



# Reforming Remuneration Practices in Financial Services

There has been growing concern in recent months, that rewarding short-term revenue and profit targets through improper remuneration practices may have contributed to the credit crisis. On 18 March 2009, the Financial Services Authority (the “FSA”) published the consultation paper, “09/10 – Reforming Remuneration Practices in Financial Services” (the “Consultation”).<sup>1</sup> At the heart of the Consultation’s proposals, is the view that the FSA’s draft Code of Practice (the “Code”) published on 26 February 2009,<sup>2</sup> should be incorporated into the FSA Handbook and applied to certain financial institutions, including large banks, building societies and broker dealers.

## Current Remuneration Concerns

The FSA strongly believes that inappropriate remuneration practices are at least partly to blame for recent losses across the banking and investment community. Following the publication of a number of high-level reports on the issue,<sup>3</sup> findings clearly point to the failure of control systems to deal with increasingly complicated risk taking, incentivised by potentially substantial short-term profits for the firm that result in high remuneration for the individual. The greater the short-term profit, the greater the potential bonus. What is not accounted for, however, is the disproportionate level of risk. What happens if there are losses? Bonuses can only fall to zero, while the implications of financial losses due to excessive risk taking can reach (and recently have reached) considerably further than the depths of the pockets of those who take the risks. These broader consequences are rarely accounted for in a system where remuneration drives greater risk taking and it is this issue that the FSA seeks to address in its Consultation.

## The Draft Code of Practice

The Code was prepared following the publication of a “Dear CEO” letter (the “Letter”) sent by the FSA in October 2008, which first outlined regulators’ views in respect of good remuneration practice (responses to the Letter are set out in the Consultation). It begins by setting out the general requirement (the “General Requirement”) that firms must ensure their remuneration packages for employees (which may include salaries, bonus payments and other incentives) are established, implemented and maintained in a way that is consistent with effective risk management. While the FSA is not concerned with specific remuneration levels (such matters being only the concern of internal management), the Code has been used to set out ten principles (the “Principles”), primarily aimed at assisting firms in assessing and revising their remuneration policies such that exposure to excessive risk taking is reduced.

<sup>1</sup> [http://www.fsa.gov.uk/pubs/cp/cp09\\_10.pdf](http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf).

<sup>2</sup> <http://www.fsa.gov.uk/pubs/other/remuneration.pdf>.

<sup>3</sup> Examples include the Interim Report of the Institute of International Finance (IFF) Committee on Market Best Practices, April 2008. This has now been followed by the IFF report: “*Compensation in Financial Services Industry Progress and Agenda for Change*” published on 30 March 2009, which sets out seven core principles of conduct on incentive compensation.

The Principles include:

1. A requirement that the remuneration committees of any firm should be appropriately skilled and experienced, and constituted in a way that enables the exercise of independent judgment;
2. All procedures for setting remuneration should be clear and well documented with a firm's risk management and risk compliance functions providing "significant input" into their creation;
3. The remuneration of employees carrying out risk management and compliance functions should be determined independently of business areas and those functions should have performance metrics based on whether the objectives of those functions have been achieved;
4. The assessment of financial performance used to calculate bonus pools should be principally based on profits, rather than revenue and should take into account current and future risk and the cost of capital employed and liquidity required;
5. The performance-related component of an employee's remuneration should be based on long-term performance;
6. Non-financial performance indicators (including adherence to effective risk management policies and compliance with the regulatory system) should form a significant part of the assessment process;
7. The measurement of performance for long-term incentive plans should be risk-adjusted;
8. In order to ensure a fully flexible bonus policy, any fixed element of a remuneration package should be a sufficient proportion of the total;
9. Where a bonus package comprises a significant proportion of the total remuneration, the majority of such bonus should be deferred with a minimum vesting period; and
10. Where a deferred element is included in a remuneration package, it should be linked to the future performance of the firm as a whole, as well as to an employee's own division or business unit.

## Consultation Proposals

The Consultation firstly proposes that the Code's General Requirement be incorporated as a "rule" in the FSA's handbook (the "Handbook"). Secondly, it is proposed that the Principles should also be entered into the Handbook, either as "evidential provisions"<sup>4</sup> or as guidance to support the General Requirement. The General Requirement and evidential provisions would then be applied to FSA-regulated banks and building societies which meet certain criteria, either:

1. having total regulatory capital in excess of £1 billion (or £750 million or its equivalent in foreign currency, for FSA-regulated BIPRU 730k firms);<sup>5</sup> or
2. being part of an international financial group with regulatory capital in excess of £20 billion (or £5 billion or its equivalent in foreign currency, for FSA-regulated BIPRU 730k firms).

<sup>4</sup> Evidential provisions are a type of rule primarily used to provide evidence supporting the view that another rule (i.e., the General Requirement) has been breached or complied with.

<sup>5</sup> A bank, building society or investment firm that is subject to the Capital Requirements Directive (comprised of Directive 2006/48/EC and Directive 2006/49/EC) and to minimum capital requirements of €730,000.

It is worth noting that that the UK branches of EEA firms would be excluded from the rules, since the responsibility for these branches falls to the relevant authorities. Overseas branches of UK firms, however, would be included.

Having incorporated the Code into the Handbook, the FSA may also ask a firm's remuneration committee to prepare a statement setting out their remuneration policy and explaining how it affects the firm as a whole. Such statement is likely to consider what impact these new policies will have on employee behaviour and attitude to risk, while it may also provide evidence of how the Code's principles have been implemented.

### Extending the Code to Sectors other than the Banks and Large Broker-Dealers

The FSA is not of the opinion that inappropriate remuneration practices in firms outside of the financial sector have played a significant role in creating the recent credit crisis. However, it does believe that such practices might cause concern in circumstances where they increase the risk of material financial loss in firms, even if that risk has no significant implications for the wider market. Equally, where there is potential that remuneration practices might cause employees to promote one product over another to the possible detriment of the customer, or to maximise the quantity of output and not the quality (*e.g.*, in commission-based structures), there is still an arguable case that the Code should be extended to help prevent these risks from arising. Examples of the types of firms which might be caught as a result of the extension of the Code include, *inter alia*, BIPRU 730k firms not already covered by the consultation, asset managers, hedge fund managers, insurers, managing agents, mortgage providers and credit unions.

### One Size Fits All

As outlined in the Consultation, one of the main concerns raised in response to publication of the Letter appears to be the need to ensure that regulators avoid a "one size fits all" approach. As an example, some firms have highlighted the need to distinguish between retail and investment banks, while other firms have highlighted that smaller firms often do not have separate remuneration committees (which would be particularly relevant if the Code were extended to smaller firms). Similarly, guidance in respect of shareholders will not be applicable to building societies or other mutual firms. The FSA has been keen to point out that the Code is proposed to be implemented in a "principles-and-risk-based" way, such that not every principle will be applied in the same way to every firm. However, it remains to be seen whether the Code will be further amended in order to avoid an overly formulaic approach.

### Next Steps

The Consultation has specified a two-month period to consider implementing the Code in respect of the larger banks and broker-dealers.<sup>6</sup> A three-month period has been provided for feedback in respect of any possible extension of the Code to other firms.<sup>7</sup> The intention is that relevant feedback will be published in early August 2009, such that the Code can be brought into effect by the beginning of November 2009. As a result, it is hoped that it will be in place before the commencement of any 2009 remuneration reviews. During the consultation process, the FSA has stated that it will also be taking account of policies on remuneration being implemented around the world, in order to ensure that our approach is as consistent as possible with that of the authorities in the other major financial centres.

<sup>6</sup> Comments to be received by 18 May 2009.

<sup>7</sup> Comments to be received by 18 June 2009.

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