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REFORMING REMUNERATION PRACTICES IN FINANCIAL SERVICES

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Overview

In August the FSA published its feedback on earlier consultation on reforming remuneration practices in financial services together with its final rules. Initially the new rules, to be known as the Remuneration Code, will only apply to a small number of the largest financial institutions. However, in the light of draft amendments to the Capital Requirements Directive which include provisions on remuneration, the FSA is actively considering whether the scope of the Code should be extended to other FSA authorised firms.

Objectives

The 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. In the FSA's view inappropriate remuneration policies, practices and procedures were a contributory factor rather than a dominant factor behind the recent market crisis.

Scope

Initially the Remuneration Code will apply to UK banks and building societies which have capital resources in excess of £1 billion, BIPRU 730k firms with capital resources exceeding £750 million and finally, banks and BIPRU 730k firms which meet the above criteria on a group basis. The FSA estimates that only about 26 firms fall within the above criteria.

The consultation process also invited discussion and feedback on whether the Code should be extended to other FSA authorised firms. This point is to be addressed in a separate document to be published October. The consultation paper also announced that the FSA would be increasing its focus on remuneration within its supervisory programmes for all authorised firms by incorporating remuneration risk into Arrow and other supervisory programmes. The clear message is that remuneration policies have moved up the regulatory agenda for all firms.

The Remuneration Code

The Remuneration Code, to be contained within SYSC 19, consists of one general rule which requires firms to establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management. The general rule is supported by eight principles which have evidential effect in relation to the general rule. The principles are as follows:

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

A remuneration committee should (a) exercise, and be constituted in a way that enables it to exercise, independent judgement; (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 judgement on the

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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.

Principle 2: Procedures and risk and compliance function input

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 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.

Principle 3: Remuneration of employees in risk and compliance functions

Remuneration for employees in risk management and compliance functions should be determined independently of other business areas. Risk and compliance functions should have performance metrics based principally on the achievement of the objectives of those functions.

Principle 4: Profit-based measurement and risk-adjustment

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

Principle 5: Long-term performance measurement

Where the performance related component of an employee's remuneration is a significant part of his total remuneration, the assessment process should be designed to ensure assessment is based on longer-term performance.

Principle 6: Non-financial performance metrics

Non-financial performance metrics should form a significant part of the performance assessment process. Non-financial performance metrics should include adherence to effective risk management and compliance with the regulatory system and with relevant overseas regulatory requirements.

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

The measurement of performance for long-term incentive plans, including those based on the performance of shares, should take account of future risks.

Principle 8: Remuneration structures

A firms should ensure that the structure of remuneration for a person who performs a significant influence function or an employee whose activities have, or could have, a material impact on the firm's risk profile is consistent with and promotes effective risk management.

Timetable

- October 2009 – FSA to report on the extent to which other FSA firms will be subject to the Remuneration Code;
- 31 October 2009 – Remuneration policy statements to be submitted to FSA by firms initially subject to the Code;
- 1 January 2010 – Remuneration Code takes effect.

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