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# FSA Remuneration Code review – a checklist

## Introduction

FSA is proposing changes to its handbook. A new rule on remuneration requires a firm to establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management (SYSC 19.2.1R). In addition to this rule, an ancillary draft code (the “Code”) sets out further guidance on FSA expectations for a firm’s remuneration practices.

The rule and Code will not just apply to bonuses/incentives but to all aspects of remuneration that could have a bearing on effective risk management including salary, long-term incentive plans, pensions and severance arrangements. They also cover all levels within a firm so will not just apply to directors but also to sales staff, traders etc.

The consultation periods closed in May and June. SYSC 19 will apply to 45 of the largest institutions; FSA also consulted on how the Code will apply to the rest of the banking sector and to other financial institutions.

## Which rules apply?

Are you one of the “45”? If not, what provisional steps should you take now? You need to decide how far to take your preparations at this stage, whilst FSA is still deciding on the application of its new rules and Code. An initial review is advisable, particularly as FSA has already said it will increase focus on remuneration in its supervisory programmes (including ARROW), across all sectors.

Determine which rules apply to which parts of your business. In many cases, these will be the domestic rules (such as the Code in the UK) but the position is complex particularly for international businesses. You will need to track developments – see the timeline on page 3. The Walker review on governance will cover the independent role of non-executives, risk management and board remuneration. It will now cover all sectors, including insurance.

For listed companies, the Listing Rules and expectations on executive pay (e.g. the Association of British Insurers guidelines) will also need to be considered.

## Initial steps

Collate complete information on remuneration including remuneration policies, governance and approval controls and pension, incentive and share schemes – from HR, company secretarial and business units.

Determine the scope of the review – particularly the geographical scope if the business is international.

Training and awareness – are the different departments (risk, compliance and HR) and REMCO members, directors and non-executives up to speed with FSA’s requirements, expectations and deadlines?

## Governance

In order to meet the Code’s requirements, you need to review and develop your governance, and controls over, remuneration policies and their operation. Key issues include:

- A bigger role for your remuneration committee (REMCO) (beyond board remuneration) and the expertise and skills required within a REMCO – including risk management skills - particularly for the non-executive directors on the committee.
- If you do not have a REMCO, what is the relevant body to take these decisions? How does this work in a group or international context?
- What professional support will be required?

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- How will the risk and compliance functions and those in areas such as financial modelling be involved?
- More developed documentation will be required recording enhanced governance and related controls, including the process for review and supervision of the new remuneration policy.

REMCOs need to be ready to provide FSA with evidence of how well the firm's remuneration policies are complying with the Code and may have to meet FSA to discuss the position.

The risk function is likely to be involved in setting the risk adjustment criteria, monitoring the application of discretionary factors and managing the conflicts of interest which can arise when employees are involved in determining remuneration for their own business areas.

## Your firm's remuneration policies

In many cases a firm's remuneration practices may not be set down in formal policies and may be operated at various levels (e.g. group and divisional). More formal, detailed and comprehensive policies will have to be prepared and rolled-out. New processes will have to be designed for compliance monitoring, periodic review and stress testing.

The new arrangements need to cover a wide range of issues from hiring to pensions (including early retirement rights).

New disclosure requirements may apply to a firm's remuneration policies. The Financial Stability Forum has stated, in its principles for sound compensation practices, that firms should disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders. Firms therefore need to consider how their internal policy may be disclosed outside the firm to regulators or shareholders (and how their employees and competitors may react).

## Bonus and incentive schemes – risk adjusted

What is your new policy on the balance between fixed remuneration and bonus/incentives?

- Do you operate a fully flexible bonus policy? A firm must carefully consider the ratio of salary versus bonus and should make sure that it is able not to pay a bonus in a particular year (i.e. that an employee's basic remuneration is sufficient) in the event that the firm or business units fail to meet the thresholds. What should that ratio be?
- Whose performance will dictate bonus awards – at pool level, individually and in relation to adjustment/claw-back on deferred entitlements? What happens to profitable departments if the bank makes losses?

How will criteria be risk adjusted?

- What numerical criteria will apply – are these based on profits not revenue? How will criteria be risk adjusted? The question of what the risk adjustment should be (i.e. what risks and what weighting to apply) will be one of the biggest questions facing firms – cost of regulatory capital/internal models, liquidity factors, off-balance sheet and reputation risks etc.
- What non-numerical criteria will apply e.g. to cover compliance with internal risk and compliance controls?
- What longer-term criteria will use for tail risks, which may involve adjusting or claw back of deferred bonus?

How much bonus will be deferred and for how long and in what stages?

- Have you considered the complex pros and cons and FSA's expectations on deferral? The Code has a simplistic approach to vesting periods with its best practice recommendation of 2/3 of bonus being deferred. The EU recommendation, however, just refers to a majority. What about non-tail business and more junior staff and the question as to whether deferred and conditional bonus serves as an incentive at all? In what form will deferred bonus be paid - in cash subject to performance criteria or risk-adjusted amounts paid in shares? What percentage will you defer and in what form? What about good and bad leavers?

## Integration – risk management

How will remuneration interact with internal risk management and the related areas of finance, internal models, and compliance and FSA regulation? How will you deal with remuneration and risk in the context of:

- ARROW visits

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- Individual capital and liquidity assessment/guidance and related supervisory review under Basel and other rules
- REMCO reports to FSA

## Documentation and sign-off

Introducing these changes will involve a host of employment law, tax and contractual issues and will require an amount of significant legal drafting and review. How will you document the new schemes and policies, what contractual, tax and employment law status will they have and how will they impact their operation? How will you review all documentation to capture offending terms? Do you have the contractual flexibility to implement changes to your existing bonus scheme and entitlements and can you unilaterally do this in time for the 2009 and 2010 deadlines – or do you need to negotiate as well as communicate? How can you deal with employees who do not consent?

## How we can help

Our experts below can cover all these FSA regulation, employment law and incentive scheme issues -

- Review of remuneration policies, schemes and practices
- Re-structuring schemes and benchmarking (including risk adjustment)
- Market practice
- Prepare reports for/from REMCO, risk, HR, compliance and FSA
- Draft documentation and contracts
- Employment law and tax advice including the transition of existing employees and their rights
- Sign-off of remuneration policies and documentation
- Training and keeping up-to-date with developments

## Key documents

- FSA Consultation Paper CP09/10 on “Reforming remuneration practices in financial services”  
[http://www.fsa.gov.uk/pubs/cp/cp09\\_10.pdf](http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf)
- Financial Stability Forum “Principles for Sound Compensation Practices” April 2009  
[http://www.fsforum.org/publications/r\\_0904b.pdf](http://www.fsforum.org/publications/r_0904b.pdf)
- CEBS “Principles on Remuneration Policy” March 2009  
<http://www.c-ebs.org/getdoc/34beb2e0-bdff-4b8e-979a-5115a482a7ba/High-level-principles-for-remunerationpolicies.aspx>
- European Commission Recommendation on Remuneration in the Financial Sector April 2009  
[http://ec.europa.eu/internal\\_market/company/directors-remun/index\\_en.htm](http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm)

## Timeline

18 May 2009	FSA consultation on remuneration closed for the consultation questions (content of Code)
18 June 2009	FSA consultation on remuneration closed for questions for discussion (should Code apply to more than the 45)
Before summer 2009	Treasury White Paper on regulatory reform, strengthening bank capital and remuneration practices
Summer 2009	RDR consultation Walker review - consultation
End of July/ early August 2009	FSA will publish the new remuneration requirements
Autumn 2009	Conclusions from the Walker review

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6 November 2009

New handbook rule change on remuneration policies (SYSC 19.2.1 R) takes effect (proposed date)

31 December 2009

Proposed deadline for amending existing employment contracts (unless contract cannot be amended, in which case it must be terminated by 6 November 2010)

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