

Risk, reward and reform

Christopher Hitchins and Ashley Brown discuss the FSA's new Code of Practice, which aims to introduce a culture of longer-term performance incentives in the financial sector



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'If the FSA presses ahead with implementing the Code by January 2010, this could result in affected UK financial institutions having to amend their remuneration policies, contracts of employment and bonus structures not only now but again in the future if the code is subsequently amended.'

The big-bonus culture associated with financial services institutions worldwide has been heavily criticised by the media for encouraging employees to take excessive short-term risks, thereby contributing to the recent economic crisis.

To sustain market confidence and promote financial stability by removing the incentives for inappropriate risk-taking by authorised firms, the Financial Services Authority (FSA) consulted extensively with relevant financial institutions on executive remuneration earlier this year. Although the FSA conceded that 'inappropriate remuneration policies' contributed to the recent economic crisis, it found that this was not the 'dominant factor'. Nonetheless, the FSA has proposed introducing a Code of Practice on Remuneration Policies (the Code) as an attempt to move away from the financial services sector's unique culture of linking incentives primarily to short-term risk-taking. At the very least, the FSA hopes this will provide shareholders with some reassurance that risk is being managed.

The final version of the Code was published by the FSA on 12 August 2009, together with a Policy Statement 09/15 (Reforming Remuneration Practices in Financial Services), summarising the feedback on the consultation that took place earlier this year.

The Code will be included in the FSA Handbook from 1 January 2010 (rather than 6 November 2009, as originally proposed) so that the FSA can enforce it directly.

Hector Sants, the FSA's chief executive, has stated that at its heart the Code has two aims:

- to ensure that boards and remuneration committees focus more closely on the link between compensation, risk appetite and sustainability; and
- to ensure that individual compensation practices provide the right incentives.

Scope

Initially, the Code will apply to only around 26 of the largest banks, building societies and broker-deal firms (in contrast to the 47 firms to which the consultation paper anticipated it would apply). At the time of writing, the FSA had not yet publicly issued a list of the organisations affected, although the organisations themselves should know who they are by now, as the FSA will have contacted them. Most overseas banks with UK subsidiaries will not be affected unless they are part of a group that contains UK banks or building societies that meet the following criteria:

- they have a total regulatory capital in the UK banking entities exceeding £1bn, or they are part of a finance group (UK or international) with regulatory capital in excess of £20bn, or the equivalent amount in another currency; or
- they are FSA-regulated BIPRU 730k firms (ie, a bank, building society or investment house that is subject to the Capital Requirements Directive and to minimum capital requirements of €730,000) that have a total regulatory capital in the UK-authorized entity exceeding £750m, or the equivalent amount in another currency, or are part of a finance group (UK or

international) with regulatory capital in excess of £5bn, or the equivalent in another currency.

Main recommendations

The Code is intended to target senior employees and those employees with 'significant influence', as opposed to the wider employee population. It is intended to apply to all remuneration issues, including wages, bonuses, long-term incentive plans, stock options, sign-on bonuses, severance packages, pensions and the thorny issue of rewards associated with failure.

The general requirement of the Code is that affected financial institutions must:

... establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.

To ensure compliance with this general requirement, affected firms should comply with eight evidential principles, which are accompanied by additional guidance in the Code (see box, below).

However, although compliance with the eight principles is likely to indicate compliance with the overriding general principle of effective risk management, it is not compulsory *per se*. Firms may be able to demonstrate good risk management without compliance with the evidential provisions. Indeed, there

financial institutions would relocate outside the UK to avoid compliance with the new rules, although, in our opinion, it is highly unlikely that this would ever happen.

Largely as a result of these concerns, and to retain London's competitiveness, the final version of the

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may be circumstances in which it would not be appropriate for firms to comply with specific evidential provisions.

During the consultation period, many financial institutions argued that the draft Code was too prescriptive and imposed many draconian provisions that went significantly further than proposals made by regulatory bodies overseas. It was even suggested that the strict provisions of the draft would encourage a brain drain or that

Code has been significantly narrowed in scope. However, the FSA does not seem to be able to escape criticism, as commentators in the media have condemned the watering-down of the draft Code, particularly its stringent proposals on bonus payments. The draft Code was made up of ten separate principles (reduced to eight in the final version), one of which controversially required deferral of at least two-thirds of bonuses over three years. This principle,

Summary of the Code's eight principles

(1) Role of bodies responsible for remuneration policies and their members

An independent remuneration committee should be set up with a specific focus on risks associated with employee recruitment and management (with a focus on remuneration policies).

(2) Procedures and risk and compliance function input

The risk management and compliance function should be involved in establishing remuneration policies.

(3) Remuneration of employees in risk and compliance functions

The remuneration of employees involved in risk management should be considered separately from other business areas. Any variable compensation for those in risk and compliance should be significantly less than for risk-takers themselves.

(4) Profit-based measurement and risk adjustment

Profit levels (as opposed to revenue or turnover) should be the performance indicator used to calculate bonus pools.

(5) Long-term performance measurement

Where a substantial element of an employee's salary is linked to performance, the assessment process for that performance-related component should be designed to assess longer-term performance.

(6) Non-financial performance metrics

Non-financial performance metrics should form a significant part of the performance assessment process. These metrics should include adherence to effective risk management and

compliance with the regulatory system and with relevant overseas regulatory requirements.

(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 be risk-adjusted.

(8) Remuneration structures

Remuneration should be linked to careful risk management. Good practice is:

- To have a fixed component of remuneration that is a sufficient proportion of total remuneration to allow a firm to operate a fully flexible bonus policy (so that it does not have to pay a bonus if it suffers a loss).
- To defer a significant part of an annual bonus with a vesting period of at least three years. If, when compared with the fixed component of an employee's remuneration, the bonus is a significant proportion, then a reasonable starting point would be to defer two-thirds of the bonus.
- 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).

It is unlikely that a guaranteed minimum bonus for more than one year is consistent with the Code.

together with tying incentives to the performance of the entire financial institution and not just the particular division (and therefore not paying out where the financial institution has made a loss), has now been relegated to guidance. Although compliance with the guidance is seen as best practice, failure to comply with it will not automatically result in non-compliance with the Code.

The FSA does not intend to restrict the amount of individual bonuses. However, it expects banks to move away from guaranteed bonuses and short-term, cash-based remuneration for highly paid employees in favour of the deferred and longer-term performance incentives more commonly seen in other major UK companies.

Although this is limited to guidance only, the Code also discourages guaranteed bonuses that run for more than one year. It states that such practices are unlikely to be consistent with the general requirement of the Code or to accord with good risk management.

Financial institutions will welcome the freedom that the FSA has given them to tailor remuneration

procedures to their specific needs. In certain circumstances, it may still be appropriate to allow guaranteed bonuses, perhaps to entice a new recruit to join the organisation or to develop a particular business team.

Enforcement

Banks will be made to prove that they have enough capital to pay bonuses, and if this requirement is not met the FSA can step in. It can force them to hold more capital where it feels that they have risky bonus structures, which in turn will decrease profitability and the end pool available for distribution. If necessary, the FSA may resort to taking enforcement action or impose a fine.

The FSA has confirmed that it is already carrying out spot checks on individual bankers' bonus agreements to ensure that they are consistent with the Code.

Main criticisms

The issue of bankers' bonuses has been at the forefront of media coverage both in the UK and internationally, and it is also high on political parties'

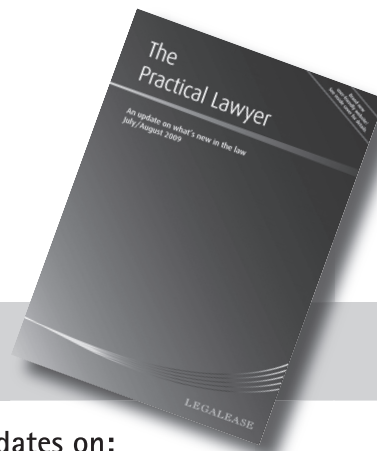
agendas. The European Commission has confirmed its intention to publish regulations on remuneration in the financial services sector by the end of 2010. In addition, the Basel Committee on Banking Supervision plans to introduce global remuneration practices, and regulations have been proposed in the Netherlands to cap bonus payments there.

So there is international consensus on the need to change the structure of executive remuneration in the financial services industry for the better. However, there are proposals for multiple strands of legislation – at a national, European and international level – and undoubtedly with these various layers of regulation will come inconsistencies. Banks that operate in multiple jurisdictions will have to grapple with different rules coming into force in various places and at various times.

The UK government is clearly hoping that because the FSA is bringing changes in sooner rather than later, the other financial centres will aim to introduce something similar to the UK's rules, safeguarding London's status as one

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of the world's major financial centres. However, in being the first regulatory body to implement regulations on executive remuneration, the FSA has its work cut out and there will be many complex employment issues that need to be addressed (see below). Pressing ahead with implementing the Code by January 2010 could result in affected UK financial institutions having to amend their remuneration policies, contracts of employment and bonus structures not only now but again in the future if the Code is subsequently amended in light of domestic or cross-border legislation.

Another concern is that restricting bonus payments may encourage firms to increase employees' base salary to maintain the same level of total compensation. Indeed, our understanding is that many firms are already doing this as a reaction to the backlash against bankers' bonuses.

Employment law issues

From an employment perspective, affected firms clearly need to carry out a considerable amount of work in the months ahead to review and, where appropriate, amend remuneration policies, bonus structures and employment contracts.

The Code provides some latitude for affected firms, which will have a transitional period to amend existing non-compliant contractual remuneration packages. Contractual agreements entered into on or before 18 March 2009 are accordingly exempt from the Code's provisions for a limited period of time as follows:

- if the non-compliant agreement can be amended or terminated unilaterally, affected firms must do so by 31 March 2010; or
- if the non-compliant agreement cannot be amended unilaterally, then it must be amended or terminated by 31 December 2010.

For those contractual agreements entered into after 18 March 2009 (when the consultation paper was issued), all remuneration practices must comply with the Code by 1 January 2010. Accordingly, those firms subject to the Code will need to identify and review any potentially non-compliant agreements without delay. Where there is doubt about whether an agreement

or practice is compliant, the FSA has advised affected firms to seek guidance from it on how to proceed.

Firms affected by the Code which have non-compliant agreements that cannot be amended unilaterally are in a difficult situation and should seek employment advice on the available options. On the one hand, such firms have to comply with the new Code. On the other, if they cannot amend contracts of employment unilaterally, they will be forced to terminate the relevant agreements to ensure compliance, opening themselves up to potential claims from affected employees for breach of contract.

It remains to be seen whether the reason for terminating the agreement (to avoid non-compliance with the Code

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and possible sanctions) is sufficient legal protection against such a claim. Firms in this situation are strongly advised to get written confirmation from the FSA that the agreement was non-compliant and that they would suffer penalties from the FSA unless the agreement were terminated.

Any claim brought by an affected employee on this basis is likely to be high profile and high value, and to bring further negative publicity to the banking industry. It would perhaps be ironic if the forced termination of a highly generous bonus scheme resulted in a firm having to pay a comparable amount in damages for breach of contract.

Link with other proposals

The FSA acknowledges that the Code 'is not going to change the bonus culture overnight', and it recognises shareholders' vital role in monitoring and controlling remuneration risks. As considered in last month's edition of *ELJ*, the Walker Review has also recently made proposals on executive remuneration in the financial services industry, and the FSA has confirmed that it will work closely with the Walker Review team on such corporate governance issues.

What happens next?

The FSA planned to write, by the end of August, to the 26 firms that it anticipates will be affected by the Code, inviting them to complete a remuneration policy statement on their compliance with the Code by the end of October. Separately, the FSA is expected to issue further guidance in October on the extent to which remuneration-related rules, including the Code, should apply to other financial institutions operating in the UK.

As recent reports indicate that financial institutions have returned to pre-credit-crunch profits and bank bonuses are predicted to reach £4bn this coming year, it is certain that the issue is going to remain a political hot potato. Alistair Darling, the Chancellor

of the Exchequer, led efforts to reach a global consensus on a crackdown on bankers' bonus at the meeting of the G20 finance ministers in London in September, ahead of the full G20 meeting in Pittsburgh, US, on 24 September 2009. In addition, Gordon Brown; the French President, Nicholas Sarkozy; and the German Chancellor, Angela Merkel, wrote an open letter to fellow EU leaders urging a united EU position on bankers' compensation at the Pittsburgh meeting.

Although the Code is, of course, a step in the right direction towards balancing risk and reward, executive remuneration undoubtedly needs to be controlled on a global basis to achieve any real success. We await the implementation of the Code and further international developments with interest, as the months ahead will undoubtedly provide interesting debate and comment. ■

Reference point

The Code of Practice on Remuneration Practices can be accessed at:
www.fsa.gov.uk/pubs/policy/ps09_15.pdf