

Insight

on Employment & Benefits

UK regulators to scrutinise bankers' pay

As the banking bail out bill in the UK is estimated by the IMF to end up costing GBP £190 billion or 13.7 per cent of GDP (more in percentage terms than any other G7 economy including the US), financial services regulators are seeking to ensure that remuneration structures that gave incentives to staff to pursue risky policies are a thing of the past.

The Financial Services Authority (FSA), which regulates the financial services industry in the UK, is proposing to introduce a Code of Practice including principles which will be encapsulated into a new rule and evidential provisions applicable to the structure of remuneration practices of certain large banks and broker dealers. The current estimate is that 48 firms operating in the UK will be covered by the rule and provisions, including a number of the major US banks. Whilst the rule and provisions will not apply directly to other smaller FSA regulated firms, they will be expected to ensure that their remuneration structures reflect the principles of the Code.

The FSA's approach on this issue is in line with the widespread consensus that remuneration practices within the financial services industry may have been a contributory factor to the market crisis, particularly those designed to reward short-term revenue and profit.

The rule and evidential provisions

The FSA has made it clear that whilst it is not concerned with the absolute amount of remuneration which firms may choose to pay their employees, its focus

is on the extent to which remuneration practices may pose risks to a firm and be inconsistent with effective risk management. Therefore the proposed rule is that:

A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.

The rule will be included in the FSA Handbook and the FSA has wide-ranging investigatory and penal powers to enforce compliance. All aspects of remuneration are intended to be covered, including fixed and variable compensation elements, hiring policies, severance packages and pension arrangements.

The Code's 10 principles will also be inserted into the FSA Handbook as evidential provisions, so that compliance with the evidential provisions can be monitored to establish compliance with the rule itself. The evidential provisions are summarised overleaf:



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1. The remuneration committee of a firm has an important role to play in relation to the approval and review of remuneration policies.

This is likely to require at least one member of the remuneration committee to possess practical skills and experience of risk management and more regular meetings of the committee with reports directly from the firm's risk management function. The FSA may ask the committee to prepare a statement on the firm's remuneration policy which should also be made available to shareholders.

2. Compliance and risk functions should have independent roles in the setting of remuneration.

These functions will play an important role in validating and assessing the risk adjustment data for the remuneration committee.

3. Remuneration for compliance and risk functions should be separately determined from front-office functions.

The role of compliance and risk functions should not place those employees in a conflict of interest in respect of the setting of remuneration for their own business area. The need to avoid undue influence is particularly important where such employees are embedded in other front-office business areas.

4. Assessments of financial performance should be based principally on profits, and bonus pool calculation should include an adjustment for current and future risk.

The use of revenues or turnover to measure performance is criticised for having insufficient regard to the quality of business undertaken.

The FSA expects a firm to provide information relating to the workings of the calculation to show that consideration was made for risk-adjustment.

5. Assessment of the performance-related component of an employee's remuneration should be based on longer-term performance.

The FSA suggests that performance assessment on a moving average of results can be a good way of meeting this principle.

6. Non-financial performance metrics should form a significant part of the performance assessment process.

The importance of non-financial performance such as effective risk management and compliance with the regulatory system should be recognised in the determination of incentive and bonus awards.

7. Measurement of share performance should be risk-adjusted.

This is particularly important in long-term incentive plans, in order to mitigate against the risk of strategies devised to boost earnings per share and total shareholder return in the short-term, to the detriment of the true longer-term health of the firm.

8. The ratio between fixed and variable components of remuneration should allow a firm to operate a fully flexible bonus policy.

If the fixed component is too low, the firm may not realistically be able to cut or reduce bonus. This will require firms to reassess whether bonus schemes which can deliver several multiples of base salary can truly be said to be discretionary and

non-contractual, particularly in the context of a year in which results do not merit any bonus awards whatsoever.

9. The majority of any bonus should be deferred if that forms a significant proportion of overall remuneration.

The FSA recommends that at least two-thirds of such a bonus should be deferred for an appropriate vesting period.

10. The deferred element of any bonus or remuneration should be linked to future performance of the firm and the employee's business unit.

This is intended to ensure that the deferred element can reduce in the event that future performance declines.

Potential difficulties for firms

As part of its ongoing consultation with firms following the issue of a letter to the CEOs of 22 major firms in October 2008, the FSA recognises that some of the principles in the Code may cause difficulties for firms in the UK. These concerns broadly fall into the following categories:

Legal & Tax

- Difficulties in changing current employment contracts, whether existing contractual rights arise as a result of express terms or custom and practice.
- Potential restraint of trade arguments if the vesting period for deferred elements of variable remuneration is too long.
- Difficulties in enforcing any clawback from deferred elements of bonus already earned in the event of poor future performance.

- Increase in tax liabilities in respect of fixed elements of remuneration if the overall proportion of variable pay is reduced.

Practical

- Difficulties of influencing group-level practices of non-UK firms operating in the UK market.
- Costs of implementing the Code, for example in changing the way remuneration policies are set, issuing an annual remuneration statement, increased time commitment of the remuneration committee, enhanced risk management function and changing employment contracts.
- Differences in business practices as between investment banking and retail banking make a “one size fits all” policy difficult to implement.
- Complications of performance measurement based on a moving average of performance, particularly if employees move jobs within the firm or there is a poor “line of sight” between performance and incentive award.
- Difficulties of building risk-adjustment into incentive arrangements when shareholders are also focused on short-term growth.
- Difficulties of remaining competitive in the international labour market.
- Difficulties and cost for firms to recruit sufficiently qualified and experienced people to sit on the remuneration committee.

What comes next?

The Code was issued by the FSA on 18 March 2009 and, following further consultation, the provisional date for the new rule and evidential provisions to come into force in the FSA Handbook is 6 November 2009. On 18 March, the FSA also published “The Turner Review”: a wide-ranging review of global banking regulation, in which Lord Turner asserted that pay and pay structures in financial services firms were no more than contributory factors to the banking crisis. Since then, a global survey of banking staff has revealed that the pay of London bankers is the lowest of the major global financial centres, despite being at the top of the league table just 12 months ago, indicating that the average pay and bonus package for a London banker has plummeted 62 per cent compared to this time last year. The UK Government has also announced increases in income tax on high earners which, when added to employer and employee National Insurance Contributions, will result in a tax burden on the top end of income of around 65 per cent. In addition, the European Commission is shortly due to announce recommendations regarding remuneration in the financial services sector which may include a cap on bonus payments.

Some major banks have already taken significant steps to restructure remuneration packages in light of the banking crisis. Notably innovative structures have been introduced by the Swiss banks, which involve the recovery of share awards by a “malus” and the award of interests in legacy assets. Those large banks and broker dealers regulated in the UK by the FSA are therefore coming under pressure to review and amend pay

structures in good time before the 2009 remuneration reviews which are likely to be conducted at year end. It remains to be seen whether the end result will compromise the UK’s effectiveness in the international financial marketplace.

International issues

The FSA will take into account whether there is satisfactory alignment of implementation plans by the authorities in the major financial centres when finalising the Code. This is clearly important in order to enable firms in the UK to recruit and retain suitable talent and to ease the regulatory burden on international firms operating in the UK where those firms are already subject to requirements of their home competent authorities.

The major differences and similarities between the Code and the executive pay restrictions and standards that apply to companies that receive monetary assistance from the US government under the Troubled Asset Relief Program (TARP Recipients) are set forth overleaf.

Differences

UK	US
The Code does not, of itself, have the force of law.	The executive pay restrictions applicable to TARP Recipients have been enacted into law. The regulatory agencies tasked with overseeing compliance were granted limited enforcement mechanisms and authority to establish further guidance.
No limits are placed on the number of executives in any particular firm to whom the Code applies.	Generally, one to 25 executives of a TARP Recipient may be subject to the compensation restrictions, depending on the type of pay (e.g., salary, bonus, severance), the particular restriction, or the amount of governmental assistance.
The Code deliberately avoids addressing the actual amount of compensation paid by a firm to its executives.	Generally, a TARP Recipient may not pay compensation in excess of \$500,000 to the CEO, CFO and three other highest paid executives, and is prohibited from accruing or paying monetary bonuses to one or more executives.
There are no tax consequences for noncompliance with the Code.	Each TARP Recipient cannot claim a tax deduction for compensation in excess of \$500,000 per year for compensation paid to its CEO, CFO or any three other highest paid executives.
The Code does not place express restrictions on contractual mechanisms such as golden parachutes.	Each TARP Recipient is prohibited from making any golden parachute payments to the CEO, CFO and eight other highest paid executives in connection with their departure from the company for any reason.
The Code does not provide for any "say on pay" shareholder vote on remuneration policy (although shareholders in the UK do have a non-binding vote on directors' remuneration at the AGM).	Generally, a TARP Recipient must provide its shareholders with non-binding votes to approve the compensation of the CEO, CFO and three other highest-paid executives.

Similarities

UK	US
The inclusion of the rule and evidential provisions in the FSA Handbook will place an onerous regulatory requirement on firms within the relevant ambit to comply.	TARP Recipients must rethink compensation philosophies, restructure pay arrangements, revamp corporate governance procedures, and assess how remuneration programs affect risk taking in order to comply with executive remuneration restrictions.
The Code requires firms to establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.	Each TARP Recipient must prohibit incentives that encourage executives to take unnecessary and excessive risks that threaten the value of the company.
Clawback provisions are consistent with the Code's principles of profit-based measurement and risk-adjustment.	The clawback provision requires executives to forfeit or repay any bonus received that was based on materially inaccurate financial statements or other criteria.
The Code makes recommendations about the medium of pay and the ratio between cash and other forms of remuneration.	As an exception to the prohibition on paying monetary bonuses to certain executives, TARP Recipients may grant restricted stock that does not fully vest until the government is repaid, provided the value of such award does not exceed 1/3 of the executive's compensation.
The role of the remuneration committee is extremely important in relation to the approval and review of remuneration policies.	Each TARP Recipient must establish a committee comprised of independent directors, which meets at least semi-annually, to discuss and evaluate employee compensation plans in light of an assessment of any risk posed to the TARP Recipient from such plans.
The Code recommends that a firm makes a statement from the remuneration committee on the firm's remuneration policy available to shareholders, probably on an annual basis.	The CEO and CFO of each TARP Recipient must provide written certification of compliance with the executive compensation restrictions to a regulatory agency.

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