

Reforming remuneration practices



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The FSA has introduced a new code which will require large banks, building societies and broker dealers in the UK to establish and implement remuneration policies that, in essence, link pay and bonuses to long-term profitability. Hector Sants, FSA chief executive, said: “The FSA is determined that banks’ remuneration policies should be consistent with, and promote, effective risk management. The new rules and code of practice, which will take effect from January, next year, are aimed at achieving this.”

→ The Code

Seemingly poor remuneration practices are said to have been a contributory factor to the economic crisis and the fundamental objective of the code is to “sustain market confidence and promote financial stability through removing the incentives for inappropriate risk taking ...”

The code thus seeks to ensure:

- a that boards concentrate on ensuring that the total amount distributed by a firm is consistent with good risk management and sustainability; and
- b that individual compensation practices provide the right incentives.

→ Principles

Eight principles have been added to the FSA’s handbook in order to make sure firms understand how the FSA will assess compliance. In particular, these make clear that bonuses should only be guaranteed for 12 months, and that senior employees will see two-thirds of their bonuses paid out over three years.

→ Scope

The code only applies to approximately 26 of the largest institutions in the UK. As defined in handbook reference SYSC 19.1 a firm is captured if it is:

- > a UK bank or building society if it had capital resources exceeding £1 billion
- > a BIPRU 730k firm if it had capital resources exceeding £750 million
- > a full credit institution, BIPRU 730k firm or a third country equivalent to a BIPRU 730k firm that is part of a group if the total capital resources held within the group by UK banks or building societies exceeded £1 billion or by BIPRU 730k firms exceed £750 million.

Such firms will have been contacted by FSA in August and will be expected to submit a remuneration policy statement to them by the end of October

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→ Good practice

Whilst the code only applies to those firms in scope, the FSA has suggested that it may be good practice for all firms to follow this high level requirement.

In practical terms, it is unlikely that smaller firms will be asked to present a remuneration policy, but it is certainly sensible for all firms to appraise internal remuneration practices against the code. Further, at any ARROW visit the FSA might conduct, they may well touch upon remuneration and ask the firm to explicate their policies and whether any changes have been made in consideration of the code.

Presently, it may be said that remuneration practises should already be captured in a firm's risk policy and procedures under SYSC 7 and conflict of interest procedures under SYSC 10. Notwithstanding the rule requirements, investors would expect firms to have sound practices to prevent inappropriate risk taking and conflicts in interest.

For investment managers, for example, a good starting point for meeting the code will be to align their interests with those of its investors. However, they may find the FSA take the view that simply co-investing in a fund may not be sufficient for demonstrating that managers have mitigated conflict issues, and further measures may also be necessary.

→ Hector's defence

After certain high profile accusations that the rules do not go far enough, Hector Sants issued the following rejoinder; “We [the FSA] are not mandated to limit individual pay for social reasons...[and] there may well be debate about whether bankers should be paid multiples of [the pay of] doctors or others but that debate is for government...” To align practices to risk management is the extent of the Regulator's ambitions.

→ First moves

Those ambitions will soon be put to the test after it emerged that JPMorgan has asked the FSA to 'review' a remuneration package that Barclays Capital offered one of JPMorgan's proprietary trading teams.

→ Next Steps

The new code will come into force on 1 January 2010, therefore, the FSA expects firms to have in place changes to policies and procedures by this date.

The rule and code are said to be consistent with the recommendations of the Financial Stability Board and measures being considered by the EU. International negotiation on common guidelines is expected to be concluded in the first half of 2010.

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