Finalised guidance

'Dear CEO' letters providing guidance on issues relating to remuneration

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[Name] [date]
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Dear [CEO],

IMPLEMENTATION OF THE FSA'S REMUNERATION CODE FOR THE 2011/2012 ROUND

1. This letter has two main purposes. The first is to set out how we intend to monitor the implementation of the Remuneration Code (the Code) by your firm, and what we are asking you to do. The second purpose is to provide guidance on a number of policy issues mainly to make our policy position in these areas clearer. Our policy clarifications are in Annex 1 to this letter.

2. We are sending this letter to firms which fall into proportionality tiers 2, 3 and 4 under our *General Guidance on Proportionality* (December 2010)[1]. A separate letter is being sent to firms that fall into tier 1. In line with our proportionate approach to implementing the Code, the process for those firms will be somewhat different from that set out here.

[1] See www.fsa.gov.uk/pages/Library/Policy/Policy/2010/10_20.shtml

I. Background

3. We first introduced the Remuneration Code in 2009, and included it in the FSA Handbook as a set of rules and guidance for a group of large banks and broker dealers with effect from 1 January 2010. During 2010 we revised the Code to transpose the relevant parts of the Third Capital Requirements Directive (CRD3), and discharge our duties under the Financial Services Act 2010. The revised Code came into effect from 1 January 2011.[2] The most significant change was an increase in the number of firms in scope, from around 27 to over 2,500. The Code continues to apply not only to firms directly within scope, but also at the level of the UK consolidation group or EEA sub-group, including overseas group members that form part of the group or sub-group.

4. Given the significant changes to the FSA Handbook on remuneration over the last two years, our aim is to keep further changes in 2011 to a minimum. Nevertheless, in several policy areas we have done more work to clarify certain aspects of the Code and make clear how we expect firms to comply with it.

5. Since 1 January, we have made one rule change and issued guidance covering the following issues:

   a) We published further guidance (in SYSC TP3.7G) to unlisted firms (including mutuals) who do not have a listed parent. The guidance relates to the requirement on the award of variable remuneration in share-like instruments or other capital instruments.

   b) Following consultation, we have published guidance on: guaranteed variable remuneration; retention periods; templates for the completion of remuneration policy statements for tier 2, 3 and 4 firms; and on a range of other issues in the form of Frequently Asked Questions. There are links to these on the remuneration pages of the FSA website[3].

   c) **Section III and Annex 1 of this letter constitute general guidance on Remuneration Code staff, Long Term Incentive Plans and the structure of alternative instruments for the purposes of SYSC19A.3.47R.**

6. For firms not previously subject to the original Code, we put in place transitional guidance relating to remuneration structures which, with the exception of the SYSC TP3.7G rule change noted above, expired on 1 July 2011.

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[2] SYSC 19A. See the Policy Statement, PS10/20, *Revising the Remuneration Code*, (December 2010).
[3] www.fsa.gov.uk/remuneration

II. How assessment will be carried out in 2011/12

Our supervisory approach

7. For the last two years, we have conducted an annual review to monitor the implementation of – and compliance with – the Code for those firms which were subject to the original Code. This will continue for all firms who fall into proportionality tier 1 under the scope of the current Code that came into effect on 1 January 2011.

8. This section sets out the key elements of our approach to supervising the implementation of the Code for the vast majority of tier 2, 3 and 4 firms, including the information firms are expected to maintain in the form of a Remuneration Policy Statement and how our assessment of these will reflect our proportionate approach.

9. In the case of a small number of tier 2 firms, supervisors are likely to tailor the assessment approach more closely to the firm, taking account of its business model and risk profile. If your firm is one of these, your supervisor will be in touch soon.

Completion of a Remuneration Policy Statement (RPS).

10. All firms within the scope of the Code are expected to ensure that their remuneration policies, practices and procedures are clear and documented. To record those policies, practices and procedures, and assess their compliance with the Code, firms should complete a Remuneration Policy Statement (RPS).

11. The level of detail within the RPS may vary depending on a firm's size, internal organisation, and the nature, scope and complexity of its activities. We published RPS templates for the tier 2, 3 and 4 firms for consultation on 19 April 2011. We published final guidance on these templates on the remuneration pages of our website on 5 August 2011.

12. These templates are designed as a tool for tier 2, 3 and 4 firms to document their remuneration policies, practices and procedures. It sets out some of the principal questions that we are likely to ask if we review your firm's remuneration policies. It would be good practice for firms to use the template as it sets out the level of detail we expect you to include and makes it less likely that we have to ask you for more information, saving time for you and for us. It is not compulsory and you may choose to document your remuneration policies in a different way. However, if you choose not to use this template, you should ensure that you provide all the information that we need (as indicated by this template) in a clear and structured manner.

13. You do not need to send us a copy of your RPS unless requested to do so; however, it should be reviewed and approved by the firm's Remuneration Committee or equivalent body with responsibility for remuneration policies. It should be reviewed annually to take account of any changes to policies, practices or procedures, and changes should be approved by the Remuneration Committee or equivalent body.

14. We recognise that a firm's RPS is likely to evolve along with its business and strategy. Nonetheless, we would advise firms in tiers 2, 3 and 4 (which are not subject to annual review) to

save a version of their RPS and Code Staff list drawn up at the end of each performance year. This is likely to be helpful in the event of any supervisory assessment work on remuneration (for example, as in paragraph 16 below). As a first step, firms may wish to complete a RPS and Code Staff list in respect of the most recent full performance year. .

ARROW

15. Remuneration has been raised in a number of ARROW programmes over the last year or so, and this will continue. It will also be incorporated into our planning of risk-review programmes over the longer term.

16. FSA supervisors will usually ask for a copy of your RPS as part of the information we ask you for before an ARROW review. We will then decide whether to include remuneration as an issue for discussion during the onsite review. If remuneration risks are identified during an ARROW review, we will discuss the assessment with you and a risk mitigation plan will be agreed according to ARROW procedures.

ICAAP

17. Where relevant, firms should take account of risks arising from their remuneration policy when considering the risks to which they are or might be exposed under the overall Pillar 2 rule (GENPRU 1.2.30R). From September 2011, as part of our work to embed monitoring of remuneration into business as usual supervisory processes, we will be looking for evidence that remuneration risk has been given appropriate consideration under ICAAP, and potentially as part of a SREP where relevant. Where a SREP is being performed, we intend to place greater supervisory focus on remuneration risk. Where we consider there are material remuneration risks not adequately addressed by the Code (e.g. relating to non-Remuneration Code staff) that have not been appropriately identified and mitigated, we may consider using an appropriate capital add-on as a mitigation tool.

Thematic work

18. For firms not subject to ARROW, we will assess compliance through thematic reviews. Our first thematic review is likely to take place in the first half of 2012.

Risk adjustment

19. Ex-ante risk adjustment is a fundamental measure for securing sound and effective risk management. We have held discussions with the tier 1 firms within scope of our earlier Code about the quality of risk-adjustment techniques in both the 2009/10 and 2010/11 remuneration rounds. Last year we asked these firms to provide data to allow us to compare their proposed total variable incentive payout against an estimate of their economic profit, taking account of their cost of capital. We did not prescribe this as the method by which they should achieve ex-ante risk adjustment, but it did allow us to identify instances where the proposed variable incentive payout produced an economic loss and to discuss this result with the relevant firms.

20. In any discussion of risk adjustment with tier 2, 3 and 4 firms, we are likely to focus on two main aspects:
    - The risk adjustment technique(s) employed within your firm.
    - The role of the Remuneration Committee or other senior committee in reviewing and approving the ex ante risk adjustment of bonus pools. The RPS asks you to have available copies of the documents which will be supplied to the Remuneration Committee on this subject, and along with relevant extracts of minutes.

Data

21. The European Banking Authority (EBA) has consulted on proposals to collect certain data on remuneration from member states (see www.eba.europa.eu). The details of what we will be asked to provide are still being finalised, but the information we provide will be in aggregated form. The data will fall into two categories. The first set will be on the remuneration structures of 'significant institutions'. The second will be aggregated data on the number of individuals with total remuneration in excess of €1m. Once the data requirements are finalised, a further data request will be necessary.

22. It is likely that we will incorporate some data and other information requirements (including the EBA's requirements) into an FSA data return at some time in the future. This will not replace the need for an RPS but it may allow us to reduce its size/scope.

III. Selected policy issues

23. In Annex 1 we give additional guidance for consultation in three policy areas. Not all of these will be relevant to firms in tiers 3 and 4. The purpose of this additional guidance is to clarify our policy position on the following:

Defining Remuneration Code staff

24. During the 2010/11 round we recognised that firms had some difficulty in interpreting the Remuneration Code staff definition and, in particular, interpreting the part of the definition that refers to employees whose remuneration takes them into the same bracket as senior management and risk takers, whose activities have a material impact on the firm's risk profile. The guidance contained in Annex 1 provides some clarification on how we expect firms to identify this group of employees.

Long-term Incentive Plans (LTIPs)

25. Firms in tier 1 and 2 are expected to observe the rule on deferred remuneration as set out in SYSC19A.3.49R. Existing guidance (SYSC 19A.3.24G(3)) permits firms to include LTIPs in their calculation of variable remuneration to meet the deferral rule only if the upside incentives are adequately balanced by downside adjustments. We provide additional guidance in Annex 1 on the qualities that a plan should have in order to qualify as part of deferred remuneration. Our focus is on ensuring an appropriate balance between upside incentives and downside (malus) adjustments.

Structure of alternative instruments

26. Firms in tier 1 and 2 are expected to observe the rule on retained shares or other instruments, as set out in SYSC19A.3.47R. The Code requires at least 50% of variable remuneration to be paid in an appropriate balance of: (i) shares or equivalent ownership interests, 'share linked instruments', or 'equivalent non-cash instruments' and (ii) capital instruments that meet the requirements of stage B1 of our capital table (in effect, hybrid capital). The guidance in Annex 1 describes how we interpret the alternatives to shares. This policy stance is subject to any further guidelines that may emerge from the EBA.

27. If you have any queries about this letter, please contact either your supervisor or the Remuneration team on remuneration@fsa.gov.uk.

Yours sincerely

Andrew Bailey
Director, UK Banks & Building Societies

cc [Firm supervisor]

Annex 1 – Guidance

General Guidance: Defining Remuneration Code staff

1. This guidance relates to the definition of Remuneration Code staff under SYSC 19A.3.4R.

2. We expect firms to have a robust methodology for identifying Remuneration Code staff in accordance with SYSC19A.3.3R to SYSC 19A.3.6G. We consider that firms should include a list of such staff in their Remuneration Policy Statement (RPS). The list should be updated on a regular basis as part of the general expectation that firms should keep their RPS up to date. We may want to discuss the Remuneration Code staff list with a firm during any review of the firm's remuneration policies and practices undertaken under its supervisory programmes.

3. The guidance given in the Remuneration Code ("the Code") (SYSC 19A.3.6G (1) and (2)) is designed to help firms identify Remuneration Code staff. However feedback from firms indicates that there is still an element of confusion in the interpretation of SYSC 19A.3.4R. This relates in particular to the reference in the definition in SYSC 19A.3.4R which has been underlined below:

   'Remuneration Code staff comprises categories of staff including senior management, risk takers, staff engaged in control functions <u>*and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the firm's risk profile*</u>*'*

4. In our view, firms should first identify Remuneration Code staff falling into the first three categories. Firms should then prepare a list of employees whose remuneration places them in the same remuneration bracket as the group of staff included as senior management and risk takers. The list should be reviewed, and any employees 'whose professional activities have a material impact on the firm's risk profile' should be included as Remuneration Code staff.

5. This guidance also draws your attention to the guidance in the Remuneration Code that firms should have firm-wide policies on deferral (SYSC 19A.2.3G (3) and SYSC 19A.3.50G (2) and apply the principle relating to guaranteed variable remuneration on a firm-wide basis (SYSC 19A.2.3G(2)), together with other principles (SYSC 19A.2.3G(3)).

6. Where we identify poor implementation of this guidance we will discuss this with the Chair of firms' remuneration committees or their equivalent.

General Guidance: Long Term Incentive Plans (LTIPs)

1. This guidance relates to the inclusion of LTIPs in the calculation of the deferred portion of variable remuneration. The purpose of this Guidance is to clarify how firms should implement SYSC 19A.3.24(3). This states:

   Long term incentive awards may be included in the calculation of the deferred portion of variable remuneration only if upside incentives are adequately balanced by downside

adjustments. The valuation of the award should be based on its value when the award is granted, and determined using an appropriate technique.

2. As a general principle, the downside adjustments to be applied to LTIPs must be at least comparable to those applied to other deferred remuneration if they are to be included in deferred remuneration. We would expect the following conditions to apply to LTIPs that qualify for inclusion in the deferred portion of variable remuneration:

- Awards made under the LTIP are subject to risk adjustment in line with SYSY19A.3.22R to SYSC19A.3.24G.
- The performance conditions of the LTIP are such as to allow the realistic possibility of a zero payout.
- The LTIP agreement specifically provides for performance adjustment in accordance with both SYSC19A.3.51R and SYSC19A.3.52 E as a minimum.

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General Guidance: Structure of alternative instruments

1. SYSC 19A.3.47R(1) of the Code requires:

   'A *firm* must ensure that a substantial portion, which is at least 50%, of any variable *remuneration* consists of an appropriate balance of:

   a) *shares* or equivalent ownership interests, subject to the legal structure of the *firm* concerned, or *share*-linked instruments or equivalent non-cash instruments in the case of a non-listed *firm*; and
   b) where appropriate, *capital instruments* which are eligible for inclusion at stage B1 of the calculation in the *capital resources table*, where applicable that adequately reflects the credit quality of the *firm* as a going concern.'

2. The CEBS Guidelines, published in December 2010, make clear that a key purpose of payment in instruments 'is to put the staff into an owner-like position in order to align the staff's interest with those of the stakeholders'. The Guidelines also recognise that the types of instrument a firm may use will be governed by the firm's legal structure, in particular if the firm is not able to issue shares.

3. Here we give guidance on how firms may interpret the three alternatives to shares noted above.

Share-linked instruments

4. Share-linked instruments are those whose value is based on a market valuation of the share, and have the share-price as a reference point. In our view, this encompasses a traditional phantom share scheme, in which the value of an instrument tracks the share price of the company (or potentially of the company's parent). Upon maturity, the value of the instrument may be paid out in cash to the holder.

Equivalent non-cash instruments

5. We expect that firms which are either listed entities, or branches or subsidiaries of a listed credit institution, or branches or subsidiaries that are part of a consolidation group headed by a listed entity, will use their own shares or those of the listed entity to meet the requirements of SYSC19A.3.47R(1)(a). The point has been put to us, and we are still considering, whether it may be open to a firm to argue that it is 'non-listed' for the purposes of SYSC 19A.3.47R(1)(a) in circumstances where the listed entity is listed on a market that is not accessible to Remuneration Code staff at reasonable cost.

6. Firms that do not fall within the categories described above should note the CEBS guidelines on equivalent non-cash instruments state, in paragraph 125:

   'For many institutions which are not stock corporations, share-linked instruments are not an option due to their legal form. Even for unlisted stock corporations it may be difficult to determine a share price that represents the institution's value when no market price is available. In these cases alternative instruments, also those based on cash pools, may be used that reflect the institution's value and have the same intended effect as share-linked instruments. Differently from shares and share-linked instruments, the value of these equivalent non-cash instruments is determined by a third party, not by a stock market. Instruments, other than shares or share-linked instruments should have comparable features to shares in terms of their loss absorbency capacity. For the acceptance of alternative instruments like phantom plans based on a third party valuation, it is crucial that the institution's value is determined correctly and comprehensibly. To reflect the institution's current value in these alternative instruments the institution's value must be determined directly on the moment of awarding, before the vesting and before the retention period ends respectively. A negative development of the institution's value will so be reflected in the value of these alternative instruments.

   Neither dividends nor interests are paid on these types of instruments before vesting.'

7. We consider that an equivalent non-cash instrument may be accepted as meeting the requirements of SYSC19A.3.47R(1)(a) if it is based on one of the following:

   a) The firm may commission a full valuation by an independent third party on a periodic basis. The proposed instrument should be structured so as to reflect and track these valuations over the life of the instrument.

   b) The firm may use an instrument that reflects the value of the firm by reference to the firm's Return on Risk-weighted Assets, or a similar risk-based measure that may be verified by an independent third party.

   We would not view a related entity (such as, but not limited to, any member of the firm's group) as an independent third party.

8. Where a firm applies the approach in paragraph 7(b) above, we would expect the governing body or Remuneration Committee of the firm to verify that the chosen measure presents a fair reflection of the value of the firm. We would expect firms to select a measure that is appropriate

to their business model and risk profile. The chosen measure, the method by which the value of the instrument is linked to that measure and any benchmark values of the measure used, should not be capable of being adjusted unilaterally by the firm or a related party.

9. The instrument should be capable of loss absorbency by exposing the holder to downside as well as upside risks, including the potential for the value of the instrument to move to zero. We would expect the value of the instrument to have a similar sensitivity to any weak or loss-making performance by the firm that a listed share price might have.

Capital instruments

10. The Code indicates that capital instruments proposed for use in this category must be eligible for stage B1 of the capital resources table. This transposes the requirement of CRD3,[4] which specifies 'instruments within the meaning of Article 66(1a)(a), that adequately reflect the credit quality of the credit institution as a going concern'.

11. We are aware that there are a limited number of instruments in this category at present. We are following closely the Basel Committee's considerations regarding contingent convertible instruments (CoCos), in particular whether these will fall within Article 66(1a)(a). We aim to provide an update as and when the Basel Committee's views are finalised.

Conclusion

12. All firms in proportionality tiers 1 and 2[5] will need to comply with SYSC 19A.3.47R

13. We consider that these alternatives give firms an appropriate degree of flexibility. Firms should engage with their advisers to devise schemes which comply with SYSC19A.3.47R and are suitable to their internal structure. If you have any questions about your scheme you should consult the supervisory or remuneration teams.

14. This guidance is subject to any further guidelines from the EBA and may be revised accordingly.

[4] Directive 2010/76/EU.
[5] See www.fsa.gov.uk/pages/Library/Policy/Policy/2010/10_20.shtml.