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Financial Services and Markets

FSA publishes code of practice on remuneration policies

The FSA has published a draft code of practice on remuneration policies. The draft code builds on its "Dear CEO letter" of last October addressed to banks. The draft code clearly applies to <u>all</u> FSA regulated firms, not just those in the banking sector.

The FSA has taken the unusual step of publishing the draft code in advance of the related consultation paper (due in March 2009). The publication of the draft code now sends a clear message that the FSA expects firms to address the issues raised without delay. Firms may therefore wish to review the draft code and begin to consider whether and how their remuneration policies may need to be updated.

The draft code is aimed at ensuring that firms' remuneration policies are consistent with sound risk management. It consists of a "one size fits all" set of principles, against which the FSA proposes to measure the quality of firms' remuneration policies and any link between those policies and excessive risk-taking conduct.

The draft principles are <u>not</u> concerned with setting levels of remuneration, which the FSA has said remains a matter for firms' boards and shareholders.

The FSA has said it may ask firms' remuneration committees to demonstrate how well their policies comply with the principles together, where appropriate, with their plans for improvement. The FSA will also ask firms that undertake an Internal Capital Adequacy Assessment Process (ICAAP) to use the principles in assessing the risks arising from their remuneration policies.

Key points to note include:

- Firms must ensure that their remuneration policies are consistent with effective risk management.
- Boards and remuneration committees should take account of the firm's financial situation and future prospects in drawing up remuneration policies. Industry practice (including the need to offer competitive packages) should not be a primary factor.
- Remuneration policies should be clearly documented and should include procedures for avoiding potential conflicts of interest. Firms' risk and compliance functions should have significant input.
- Compensation for risk and compliance staff should not depend on performance metrics used in the business areas.
- Bonus pool calculations, and performance measurement for long-term incentive plans, should be risk-adjusted.
- Staff performance should not be assessed from a short term perspective. Assessments should include non-financial performance metrics, e.g. relating to compliance and risk management issues.
- Base salaries should not be so low (as a proportion of total remuneration) that the firm will find it difficult to cut or eliminate bonuses in a poor financial year.
- The major part of any bonus which is a "significant" proportion of the fixed remuneration component should be deferred for a period appropriate to the firm's business and the risks it faces. "Significant" is not defined.
- The deferred element of variable compensation should be linked to the future performance of the firm or business unit as a whole.

The draft code is accessible online at:
http://www.fsa.gov.uk/Pages/Library/Other_publications/Miscellaneous/2009/cop_remun.shtml.

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