

# Revising the Remuneration Code

---

February 2011

The revisions to the FSA's remuneration code which came into effect on 1 January 2011 will have major implications for regulated firms, including many asset managers who are brought within the scope of the Code for the first time.

## Background and application

Following on the back of the Walker Review's recommendations on remuneration, the recent finalisation of amendments to the Capital Requirements Directive (CRD) and the enactment of the Financial Services Act 2010 which gives the FSA power to void certain remuneration contracts, the guiding principle of the FSA's rules is that remuneration policies and practices should have regard to risk.

Whilst this principle in itself is not new, the FSA's existing Remuneration Code introduced in August 2009 has, until now, only applied to a handful of large financial institutions. As a result of CRD 3, the scope is extended to apply to all BIPRU firms - thus including MiFID investment firms and UCITS investment firms. Firms which only carry out UCITS management are excluded, but if part of a UK group the Code will apply to all entities in that group.

As the new provisions took effect from 1 January 2011 they will be applicable for remuneration awarded after that date. Remuneration awarded, but not paid, before 1 January 2011 for services provided in 2010 will also be caught. Where necessary to comply with the Code, the FSA will expect firms to make appropriate amendment to agreements previously entered into, although they recognise that this may take a period of time.

Asset managers and other firms coming within the scope of the Code for the first time are given until 1 July 2011 to comply with the Code's detailed provisions covering remuneration structures. Whilst this extra breathing space is welcome, firms are expected to take reasonable steps to comply as soon as reasonably possible.

## Key features of the revised Remuneration Code

One of the main developments since the publication of the consultation paper in July 2010 involves welcome clarification of the FSA's approach to proportionality. Four tiers of firms are created with different levels of compliance for each tier. The tiers are determined based on the extent to which firms take risk onto their own balance sheets:

Tier 1 - includes large banks and building societies, plus full scope BIPRU 730K investment firms with capital resources exceeding £750m

Tier 2 - includes medium sized banks and building societies, plus full scope BIPRU 730K firms with capital resources between £100m and £750m

Tier 3 - includes small banks and building societies, plus full scope BIPRU 730K firms not falling into any of the other tiers

Tier 4 - includes all limited licence and limited activity firms.

As limited licence and limited activity firms fall within proportionality tier four, this should result in many asset managers generally benefiting from the maximum proportionality available when implementing the Code. In addition there is a de minimis concession available in respect of certain Code provisions.

## Principal employees affected

Firms are required to keep a record of 'Code Staff' - ie staff to whom the Code applies - and make these individuals aware of the implications. Code Staff includes individuals who have a material impact on the firm's risk profile. The FSA expects that this will include anyone who performs a significant influence function, Senior Management, and any staff whose remuneration takes them into the same bracket as senior management/risk takers and whose activities could have a material impact on the firm's risk profile.

Special considerations apply for employees in risk/compliance functions, whose remuneration will require to be set independently, based on achieving risk/compliance objectives.

### **Remuneration policies**

Remuneration policies should be in line with the firm's business strategy and long term corporate values, and should avoid conflicts of interest. They must also be consistent with and promote effective risk management. This general rule applies to all staff within the firm and as a point of principle, FSA expects firms to avoid remuneration practices which could incentivise the taking of excessive risk. There is also a new rule stating that firms should not award remuneration through alternative vehicles or structures which attempt to avoid the Code rules.

Firms will be required to produce a Remuneration Policy Statement containing a self assessment of compliance with the Code. The content of this will be proportionate and for tier three and four firms will be based on a questionnaire/template to be issued by the FSA. The FSA are also likely to begin collecting data on remuneration practices via GABRIEL in the second half of 2011.

### **Governance**

Larger, more complex firms will be expected to have a remuneration committee. This will not apply to firms in tiers three or four, but all firms will be required to periodically review their remuneration policies.

### **Capital**

Variable remuneration must not limit the firm's ability to strengthen its capital base.

### **Profit based variable remuneration**

Variable remuneration must be based principally on profits, and must be reduced where negative financial performance occurs. Tier four firms are allowed to take into account the specific features of their activities when applying this principle.

### **Remuneration structures**

The rules governing remuneration structures cover a range of topics, including:

(a) Balance of remuneration - firms must have an appropriate balance between fixed and variable remuneration and the fixed component should be sufficient to allow for the possibility that no variable component might be paid. These rules may be disapplied by firms in proportionality tier four.

(b) Deferral - for Code Staff, at least 40% of variable remuneration must be deferred over a period of 3 years or longer. This rises to 60% for employees receiving bonuses

over £500,000, although lower amounts could be subject to 60% deferral if there are significant variations in the level of remuneration paid to Code Staff. These rules are disapplied for firms in proportionality tiers three and four although the use of deferral techniques is encouraged by the FSA.

(c) Payment in the form of shares - 50% of any variable remuneration (applied equally to both the deferred and non-deferred components) requires to be made in shares or equivalent instruments reflecting the firm's value, and these will need to be subject to transfer retention periods. These rules are disapplied for firms in proportionality tiers three and four.

Variable remuneration should be subject to performance adjustments, which might be triggered for example where financial performance deteriorates or material risks crystallise. These rules are also disapplied for firms in proportionality tiers three and four.

(d) Pension payments - non standard one-off pension payments require to be held for 5 years in the form of shares. This is likely to be most relevant to more highly remunerated staff in larger firms.

(e) Guarantees - Guaranteed bonuses may only be given in exceptional situations to new employees and must not extend beyond one year. Retention awards are unlikely to be permitted other than in circumstances where the firm is undergoing a major restructuring and there is a prudential case for key staff retention. The provisions relating to guaranteed bonuses will not apply to Code Staff whose total remuneration is less than £500,000 and their variable remuneration is less than 33% of the total.

(f) Severance payments - payments related to early termination of a contract must reflect performance achieved over time and must be designed in a way that does not reward failure.

### **Voiding of contracts**

Under the provisions of the Financial Services Act 2010, the FSA has the power to prohibit a firm from paying remuneration in a particular way and can render void any contractual provisions which contravene such prohibition. It also has the power to require the firm to recover amounts paid. The FSA's intention is to exercise these powers only in relation to Code Staff and only in relation to deferral arrangements and guaranteed bonuses.

### Pillar 3 disclosures

In conjunction with the revisions to the Code, the FSA has also published requirements to make additional Pillar 3 disclosures relating to remuneration, consistent with CRD 3. Again the FSA's four tier approach applies to these requirements. The disclosures are expected to be both qualitative and quantitative and tier four firms are required to disclose information relating to Code Staff as follows:

- the process for determining remuneration policy
- the link between pay and performance (including the main performance metrics and the forms of remuneration)
- aggregate quantitative remuneration data by business area (although smaller firms may well consider they only have one business area)
- aggregate quantitative remuneration data broken down by reference to senior management and other staff whose actions have a material impact on the risk profile of the firm.

Firms in tiers one to three will, in addition to the above, be required to disclose the amounts of remuneration split between fixed and variable components and the number of beneficiaries.

The first reports containing this additional information require to be made by 31 December 2011 and reporting thereafter would be at least annually. Firms will also need to give consideration to the form/content of disclosure and its location; as with the existing Pillar 3 disclosures, website disclosure is likely to afford firms the greatest flexibility.

### Conclusion

The FSA's proportionality framework in its final form is helpful to firms such as asset managers coming within the scope of the Code for the first time. These firms have however had a relatively short period in which to get to grips with the requirements.

In view of the tight timetabling, firms should have already been considering a range of matters, including:

- whether they are within the scope of the proposed rules
- the impact of the proportionality provisions
- the application of the proportionality tiers where firms are part of a group
- which staff are likely to be defined as "Code Staff"

- communication with staff affected
- what governance arrangements and procedures need to be in place
- the extent to which documentation will require to be put in place or revised
- compliance of existing remuneration policies with the Code
- compliance of bonus pool calculation methodologies etc with the rules on remuneration structures
- relevant tax considerations
- proposed approach to Pillar 3 disclosure.

### Contact us

If you would like to discuss any of the matters raised in this release further, please contact Julian Bartlett or Alastair Robertson on the details below.



**Julian Bartlett**  
Audit Partner  
T 0207 865 2327  
E [julian.bartlett@uk.gt.com](mailto:julian.bartlett@uk.gt.com)



**Alastair Robertson**  
Director  
T 020 7865 2275  
E [alastair.robertson@uk.gt.com](mailto:alastair.robertson@uk.gt.com)