

FSA draft Code of practice on remuneration policies

This is a draft Code of practice, published in conjunction with the Government's announcement about its Asset Protection Scheme ('the Scheme'). HM Treasury has indicated that the Code of practice will form part of the eligibility criteria for participating in the Scheme. Therefore, the FSA has released details of the Code, while still in draft form, to provide clarity on what eligibility may involve.

This draft Code will be the subject of a formal consultation process in March, and only when that consultation has finished will the Code of practice be added to our handbook. For banks not participating in the Scheme, this Code will only become effective following this process.

In October 2008, we issued a 'Dear CEO' letter to bank CEOs. All banks are expected to take account of the comments in that letter and be operating remuneration policies that fall within the good practice it outlined.

Introduction

- The principles in this Code of practice ("Code") are relevant to all FSA-regulated firms.
- The principles embodied in the Code are not concerned with levels or quantum of remuneration, which are a matter for firms' boards.
- The aim of the Code is to ensure that firms have remuneration policies which are consistent with sound risk management, and which do not expose them to excessive risk.
- The principles in the Code will be used by the FSA to assess the quality of a firms' remuneration policies and linkage, if any, between such policies and excessive risk-taking by staff.
- We may also ask the committee with overall responsibility for a firm's remuneration policies to provide us with evidence of how well its policies measure against these principles, together with plans for improvement where there is a significant shortfall. We will also ask firms to use the principles in assessing their exposure to risks arising from their remuneration policies as part of the ICAAP process

General principle

Firms must ensure that their remuneration policies are consistent with effective risk management.

Rationale:

If a firm's remuneration policies are not aligned with sound risk management it is likely that those policies will provide incentives for employees to act in ways that might undermine it.

Poor remuneration policies can lead to implicit or explicit expectations of performance from the employee, which are misaligned with the firm's risk appetite and contrary to sound risk management.

The FSA's purpose in encouraging firms to create and consistently implement better, risk-focused remuneration policies is that, while relevant Handbook rules require firms to manage the risks in their business appropriately, significant doubt has recently arisen over the efficacy of other risk management mechanisms to override the specific risks created by extravagant or excessive incentive structures, which in turn can lead to excessive risk-taking.

Specific principles

A. Governance

1. Boards and relevant remuneration committees should exercise independent judgement and demonstrate that their decisions are consistent with the firm's financial situation and future prospects. Their members should have the skills and experience to reach an independent judgement on the suitability of the remuneration policies, including the implications for risk and risk management.

Rationale

Boards and relevant sub committees should exercise their own judgement and take account of the financial situation of their firm in drawing up remuneration policies. The need for firms to offer competitive remuneration packages is recognised, but industry comparators should be a secondary rather than a primary factor in the determination of remuneration policies.

Clarification

Remuneration is usually the single most important cost incurred by firms after funding costs, and "people risk", including the risks posed by remuneration policies, constitutes one of the most important risks. Boards, and their remuneration committees, should pay specific and increased attention to these risks.

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

The FSA expects foreign firms with UK subsidiaries to have a body with oversight of remuneration policies in the UK entity which can meet the requirements of this Principle relating to risk, and to any reporting requirements that the FSA might require as explained below.

The FSA may ask a firm to prepare an annual statement on its remuneration policies, and will anticipate that this statement covers the implications of those policies for the firm. The FSA will also expect the statement to include an assessment of the impact of their policies on behaviour, and on the risk profile of the firm. In drawing up this

assessment, boards and remuneration committees should exercise their own judgement and not rely solely on the judgement or opinions of others. The FSA may seek a meeting with the Chair of the Remuneration Committee (or a firm's equivalent body) to discuss the annual statement.

It would be good practice for a statement on remuneration policies to be available also to shareholders, ahead of the annual vote on directors' remuneration.

2. The procedures for setting compensation within the firm should be clear and documented, and they should include measures to avoid conflicts of interest. Risk and compliance functions (in consultation with the firm's HR function as may be deemed appropriate) should have significant input into setting compensation for business areas.

Rationale

Conflicts of interest can easily arise when staff are involved in the determination of remuneration for their own business area. These need to be mitigated by having in place independent roles for control functions including, notably, risk departments.

Clarification

Principle 4 stresses the importance of risk-adjustment in measuring performance, and the importance within that process of applying judgement and common sense. It would be good practice for Remuneration Committees to ask the risk function to validate and assess risk adjustment data, and to attend a meeting of the Remuneration Committee for this purpose.

3. Compensation for staff in the risk and compliance functions should be determined independently of the business areas. They should have different performance metrics, with greater emphasis on the achievement of their own objectives.

Rationale

This principle is also designed to avoid conflicts of interest, such as might arise if the business areas had undue influence over the remuneration of control functions.

Clarification

This principle reflects the need to avoid undue influence by the business areas over the remuneration of control functions is particularly important where staff from the control functions are embedded in the business areas. However, the principle does not prevent the views of business areas being sought as part of the assessment process.

B. Measurement of performance for the calculation of bonuses

4. Assessments of financial performance to calculate bonus pools should be principally based on profits. The bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required.

Rationale

Measuring performance based wholly or mainly on revenues or turnover can provide an incentive for employees to pay insufficient regard to the quality of the business, or its suitability for the client. Profits are the preferred measure, but they should be adjusted for risk, including future risks not adequately captured by accounting profits. Such

adjustment may anyway become a requirement to address systemic risks and risks associated with the economic cycle.

Clarification

Management accounts should provide profit data at divisional/departmental/business unit levels to the extent possible. If revenue or turnover is used as a component in financial assessment, processes should be in place to ensure that the quality of the business done and its suitability for clients is taken into account. Risk-adjustment is likely to be based upon a calculation of economic profit or economic capital. The full range of potential risks (including, for example, liquidity risk) should be covered. A number of techniques are available to adjust profits and capital for risk, and firms should choose those which best suit their circumstances. However, the FSA would expect firms to be able to provide the FSA with information relating to the workings of the calculations. The FSA recognises that the results of risk-adjustment are not foolproof, and accordingly firms should apply judgement and common sense in the final decision about performance pay.

5. Firms should not assess performance solely on the results of the current financial year.

Rationale

Profits from banking activities are volatile and subject to cycles. The financial performance of firms and individual employees can be exaggerated as a result. The assessment process should include measures to ensure that employees are assessed on their longer term performance.

Clarification

Performance assessment on a moving average of results can be a good way of meeting the requirements of this criterion, however, other techniques, e.g. good quality risk adjustment (principle 4) and deferment of a sufficiently large proportion of remuneration (principle 9) can be used.

6. Non-financial performance metrics, including adherence to effective risk management and compliance with regulations, should form a significant part of the performance assessment process

Rationale

Poor performance in non-financial metrics, e.g. poor risk management or other behaviours contrary to company values can pose significant risks for a firm and should if necessary override metrics of financial performance.

Clarification

The performance appraisal process should be clearly explained to relevant staff, and implemented, and, secondly, the importance of non-financial assessment factors in the process should be explained. A "balanced scorecard" is a good way to do this. All processes and decisions should be fully documented, with firms recognising that the FSA may consider requiring firms, in appropriate cases, to produce such documentation.

C. Measurement of performance for long--term incentive plans

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

Rationale

Common measures of share performance, such as earnings per share (EPS) and Total Shareholder Return (TSR), are not adjusted for longer term risk factors. Many "longer term" incentive plans mature within a 2-4 year period, and 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 the company. For example, increasing leverage is a technique which can be used to boost EPS and TSR.

Clarification

The FSA will press for a wider review of the use of unadjusted share performance measures in longer term performance based remuneration schemes in the corporate sector.

D. Composition of remuneration

8. The fixed component of remuneration should be a sufficiently high proportion of total remuneration to allow the company to operate a fully flexible bonus policy.

Rationale

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

Clarification

A measure of the effectiveness of this principle would be the ability of a firm to be able to pay no bonus in a year in which the firm makes a loss.

9. The major part of any bonus which is a significant proportion of the fixed component should be deferred, with a minimum vesting period.

Rationale

This principle is designed to ensure that the interests of those receiving significant amounts of bonus are aligned with the longer term interests of the firms, whilst still providing flexibility for firms to devise attractive remuneration structures measured against practices across the corporate sector.

Clarification

In the FSA's view an example of good practice would be that where a bonus is a significant proportion of the fixed component, the proportion to be deferred should be not less than two-thirds. The vesting period of the deferred element should be appropriate to the nature of the business and its risks.

10. It is highly desirable that the deferred element of variable compensation should be linked to the future performance of the division or business unit as a whole.

Rationale

Most business undertaken in banking is subject to future risk and uncertainty. If variable compensation is paid out without any link to future performance, the employee has less incentive to take future risk into account, and the firm is exposed to the risk of paying out variable compensation which will prove not to be justified by results.

Clarification

Deferred compensation paid in stock can meet this principle provided that the scheme meets appropriate criteria, including risk-adjustment of the stock performance measure as described in principle 4. Deferred compensation paid in cash should also be subject to performance criteria. Linkage to the future performance of a business unit or division is usually preferable to the future performance of a smaller departments or teams since the latter arrangement can be less effective in promoting teamwork. It is accepted that such schemes are complex to administer. Nevertheless some leading investment firms have introduced them for their senior executives, and the FSA would encourage these to be adopted more generally across the banking industry.