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Financial Services Authority:
Reforming Remuneration Practices in Financial Services

By Brian Flume and Kelly Clark
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Regulatory bodies and industry associations across the world have been focused on incentive compensation practices in order to assess their impact on the recent financial crisis and more importantly to identify ways to prevent future problems. On August 11, 2009, the United Kingdom's Financial Services Authority (FSA) published a policy statement for regulating remuneration policies in the UK. This was preceded on July 13th by a report from the European Commission. The overall objectives of the policy statement and recommendations are to sustain market confidence and promote financial stability. Most regulatory and industry organizations have concluded that by removing incentives that encourage inappropriate risk-taking, there will be greater stability in the financial markets.

Among most stakeholders in the financial services industry, it is generally agreed upon that compensation practices played a contributory role in the recent financial crisis. Nearly all regulatory guidelines published to date have cited a clear need to ensure that compensation structures are consistent with effective risk management.

Earlier this year, the FSA published a consultation paper on their proposals to implement a code of practice on remuneration policies. The FSA welcomed comments and input from the firms who would be affected by these new regulations. The FSA has now published the final regulations after reviewing firms' feedback, other regulatory organizations' guidelines, and analyzing what would be most appropriate for the UK's financial services industry.

POLICY STATEMENT FINAL RULE

The policy statement sets out a high-level general rule and evidential provisions. It is possible that firms can demonstrate compliance with the general rule even without complying with all of the evidential provisions.

The final rule will go into effect January 1, 2010 and will generally apply to financial services firms with over £750 million in capital. Originally, the criteria outlined by the FSA contained 47 organizations to be covered by the new regulations. The final regulations will now cover 26 institutions, which are not specifically identified in the regulations. The firms that have been excluded since the consultation paper are primarily non-UK organizations.

GENERAL RULE

The general rule states that "firms must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management." The aim of the code is to ensure that firms have risk-focused compensation policies. These policies should promote effective risk management and not incentivize employees to undermine the

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overall risk profile of the organization.

EVIDENTIAL PROVISIONS

1. Compensation Committees should:
   - Exercise independent judgment.
   - Demonstrate that decisions are consistent with the firm's financial situation.
   - Have the skills and experience to reach an independent judgment considering implications of risk.
   - Periodically review and approve the adequacy and effectiveness of compensation policies.
2. Procedures for setting remunerations within a firm should be clear and documented and should include appropriate measures to manage conflicts of interest.
   - Risk and compliance functions should have significant input into compensation where there is concern about the behavior of individuals or the risk level of a business function.
3. Compensation of employees in risk and compliance functions should be determined independently of other business areas. Risk and compliance should have performance metrics that focus mainly on the achievement of the objectives for those functions, and the ratio of variable to fixed pay should be lower for these functions.
4. Bonus pool calculations should:
   - Be based primarily on profits.
   - Include adjustments for current and future risk not adequately captured in accounting profits.
   - Take into account the cost of capital employed and liquidity required.
5. For employees who have a significant amount of performance-related compensation, performance assessments should be based on the long-term.
6. Non-financial performance metrics should form a significant part of the performance assessment process and include adherence to effective risk management and regulatory compliance as metrics.
   - The performance assessment process and the importance of non-financial metrics should be clearly communicated to employees.
7. Performance measurement for long-term incentive plans should take into account long-term performance. Firms should develop risk-adjusted performance metrics, considering that many commonly used long-term performance metrics (e.g., earnings per share, total shareholder return) can be manipulated in the shorter-term.
8. For employees who perform a "significant influence function" for a firm or whose activities have or could have a material impact on a firm's risk profile, it is good practice to:
   - Ensure that the "fixed component of the employee's compensation be a sufficient enough proportion of their total compensation to allow a firm to operate a fully flexible bonus policy" so that the firm would have the ability to not pay a bonus in a year when a firm or part of a firm has

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a loss. (This practice need not prevent a firm from paying a bonus on other justified grounds despite a loss for the firm.)

- Defer a significant portion of bonus (to be paid out in either cash or shares) with a minimum vesting period of at least three years, resulting in an appropriate deferred amount and vesting period for the nature of the business and its risks. When an employee's bonus is significant compared to the fixed compensation amount, a reasonable starting point would be to defer two-thirds of the bonus.
- Link a reasonable portion of variable compensation to (1) the firm and business unit, where applicable and (2) the business undertaken by the employee.
- Determine bonus pools and individual bonuses using an appropriate combination of the employee's division, business unit or the firm performance in order to ensure alignment with future firm performance and assure that the risks which the employee had a role in assuming continue to impact compensation.
- Avoid multi-year bonus guarantees in employment agreements.

REMUNERATION STATEMENT

The FSA will require firms to provide them with a Remuneration Policy Statement (RPS) by the end of October and annually thereafter. The RPS must include an assessment of the impact of the firm's compensation policies on its risk profile and employee behavior. This statement will be a separate document from the information on compensation policies that the firms publicly disclose, and it is likely that the FSA will request information that firms may not publicly disclose.

The FSA will provide a questionnaire to each firm by the end of August that will explain the level of detail that will be requested in the RPS. The questionnaire will request information under the following headings:

- Principles of the compensation policy and how it is applied to employees according to seniority, business line and function
- Intended impact on employee behaviors and on the risk profile of the firm
- How compensation policies are communicated to employees
- Selected data on compensation policies in 2009
- Information on proposed compensation practices in 2010, referenced to each of the evidential provisions
- Statement of whether the firm expects to comply with the general rule

The proposed recommendations by the European Union are generally consistent with the key provisions issued by the FSA. However, they are different from the FSA's policy statement in the following ways:

- Applies to credit institutions and investment firms across the entire European Union.
- The requirement is restricted to employees whose function has a material impact on the firm's risk profile.

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- It gives authority to supervisors under the policies to impose financial penalties for breach of any compensation requirement.

CONCLUSION

One major implication for firms is that the FSA is requiring contract amendments to comply with the general rule. For contracts that allow amendments, changes must be made prior to March 31, 2010. For all other contracts, changes must be made so that the contract is in compliance with the rule by December 31, 2010.

One major concern of respondents during the consultative period was the potential adverse impact on firms in the UK if the FSA implemented compensation regulations while other major financial centers do not. The FSA addresses this in the policy statement by noting the international developments regarding compensation principles in the time since the FSA's consultative paper was published (e.g., FSF *Principles for Sound Compensation Practices*, EU recommendations for compensation practices (as mentioned above), Treasury's proposed compensation reforms) and cites the similarities of these various principles and the FSA's final general rule.

The FSA is sending covered firms a letter by the end of August with more information for compliance and recognizes that what is necessary for a firm to comply will depend on the nature, scale and complexity of the firm. The FSA expects changes based on the general rule to be in place by January 1, 2010. ■

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