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Financial Sector Remuneration in the UK and the EU

Banks' business models involve taking on risk in return for reward, and they rely on the judgment of their officers and employees as to the appropriate types and levels of risk to take on. During the financial crisis, many institutions were shown to have taken on too much risk in certain areas and as a result, various principles were agreed by the G20 at its November 2008 summit in Washington, D.C.[1] to make the financial sector more resilient to crises. Along with other principles designed to strengthen firms' governance and risk management arrangements, the G20 resolved that firms should avoid compensation schemes which act as incentives for officers and employees to pursue short-term rewards at the expense of excessive and imprudent risk taking.

In April 2009, the Financial Stability Board ("FSB") published its "Principles for Sound Compensation Practices"[2] (the "FSB Principles"), designed to align compensation practices with prudent risk taking. The FSB Principles were endorsed later that month at the G20 London summit, while in September 2009[3] they were supplemented by implementation standards which were endorsed by the G20 Pittsburgh summit.[4] At the Pittsburgh summit, the G20 called for certain principles to be observed by financial institutions in setting compensation policies (i) avoiding multi-year guaranteed bonuses, (ii) requiring a significant portion of variable compensation to be deferred, tied to performance, subjected to clawback and to vest in stock or other non-cash instruments, (iii) ensuring that compensation for senior executives and other significant employees is aligned with performance and risk, (iv) making the institution's compensation principles transparent through disclosure, (v) limiting variable compensation as a percentage of the institution's total net revenues, and (vi) ensuring the independence of the institution's compensation committee.

At the request of the G20, on 4 October 2010, the Basel Committee on Banking Supervision ("BCBS") published[5] a further set of principles designed to promote effective corporate governance practices for banking organisations (the "BCBS Principles"). These include the requirement for an institution's board to oversee the design and operation of a remuneration system that aligns employee compensation with prudent risk taking, consistent with the FSB Principles and implementation standards. The BCBS Principles were closely followed (on 14 October 2010) by publication by the BCBS of a consultative document[6] on the range of possible methodologies for risk and performance alignment of remuneration. These included an overview of (i) frameworks for measuring employees' performance, (ii) processes for awarding remuneration, such as the mechanics for distributing a bonus pool, (iii) the use of "ex ante" risk adjustments, i.e., adjustments to remuneration at the time of accrual to account for potential future adverse eventualities, and (iv) the use of "ex post" risk adjustments, such as deferral of

[1] http://www.g20.org/Documents/g20_summit_declaration.pdf.
[2] http://www.financialstabilityboard.org/publications/r_0904b.pdf.
[3] http://www.financialstabilityboard.org/publications/r_090925c.pdf.
[4] http://www.pittsburghsummit.gov/mediacenter/129639.htm.
[5] http://www.bis.org/publ/bcbs176.pdf.
[6] http://www.bis.org/publ/bcbs178.pdf.

remuneration and clawback arrangements that apply to remuneration that has already accrued. It is not intended that either the content of this document or the BCBS Principles outlined above, form a second layer of regulatory governance operating alongside CRD 3 (as defined below). Instead, the intention is to guide banking institutions as they seek to enhance their corporate governance arrangements and to help relevant supervisors assess the quality of such arrangements.

In Europe, the first few months of 2011 will see the introduction of a number of regulations and guidelines coming into force and effect, both at the EU and national level (in certain member states including the UK), which will require banks and other financial institutions to replace their existing remuneration policies and practices with those designed to be aligned with performance and risk. In particular:

1. On 7 July 2010, the European Parliament ("Parliament") approved a final draft of the EU Directive (2010/76/EU, also known as "CRD 3"), amending the Capital Requirements Directive (2006/48/EC and 2006/49/EC). The CRD 3 measures relating to remuneration policies in the financial sector were required to be implemented by member states (as CRD 3 does not have direct effect in member states) by 1 January 2011;[7]

2. On 10 December 2010, the Committee of European Banking Supervisors ("CEBS") published the final version of its guidelines, intended to assist national legislators and regulators in the EU with their implementation of the CRD 3 requirements (the "CEBS Guidelines");[8] and

3. On 17 December 2010, the UK Financial Services Authority ("FSA") published a policy statement adopting a revised remuneration code that came into force on 1 January 2011 (the "FSA Code").[9] The FSA Code implements the CRD 3 provisions in the UK.

CRD 3 and CEBS Guidelines

Scope

CRD 3 applies to all EU credit institutions (comprising banks and building societies) and investment firms (incorporating other financial institutions, including certain funds and investment management firms) as defined by the Markets in Financial Instruments Directive.[10] In many cases, uniform application of the CRD 3 provisions across an institution[11] as a whole will be required. For example, the prohibitions on guaranteed variable remuneration and personal hedging (see below) should apply to all staff equally. However, in other cases, institutions will be required to identify individual staff members to whom specific requirements will apply. As such, the institutions themselves[12] must take responsibility for identification of relevant employees, and must be able to demonstrate to supervisors how they have been assessed and selected. Such employees should include, at least, senior management and executive board members, risk takers whose professional activities can influence the institution's risk profile, senior staff engaged in control functions (such as compliance or risk management), and any employee whose total remuneration takes them into the same remuneration category as senior management and risk takers ("identified staff").

[7] CRD 3 2010/76/EU, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:329:0003:0035:EN:PDF.
[8] CEBS Guidelines, http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Guidelines.pdf.
[9] FSA Remuneration Code, http://www.fsa.gov.uk/pubs/policy/ps10_20.pdf.
[10] Markets in Financial Instruments Directive 2004/39/EC, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0001:EN:PDF.
[11] For the remainder of this article, we shall refer to both credit institutions and investment firms collectively as "institutions."
[12] Parent institutions should also make sure that the requirements are observed at a group and subsidiary level (including non-EEA subsidiaries).

Key Remuneration Principles

The primary requirement of the new rules is set out at Article 22 of the CRD (as amended by CRD 3), which provide that member states must require that credit institutions have "*robust governance arrangements, which include…remuneration policies and practices which are consistent with and promote sound and effective risk management*." The CEBS Guidelines define "remuneration" in this context as any form of payment or benefit (whether in cash, shares, options, pension contributions, loan cancellations, etc.) paid (either directly or indirectly) by a relevant institution in exchange for professional services rendered by staff. Remuneration can be either "fixed" (meaning that no additional benefits accrue based on performance criteria) or "variable" (meaning that additional benefits will accrue based on performance or other contractual criteria). Variable remuneration, including retention bonuses, will be required to be appropriately aligned to performance and risk.

Governance. Each institution's management body (acting in a supervisory function) must include non-executive members who collectively have sufficient knowledge of remuneration policies and structures. This supervisory function is responsible for approving, maintaining and implementing all remuneration policies in order to ensure that they are consistent with, and promote, sound and effective risk management. Members of the management body in its management function may not determine their own remuneration—this should be determined by the supervisory function, and CEBS recommends that members of the supervisory function should receive only fixed remuneration. The remuneration policy should be approved by the shareholders and should be reviewed at least annually by the supervisory function. Further, each institution that is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities must establish a remuneration committee.[13] The committee should consist of non-executive members of the supervisory function, the majority of whom should qualify as independent. At least one member should have experience in aligning remuneration structures to firms' risk and capital profiles. The committee should, amongst other things, prepare recommendations on remuneration to the supervisory function regarding management and highly paid staff members, help oversee the remuneration system's design and operation, and assist in assessing the mechanisms designed to ensure the remuneration systems account for all types of risks.

Risk Alignment. The CRD 3 provisions are designed to ensure that remuneration becomes fully aligned with prudent risk taking. Accordingly, remuneration systems must be structured so as to take account of long-term risk and be capable of withstanding adjustment. This requires a careful balance of fixed and variable remuneration,[14] with the potential for risk adjustment of all variable remuneration, as well as a well-considered measurement of performance. Accordingly, the variable components of any remuneration policy are required to be fully flexible, and must therefore be allowed to decrease following negative performance.[15]

Deferred Remuneration. A deferral concept has been implemented to allow variable remuneration to be recalculated over time through ex-post risk adjustments. Between 40% and 60% of a staff member's variable remuneration must be deferred over a minimum period of three to five years, depending on the impact that the relevant staff member may have on the institution's risk profile and the amount of the total variable remuneration (the higher the total amount, the higher the minimum deferred percentage).

Performance and Risk-Based Adjustments. Institutions must be able to adjust the variable remuneration component of their staff's pay, including as a result of a periodic re-assessment of the risks assumed as a result of the staff actions. Consequently, CRD 3 envisages the use by institutions of malus (operating to reduce the value of any deferred remuneration prior to vesting) and/or clawback (entitling the institution to claim back some or all of the amounts already accrued, i.e., after vesting) arrangements. Such clauses might be invoked in circumstances

[13] This general requirement is subject to possible neutralisation under the principle of proportionality (see further below).
[14] Achieving the appropriate balance will depend upon a number of factors including (but not limited to) the length of the deferral periods (see "Deferred Remuneration"), the level of staff members in the organisation, the business types and which risks are involved.
[15] The CEBS Guidelines make clear that a floor in respect of any adjustment should not be imposed, such that in some cases, it is possible for the variable remuneration component to fall to zero.

where, for example, there is evidence of serious misbehaviour by the employee, the institution suffers a severe financial downturn, or where there are substantial changes to the regulatory capital base of the institution.

Payment in Cash or Instruments. At least 50% of any variable remuneration element shall consist of an appropriate balance of shares (or equivalent ownership interests), share-linked instruments, equivalent non-cash instruments (in the case of non-listed institutions), or if appropriate, any instruments that (i) convert to equity in emergency situations or at a regulator's instigation and (ii) "adequately reflect the credit quality of the institution as a going concern." The CEBS Guidelines clarified that this requirement is applied equally to both the deferred and non-deferred component of variable remuneration, although they did not clarify the meaning of the phrase in (ii) above.

Guaranteed Remuneration. CRD 3 provides that "guaranteed variable remuneration" should be "exceptional" and only arise under the condition of hiring new staff and during the first year of employment. The CEBS Guidelines explain that this type of benefit may include a bonus payment under a number of descriptions, including a guaranteed, welcome, sign-on, or minimum bonus.

Personal Hedging. It is required that staff must undertake not to employ hedging strategies or contracts of insurance which are intended to undermine the risk alignment effects of their remuneration package. Generally, this is not intended to prohibit arrangements such as payment protection insurance, but regulators will be looking at the circumstances of each case to ensure such arrangements are not used to circumvent the CRD 3 principles.

Proportionality. It may not be appropriate, or proportionate, for all institutions to comply with all the remuneration principles, and CRD 3 provides that institutions should apply the CRD 3 provisions "*in different ways according to their size, internal organisation and the nature, scope and complexity of their activities*." So for example, "limited licence" and "limited activity" institutions (being institutions that are deemed to be lower risk as they do not provide certain services, such as dealing on own account or underwriting) may be given certain flexibility in their application of the requirements. That is not to say that such principles of proportionality will allow these institutions to avoid any of the minimum obligations as set out in CRD 3 (such as the minimum portion of 40% to 60% variable remuneration that should be deferred or the minimum deferral period—see "*Deferred Remuneration*" above). However, certain requirements may be "neutralised" by decision of the institution if this is reconcilable with the risk profile, risk appetite and the strategy of the institution. In particular (amongst other things), neutralisation can be applied to the CRD 3 disclosure requirements (see below), and the requirement to establish a remuneration committee (see "*Governance*" above). Annex 2 to the CEBS Guidelines indicates which principles may be neutralised and in which circumstances.

Disclosure

In order to ensure greater transparency, CRD 3 incorporates provisions which require that all institutions publicly disclose detailed information with respect to any remuneration policies relating to staff whose activities have a material impact on their risk profiles. This information might include, amongst other things, information on the link between pay and performance, information on the performance criteria on which entitlement to shares is based, and/or aggregate quantitative information on remuneration.

There are, however, no specific requirements presently as to how such information is to be disclosed, although the CEBS Guidelines make it clear that the information must be "easily accessible." As such, it seems reasonable that such information could be disclosed via, for example, a corporate website. These disclosure requirements are also subject to the principles of proportionality, such that small or non-complex institutions are only expected to provide "*some qualitative information and very basic quantitative information where appropriate*." Certain types of information may also be exempt from disclosure on the basis of materiality, their proprietary nature or confidentiality.

UK's FSA Code

The revised FSA Code primarily serves to incorporate the provisions of CRD 3[16] into UK law and carry over certain provisions from the existing code.[17] In addition, it includes rules made under powers provided to the FSA by the Financial Services Act 2010, and takes account of the principles set out in the Financial Stability Board's "*Principles for Sound Compensation Practices*."

The FSA Code applies to all credit institutions and investment firms in the UK within the scope of CRD 3 (see "*Scope*" above). It also applies to overseas branches of certain UK institutions; however, it will not apply to UK branches of EEA institutions, which will instead be subject to the provisions of CRD 3 as implemented in the relevant EEA home state. This is a substantial expansion of the scope of the previous version of the Code, which was only applied to 26 institutions that met significant financial thresholds. It is estimated that more than 2,500 institutions will now be subject to the revised code.

The FSA Code comprises rules, evidential provisions and guidance encompassing three principal areas: the governance of remuneration, its structure, and performance measurement in relation to performance-related bonuses. The primary requirement of the new CRD 3 rules is mirrored in the FSA Code, being that an institution "*must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management*."

As with CRD 3, the provisions of the FSA Code will in many cases require uniform application across an institution as a whole. However, special provision is made for "Code staff," a new definition introduced by the FSA Code that includes: senior management, risk takers, staff engaged in control functions and any employee whose total remuneration takes them into the same remuneration bracket as senior management and risk takers who have a material impact on the institution's risk profile.[18] Certain provisions of the FSA Code apply specifically to Code staff. For example, each institution must keep a record of such staff and take reasonable steps to ensure that the Code staff understand the implications of their status as such. This includes, for example, the possibility of remuneration, which does not comply with certain provisions of the FSA Code, being rendered void and recouped by the institution.

Proportional Application

As stated above with respect to CRD 3, institutions should apply the provisions of the FSA Code proportionately. Whilst emphasising that institutions should consider proportionality according to their particular circumstances, the FSA Code develops the CRD 3 principles by identifying four tiers of institutions, with varying standards of compliance resulting from falling within each one. Tiers are determined according to the type of institution and level of capital resources held at the last accounting reference date.[19] The FSA has also stated that proportionality will be applied across the institutions in each tier in order to prevent vast contrasts in the application of the rules between institutions at the bottom of one tier and the top of the next. Furthermore, tiers 3 and 4 will not be

[16] There is seemingly no intention, however, to "gold plate" the CRD III requirements.

[17] The original FSA Code was incorporated into the FSA Handbook on 1 January 2010, providing rules and guidance with respect to remuneration.

[18] The FSA Code provides a non-exhaustive table of examples of key positions that should fall within an institution's definition of "Code staff," although the FSA Code states that institutions should review the appropriateness of this table within the context of their own organisational structure. It is also worth noting that it is possible that consultants and secondees (who may not technically be employees of an institution) may be covered by the definition. As such, institutions should carefully consider consultants and special advisors in the context of the FSA Code rules.

[19] Tier 1 comprises UK banks and building societies with capital resources in excess of £1 billion, BIPRU 730k firms which are full-scope BIPRU investment firms (all as defined in the FSA Handbook) with capital resources in excess of £750 million and third-country BIPRU firms with assets exceeding £25 billion. Tier 2 comprises UK banks and building societies with capital resources between £50 million and £1 billion, BIPRU 730k firms which are full-scope BIPRU investment firms with capital resources between £100 million and £750 million and third-country BIPRU firms (other than limited licence/limited activity firms) with assets between £2 billion and £25 billion. Tier 3 comprises UK banks and building societies and full-scope BIPRU firms not within tiers 1 and 2, and third-country BIPRU firms not within tiers 1, 2 and 4. Tier 4 comprises limited licence and limited activity firms.

required to apply rules which the CEBS guidelines provide can be disapplied. These include rules regarding deferral, appointing a remuneration committee, and the proportion of variable remuneration to be paid in shares. In other cases, the FSA has explained that it will employ an approach which is likely to result in less onerous requirements compared to tiers 1 and 2.

As a consequence of the FSA's proportional approach, it has also opted to employ the neutralisation provisions outlined in the CEBS guidelines (see "*Proportionality*" above with respect to CRD 3) in order to ensure that institutions can apply a "de minimis" concession. This means that certain of the FSA Code's provisions will not have to be applied with respect to any individuals whose remuneration is below certain thresholds. In particular, certain rules relating to (amongst others) deferral and performance adjustment, will not have to be applied to Code staff with variable remuneration consisting of less than 33% of their total remuneration, provided their total remuneration is also under £500,000.

Implementation

As with CRD 3, the FSA Code was timetabled to come into force on 1 January 2011, although for institutions now falling within the scope of the FSA Code for the first time, transitional rules will be applied. These institutions must comply as soon as reasonably possible, and by 31 July 2011 at the latest. Institutions previously subject to the FSA Code will have until that same date to comply with the provisions, which require at least 50% of variable remuneration to be paid in non-cash instruments.

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