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Financial Services Authority

**Reforming
remuneration
practices in
financial services**

Feedback on CP09/10
and final rules

August 2009



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Annex 1: List of respondents to CP09/10

Appendix 1: Handbook text

This Policy Statement reports on the main issues arising from Consultation Paper 09/10 (*Reforming remuneration practices in financial services*) and publishes final rules.

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1 Overview

Purpose

- 1.1 In Consultation Paper 09/10 (CP09/10) we set out our proposals to implement a Code of practice on remuneration policies. We proposed, and **formally consulted** on, incorporating the Code into our Handbook and applying it to large banks, building societies and broker dealers. We also reported 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.
- 1.2 This Policy Statement (PS) reports on the responses we received to our consultation and the decisions we have reached on the application of the Code.
- 1.3 In CP09/10 we **invited general discussion** and feedback on whether the Code should be extended to other FSA-authorized firms. We will not be reporting on this point in this PS. This will be addressed in a separate FSA document which we expect to publish in October.

Background

- 1.4 In CP09/10 we proposed a new framework for regulating financial services remuneration structures.
- 1.5 The framework set out in CP09/10 consisted of one general rule which required firms to establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management. The general rule was supported by ten principles which we proposed should be put into the Handbook as 'evidential provisions' (EP) or where appropriate, as guidance. The ten principles related to the three areas of governance, the measurement of performance and the composition of remuneration.
- 1.6 The CP also announced that we would be increasing the focus on remuneration within our supervisory programmes for all FSA-authorized firms by incorporating

remuneration risk into Arrow¹ and other supervisory programmes. In doing so, we would be taking a risk-based and proportionate approach.

- 1.7 We made it clear in our CP that in deciding whether to go ahead with our policy we would take into account whether we considered there was a satisfactory alignment of implementation plans by the authorities in the major financial centres.

Outcome of our consultation

- 1.8 During the consultation period, we attended meetings in London with trade associations and firms and held bilateral discussions with regulators from other countries.
- 1.9 We received 47 responses to CP09/10 from a range of interested parties including trade associations, professional services firms, consumer bodies and firms. A list of respondents is provided in Annex 1.
- 1.10 In general, respondents agreed on the need for changing the current framework on remuneration practices and recognised the validity of the FSA's interest in regulating this area. This is consistent with the feedback we received when we conducted our review of remuneration practices in the London market.
- 1.11 In terms of the proposed contents of the new framework, there was near-universal agreement on the proposed general rule and its introduction into our Handbook.
- 1.12 There were, however, mixed responses to the Code's EPs. The trade associations and major banks were concerned that the EPs, as drafted, were too prescriptive and too inclined to a 'one size fits all' approach. The strongest criticisms were directed at principles 8, 9 and 10 relating to remuneration structures.
- 1.13 There was widespread concern from almost all respondents that putting the Code as proposed in the CP into the Handbook now could have adverse competitive implications for the UK as a financial centre if regulators in other countries did not implement similar (or even identical) principles and to the same timetable. Some respondents wanted more information on how we would judge whether there had been sufficient international alignment with its Code.
- 1.14 Most respondents felt that the proposed implementation period (with the Code due to come into force in November 2009) was too short. They were also concerned about the lack of clarity on what we would expect from firms by November, in relation to risk adjustment and remuneration structures.

1 Advanced risk responsive operating framework – the FSA's principal risk assessment process.

Summary of our policy response

1.15 We have made rules on remuneration in the form set out in Appendix 1. We have changed the Code to take account, first, of the responses to the CP summarised above and second, of our own assessment of progress in the international implementation of remuneration principles. Full details of our policy response are set out in Chapters 3 and 4. The key changes are:

- Removing non-UK firms from the scope unless they are part of a group that contains UK banks and building societies that have total regulatory capital exceeding £1bn or BIPRU 730k firms that have total regulatory capital exceeding £750m. As a result only about 26 firms will fall within the scope, against around 47 under the proposals set out in the CP.
- Replacing principles 8, 9, and 10 – all of which relate to the structure of remuneration – with one new principle. This focuses on the need for the remuneration structures of senior employees and risk takers to be consistent with and promote effective risk management. The previous EPs on flexible bonuses, deferment and performance adjustment of deferred bonuses are now expressed as guidance. We have kept this text since we believe the standards which they set for remuneration structures are fair and correct.
- The guidance accompanying principle 8 now includes a reference to guaranteed bonuses. We say that guaranteed bonuses which run for a period of more than one year and similar payments in addition to salary are unlikely to be consistent with effective risk management.
- Changing the implementation date from 6 November 2009 (as proposed in the CP09/10) to 1 January 2010.
- A clearer distinction in the guidance to principle 1 between what we expect firms to do to communicate their remuneration policies to us in the course of our supervisory relationship and what it would be good practice for them to disclose publicly to their shareholders and other stakeholders.

1.16 We also provide some clarification about the way we intend to implement the Code, which appears in Chapter 6. The key points are:

- Giving more clarity about what we expect firms to have done by the implementation date of 1 January 2010. Essentially, we say that changes to policies and procedures should be fully in place **by** 1 January 2010, and changes to remuneration structures and contracts should be implemented with effect **from** 1 January 2010. Implementation of risk-adjustment techniques (principle 4) should take effect from 1 January 2010. Where shareholder approval for changes to a firm's remuneration policy is required, this approval should be sought at the earliest possible opportunity.

- A request that the firms within the scope should communicate their first remuneration policy statement (RPS) to us by end October 2009. We will communicate further details of what we expect an RPS to contain when we write to the Chairs of firms' remuneration committees by the end of August 2009.
- On principle 7, which is about the measurement of performance for long term incentive plans, we indicate that we will expect firms to have initiated a review by 1 January 2010 of how well their long-term incentive plans take account of future risks. We do not expect full implementation of this point by 1 January 2010. We will engage in further discussions on this issue with others concerned with corporate governance issues.

Key messages in this policy statement

Objective of the Code

- 1.17 The fundamental objective of the FSA's remuneration policy is to sustain market confidence and promote financial stability through removing the incentives for inappropriate risk taking by firms, and thereby to protect consumers.
- 1.18 Inappropriate remuneration policies, practices and procedures were a contributory factor rather than a dominant factor behind the market crisis. Nevertheless fundamental changes in the approach of many financial firms to remuneration will be needed if we are to be confident that we have laid a solid foundation to avoid future crises. Equally important will be changes in attitudes and behaviours on the part of employees, particularly those who perform key management functions and key risk takers.
- 1.19 Our Remuneration Code is not going to change the 'bonus culture' overnight. That is going to take time, and the involvement of many other players – the remuneration committees of firms and senior executives, shareholders, other regulators and authorities in the other major centres. But we believe that the proposals in this PS represent a significant first step and will deliver significant benefits in terms of improved risk management. We will follow this through with determination as we implement our supervisory programme to monitor and to control the risks that can arise from inappropriate remuneration policies.

The link between remuneration policies and effective risk management

- 1.20 The need to ensure that remuneration policies and practices are consistent with and promote effective risk management is fundamental. The statement may appear to be common sense, but in our experience – drawn from our research at the end of last year and from what we have observed in our day-to-day supervision – the policies and practices of many firms exhibit significant weaknesses and are inconsistent with effective risk management.

The international context

- 1.21 As noted above and discussed in more detail in Chapter 5, international discussions on the international alignment and implementation of remuneration principles are underway under the auspices of the Basel Committee on Banking Supervision and the European Council. We will play a leading role in those discussions, and we will seek to secure international agreement which corresponds as closely as possible to our principles.
- 1.22 International discussions will extend into 2010. A target date for the implementation of an agreement in Basel has not yet been set, while the date proposed for implementation of the EU proposals is the end of 2010. So it is likely that the UK and possibly one or two other countries will be implementing a remuneration code at least a year ahead of others.
- 1.23 We plan to publish a statement during the third quarter of 2010 which will assess the effectiveness of the Code so far and also provide an update on international implementation. The timing of this statement will also need to take account of discussions at the EU level.

Relationship of remuneration to governance

- 1.24 We recognise the vital importance of the role of shareholders in monitoring and controlling remuneration risks, and we take the opportunity in the Code to encourage this. In Chapter 2 we lend support to the idea that shareholders should reconsider the current practice, common in many firms, of accruing bonus pools ahead of any distribution of risk-adjusted returns to the providers of equity capital.
- 1.25 Assuring that equity capital receives the minimum reward necessary to compensate equity capital for the risk that equity capital bears is consistent with assuring that banks can continue to attract new investment – a factor that will strengthen banks’ resiliency. However, once capital is adequate and sustainable, the division of reward between shareholders and management is a matter for the firm and its shareholders to decide, subject of course to the corporate governance and fair disclosure requirements about such arrangements that will allow shareholders to take an informed decision about the level and composition of management compensation. The *Walker Review* has made proposals in this area, and we will continue to work closely with the Walker Review team on such corporate governance issues.²

Timing

- 1.26 We are incorporating the Code into the Handbook now because we want to have clear rules and guidance in place so that firms can incorporate the Code into their planning for 2010. We believe that the current version of the Code and Handbook limits the risk of damage to the UK’s competitiveness, especially in light of the strong G20 endorsement of the Financial Stability Forum (FSF) Principles on Remuneration and the efforts of the EU and the Basel Committee to implement these principles within the EU and globally.

2 ‘A review of corporate governance in UK banks and other financial industry entities’, 16 July 2009.

- 1.27 The need to get clear rules and guidance in place is underlined by recent market developments, where we have seen signs that some firms may be reverting to remuneration practices which we would regard as inconsistent with effective risk management. To reduce the risk of firms engaging in practices that would contravene the rule and/or proposed Remuneration Code we wrote to the Chief Executives of firms likely to fall within the scope of the proposed rule on 15 July 2009, reminding them that we were finalising plans to make rules along the lines proposed in the original CP.

Amending the Code

- 1.28 We will keep our Code under close review, to take account of future market developments and also of progress on international implementation. Inevitably an international agreement may differ from our present Code in some respects, although we do not think that the differences will be great because there is a wide agreement on the approach needed. If appropriate we will amend our Code in line with an international approach once it has been agreed.

Who should read this PS?

- 1.29 This paper should be read by all banks, building societies and broker dealers. Although the scope of the PS is restricted to larger firms the proposals we have set out indicate our thinking on what we view as good practice (where relevant) to all firms in these groups.
- 1.30 This PS will also be of interest to all other FSA-authorized firms, trade bodies and consumer groups.

Structure of this policy statement

- 1.31 This PS is structured as follows:
- Chapter 2 reviews the fundamental objectives of our new policy, reflecting on the links between remuneration policies and effective risk management and corporate governance.
 - Chapter 3 sets out the responses to our proposed framework and how we will be taking it forward.
 - Chapter 4 focuses on the responses we received to the Code and explains the amendments that we are making to it.
 - Chapter 5 assesses what progress has been made in the international implementation of remuneration principles.
 - Chapter 6 sets out the timetable for implementation, and what we expect firms to do in order to be compliant by the implementation date.

- Annex 1 lists the respondents to CP09/10.
- Appendix 1 contains the final handbook text.

Cost benefit analysis

- 1.32 CP09/10 included a cost benefit analysis (CBA). We do not think there will be any increase in costs arising from the amendments to the code (over and above those stated in the CBA) or if there will be any such increases, they will be minimal. We therefore have not issued a revised CBA.

Compatibility statement

- 1.33 CP09/10 included a compatibility statement which explained why we considered that our proposals were compatible with our general duties under section 2 of FSMA and with our regulatory objectives, set out in sections 3 to 6 of FSMA. We believe this statement is still valid as our fundamental regulatory objectives remain unchanged.
- 1.34 One of the Principles of Good Regulation requires that we have regard to ‘The international character of financial services and markets and the desirability of maintaining the competitive position of the UK’. We stated in the compatibility statement in CP09/10 that when we finalised our policy we would take into account whether there was satisfactory alignment in the implementation of the plans of authorities in the major financial centres. We have done so in finalising the Code. We explain above and in more detail in Chapter 4 why the current version of the Code limits the risk of damage to the UK’s competitive position when compared against the version of the Code published in CP09/10. In Chapter 5 we highlight the alignment of our Code with international principles and principles from other regulators and stress that we will be prepared to amend our Code again once there is an agreed international approach to the implementation of remuneration policies by the major regulators.

Next steps

- 1.35 The new Code will come into force on 1 January 2010. The key steps for the implementation of the new regulatory framework will be:
- 1.36 By the end of August we will send letters to firms’ remuneration committees asking them to complete a remuneration policy statement.
- 1.37 Firms return their remuneration policy statements to us by end-October.
- 1.38 We hold meetings with remuneration committees and HR/risk function staff between November 2009 and February 2010.

- 1.39 The Code on remuneration practices comes into force for firms within its scope on 1 January 2010.
- 1.40 The transitional arrangements for firms required to amend employment contracts that may be amended by the firm end on 31 March 2010.
- 1.41 Transitional arrangements for firms required to amend or terminate other employment contracts end on 31 December 2010.

2 Remuneration policies and risk

Introduction

- 2.1 In our CP we stated that ‘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’. If remuneration consists predominantly of cash bonuses that are paid out immediately without any deferral or claw back mechanism, and are based on a formula that links bonuses to current year revenues rather than risk-adjusted profit, there are strong incentives for managers to shy away from conservative valuation policies, strong incentives to ignore concentration risks, strong incentives to rig the internal transfer pricing system in their favour and strong incentives to ignore risk factors, such as liquidity risk and concentration risk, that could place the institution under stress at some point in the future. These strong incentives could undermine effective risk management.
- 2.2 Market discipline has not been effective in limiting the adverse effect of poor remuneration practices on risk management, particularly at large systemically relevant institutions. In many cases shareholders have allowed management to introduce compensation policies that in effect subordinate the interests of shareholders to those of employees, particularly senior employees engaged in trading businesses. Bonuses in many firms are accrued before taking into account the risk-adjusted return that shareholders should receive in return for providing the capital to the firm that allows management to take risk.
- 2.3 We concluded that this market failure could in principle be addressed by regulatory intervention, subject to two key conditions. The first was that the intervention should be directed at ensuring that remuneration policies and practices were consistent with and promoted effective risk management. The second was that it should be principles based, avoid excessive detail and use EPs to support one general rule.
- 2.4 The first of these two provisos is captured in our Code and the Handbook by the general rule. It is a fundamental rule which may appear self evident and common sense. However as discussed below, the findings of our review of remuneration practices in the London market – set out in Chapter 3 of our March 2009 CP – found significant weaknesses in several areas.

The link between remuneration policies and effective risk management

- 2.5 Effective risk management is explained in the Handbook, notably SYSC 7.1. It says that common platform firms must establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment. These must identify the risk relating to the firm's activities, processes and systems, and, where appropriate, set the level of risk tolerated by the firm.
- 2.6 In particular, a firm must set the level of risk that the firm takes so that the firm can be expected to meet threshold conditions even in a stressed environment. This involves the firm complying with our capital and liquidity frameworks as well as having adequate policies, procedures and controls in place with respect to the measurement and reporting of risk, the valuation of positions, the development and enforcement of limits and the design and implementation of internal transfer pricing.
- 2.7 Inappropriate remuneration policies can lead to excessive risk taking in almost any area of financial risk – for example, credit, market, liquidity or operational risk. They can also lead to the risk of serious misconduct, and of fraud – for example, by increasing the temptation for employees to mis-state or exaggerate their performance and mis-mark the valuation of positions.
- 2.8 Remuneration policies which can lead to excessive risk taking can also take many forms, but the findings from our review of remuneration practices in the London market identified some common themes.
- An excessive focus on short term results, and a failure to take account of current or future risks which may not be fully reflected in the measurement of performance. Many investment banks take net revenue (typically, revenues after deduction of expenses) and then determine bonus pools by reference to a revenue to compensation ratio, frequently in the range of 45 – 50%. Profit is a better measure, but only a few firms were making satisfactory measures to adjust profit data for future risks. Few firms were accruing bonuses after accrual of profits at a rate which was sufficient to award shareholders a minimum risk adjusted return on the capital employed in the firm.
 - Reliance on metrics such as earnings per share which are not risk adjusted and which can be used to drive short term performance targets to the detriment of the longer term health of the firm.
 - Policies and procedures which fail to deal with the conflicts of interest that can arise in the remuneration of those employees whose job is to control the risk taking and the risk management of revenue producing business units.
 - Insufficient weight given to non-financial measures of performance (including in some cases attitudes to risk and compliance) alongside financial performance measures.
 - Providing all or most significant bonuses in cash, with no deferment, thereby encouraging a focus on short term results, and giving incentives to exaggerate performance in the current year.

- Relatively few remuneration structures which provided a link between deferred bonuses (especially deferred cash bonuses) and the future performance of the firm (or, where practicable, the future performance of the employee's division or business unit).

Remuneration policies to support effective risk management

2.9 We would expect remuneration policies that support effective risk management to include the following steps:

- Identify the incentives created by the firm's remuneration policies, and therefore the behaviours and actions which could result. This exercise needs to be undertaken at the firm level for firm-wide policies and at the individual level for senior executives and significant risk takers.
- Consider what risks might be created by those behaviours and actions. These risks can fall into any of the principal categories – for example credit, market, liquidity, operational and reputational.
- Consider whether those risks fall within the firm's overall risk tolerance level.
- If the remuneration policies, procedures or practices contribute to the firm exceeding its risk tolerance level, revise remuneration to deliver the incentives and behaviours that are aligned with the firm staying within its risk tolerance level.
- Set up procedures and controls to ensure that the agreed remuneration policies are implemented in practice.
- Set up management information systems to ensure that there is effective monitoring of outcomes. Check that the remuneration policies have delivered the desired behaviours, actions and outcomes.

2.10 Another key element of effective risk management is the communication of the firm's values and objectives to employees, and a high degree of transparency about what is required of them if they are to benefit from variable remuneration awards. Firms will usually communicate their business objectives and strategy to their employees. However, it would be an example of effective risk management to link that to individual objectives, including non-financial objectives, ahead of the period during which performance will be assessed. Employees should know in advance what sort of behaviours and actions will be rewarded in the remuneration review process, and what sort of behaviours will lead to a reduced award or to no award.

2.11 We will be asking firms to explain in some detail how they are ensuring that their remuneration policies are consistent with effective risk management in their remuneration policy statements. See Chapter 6.

Remuneration policies and corporate governance

2.12 Principle 1 places increased responsibilities on the Boards and remuneration committees of the larger banks and broker dealers. It requires them to extend their terms of reference beyond the specific requirements of the Companies Act, which

only refers explicitly to the responsibilities of the Board in relation to the remuneration of the executive directors, and to address at a high level the remuneration policies of the firm as a whole. The principle requires them to consider the implications of those policies for risk and risk management, and to have the necessary skills and experience to do so.

- 2.13 Remuneration policy raises wider governance issues, which go beyond the remit of the FSA and the scope of this PS, but are nevertheless of fundamental importance to the firm. These have been covered in the *Walker Review*.
- 2.14 In his review, Sir David Walker makes certain recommendations about remuneration. These are consistent with the Remuneration Code proposed here. After the conclusion of the consultation, we will consider whether to reflect the recommendations of the *Walker Review* on remuneration in the Remuneration Code in due course.

3 Introducing a new framework

- 3.1 This chapter outlines the views of respondents on the reasons for proposing the new framework (including the cost benefit and market failure analysis), the implications for the UK as a financial centre, and questions relating to implementation and transitional arrangements. We also set out our responses to these views and how we have decided to proceed.
- 3.2 Chapter 4 will cover feedback and our policy responses on questions 4 and 5, on the Code itself.

The need for change

- 3.3 We asked:
 - Q1: Do you agree with our analysis on the need for change and the gaps in the current regulatory approach?
- 3.4 Almost all of the respondents agreed with the need for change to the status quo, recognising gaps in the existing regulatory approach and body of regulation. The vast majority of respondents also agreed that more could be done across the financial services industry to ensure that the incentives of those able to put firms at risk were better aligned with sound risk management. A good number of respondents also highlighted that poor remuneration practices should be recognised as a contributing factor to the market crisis, rather than an underlying cause.
- 3.5 Some firms chose to answer this question by highlighting that there is no empirical evidence of remuneration policies being responsible for the crisis and that the FSA should make this explicitly clear. A couple of banking institutions also pointed out the effect of remuneration practices was not uniform across firms in the banking industry. The Association of British Insurers (ABI) mentioned that the reform on remuneration would only be effective if it were part of a wider set of reforms of the international regulatory infrastructure and that the banking industry was largely reacting to poor supervision and to inappropriate incentives built into the regulatory structure.

- 3.6 However, there was a minority of institutions which felt that the existing body of regulation was adequate and that the Code as drafted was not a proportionate means of filling the gaps because it was too prescriptive.

Our response: We interpret the responses as broad agreement with our analysis and support for the need for change. As some respondents have pointed out, poor remuneration policies were a contributory factor rather than the underlying cause to the crisis and there is no empirical evidence of remuneration policies being responsible for the crisis. We recognised these points in paragraphs 1.5 and 3.3 in CP09/10 and in the *Turner Review*.³ However, we still believe the Code will deliver benefits for the protection of consumers by addressing incentives that may undermine the adequate management of risks by firms.

We considered the views of those respondents who argued that the existing body of regulation of remuneration is adequate. However, we have decided to press ahead with introducing the Code of practice on remuneration into the Handbook for the reasons set out in paragraphs 26 – 28 and Annex 3 in CP09/10. We have made significant amendments to the Code from the one presented in CP09/10 to make it less prescriptive.

We also note the response that the reform on remuneration would only be effective if it is a part of a wider set of reforms of the international regulatory infrastructure. We agree that reforms of remuneration need to be supplemented by other reforms and we are working actively to progress the range of regulatory reforms set out in the *Turner Review*. However, we believe that instituting the reform of remuneration regulation is helpful in its own right.

The impact of the Rule and Code

- 3.7 CP09/10 outlined the two main international fora that – at the time of writing the CP – had published or were about to publish principles on remuneration (namely, the Financial Stability Forum [FSF] and the Committee of European Banking Supervisors [CEBS]). We also set out what we believed to be the implications of introducing the Code for the UK’s competitive position. We made it clear that to avoid the risk of putting the UK’s financial services at a competitive disadvantage we would take into account whether we considered that there was a satisfactory alignment of implementation plans by the authorities in the major financial centres.

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?

- 3.8 All respondents interpreted the phrase ‘as proposed’ as implying that we might go ahead with the Code as proposed in CP09/10 without international alignment of

3 <http://www.fsa.gov.uk/pages/Library/Corporate/turner/index.shtml>

remuneration plans. There was a general concern that the UK would thereby be rushing to regulate and end up with a solution that put the UK at a competitive disadvantage with the rest of the world.

- 3.9 The banks in particular in their responses urged us not to go further than the FSF and CEBS principles and stated that ideally regulators and regulatory bodies worldwide should be issuing identical wording when defining remuneration principles. This would create a level playing field and avoid regulatory arbitrage.
- 3.10 Most of the trade bodies and consultants that responded to this question acknowledged the potential benefits of the Code provided international alignment had been achieved. They commented that the Code would promote good practice and have a positive impact on London (enhancing the UK's standing and ultimately contributing to value creation in the longer term by attracting investors to the UK).
- 3.11 The majority of trade bodies urged us to promote mutual recognition or to enable supervisors to place reliance upon other supervisors' implementation of FSF principles.
- 3.12 One consumer organisation stated a contrary view, namely that in view of the FSA's leading role in the worldwide financial markets, we could take the initiative by putting in place a mandatory Code ahead of approaches taken in other jurisdictions.

Our response: We accept the concerns raised with respect to implementing the Code as originally proposed ahead of authorities in other major financial centres, and the adverse implications this might have for the UK market.

Our assessment of progress with international alignment is set out in Chapter 5. As a result of that assessment, we have decided to amend the principles in the Code of practice that have caused the most controversy and which pose the greatest risk of putting the UK at a competitive disadvantage – namely principles 8, 9, and 10 as originally proposed in CP09/10.

We welcome the feedback received from institutions on the benefits of introducing an internationally aligned Code at the right time. We agree that ultimately a successful introduction of the Code will strengthen governance and controls and will help to reduce the risks posed to individual firms, consumers and financial stability by inappropriate remuneration policies.

Market failure analysis

Q3: Do you agree with the analysis of market failure?

- 3.13 There was general agreement on our market failure analysis. However, some respondents mentioned that not all points made in the market failure analysis applied to all firms and that there were multiple causes for the financial crisis – of which remuneration was just one. So some institutions made the point that our proposals on remuneration should not be seen as the 'silver bullet' in resolving the crisis or averting another one.

- 3.14 One institution was not convinced that the proposed changes to remuneration would prevent future failings and argued that it was more appropriate for the FSA to look at ways of strengthening risk management practices within the banking sector by raising the standard of banking supervision and placing principles-based obligations on firms' Boards.
- 3.15 Some professional services firms were of the view that regardless of the role which remuneration structures played in the market failure there was a clear need for change due to the public perception of salaries and bonuses in financial services. This is at an all time low given that the taxpayer is in essence acting as the financier of last resort.

Our response: We welcome respondents' broad agreement with our market failure analysis. We had already noted in paragraph 4.2 of CP09/10 that the causes of excessive risk taking are numerous and complex and that remuneration was one of several contributory factors to excessive risk taking. We strongly concur that revising the regulation of remuneration alone will not be sufficient to prevent future crises, but we believe that such a revision is an important part of such a package and worthwhile in itself as a measure to protect the consumers of regulated activities.

Voluntary Code

- 3.16 To gauge the extent to which firms would comply with the requirements of the code were it to be a voluntary Code we asked:
- Q6: What parts of the Code would be implemented by your firms (or all of the larger banks/broker dealers) if this Code were voluntary rather than mandatory?
- 3.17 Nearly all institutions to whom this question applies to answered this question in a similar manner, namely, by emphasising that they were already broadly compliant with the Code. The institutions also emphasised that they were examining their remuneration structures and in the process of changing them – where necessary – to increase their compliance with the Code.
- 3.18 One firm of solicitors believed the Code should not be compulsory and that it could be implemented on a voluntary basis.

Our response: We welcome the message that firms are already taking action to review their remuneration policies against the Code and are adjusting them accordingly. It is encouraging to hear that the industry is committed to raising standards of remuneration and stamping out bad practice. We note that the evidential provisions in the Code are not per se compulsory. It remains open for a firm to attempt to demonstrate that it complies with the general rule, even if it does not comply with the evidential provisions.

Remuneration statement

- 3.19 One of the ideas we put forward in the Code was for firms to publish an annual remuneration statement.
- 3.20 We asked:
- Q7: Do you have any comments on the suggestion that firms publish an annual remuneration statement?
- 3.21 We received mixed responses to this question. On the one hand respondents were supportive of this idea particularly if we could align the remuneration statement with statements that other countries' regulators might require. Respondents argued that it would be preferable for these statements to consist of high level principles and policies and opposed revealing details on the allocation of bonus pools. On the other hand some respondents said there was no need to publish such a statement as they already published details of directors' remuneration in their annual reports.
- 3.22 In general all institutions wanted more details on the contents of the remuneration statement.

Our response: We are sympathetic with respect to the comments received and should clarify that we did not intend to request that firms publish these statements. This was an error in the drafting of question 7.

As explained in Chapter 6, the remuneration statement is a report that we will ask firms to produce as part of our supervisory work and as such will, to the extent it contains confidential information, be subject to the confidentiality regime under FSMA. It will be a separate document from the remuneration report that Boards should make to their shareholders.

Outsourced activities

- 3.23 We asked:
- 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)?
- 3.24 There was general agreement among the firms that the Code should be extended to firms carrying out FSA-regulated activities only and that we should not implement a blanket extension to cover all outsourced arrangements. Respondents also highlighted that firms should not be given the opportunity to structure themselves with outsourced broker dealer arrangements in order to evade the requirements of the Code of practice.

- 3.25 The banks that responded to this question highlighted the importance of international alignment in the approach we decide to pursue.
- 3.26 One trade association said that it was not clear why the FSA had posed the question on applying the FSA Code to outsourcers and other contracted third parties. They mentioned that no specific evidence was given of excessive risk taking by such third parties on behalf of regulated firms.

Our response: We note the point made on extending the Code to firms carrying out FSA-regulated activities only and to avoid a blanket extension.

We have, however, decided to defer answering this question, partly in order to try to get a consistent international approach, and partly because we prefer to wait until we provide feedback to the Discussion Paper (DP) section of CP09/10.

Transitional issues and timing of implementation

- 3.27 In CP09/10 we set out a timetable for implementation including transitional issues. We specified 6 November 2009 as a provisional date for the Handbook rules to come into force, and allowed some transitional arrangements for firms to change employment contracts: 31 December 2009 for firms to change employment contracts that can be amended, and 6 November 2010 as the final date by which all other contracts should be amended or terminated to ensure compliance with the Code. In question 9 we asked firms:

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

- 3.28 The universal feeling among respondents was that the timeframes for both implementation of the Code and for transitional issues were too aggressive. Some respondents added that the timescales for terminating and renegotiating contracts were too tight as this might require consultations with trade unions which could take time.
- 3.29 Most firms highlighted that the planned date for the publication of the FSA's Policy Statement would allow a very limited timeframe for other regulators to catch up with the FSA. The firms therefore questioned to what extent we could ensure other regulators were aligned to our Code. A few trade associations asked that we hold fire and only publish our final Code at a later stage, only publishing revised draft proposals in late July/early August 2009. Some banks asked for further clarification on what is expected by the implementation date, in particular, whether we wanted implementation in November 2009 or for firms to be ready to implement for 2010.

Our response: We accept the concerns raised about the implementation deadline. However we believe that it is important to have the Code in place for 2010. To respond to the concerns we have decided to move the implementation date to 1 January 2010.

We are responding with more clarity on what firms will be expected to do and by when in Chapter 6. Essentially, we say that changes to policies and procedures should be fully in

place **by** 1 January 2010 and changes to remuneration structures and contracts should be implemented with effect **from** 1 January 2010. Implementation of risk adjustment techniques (principle 4) should take effect from 1 January 2010.

Cost Benefit Analysis

3.30 We prepared a cost benefit analysis for our CP informed by responses to a survey of firms carried out in March which asked for an indication of the costs associated with the proposed principles of the Code.

3.31 We asked:

Q10: Do you have any comment on our CBA of the proposals?

3.32 The respondents broadly agreed on the potential benefits identified and no-one challenged the CBA on the grounds that costs outweighed the benefits. The widespread view was that the cost of implementation quoted in the CBA was too low, although no further evidence or cost estimates were provided to support this view. The main drivers for costs which respondents believe we have underestimated are:

- the costs for renegotiating contracts;
- costs in management time; and
- professional services costs.

Our response: As we stated in our CBA, estimating the costs of implementation is difficult and costs will vary widely by firm – as confirmed by the wide variation of responses that we received for the cost survey which informed our CBA. We acknowledge the firms' concerns that the cost estimates may be on the low side. However we also note that no respondent sought to argue that the costs outweigh the benefits.

Compatibility Statement

3.33 In Annex 5 of CP09/10 we set out our assessment of the compatibility of the proposals with our general duties under section 2 of FSMA and our regulatory objectives which are set out in sections 3 to 6 of FSMA.

3.34 We asked:

Q11: Do you have any comment on the compatibility statement in Annex 5?

3.35 The respondents agreed with the compatibility statement and most highlighted the concerns they have raised in relation to other questions, namely:

- that we have underestimated the cost of complying with the Code;
- they reiterated the need to ensure international agreement to enforce similar principles and implementation plans on remuneration; and

- that the causes of the crisis were varied and differed markedly between firms and that not all firms were seriously harmed.

Our response: We note the comments made. These have been addressed in our responses to other questions.

Specifying remuneration risk as a separate risk in GENPRU

3.36 We asked:

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?

3.37 We received mixed answers to this question. Some firms and trade associations did not see remuneration risk as a standalone risk. Others thought remuneration should be identified as a separate risk in GENPRU. There were also a number of respondents that were unsure about the implications and were content for the FSA to decide.

Our response: We note the mixed answers we received to this question and have decided that on balance remuneration risk sits better in the context of business risk and as such will not be specified as a major source of risk in GENPRU 1.2.30R. We believe that the risks arising from inappropriate remuneration structures fall under business risks because ultimately the risks are linked to losses resulting from a failure to align the behaviour of employees with the business objectives and risk appetite of the firm.

4 The contents and scope of the new Code of Practice

- 4.1 This chapter summarises the feedback that we received, and our responses to that feedback, to two questions in the CP. Question 5 asked for views on making the general requirement in the Code into a general rule, and the Code’s principles into evidential provisions. Question 4 asked for comments on the content or scope of the draft Code.

The general rule and evidential provisions

- 4.2 In CP09/10 we consulted on introducing a rule into the Handbook that would require firms to have remuneration policies, procedures and practices that are consistent with and promote effective risk management. This high-level principle would apply to banks, building societies and the large broker dealers but it would be good practice for all firms to follow this high-level requirement. We also consulted on supporting this high-level rule with ten principles which would be introduced into the Handbook as ‘evidential provisions’.
- 4.3 An evidential provision is a type of rule which has evidential value in showing that another rule (in this case, the Code’s general requirement) has been breached or complied with. Each evidential provision would in turn be supported by ‘guidance’ which provides the rationale for the principle and further clarification as needed. Firms can take the guidance into account in deciding how they can meet the rule.
- 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?
- 4.4 Nearly all respondents agreed on the substance of the general rule and said that it was a rule that made good sense and promoted good practice. Equally, nearly all respondents supported the introduction of the rule into the Handbook.
- 4.5 However the majority of respondents expressed concern about the contents of the evidential provisions. Most respondents felt that the current drafting of some of the evidential provisions was too prescriptive and promoted a one-size-fits-all approach.

Some trade associations and large banks said that they would prefer the evidential provisions to be recast as guidance.

- 4.6 The firms that responded to this question said that on the one hand they would like more flexibility in the principles so that they have the latitude to differentiate themselves and to explain their approach to regulators. On the other hand, they would like a degree of prescription in the principles to limit the scope for judgement and interpretation as these may present opportunities for inconsistency and confusion between firms and supervisors on the standards expected. Two trade associations believed that the current guidance as drafted was also too prescriptive and drafted in a way that implies compulsion.

Our response: We welcome the support for our proposal to make the general requirement into a rule and will be pressing ahead by introducing the rule into the Handbook.

On the evidential provisions, we have accepted the concerns raised and we are responding by making significant amendments to the evidential provisions. The changes are set out below.

We have endeavoured to strike the right balance between prescriptive detail and high level principles in the new Code. On the one hand we are anxious to avoid a one-size-fits-all approach and have scaled back on the evidential provisions and guidance that has been viewed as being too detailed, and on the other hand we have endeavoured to use the guidance to give firms clarity on the intentions of the evidential provisions and how firms might bring themselves within them.

Scope and contents of the Code

- 4.7 We asked:

Q4: Do you have any comments on the content or scope of the draft Code?

Scope of the Code – which firms?

- 4.8 In CP09/10 we consulted on the proposal that the Code's rule and evidential provisions would only apply to certain large banks, broker dealers and building societies defined as follows:
- FSA-regulated banks and building societies which meet either of these criteria:
 - total regulatory capital in the UK banking entities in excess of £1 billion; or
 - 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:
 - consolidated regulatory capital in the UK authorised entity is in excess of £750 million or the equivalent amount in another currency; or

- 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.

4.9 We did not receive any comments specifically on the criteria set out above. However, we have decided to amend them, as discussed in the ‘our response’ section below.

4.10 The British Bankers’ Association (BBA) and several banks asked for clarification about the application of the Code to UK firms’ overseas branches and subsidiaries. A number of banks expressed concern about the fact that UK branches of EEA firms were excluded. There were calls also for the scope to be extended to all FSA-regulated banks irrespective of size, and to other regulated firms that provided services in competition to banks. Others answered the question by saying that the scope should mirror any proposals that come out of Europe.

Our response: In finalising the Code, we have carefully considered its implications for the competitive position of the United Kingdom and the need to minimise any adverse effects on competition flowing from it.

Although we did not receive any feedback on this specific point, we have decided for the time being to remove the criteria for FSA-regulated banks and BIPRU 730k firms which are part of financial (UK or international) groups whose regulatory capital is in excess of £20 billion (for banks) or £5 billion (for BIPRU firms) or the equivalent amount in another currency. We have decided to do this because:

- the risk of firms within the scope of the Code being put at a competitive disadvantage compared to those outside it is now significantly reduced as a result of the amendments that we are making to the Code; and
- the question of extending scope to firms that meet this criteria is linked, first, to ongoing discussions about implementing remuneration principles in other jurisdictions, and secondly, to our own project on extending scope to other FSA-regulated firms. We will be reporting on the latter issue around October, and will give an update on our thinking then.

However, in view of the potential impact on consumers of the firms covered by the amended Code, we believe it is appropriate to make the Code in relation to these firms now.

On the issue of extending the scope to UK branches of EEA firms we appreciate the implications and concerns if these branches are not caught by the scope of the Code, however, from a legal perspective the risk management functions of these branches generally fall outside our scope of supervision. We note that some Member States have already adopted rules that are consistent with our Code and that the EU is actively considering adoption of legislation that would embody the FSF Principles on Remuneration (as our Code does). We therefore expect that a level playing field can be created between firms that fall within the scope of our Code and other firms by sufficient internal alignment of remuneration principles. This will avoid UK branches of EEA firms securing a competitive advantage over UK firms.

We believe the changes we have made to the Code will minimise any adverse impact of the Code on competition and on the competitive position of the United Kingdom, while still delivering real benefits for the protection of consumers.

More information on the application of Code to firms can be found in Chapter 6, on implementation, paragraphs 6.10 to 6.14. The rules are in SYSC 19.1 in the Handbook.

Scope of the Code – which individuals?

- 4.11 Most firms that responded to this question favoured the scope to be limited to or at least to focus on senior staff and key risk takers in the firm (or those individuals that have sufficient levels of authority to present significant risks to the survival of a systemically important firm).

Our response: We have revised the scope of application of the Code to address the concerns raised. The principles relating to governance, risk management and performance measurement will apply to all employees. For the principles relating to remuneration structures (principles 8 – 10 in the Code as published in CP09/10) we have responded to the concerns raised by limiting the scope of application to senior management and to employees whose activities have or could have a significant impact on the firm's risk profile.

The contents of the Code

- 4.12 The following section considers the responses to each of the ten principles of the Code and associated evidential provisions as published in CP09/10 on 18 March 2009. We will provide detailed feedback principle by principle along with how we are planning to amend the Code in the light of the responses received. The new version of the Code is found the handbook text in Appendix 1.

Principle 1:

Evidential provision:

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.

- 4.13 The majority of respondents expressed their support for this principle with only a handful raising concerns or requesting clarification.
- 4.14 The London Investment Banks Association (LIBA) and two other institutions sought clarification that principle 1 does not require non-UK firms to set up local remuneration committees.

Our response: In drafting this principle, it was never our intention to require non-UK firms to set up local remuneration committees. Our objective is to have contact with the body with ultimate responsibility for remuneration policies. This may of course be at group level and if that is the case then that is the body we will seek to have contact with, irrespective of location. However, the fact that a firm relies on a remuneration committee in another group company does not relieve it of the requirement to comply with the Code. Where a firm relies on a remuneration body located in another entity, it should also comply with the provisions on outsourcing in SYSC 8.1.

- 4.15 The ABI disagreed that remuneration committees should take responsibility for firm-wide remuneration policies. They were of the view that it is confusing to identify remuneration committees as the body responsible for corporate remuneration policy. The Board has a responsibility to promote the success of the company, in line with its legal duties, and part of this will include putting in place remuneration structures in line with business strategy and agreed risk appetite. This could be achieved by the board as a whole, an appropriate sub-committee ('employee reward committee') or through better integration of existing structures, such as the remuneration and audit committees. They believe that this should be recognised in the Code.

Our response: We appreciate that we are asking for an extension of the terms of reference of many remuneration committees. However we think that, particularly in the financial sector, it is important for remuneration committees to review the remuneration policies and of employees below Board level and their implementation in practice. This is also consistent with the recommendations of the *Walker Review*.

The design of such policies, and their implementation should remain the responsibility of management.

- 4.16 The Association of Foreign Banks and two other respondents made the point that there is a shortage of non-executive directors with skills and experience stipulated by the code and that as a result it may be challenging to find the appropriate people in time for implementation.

Our response: We note the concern raised by the respondents. We believe this issue relates to the composition of bank Boards more broadly. This issue is currently under consideration by the FSA and the review on corporate governance carried forward by Sir David Walker.

We are responding to the concern on the shortage of skills and experience raised by the respondents by making an amendment to the third paragraph of the guidance relating to this principle. The guidance now suggests that firms may be able to increase the risk experience of remuneration committees by having a member of the risk or audit committee sit on the remuneration committee.

- 4.17 Several respondents asked whether the fifth paragraph of the proposed guidance relating to principle 1, which is about public disclosure of remuneration policies, was separate to the remuneration statement we may ask firms to prepare (see the fourth paragraph of the guidance on principle 1).

Our response: We recognise the confusion caused and have amended the text in the fifth paragraph of the guidance on principle 1 to make it clear that the remuneration statement for public disclosure is a separate document to the remuneration policy statement.

The information contained in the remuneration policy statement referred to in the fourth paragraph of the guidance will, to the extent it is confidential, be subject to the FSMA confidentiality regime. The fifth paragraph of the guidance is designed to encourage greater disclosure of remuneration policies to other stakeholders. We have amended the guidance note to include also the suggestion that the document say something about the implications of remuneration policy for the risk profile of the firm and for employee behaviour. We note that the wider question of disclosure of remuneration arrangements has been considered in the *Walker Review*.

Principle 2:

Evidential provision:

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.

- 4.18 The large majority of institutions that commented on this principle were of the view that the compliance and risk functions should not set remuneration for business areas outside their own. They were also concerned about the use of the term 'significant input' in the setting of remuneration for other business areas.

Our response: We appreciate the concerns the respondents have raised and have amended the principle to address these.

The amended principle 2 generally refers to 'appropriate' (rather than 'significant') input from risk management and compliance into the setting of remuneration for other business areas. However, where compliance or risk have concerns about the behaviour of individuals or the riskiness of the business they undertake, they should be able to have significant input into the setting of individual remuneration awards.

Principle 3:

Evidential provision:

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.

- 4.19 Most respondents voiced their support for this principle. The minority noted that the remuneration of the risk and compliance function should not be completely divorced from the performance of the business, otherwise there risks being a misalignment of

incentives. The knock-on effect is that compliance and risk functions can be perceived to become disablers or indeed obstructive to business.

- 4.20 The trade associations asked us to clarify whether the performance metrics for people in risk and control functions should be restricted to functional objectives.

Our response: We welcome the broad acceptance of this principle and note the concerns respondents raise. As a result, we have amended the second evidential provision by inserting the word 'principally' to indicate that we are not excluding a decision by a firm to include metrics based on the performance of the firm or the business unit.

We also appreciate that there is a balance to be struck between maintaining the independence of risk and compliance function and keeping them sufficiently close to the interests of the business unit so as to not turn them into 'disablers' of business.

See also SYSC6.1.4R, which sets out requirements for the method of determining the remuneration of staff in the compliance function.

Principle 4:

Evidential provision:

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.

- 4.21 The majority of respondents agreed with this principle. The main comments centred on the practical aspects of implementing this principle and the associated costs.
- 4.22 One respondent was concerned about the risk of double counting if firms are already required to adjust for the cost of capital and then required to adjust for future risk on top of that. On the adjustments for cost of capital a few institutions highlighted the practical difficulties of doing this for smaller units (divisions or departments) within the group.
- 4.23 LIBA and the BBA supported the principle but urged us to clarify whether the current tools for measuring and pricing cost of capital and liquidity are still valid. They emphasised the importance of flexibility in the application of the principle, allowing room for judgement in the final decision on risk adjustment and in deciding on the level of granularity for the calculation.
- 4.24 Some respondents argued that risk adjustment was only really necessary for investment banking businesses. Some also expressed concern about the cost of implementing risk adjustment for smaller units below group level. It was noted that this principle would increase the resources required in risk functions and in business units to calculate risk adjustments and to monitor their implementation.

Our response: We welcome the fact that there was broad agreement with this principle. We note the technical queries that have been raised and are responding to these in Chapter 6 and in the letters that we will be sending on remuneration policy statements.

Principle 5:

Evidential provision:

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.

- 4.25 The respondents were broadly supportive of this principle. The concerns centred on two points in the guidance.
- 4.26 The first point was on the use of moving averages – for which there was little enthusiasm. Institutions noted that techniques that use moving averages are difficult to administer in practice. The respondents stated that the main difficulties arise because the timescales within which potential risks might be expected to materialise vary significantly in relation to different parts of a firm's business making accounting for this in a consistent way difficult in practice. One respondent said that we should remove the reference to moving averages altogether given that we state in the guidance that there are other techniques that firms can use to meet the principle.
- 4.27 The second point respondents made was that the principle should allow organisations to exercise their judgement in respect of employees for whom long term performance measures are not relevant – for example junior employees. Most trade associations that commented on this principle said that we should differentiate between highly compensated employees and junior employees and that it would not be appropriate for the latter to be subject to the same deferrals and multi-year assessments.

Our response: We have amended the principle itself to say that long-term performance measurement applies where the performance-related component of an employee's remuneration is a significant part of total remuneration. We set out in the guidance two criteria to guide firms in establishing whether the performance related component of remuneration is a significant part of total remuneration. The guidance as amended takes on board the concerns raised and makes it possible for firms to award significant bonuses for exceptional performance for more junior staff without necessarily having to measure the performance on a long term basis or apply smoothing techniques.

Principle 6:

Evidential provision:

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.

- 4.28 There was universal agreement with this principle. A small minority of respondents asked for guidance on balanced scorecards (referred to in the second paragraph of the accompanying guidance).

Our response: We welcome the general acceptance of this principle. We do not believe that it is appropriate for us to provide guidance on balanced scorecards. This is an area that will be specific to each firm and we advise firms to seek assistance from consultants and HR specialists in the market if they consider that would be helpful.

Principle 7:

Evidential provision:

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

- 4.29 Most institutions agreed with this principle: however, some respondents felt that the main problems lay with the metrics of earnings per share (EPS) and that total shareholder return (TSR) did not suffer from the same defects as there is less of an earnings component in the TSR metric.
- 4.30 One institution was of the view that institutional shareholder bodies were happy using EPS and TSR as performance metrics and that they would therefore not want to have to go back to shareholders asking them to change their long-term incentive plans.

Our response: We have taken the concerns on board and have amended the guidance to reflect the difference between EPS and TSR. We still note that TSR as a metric does include dividend distributions which can be based on unadjusted earnings data.

Paragraph 6.20 gives more information on the implementation of this principle.

Principles 8, 9 and 10:

- 4.31 There were widespread generic comments which apply to all three principles. We will focus on these first before turning to the responses received on specific principles.

Generic comments

- 4.32 The majority of respondents felt that principles 8, 9 and 10 – which relate to remuneration structures – were too prescriptive. The example most respondents gave was the guidance note to principle 9 where we said that it would be good practice for at least two-thirds of the bonus to be deferred. Several respondents noted that these principles and their associated guidance notes went further than the principles published by the FSF and CEBS and that if they were implemented by the UK alone they would have adverse implications for the UK as a financial centre. Some respondents wanted clarity on our view of guaranteed bonuses and whether such arrangements would be in breach of the Code.

Our response: Our analysis in Chapter 5 concludes that we do not yet have a satisfactory level of international alignment, and as a result we have made significant amendments to the principles of the code that relate to remuneration structures – namely principles 8, 9, and 10.

We have amalgamated principles 8, 9 and 10 into a single principle (the new principle 8) and put the contents of the old principles (as amended to reflect the responses received) into the guidance.

The new principle 8 is directed at those employees who perform a ‘significant influence function’⁴ and at other employees whose activities could have a significant impact on the risk position of the firm. It requires remuneration structures to be consistent with and to promote effective risk management. The new principle 8 is in SYSC 19.3.15R to 19.3.18R in the Handbook.

The guidance that accompanies the new principle 8 will be discussed in detail below as it largely reflects the contents (as amended) of the old principles 8, 9 and 10. However there is one new paragraph of guidance on guaranteed bonuses which run for a period of more than one year and which are not based on performance during the performance period under review (SYSC 19.3.17 G (7)). We say that we expect these to be inconsistent with principle 8.

This additional guidance reflects the points made in the Dear CEO letter sent by our chief executive Hector Sants on 15 July to the CEOs of the firms likely to be within the scope of the Code.

Principle 8:

Evidential provision:

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

- 4.33 Most institutions agreed with the basic objective of the principle but say that losses should not necessarily result in zero bonuses. Firms would like to retain the flexibility to award and motivate those who have done well and were not responsible for the loss (for example junior staff). Further, firms are keen to have the opportunity to pay bonuses to staff in divisions that may take several years to make a profit (for example a start-up).
- 4.34 Various institutions including the BBA and LIBA have said that this principle may result in an increase in base pay (as a result of bonuses decreasing) and hence fixed costs for firms.

Our response: The evidential provision has been recast as guidance as explained above. We have also taken account of the comments made by stating that a fully flexible bonus policy should not prevent a firm from paying a bonus despite making a loss provided that the bonus is justified on other grounds.

We want to avoid giving the impression that we want to see higher fixed components of pay. Our position on this is neutral as it is up to firms to decide how to best align their remuneration structures to meet the Code.

4 Our Handbook defines ‘significant influence functions’ in SUP 10.4. SIF individuals are senior people within firms who exert significant influence on a regulated firm’s activities.

Principle 9:

Evidential provision:

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.

- 4.35 The majority of respondents agreed with the objective of this principle but there was general opposition to the mention in the guidance that it would be good practice for at least two thirds to be deferred, largely on the grounds that this went further than the FSF or CEBS principles. Some argued that it would be better to give firms the freedom to set graduated deferral rates. Others noted that increased deferral reduces the perceived value of a bonus to the individual, so the total packages could go up. Respondents also sought clarification on what is meant by 'significant'.
- 4.36 One respondent urged us not to ignore the fact that short-term discretionary awards can be a good management tool to encourage the right behaviours and to motivate staff.

Our response: The evidential provision has been recast as guidance as explained above. The text has been amended, but we have retained the reference to two-thirds deferral. We believe that this is a reasonable objective for the structure of substantial bonuses paid to staff in the categories covered by this principle.

The determination of 'substantial bonus' will vary somewhat according to circumstances of firms and employees and we will discuss with firms on a case-by-case basis.

Principle 10

Evidential provision:

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.

- 4.37 The majority of respondents argued that this principle was not appropriate for junior staff, support functions and businesses with no carried forward risk. Most respondents also asked for us to change the principle so that 'a significant proportion of the deferred element' instead of 'any deferred element' should be linked to future performance.
- 4.38 Some correspondents noted the risk of double counting if deferred bonuses were adjusted for risks which had already been included in the risk adjustment of the bonus pool. Others noted the practical difficulties involved in devising performance adjustment schemes at lower levels within the organisation, including for individual employees.

Our response: The evidential provision has been recast as guidance as explained above. We have changed 'any deferred element' to 'a significant proportion of the deferred element' to recognise that performance adjustment schemes do not need to apply to the entirety of deferred amounts.

We accept that performance adjustment schemes can be complex to devise and to administer at levels below the group or the firm. Nevertheless, we believe that it is highly desirable to establish an effective link between the future risk of the activity undertaken by the employee and the performance adjustment scheme. Many good schemes will include a combination of linkages: to the future performance of the firm, the business unit, and the individual.

The concerns about the inappropriateness of the principle for certain staff have been taken on board by limiting the scope of application of the new principle 8.

We appreciate the concern raised about the risk of double counting, and will take account of this in our consideration of risk-adjustment techniques in remuneration policy statements.

5 Progress in international implementation of remuneration principles

Introduction

- 5.1 We discussed international work on remuneration in Chapter 2 of CP09/10. In paragraph 2.16 we stated:
- ‘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. 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’.
- 5.2 The second of our Consultation Questions asked whether introducing this Code into the Handbook as proposed would have adverse implications for the UK as a financial centre or whether its introduction might have neutral or positive implications. A substantial majority of respondents said that introducing the Code as proposed and without satisfactory alignment of implementation plans by other major financial centres would have adverse implication for the UK. Some respondents asked us not to go further than the principles established by the FSF and the CEBS.
- 5.3 This chapter assesses international developments since the publication of the CP on 18 March, and the extent to which the ‘international alignment test’ has been met. In the final section, it sets out our policy response.

International developments since the publication of the CP

The FSF Principles

- 5.4 The FSF published its set of Principles for Sound Compensation Practices⁵ on 2 April, at the G20 summit meeting in London. The G20 communiqué urged national

⁵ www.financialstabilityboard.org/publications/r_0904b.pdf

authorities to introduce them as a matter of urgency. The FSF has now become the Financial Stability Board (FSB) and now includes representatives of the G20 countries as well as those from the original G8.

- 5.5 We believe that alignment between the FSA Code as proposed in the CP and the FSF Principles is good. Some of the points of comparison are as follows:
- The Introductory paragraph to the Principles says that their aim is to align compensation with prudent risk taking, and calls for the establishment of a link between compensation systems and risk management.
 - There is good alignment on the need for remuneration committees to be independent, to have risk expertise, and to monitor and review the compensation system to ensure that it operates as intended.
 - Principle 4 says that compensation should be adjusted for all types of risk, including difficult to measure risks such as liquidity risk, reputation risk and cost of capital.
 - On the need for flexible bonus policies, Principle 5 says that bonuses should diminish or disappear in the event of poor firm, divisional or business unit performance.
 - Principle 6 says that compensation payout schedules must be sensitive to the time horizon of risks, and that management should question payouts for income whose realisation remains uncertain at the time of payout.
 - Principle 6, quoted above, goes on to say that compensation payments should be deferred according to the time horizon of risks. However it does not refer to the proportion of the variable compensation that should be deferred.
 - There are no direct references in the FSF Principles to the question of deferred remuneration, the role of control functions, or to the importance of non-financial metrics (FSA Principles 2, 6 and 8).

Developments in the European Union

- 5.6 There have been several initiatives within the EU, from CEBS and the EU Commission.
- 5.7 CEBS published the final version of its high-level principles on remuneration on 20 April.⁶ Supervisors and firms were asked to implement them by the end of the third quarter.
- 5.8 The alignment of the FSA Code to the CEBS high-level principles is also good, although there are some differences of emphasis as compared with the FSF.
- 5.9 On 29 April the EU Commission published two non-binding **Recommendations**.⁷ One updated an earlier recommendation on disclosure requirements for the pay of executive directors of all EU listed companies. The other addressed remuneration

6 www.ebs.org/getdoc/34beb2e0-bdff-4b8e-979a-5115a482a7ba/High-level-principles-for-remuneration-policies.aspx

7 ec.europa.eu/internal_market/company/directors-remun/index_en.htm

policies in the financial sector and recommends that Member States should ensure that financial institutions have remuneration policies for risk taking staff that are consistent with and promote sound and effective risk management. This is a good match with the FSA's general rule. The recommendation sets out guidelines on the structure of pay, process of design and implementation of remuneration policies (which all match well with our own Code) and on the role of supervisory authorities in the review of remuneration policies of financial institutions.

- 5.10 Alongside the Recommendations, the EU Commission published for consultation some **draft amendments to the Capital Requirements Directive (CRD)** which include provisions on remuneration. After a consultation period, formal proposals were published on 13 July 2009.⁸ These proposals have now been sent to the European Council and Parliament for further discussion and hence possible further amendment. However the 13 July proposals are important as the starting point for discussion within the EU.
- 5.11 The alignment of the FSA's Code and the CRD amendments is good. Points of comparison include:
- The Commission proposes an amendment to Article 22 of the CRD which uses similar text to that in our general rule (about the need for consistency with effective risk management).
 - On governance, the Commission proposes that the remuneration committee should subject remuneration policies to regular internal review, but does not address issues such as its composition or its experience with risk management issues.
 - On risk adjustment, the CRD does not refer to the need for measurement of performance to be based on profit, but does use the same text as the FSA in referring to the need for adjustments to take account of the capital employed and the liquidity required.
 - There is good alignment on the need for fully flexible bonus policies, on the need for deferment of a 'major part' of a significant bonus, and on performance adjustment of the deferred element.
- 5.12 The scope of the CRD amendment is different from our proposed application of the Code via the Handbook. Firms covered by the CRD include all banks and building societies, and a substantial number of investment firms. However the FSA is actively considering whether the scope of the Code should be extended to other FSA-authorized firms: we will be reporting on that question in October. However, we believe there will be sufficient benefits for the protection of consumers to justify proceeding now with the application of the Code to significant firms.
- 5.13 The Commission's proposals to amend the CRD are now under discussion in a Council working group. An agreed text is expected to be transmitted to the European Parliament early in 2010. The Commission has set a target date for the implementation of the amended CRD of the end of 2010.

8 ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf

- 5.14 Other European bodies such as the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) are also considering ways in which remuneration principles could or should be applied to the firms within their area of interest. We will report on the development of remuneration principles in these bodies when we publish our views on the question whether to extend the scope of the Code to the rest of the financial sector in about three months' time.

Developments in other major financial centres

- 5.15 At the time of writing we understand that that four other financial centres that have published plans to implement the FSF principles – Australia⁹, France¹⁰, the Netherlands¹¹ and Switzerland.¹² The alignment of our Code with other countries' proposals is good. The proposed Australian standards focus mainly on governance issues and are supported by more detailed guidance (the Prudential Practice Guide) that goes beyond governance and into structures and performance measurement. In some cases we are more explicit in the language used, but the objectives are well matched.
- 5.16 On 10 June the US Treasury announced its intention to introduce reforms to compensation practices, substantially along the lines of the FSF principles.¹³ The announcement explained that the Federal Reserve Board is working on rules and/or guidance for the implementation of their reforms.

Work on remuneration being taken forward by the Basel Committee and IOSCO

- 5.17 The FSF proposed that work on implementation of remuneration principles should be taken forward by the Basel Committee on Banking Supervision (BCBS) for banks and by the International Organisation of Securities Commissions (IOSCO).
- 5.18 A task force has been set by the Basel Committee's Standards Implementation Group to take forward the work on implementing the remuneration principles. The US, Canada, Japan and major European financial centres are represented. The aim of the task force is two fold: first, to ensure that all supervisory authorities have emphasised to their firms the need to ensure that their remuneration policies are consistent with the FSF Principles, and second to agree, as far as possible, common guidelines on how the FSF Principles should be implemented in practice.
- 5.19 The main focus of IOSCO's work will be whether there should be changes to the obligations of listed financial companies to disclose information on remuneration policies and practices in annual reports and public statements.

9 <http://www.apra.gov.au/Policy/upload/Draft-PPG-511-Remuneration.pdf>

10 [www.fbf.fr/Web/internet/content_presse.nsf/\(WebPageList\)/Remuneration+des+professionnels+des+marches+financiers+++la+FBF+adopte+des+principes+communs?Open](http://www.fbf.fr/Web/internet/content_presse.nsf/(WebPageList)/Remuneration+des+professionnels+des+marches+financiers+++la+FBF+adopte+des+principes+communs?Open)

11 www.afm.nl/corporate/default.ashx?documentid=12334

12 www.finma.ch/d/regulierung/anhoerungen/Documents/rs-verguetungssysteme-20090524-d.pdf

13 www.treas.gov/press/releases/tg163.htm

The international alignment test

- 5.20 The conclusion that we draw from this review of international developments is that full international alignment has not yet been achieved, but that the chances are reasonably good. There is a clear consensus on the need in principle to implement the FSF Principles in all the major financial centres.
- 5.21 However at present there are major uncertainties on timing. CEBS has asked EU firms and supervisors to implement its high level principles by the end of September this year but the impact of such a requirement is uncertain without more detailed guidance on implementation. The announcement by the US Treasury that it intends to implement the FSF Principles is highly significant, but its timing remains unclear.
- 5.22 As our firms have made clear, the devil is in the detail of implementation: if we are to ensure a level playing field, and reduce the risk of regulatory arbitrage between financial centres, agreement needs to be reached on issues such as how risk adjustment should work in practice, and what requirements or expectations should be set on policies such as the deferment of significant bonuses.

Our policy response

- 5.23 As discussed elsewhere in this Policy Statement, we have amended the Code to take account of the current uncertainties on international alignment, and we will go ahead with the implementation of our Code from 1 January 2010. We are doing this because:
- The need for action on remuneration remains urgent. We want to ensure that rules are in place to influence remuneration policies in 2010.
 - We believe that the amendments made to the Code significantly reduce the risk to London's competitiveness of implementing our Code ahead of further international agreement and that the amended Code is appropriate in view of the level of alignment of international proposals that has occurred so far.
 - We hope that further international alignment will be achieved soon, via the Basel task force and other international bodies.
- 5.24 We recognise that the Code may subsequently need to be amended to take account of any further agreement on international alignment. However, given the high degree of consensus based on the FSF's principles, we do not believe that such changes are likely to change the fundamental objectives and direction of the Code.

6 Implementation of the Code

- 6.1 This Chapter sets gives more information on how we propose to implement the new rules. The first section covers the remuneration policy statements that we expect firms to provide to us by the end of October, and regularly after that. It also gives more explanation on the scope of the Code: timing and transitional issues: and what action we will expect firms to have undertaken by 1 January 2010 for each of the principles.

Remuneration policy statements

- 6.2 This section gives some general information about remuneration policy statements (RPS). As stated in the letter from our chief executive Hector Sants to CEOs of firms likely to be within the scope of the Code dated 15 July, we will be writing during August to the Chairs of Remuneration Committees with more information on what we want their RPS to contain. We will be asking firms to provide us with their first RPS by the end of October.
- 6.3 SYSC 19.3.2 G (4) – which provides guidance on remuneration Principle 1 – says:
- ‘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 judgement and not rely solely on the judgement or opinions of others. The FSA may seek a meeting with members of the remuneration committee to discuss the statement’.
- 6.4 The RPS is a separate document from the information on remuneration policies that a firm may disclose to its shareholders and other stakeholders (see SYSC 19.3.2 G (5)). It is likely that we will request information that a firm may choose not to disclose in its public statements. The RPS will be requested from firms as part of our ongoing

supervisory work and to the extent that it contains confidential information, it will be subject to the FSMA confidentiality regime.

- 6.5 The Handbook defines a remuneration committee as ‘a committee or other body that is responsible for a firm’s remuneration policy’ (See Handbook glossary). For foreign owned firms in the UK, that body may be the Board or the remuneration committee of the parent company. If that is the case, we will ask the firm to arrange for the Board or the remuneration committee of its parent company to prepare an RPS covering the London-based activities of the firm according to the procedures set out in this section. The fact that a firm relies on the board or a remuneration committee in another group company does not relieve it of the requirement to comply with the Code. Where a firm relies on a remuneration body located in another entity, it should comply with the provisions on outsourcing in SYSC 8.1.
- 6.6 We currently expect to ask most firms to prepare an RPS once a year. However, if we believe a firm is not meeting the requirements set out in the Code, we may ask it to undertake a risk mitigation programme and to provide RPS on a more frequent cycle so that we can monitor progress with the risk mitigation programme.
- 6.7 In order to provide guidance which is as clear as possible on what an RPS should contain, the letters which we will send out in August will enclose a questionnaire. They will explain the level of detail that will be requested for employees individually or by group, by significant business unit, and by geographical location. It will request information under the following headings:

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

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

Remuneration practices in 2009

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

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

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

- 6.8 We will ask firms to send us their first RPS by the end of October 2009, and we will seek meetings with firms to discuss them between mid-November 2009 and mid-February 2010. We will expect those meetings to be with a member or members of the Remuneration Committee, alongside senior representatives of the HR and Risk functions.
- 6.9 It is likely that we will ask firms to prepare a further, shorter RPS shortly after the conclusion of their 2009 remuneration reviews. This will allow them to update us on the outcome of these reviews. For most firms this updating RPS will be in the spring of 2010, although the timing of each will be determined by the timetable for their end year reviews. Thereafter, we will move to an RPS reporting cycle as set out in paragraph 6.6 above. This will enable us to receive reports on the outcomes of annual remuneration reviews in a more timely manner.

Scope and application of the Code

- 6.10 As explained in Chapter 4, we have decided to apply the Code to a smaller group of firms than originally proposed in the Code. The scope is defined in the Handbook by three rules, SYSC 19.1.1 R to 19.1.3 R. The rules mean that it will apply to a UK entity if it is:
- a UK bank or building society if it had capital resources exceeding £1 billion on its last accounting reference date; or
 - a BIPRU 730k firm if it had capital resources exceeding £750 million on its last accounting reference date; or
 - a full credit institution, BIPRU 730k firm or a third country equivalent to a BIPRU 730k firm that is part of a group if, on the firm's last accounting reference date, the total capital resources held within the group by UK banks or building societies exceeded £1 billion or by BIPRU 730k firms exceed £750 million. The aim of this condition is to include all banking and broker dealing entities (smaller firms and branches) within UK groups where, aggregated, the UK entities would meet one of the conditions in the first two bullets above.
- 6.11 The rules also state that UK branches of EEA firms are not included in the scope to the extent that they are exercising passporting rights under schedule 3 to FSMA. This is because responsibility for systems and controls is in most cases reserved under the relevant Single Market Directives to home competent authorities. However, the overseas branches of UK firms (both EEA and non-EEA) are included where the relevant tests are satisfied. In the case of non-EEA branches, the requirements apply in a 'prudential context' (see SYSC 19.1.3 R (1) together with paragraph 2.18R of Annex 1 to SYSC 1). In considering remuneration policies in entities (branches and subsidiaries) in countries other than the UK we will take due account of the local jurisdiction and of local employment practices.
- 6.12 However firms within the group that are not credit institutions or BIPRU 730k firms are excluded for the time being, pending decisions about extending the scope of the Code to other FSA-authorized firms.

- 6.13 We think that about 26 groups operating in London are currently covered by this scope. The letters that we will be sending to firms in August, referred to in paragraph 6.7 above, will ask firms to confirm that they agree with our judgement that they are in scope. At present we are not able to publish a list of the firms since the regulatory capital information is supplied to us on a confidential basis. Some firms disclose regulatory capital data, but not all. This is changing as the disclosure requirements of the Basel Capital Accord come into effect, and we will endeavour to publish a list as soon as possible.
- 6.14 A firm should contact its supervisory team at the FSA if it believes it is caught by the Code but does not receive a letter from us during August.
- 6.15 The accounting reference date is the last date of the firm's accounting period. Since regulatory capital levels can change, we will review the list once a year and discuss changes with the firms who move in or out of the scope criteria.

Timing and transitional issues

- 6.16 As discussed in Chapter 3 (paragraphs 3.27 – 3.29), we have accepted the concerns respondents to the CP raised that the original implementation deadline was too tight. We have moved the implementation date to 1 January 2010 which, we accept, is not a lengthy extension. However we believe that it is important to have the Code in place for 2010.
- 6.17 As we noted in the CP, 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 the Handbook is therefore allowing transitional arrangements for two types of contract. 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 March 2010. In all other cases, the final deadline by which such contracts must be amended or terminated to ensure compliance with the Code would be 31 December 2010, and pending amendment or termination firms would need to put in place specific measures to mitigate the risks posed by the remuneration arrangements.
- 6.18 These arrangements will allow firms nearly eight months from publication of the final rules to amend the first type of contract. Firms would have nearly 17 months to amend or terminate all other types. We understand that most current remuneration obligations will not extend beyond one year.
- 6.19 As stated in the CP, and reiterated in our Dear CEO letter dated 15 July 2009, these transitional arrangements do not apply to obligations entered into after 18 March 2009 (ie after the date of publication of the CP). We alerted firms to the likelihood that this requirement would be made in the March 2009 CP in order to avoid giving firms an incentive to put in place risky remuneration structures during the period

before the Code was implemented. Remuneration arrangements entered into after 18 March 2009 will therefore need to comply with the Code from 1 January 2010.

What we will expect by the implementation date.

- 6.20 As stated in paragraph 3.39, we expect that changes to policies and procedures should be fully in place by 1 January 2010 and changes to remuneration structures and contracts should be implemented with effect from 1 January 2010, unless they fall within the transitional arrangements set out in paragraph 6.17 above.
- 6.21 Specifically, we will assess compliance with the general Rule on 1 January 2010 by reference to the following criteria relating to individual EPs (principles of the Code). For firms that elect to comply with the General Rule through adherence to the principles, we will assess such adherence as follows:
- **Principle 1.** If a remuneration committee is not fully compliant with the requirements of this principle by 1 January 2010, we will want to see evidence that action has been taken to achieve compliance by an appropriate specified date.
 - **Principles 2 and 3.** We will expect firms to have set up the procedures to ensure full compliance with these principles by 1 January 2010.
 - **Principle 4.** We will expect firms to be ready to apply risk adjustment techniques to the sums accruing to bonus pools with effect from 1 January 2010.
 - **Principle 5 and 6.** We will expect firms to have made any necessary changes to assessment processes to ensure full compliance with these principles by 1 January 2010.
 - **Principle 7.** We will expect firms to have at least initiated a review of how well their long term incentive plans take account of future risks by 1 January 2010. We will want to agree with them a date by which they will be in a position to discuss the conclusions of that review with us.
 - **Principle 8.** We will expect firms to have made the changes to remuneration structures necessary to comply with this rule by 1 January 2010, subject to the transitional provisions set out in SYSC TP3 of the Handbook.

List of respondents to CP09/10

Abbey National plc

Aegon UK

Association of British Insurers

Alternative Investment Management Association

Alvarez & Marsal

Arcus Investment Limited

Association of Foreign Banks

Aviva plc

Britannia Building Society

British Bankers Association

The Business Key Ltd

Cameron McKenna

The City of London Law Society

Consumer Panel

The Co-operative financial services

Ernst & Young

HSBC Holdings plc

Institute of Business Ethics

Investment Management Association

Leeds Building Society

Local Authority Pension Fund Forum

London Investment Banking Association

Lyntell Corporate Management
Mishcon de Reya
National Association of Pension Funds
Pacific Life Re
P&D Quantitative recruitment
RCM (UK) Limited
Royal Bank of Scotland Group plc
Securities Industry and Financial Markets Association
Securities & Investment Institute
Simmons & Simmons
Smith Equity Advisory
Somerlinck, David
Standard Life plc
Towers Perrin
UBS AG
Unite the Union
University of Southern California
University of Sydney
Zurich Financial Services Group

In addition we received six responses where the respondents requested confidentiality.

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 1 January 2010.

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
11 August 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>	a committee or other body responsible for a <i>firm's remuneration policy</i> .
<i>remuneration policy</i>	the policy, procedures and practices established, implemented and maintained in accordance with the <i>Remuneration Code general requirement</i> .
<i>third country BIPRU 730k firm</i>	an <i>overseas firm</i> that: <ul style="list-style-type: none"> (a) is not an <i>EEA firm</i>; (b) has its head office outside the <i>EEA</i>; and (c) would be a <i>BIPRU 730k firm</i> if it had been a <i>UK domestic firm</i>, had carried on all its business in the <i>United Kingdom</i> and had obtained whatever authorisations for doing so as are required under the <i>Act</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*.

...

- 6.1.4-A G In setting the method of determining the *remuneration of relevant persons* involved in the compliance function, certain *banks, building societies* and

What? Where?

- 19.1.3 R (1) If the *Remuneration Code* applies to a *firm*, it applies in the same way as SYSC 4.1.1R (General Requirements).
- (2) In relation to an *overseas firm* the *Remuneration Code* applies only in relation to activities carried on from an establishment in the *United Kingdom*.
- 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). In considering the risks arising from its *remuneration* policies, a *firm* will also need to take into account its statutory duties in relation to equal pay and non-discrimination.
- (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. For example, while the *Remuneration Code* refers to a *firm's remuneration committee* and risk management function, it may be appropriate for the *governing body* of a small *firm* to act as the *remuneration committee*, and for the *firm* not to have a separate

risk management function.

- (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 19.3.18R).
- 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 have a majority of *non-executive directors*, one or more of whom should have practical skills and experience of risk management, for example through being a member of a *firm's* risk committee or audit committee. *Remuneration committees* 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 *firm's governing body* or the *remuneration committee* to issue a separate public document to inform its shareholders and other stakeholders about its *remuneration policy* and its implications for the *firm's* risk profile and for *employee* behaviour.

Remuneration Principle 2: Procedures and risk and compliance function input

- 19.3.3 E
- (1) Procedures for setting *remuneration* within a *firm* should be clear and documented, and should include appropriate measures to manage conflicts of interest.
 - (2) A *firm's* risk management and compliance functions should have appropriate input into setting the *remuneration policy* for other business areas. The procedures for setting *remuneration* should allow risk and compliance functions to have significant input into the setting of individual *remuneration* awards where those functions have concerns about the behaviour of the individuals concerned or the riskiness of the business undertaken.
 - (3) The effect of this *evidential provision* is set out in the evidential status *rule* (SYSC 19.3.18R).
- 19.3.4 G
- (1) 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 and compliance) and human resources. It is good practice to seek input from a *firm's* human resources function when

setting *remuneration* 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: Remuneration of employees in risk and compliance functions

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|--------|---|---|
| 19.3.5 | E | <ol style="list-style-type: none"> (1) <i>Remuneration for employees</i> in risk management and compliance functions should be determined independently of other business areas. (2) Risk and compliance functions should have performance metrics based principally on the achievement of the objectives of those functions. (3) The effect of this <i>evidential provision</i> is set out in the evidential status rule (SYSC 19.3.18R). |
| 19.3.6 | G | <ol style="list-style-type: none"> (1) Remuneration Principle 3 is designed to manage the conflicts of interest which might arise if other business areas had undue influence over the <i>remuneration of employees</i> within control functions. (2) The need to avoid undue influence is particularly important where <i>employees</i> 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) The <i>FSA</i> would generally expect the ratio of the potential variable component of <i>remuneration</i> to the fixed component of <i>remuneration</i> to be significantly lower for <i>employees</i> in risk management and compliance functions than for <i>employees</i> in other business areas whose potential bonus is a significant proportion of their <i>remuneration</i>. <i>Firms</i> should nevertheless ensure that the total <i>remuneration</i> package offered to those <i>employees</i> 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 <i>remuneration of relevant persons</i> 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 19.3.18R).
- 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) One of the important responsibilities of the *remuneration committee* is to determine the proportion of risk-adjusted profits that should be accrued, and paid out, in the form of variable *remuneration*.
- (4) 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.
- (5) 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 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) Where the performance-related component of an *employee's remuneration* is a significant part of his total *remuneration*, the assessment process should be designed to ensure assessment is based on longer-term performance.

- (2) The effect of this *evidential provision* is set out in the evidential status *rule* (SYSC 19.3.18R).
- 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 deferral of a sufficiently large proportion of *remuneration* may also be useful (see Remuneration Principles 4 and 8).
- (3) In considering whether the performance-related component of an *employee's remuneration* is a significant part of his total *remuneration*, relevant factors include:
- (a) the proportion of total *remuneration* which is performance-related; and
 - (b) the absolute amount of *remuneration* which is performance-related.

So, for example, it may be consistent with effective risk management to pay a proportionately higher performance-related bonus to a relatively low-paid *employee* without basing the bonus on longer-term performance.

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 19.3.18R).
- 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 take account of future risks.
- (2) The effect of this *evidential provision* is set out in the evidential status rule (SYSC 19.3.18R).
- 19.3.14 G Many common measures of performance for long-term incentive plans, such as earnings per *share* (EPS), are not adjusted for longer-term risk factors. Total shareholder return (TSR), another common measure, includes in its measurement dividend distributions, which can also be based on unadjusted earnings data. 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: Remuneration structures

- 19.3.15 R The *evidential provision* and *guidance on remuneration* structures (SYSC 19.3.16E and SYSC 19.3.17G) apply in relation to:
- (1) a *person* who performs a *significant influence function* for a *firm*; and
- (2) an *employee* whose activities have, or could have, a material impact on the *firm's* risk profile.
- 19.3.16 E (1) A *firm* should ensure that the structure of *remuneration* for a *person* to whom this *evidential provision* applies is consistent with and promotes effective risk management.
- (2) The effect of this *evidential provision* is set out in the evidential status rule (SYSC 19.3.18R).
- 19.3.17 G (1) It is good practice for the fixed component of an *employee's* *remuneration* to be a sufficient proportion of their total *remuneration* to allow a *firm* to operate a fully flexible bonus policy. This means that a *firm* (or a part of it) would have the ability not to pay a bonus in a year in which the *firm* (or part of it) makes a loss. Such a practice need not prevent a *firm* from paying a bonus despite making a loss if the bonus is justified on other grounds, for example incentivising *employees* involved in new business ventures which could be loss-making in their early stages.

- (2) It is good practice for a significant proportion of any bonus to be deferred with a minimum vesting period. Both the proportion of the bonus to be deferred and the vesting period should be appropriate to the nature of the business and its risks. The vesting period of the deferred element should be at least three years. In relation to the proportion to be deferred, if the bonus is significant when compared with the fixed component of an *employee's remuneration*, a reasonable starting point would be to defer at least two-thirds of the bonus.
- (3) It is good practice for a significant proportion of the variable component of *remuneration* to be linked to the future performance of:
 - (a) the *firm* and, where practicable, the *employee's* division or business unit; or
 - (b) the business undertaken by the *employee*.
- (4) Deferred compensation paid in *shares* can meet Remuneration Principle 8 provided that the scheme satisfies appropriate criteria, including risk-adjustment of the performance measure used to determine the initial allocation of shares.
- (5) Deferred *remuneration* paid in cash should also be subject to performance criteria.
- (6) Bonus pools and individual bonuses should be based on *employee*, division, business unit, or *firm* performance during the period under review. Both linkage to the future performance of the *firm* and linkage to the future performance of a division or business unit can deliver important benefits. 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*. It is good practice for *remuneration* awards to be based on an appropriate combination of all of these factors.
- (7) 'Guaranteed minimum bonuses' which run for a period of more than one year and similar payments in addition to an *employee's* salary that are not based on performance during the performance period under review are likely to be inconsistent with Remuneration Principle 8.

Status of evidential provisions

- | | | |
|---------|---|--|
| 19.3.18 | R | <ol style="list-style-type: none"> (1) Compliance with the <i>evidential provisions</i> in this section tends to show compliance with the <i>Remuneration Code general requirement</i>. (2) Non-compliance with an <i>evidential provision</i> in this section tends to show non-compliance with the <i>Remuneration Code general requirement</i>. |
|---------|---|--|

Amend the following as shown.

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> :	
...	...
(3A)	<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?
...
<u>SYSC 11 to SYSC 4819</u>			No	Yes <i>SYSC</i> 1.4.2R	No

Annex C**Amendments to the General Prudential sourcebook (GENPRU)**

In this Annex, underlining indicates new text.

1.2.31 R ...

- (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>	... <i>SYSC 18 applies.</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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