonuses or where employment contracts are generally less individualised. We have set up transitional arrangements that will facilitate the adjustment processes in remuneration policies and help mitigate costs.
24. The Code could lead to a shift in the composition of remuneration towards higher fixed and lower variable salary components. We also expect a better linkage of deferred elements to future performance which may lead to a potential reduction in bonus payouts in case of bad performance. The overall impact of these changes on compensation levels and therefore staff costs is unclear and not possible to quantify.
25. However, under the assumption that overall compensation packages for employees remain stable, there will still be cost impacts:
- A shift towards higher fixed salary components will increase the fixed cost base for banks over the business cycle. It will increase staff costs to the extent to which fixed salaries are subject to National Insurance contributions and are pensionable.
 - Deferred cash compensation schemes could improve firm's cash flow (especially in years with poor profitability). However, in cases where firms make increased use of deferred share-based compensation, they might need to have shareholder approval for increased authorised capital to issue shares or increase share-buy

backs. To the extent firms increasingly use deferred compensation schemes this will increase record-keeping cost for firms (see above for a cost estimate) and may lead to additional accounting costs.

26. Banks have already been adjusting their remuneration structures independently of the Code. To the extent this is happening, this reduces the incremental costs of the introduction of the Code.

Potential impact on firms' ability to attract qualified staff

27. The application of the Code might distort the labour market as it could affect the relative competitiveness of regulated firms compared to non-regulated firms with regard to attracting talent and highly qualified employees. This applies in a cross-sectoral and international context.
28. This potentially has an adverse impact on the ability to recruit and retain highly qualified employees and may be of particular importance in an international perspective. Highly skilled financial sector employees may find it more attractive to seek employment overseas, in companies which are not subject to a similar remuneration regulation as proposed by the Code. This concern was also raised by the respondents to our survey.
29. Internationally coordinated action will help to deal with any risks to the UK's international competitiveness. However, it may be possible that the FSA code goes further than proposals by other regulators.
30. Given current uncertainties about international policy in this area and the interaction with other parts of wider economy, it is not possible to quantify the magnitude of such potential effects.

Benefits

31. The key risk which has been identified in our market failure analysis is the contribution of remuneration policies to excessive risk-taking. Excessive risk-taking by banks has led to huge costs for society during the current financial crisis.
32. Therefore the main benefit of the Code is a contribution to a reduction of systemic risk that arises from excessive risk-taking in the banking sector. The code aims at ensuring that remuneration structures provide longer-term and risk-adjusted incentives. To the extent the Code helps to achieve this, it can help to reduce excessive risk-taking and therefore contribute to a reduction in systemic risk.
33. As described in the market failure analysis remuneration policies should be a countervailing force to shareholder short-termism and to pressures in the labour market for short-term variable remuneration.
34. The Principles on measurement of performance for the calculation of bonuses, measurement of performance for long-term incentive plans, and composition of remuneration introduce a longer-term perspective for banking employees as well as a greater focus on the implications for risk of their decisions.

35. The principles on governance aim at ensuring more suitable processes to determine remuneration policies.
36. An industry-wide framework for remuneration policies removes the first-mover disadvantage currently observed for banks and broker dealers that want to change their remuneration policies.
37. The Code puts a focus on remuneration and risk-taking in all market conditions. Therefore it further ensures that reasonable remuneration policies are upheld in boom markets.
38. Benefits are potentially significant but are difficult to quantify, given the nature of market confidence and financial stability. The description of the transmission mechanisms can only be qualitative in nature and it will be very difficult to assess to what extent the introduction of the Remuneration Code will actually contribute to a reduction in systemic risk.
39. We further recognise that remuneration policies were and are not the sole driver for problems we have seen in the banking sector. Therefore remuneration policies are only one part of the measures to address the market crisis.
40. The benefits may be mitigated if the proposed Code caused new misalignments of incentives or dynamic inefficiencies, i.e. remuneration based on a moving average of risk-adjusted returns may be difficult to understand for an employee and may lead to expectations of performance which are misaligned with the firm's risk appetite.

Compatibility statement

1. This annex explains the reasons for concluding that our proposals are compatible with our general duties under section 2 of FSMA and our regulatory objectives, which are set out in sections 3 to 6 of FSMA.

Our regulatory objectives

2. Our duty is, as far as is reasonably possible, to act in a way which is compatible with our regulatory objectives and which we consider most appropriate for the purpose of meeting those objectives. The following objectives are particularly relevant to our proposals.

Market confidence

3. This objective requires us to seek to maintain confidence in the UK financial system. Excessive risk-taking in the banking industry can lead to failure of firms, systemic problems and a loss in confidence in the financial system. Excessive risk taking has been one of the main drivers of the current problems in the banking sector and the incentives created by the compensation practices to date have been a contributing factor as discussed in Chapters 2, 3 and 4.
4. The main benefit of the Code is a contribution to a reduction of the systemic risk that arises from excessive risk-taking in the banking sector. The intention therefore is that the proposals in this CP along with the proposed Code should contribute to greater market confidence by aligning compensation practices with sound risk management.
5. For the reasons described in our Market Failure Analysis (Chapter 3), we believe the proposed Code is the most appropriate way of meeting this objective.

Consumer protection

6. Although we are principally concerned with the risks posed by remuneration practices to financial stability and prudential soundness, we note the significance also of risks that inappropriate practices pose to conduct risks and the fair treatment of customers. These risks are addressed in our parallel work on the retail distribution review (RDR).

Compatibility with the Principles of Good Regulation

7. Section 2(3) of FSMA requires that, in carrying out our general functions, we must have regard to a number of specific matters. Of these, the following matters are relevant to our proposals.

The need to use our resources in the most economic and efficient way

8. There will be no additional cost for line side supervisors in supervising compliance with the Code as we expect to meet these resource requirements under our existing supervisory enhancement programme. Our proposals may, however, result in an additional staff requirement to monitor the implementation and to update policy as necessary. Our cost-benefit analysis (Annex 4) estimates costs of about £300,000. In our view this cost is justified by the benefits the proposals will deliver to the wider economy. The main benefit of our Code will be a contribution to a reduction of systemic risk that arises from excessive risk taking in the banking sector.

The responsibilities of those who manage the affairs of authorised persons

9. Our proposals would involve placing greater responsibilities on firm's senior management and in particular remuneration committees (or governing body where appropriate) to establish, implement and maintain remuneration practices that are consistent with effective risk management. They are consistent with the requirement to hold senior management responsible for risk management and controls within firms.

The principle that a burden or restriction should be proportionate to the benefits

10. In our opinion the costs associated with our proposals are proportionate to the benefits delivered. We have summarised incremental compliance costs to firms of implementing the Code in Annex 4. We note, however, that some firms are already generally in line with the requirements of the Code and that some players have already started changing their remuneration policies and practices. The main benefit of our proposals is a contribution to a reduction of the systemic risk that arises from excessive risk-taking in the banking sector.

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK

11. Our proposals could have significant impact on London's competitiveness if there is insufficient international agreement to enforce similar principles in all major financial markets. We will therefore take into account whether we consider there is satisfactory alignment of implementation plans by the authorities in the major financial centres when we finalise our policy in the summer.

The need to minimise adverse effects on competition and the desirability of facilitating competition between those who are subject to any form of regulation

12. The propositions in our Code could restrict competition in the market for certain investment banking skills to some extent. However, the paper argues that (and the industry itself recognises) that competitive pressures in this market have been a contributing factor behind the recent market crisis.

Draft Handbook text

SENIOR MANAGEMENT ARRANGEMENTS, SYSTEMS AND CONTROLS (REMUNERATION CODE) INSTRUMENT 2009

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 138 (General rule-making power);
 - (2) section 149 (Evidential provisions);
 - (3) section 156 (General supplementary powers); and
 - (4) section 157(1) (Guidance).
- B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on [6 November 2009].

Amendments to the Handbook

- D. The modules of the FSA Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Senior Management Arrangements, Systems and Controls sourcebook (SYSC)	Annex B
General Prudential sourcebook (GENPRU)	Annex C
Supervision manual (SUP)	Annex D

Citation

- E. This instrument may be cited as the Senior Management Arrangements, Systems and Controls (Remuneration Code) Instrument 2009.

By order of the Board
[23 July] 2009

Annex A

Amendments to the Glossary of definitions

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

<i>Remuneration Code</i>	<i>SYSC 19 (Remuneration Code).</i>
<i>Remuneration Code general requirement</i>	<i>SYSC 19.2.1R.</i>
<i>remuneration committee</i>	<i>a committee or other body responsible for a firm's remuneration policy.</i>
<i>remuneration policy</i>	<i>the policy, procedures and practices established, implemented and maintained in accordance with the Remuneration Code general requirement.</i>

Annex B

Amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC)

In this Annex, underlining indicates new text and striking through indicates deleted text unless otherwise stated.

1.1A Application

- 1.1A.1 G The application of this sourcebook is summarised at a high level in the following table. The detailed application is cut back in SYSC 1 Annex 1 and in the text of each chapter.

Type of firm	Applicable chapters
...	...
Every other <i>firm</i>	Chapters 4 to 12, 18, <u>19</u>

1.4 Application of SYSC 11 to SYSC ~~18~~19

What?

- 1.4.1 G The application of each of chapters SYSC 11 to SYSC ~~18~~19 is set out in those chapters.

Actions for damages

- 1.4.2 R A contravention of a *rule* in SYSC 11 to SYSC ~~18~~19 does not give rise to a right of action by a *private person* under section 150 of the *Act* (and each of those *rules* is specified under section 150(2) of the *Act* as a provision giving rise to no such right of action).

...

Remuneration policies

- 4.1.12 G Certain banks, building societies and BIPRU 730k firms will need to comply with the Remuneration Code requirement to establish, implement and maintain an effective remuneration policy that is consistent with effective risk management. See SYSC 19.1 for details of the application of the Remuneration Code.

...

- 6.1.5A G In setting the method of determining the remuneration of relevant persons

involved in the compliance function, certain *banks, building societies* and *BIPRU 730k firms* will also need to comply with the *Remuneration Code*. See SYSC 19.1 for details of the application of the *Remuneration Code*.

...

7.1.7B G In setting the method of determining the *remuneration of employees* involved in the risk management function, certain *banks, building societies* and *BIPRU 730k firms* will also need to comply with the *Remuneration Code*. See SYSC 19.1 for details of the application of the *Remuneration Code*.

...

After SYSC 18, insert the following new chapter. The text is not underlined.

19 Remuneration Code

19.1 Application

Who?

- 19.1.1 R (1) The *Remuneration Code* applies to a *firm* that is:
- (a) a *bank* or a *building society* if:
 - (i) the total *capital resources* held by *UK banks* or *building societies* within the *firm's group* exceeded £1 billion on the relevant date; or
 - (ii) it is part of a *UK consolidation group*, or non-UK group, which held *consolidated capital resources* (or, in the case of a non-UK group, equivalent capital resources) exceeding £20 billion on the relevant date; or
 - (b) a *BIPRU 730k firm* if it:
 - (i) had *capital resources* exceeding £750 million on the relevant date; or
 - (ii) is part of a *UK consolidation group*, or non-UK group, which held *consolidated capital resources* (or, in the case of a non-UK group, equivalent capital resources) exceeding £5 billion on the relevant date.
- (2) The *Remuneration Code* does not apply to such a *firm* to the extent that it is acting as an *incoming EEA firm*.
- (3) In this *rule*:

- (a) the ‘relevant date’ is a *firm’s* last *accounting reference date*; and
- (b) a “non-UK group” is a *group* subject to consolidated supervision on a full basis by an *EEA regulator* other than the *FSA* or by a *third country competent authority* under prudential rules for the *banking sector* or *investment services sector* of or administered by that *EEA regulator* or *third country competent authority*.

What? Where?

- 19.1.3 R If the *Remuneration Code* applies to a *firm*, it applies in the same way as SYSC 4.1.1R (General Requirements).
- 19.1.4 G Part 2 of SYSC 1 Annex 1 provides for the application of SYSC 4.1.1R (General Requirements).

19.2 Remuneration Code: General requirement

Remuneration policies must be consistent with effective risk management

- 19.2.1 R A *firm* must establish, implement and maintain *remuneration* policies, procedures and practices that are consistent with and promote effective risk management.
- 19.2.2 G
 - (1) 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.
 - (2) 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.
 - (3) 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).
 - (4) 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.

- (5) 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*.
- (6) 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)*.
- (7) 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*.

19.3 Remuneration Code: Remuneration principles

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

- 19.3.1 E (1) 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.
- (2) The effect of this *evidential provision* is set out in the evidential status rule (SYSC 19.3.21R).
- 19.3.2 G (1) *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.

- (2) 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.
- (3) *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.
- (4) 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 should 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.
- (5) 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*.

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

- | | | |
|--------|---|---|
| 19.3.3 | E | <ol style="list-style-type: none">(1) Procedures for setting <i>remuneration</i> within a <i>firm</i> should be clear and documented, and should include appropriate measures to manage conflicts of interest.(2) A <i>firm's</i> risk management and compliance functions should have significant input into setting <i>remuneration</i> for other business areas.(3) The effect of this <i>evidential provision</i> is set out in the evidential status <i>rule</i> (SYSC 19.3.21R). |
| 19.3.4 | G | <ol style="list-style-type: none">(1) Conflicts of interest can easily arise when <i>employees</i> are involved in the determination of <i>remuneration</i> 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 <i>firm's</i> human resources function when setting <i>remuneration</i> for other business areas.(2) 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.

- (3) Documenting procedures for setting *remuneration* includes documenting all performance appraisal processes and decisions.

Remuneration Principle 3: Risk and compliance function remuneration

- 19.3.5 E (1) *Remuneration* for *employees* in risk management and compliance functions should be determined independently of other business areas.
- (2) Risk and compliance functions should have performance metrics based on the achievement of the objectives of those functions.
- (3) The effect of this *evidential provision* is set out in the evidential status *rule* (SYSC 19.3.21R).
- 19.3.6 G (1) 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.
- (2) 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 prevent the views of other business areas being sought as an appropriate part of the assessment process.
- (3) 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 compromise their objectivity or be likely to do so (see SYSC 6.1.4R(4)) also applies.

Remuneration Principle 4: Profit-based measurement and risk-adjustment

- 19.3.7 E (1) Assessments of financial performance used to calculate bonus pools should be based principally on profits.
- (2) 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.

- (3) The effect of this *evidential provision* is set out in the evidential status rule (SYSC 19.3.21R).
- 19.3.8 G (1) 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.
- (2) Profits are a better measure, but they should be adjusted for risk, including future risks not adequately captured by accounting profits.
- (3) 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 are taken into account.
- (4) 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,) should be covered. The *FSA* expects a *firm* to be able to provide it with information relating to the workings of the calculations. The results of risk-adjustment are not foolproof, and accordingly a *firm* should apply judgment and common sense in the final decision about the performance-related component of *remuneration*.

Remuneration Principle 5: Long-term performance measurement

- 19.3.9 E (1) 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.
- (2) The effect of this *evidential provision* is set out in the evidential status rule (SYSC 19.3.21R).
- 19.3.10 G (1) 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.
- (2) 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).

Remuneration Principle 6: Non-financial performance metrics

- 19.3.11 E (1) Non-financial performance metrics should form a significant part of the performance assessment process.
- (2) Non-financial performance metrics should include adherence to effective risk management and compliance with the *regulatory system* and with relevant overseas regulatory requirements.
- (3) The effect of this *evidential provision* is set out in the evidential status *rule* (SYSC 19.3.21R).
- 19.3.12 G (1) 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.
- (2) 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.

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

- 19.3.13 E (1) The measurement of performance for long-term incentive plans, including those based on the performance of *shares*, should be risk-adjusted.
- (2) The effect of this *evidential provision* is set out in the evidential status *rule* (SYSC 19.3.21R).
- 19.3.14 G 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 to 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.

Remuneration Principle 8: Fully flexible bonus policies

- 19.3.15 E (1) The fixed component of *remuneration* should be a sufficient proportion of total *remuneration* to allow a *firm* to operate a fully flexible bonus policy.
- (2) The effect of this *evidential provision* is set out in the evidential

status rule (SYSC 19.3.21R).

- 19.3.16 G (1) 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.
- (2) 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.

Remuneration Principle 9: Deferment of the majority of any significant bonus

- 19.3.17 E (1) 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.
- (2) The effect of this *evidential provision* is set out in the evidential status rule (SYSC 19.3.21R).
- 19.3.18 G (1) 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.
- (2) 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.

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

- 19.3.19 E (1) 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.
- (2) The effect of this *evidential provision* is set out in the evidential status rule (SYSC 19.3.21R).
- 19.3.20 G (1) 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.
- (2) 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.

- (3) Deferred *remuneration* paid in cash should also be subject to performance criteria.
- (4) 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*.

Status of evidential provisions

- 19.3.21 R (1) Compliance with the *evidential provisions* in this section tends to show compliance with the *Remuneration Code general requirement*.
- (2) Non-compliance with an *evidential provision* in this section tends to show non-compliance with the *Remuneration Code general requirement*.

Amend the following text as indicated.

Sch 4 Powers exercised

The following powers and related provisions in the <i>Act</i> have been exercised by the <i>FSA</i> to make <i>rules</i> in <i>SYSC</i> :	
...	...
<u>(3A)</u>	<u>Section 149 (Evidential provisions)</u>
...	...

Sch 5 Rights of action for damages

5.4	G	Chapter/ Appendix	Section/ Annex	Paragraph	Right of action under section 150		
					For private person?	Removed?	For other person?
	

SYSC 11 to SYSC 18 19			No	Yes SYSC 1.4.2R	
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Insert the following new text. The text is not underlined.

TP 3 Remuneration code

- 1 R TP 3 applies to a *firm* that is unable to comply with the *Remuneration Code general requirement* because of an obligation it owes to an *employee* (the “obligation”) under an agreement entered into on or before 18 March 2009 (the “agreement”).
- 2 R A *firm*’s compliance with the obligation shall not cause it to be in breach of the *Remuneration Code general requirement* provided that the *firm* complies with 3R.
- 3 R (1) Where a *firm* is entitled to amend the agreement in a way that enables it to comply with the *Remuneration Code general requirement* it must do so at the earliest opportunity and no later than 31 December 2009.

(2) Otherwise, a *firm* must:
 - (a) take reasonable steps to amend the obligation or terminate the agreement at the earliest opportunity;
 - (b) amend the obligation or terminate the agreement no later than 6 November 2010; and
 - (c) adopt specific and effective arrangements, processes and mechanisms to manage the risks raised by the obligation.

Annex C

General Prudential sourcebook (GENPRU)

In this Annex, underlining indicates new text.

1.2.31 G ...

- (4) Business risk means any risk to a *firm* arising from changes in its business, including the risk that the *firm* may not be able to carry out its business plan and its desired strategy. It also includes risks arising from a *firm's* remuneration policy (see also the *Remuneration Code* which applies to certain *banks*, *building societies* and *BIPRU 730k firms* and the detailed application of which is set out in *SYSC 19.1*).

Annex D

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text.

13A Annex 1 Application of the Handbook to Incoming EEA Firms

...		
(1) Module of Handbook	(2) Potential application to an incoming EEA firm with respect to activities carried on from an establishment of the firm (or its appointed representative) in the United Kingdom	(3) Potential application to an incoming EEA firm with respect to activities carried on other than from an establishment of the firm (or its appointed representative) in the United Kingdom
...
<i>SYSC</i>	... <u><i>SYSC 19 does not apply to an incoming EEA firm when acting as such.</i></u>	... <u><i>SYSC 19 does not apply.</i></u>
...

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