The issue of remuneration has received considerable coverage of late, with the big banks bemoaning the political and regulatory pressure to reduce bonus pools, and arguing that the requirement for deferrals and enlarged non-cash components in bonuses will increase costs as the basic, non-variable elements of pay have to be uprated in order to retain “talent”. Indeed, base salaries in the City hit a four year high in 2010, according to recruitment firm poolia; 17% up on 2009 levels and 25% higher than those in 2008. Moreover, some have noted a related trend towards individuals leaving larger “tier 1” firms in favour of “tier 3” firms, thereby avoiding the metric restrictions imposed on tier 1 bonuses by the FSA’s Remuneration Code (the “Code”).

Nevertheless, although mega-bonuses garner the lion’s share of headlines the issue of pay impacts the wider financial services community as well, with the extension of the Code – to meet the requirements of the Capital Requirements Directive (CRD 3) – bringing a further 2,700 firms within its scope, and, moreover, the requirements of the Retail Distribution Review (RDR) affecting the remuneration of financial advisers (see Box 1). These developments – albeit less mainstream – pose a challenge to compliance professionals across the industry.

Extending the Code

While the extension of the Code may be viewed by some as an unwelcome addition to the compliance burden, it is worth noting that the FSA’s application of CRD 3 is more lenient than it could have been. Indeed, Tim Dolan, Partner at Pinsent Masons, believes that the proportionality principle which the FSA has applied – and the resulting four-tier system – should be praised. “I can’t imagine a more favourable interpretation of CRD 3 than the one being taken by the UK,” he argues. “If it transpires that other parts of Europe adopt a more literal interpretation of the Directive then the FSA’s approach will, for once, make the UK more competitive.”

Nevertheless, the Code does pose some challenges for those firms not previously covered, who have until 1 July 2011 to come into line with its requirements. At a very basic level, there are concerns that many tier 3 or 4 firms may not yet have realised that they are now subject to the Code.

“Extending the Code has come as a surprise to many because the original purpose of CRD 3 was to address capital failures and issues concerning banks and large building societies, but in fact the provisions in the Directive catch most firms that are subject to BPRU unless they are an exempt CAD firm.”

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Insight: Remuneration

Rewards and Risk

Bankers’ bonuses may hog the headlines, but the issue of remuneration cuts across the whole of the financial services sector. James Thomas outlines the current challenges for the UK compliance community.

“In establishing what action they need to take, firms should first conduct a gap analysis between their current and required remuneration practices, and the FSA has stated that it will publish a template for this purpose.”
Box 1: The impact of RDR

The Retail Distribution Review (RDR) is a further regulatory initiative that will impact pay in the financial services arena, moving payment for financial advice towards a fee paying situation in which commissions are taken from the value of investments will no longer be acceptable in most circumstances. But what steps should compliance be making to ensure that firms and advisers are ready for these changes?

“Advisers will still continue to receive trail commission for any business written prior to January 2013, and unless the structure is changed on the product then this will continue indefinitely,” explains Chris Hayes of Prestige Consulting. “However, the move across to fees will have an obvious impact on cash flow, in two ways. Firstly, it may reduce new client numbers and therefore decrease the level of income to the business. Secondly, it will be necessary to keep an eye on cash flow at all times and to monitor for dips. Firms will need to be more attentive to their accounts department and ensure that invoices are sent in a timely fashion.”

Firms and compliance functions should be well underway in the process of altering fee menus, putting in place policy charging and ongoing monitoring, she continues. “Compliance departments should already be working with the advisers in the firm to blend a mix of compliance requirements and the firm’s vision of how they see their firm working with clients in the future,” she says, adding that “it will take quite a few models to get the proposition into the neck which will sell it all the way.”

“Policy charging should be something which is compliant, competitive in the market place, comfortable for the advisers to work with and at the right level to keep the firm profitable,” she adds. This issue impacts, amongst other aspects of the business and it is therefore vital that everyone has input.

Finally, on the subject of monitoring Miss Hayes emphasises the importance of having a back office system which can highlight key meetings for clients so that compliance can check that from a TCF perspective clients are being serviced at the right level. This should also be worked into the KPI benchmarks for advisers to ensure it is measurable.

Interpretation and implementation issues

Ambiguities in the drafting of the Code and subtle differences between the consultative draft and the final draft have meant that the processes of interpreting how the Code applies, and the FSA has stated that it will publish a template for this purpose (although it is yet to do so at the time of writing). The findings of this gap analysis, which must be made available to the FSA on request, should be used to create an action plan to address any shortfalls and to produce a remuneration policy and procedures document which the FSA may also wish to inspect. This process will be underway, according to Tim Dolan, with most firms having undertaken the gap analysis, established which tier they are in and what they need to put in place. “Our clients almost always identify a committee of two or three people who are involved in performing the gap analysis,” he explains. “Once that is complete firms need to consider implementation, and that involves changes to employment contracts, for example, then that needs to be done sooner rather than later. Most of our clients have worked out in broad terms what committees and structures they need in place, are implementing those structures and are starting now to deal with employment contracts issues.”

on a firm-wide basis, but only so-called “Code staff” can be subject to the whole of the Code. However, identifying Code staff is not always straightforward, as Mr Spilka continues: “The definition of Code staff reads ‘all staff who have a material impact on the firm’s risk profile, including a person who performs a significant influence function for a firm, a senior manager…and risk taken’. When I consulted the FSA to enquire as to whether this definition included analysts and portfolio managers, paid at the same level as a senior manager performing a significant influence function, the regulator’s response was that it was still considering whether such individuals should or should not fall under the code.”

Risk and remuneration

A further challenge for coming within scope is the requirement for a robust, firm-wide understanding of risk, and for compliance functions the key is translating this into policy. Therefore the application of Principles 1 to 11 – which are concerned with the establishment of a remuneration policy which is in line with the firm’s risk management; risk tolerance; current and future capital and revenues; and long term business strategy, objectives and interests – could pose an immediate challenge for some tier 3 and 4 firms.

According to Andrew Nord, Avantage: “Ultimately the Code demands that firms make a clear and transparent link between what is accepted as being an appropriate risk reward trade off and how this is reflected in the remuneration policy, not only in the current year but in future years as well. This requires that firms have a well-established risk appetite and tolerance framework, which provides the ability to link enterprise, disposal and individual goals.”

This represents a challenge for compliance functions, which will be instrumental in determining the relationship between risk and reward and ensuring that it applies from a high level right down to the level of the remuneration of named individuals. As the Code states: “A firm’s risk management and compliance functions should have appropriate input into setting the remuneration policy for other business areas. The procedures for setting remuneration should allow risk and compliance functions to have significant input into the setting of individual remuneration awards where those functions have concerns about the behaviour of the individuals concerned or the riskiness of the business undertaken.” (Principle 5, controlled functions, handbook text, rule 19A.3.15).

The question is what “appropriate” and “significant” input should be. Firms need to consider the types of differing approaches that a compliance function might choose to take. The first is to present a list of individuals about whom there is a concern, providing details of those concerns. Instead, he suggests that it is preferable to take the approach of developing a framework which stipulates that, if a specific range of circumstances exist about any individual, then that should be regarded as “a matter of concern.” In addition, a policy should be set which outlines the type of action which would be appropriate to deal with such matters of concern.

As with so much of the Code, risk tolerance and its translation into policy is a firm-specific issue. Indeed, much of the Code’s effect is to make the whole issue of remuneration increasingly firm-specific, making it more difficult for firms to benchmark their pay against the competition. In line with that concern, it will be paramount that the FSA is not consistent in ensuring that the Code is observed, thereby maintaining a level playing field. As Tim Dolan remarks: “The Heads of Compliance I have spoken with are less concerned with the issues of deferred compensation than with ensuring that the Code is applied consistently across the board and that employees don’t simply move to another firm that’s not complying and offering big bonuses.”

A good policy

Despite some of the headaches associated with implementing the Code – of which those outlined are just a selection – it is possible most constructive to view implementation less as a burden and more as an opportunity to improve remuneration practice within the firm. In that spirit, what might be viewed as a short term inconvenience could instead, at the very least, provide some longer term benefit. As Aeron Brown, Complyport, explains: “Tier 4 firms, which are the majority of the firms now coming into scope, can actually disapply much of Principle 12 for the majority of their employees, meaning that the challenge that remains for these firms when setting up a firm-wide remuneration policy in essence, involves looking at the pools of profit that are going to be paid back to staff and deciding what award is appropriate. Because many of the more contentious issues which have been generating the headlines – such as deferred, performance adjustment and so forth – can be disappplied, what tier 4 firms will be left with is essentially a good remuneration policy that will actually be quite a straightforward document.”

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The first challenge, then, is for firms to establish whether they are within scope and, if so, which tier they fall under and what they therefore need to comply with. For tier 1 firms (banks or building societies with capital above £1bn) this should be straightforward. Firms having already been subject to the Code prior to its revision. Similarly, adherence with the Code should not be totally alien to most tier 2 firms (banks or building societies with capital between £50m and £1bn, or full-scope BRMs of tier 3 firms). The firms for whom the Code is likely to be less familiar, however, are those in tier 3 (any other bank, building society or full-scope firm) and tier 4 (all limited license building society or full-scope firms).

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**Interpretation and implementation issues**

Ambiguities in the drafting of the Code and subtle differences between the consultative draft and the final draft have meant that the processes of interpreting how the Code applies, and then implementing it, are not without their problems, however. For example, Irwin Spilka, the Code’s author and compliance consultant, has found that many areas of his understanding of the Code changed dramatically following informal discussions which he had with the FSA as to its application. “The fact that the final version has been published and it is now impossible to review it, that is why it is difficult,” he explains. “In the current year but in future years as well. This requires that firms have a well-established risk appetite and tolerance framework which provides the ability to link enterprise, divisional and individual goals.”

This represents a challenge for compliance functions, which will be instrumental in determining the relationship between risk and reward and ensuring that it applies from a high level right down to the level of the remuneration of named individuals. As the Code states: “A firm’s risk management and compliance functions should have appropriate input into setting the remuneration policy for other business areas. The procedures for setting remuneration should allow risk and compliance functions to have significant input into the setting of individual remuneration awards where those functions have concerns about the behaviour of the individuals concerned or the riskiness of the business undertaken.” (Principle 5: controlled functions, handbook text, rule 1A.3.15).

The question is what “appropriate” and “significant” input should look like. Mr Spilka suggests there are two possible approaches that a compliance function might choose to take. The first is to present a list of individuals about whom there is a concern, providing details of those concerns. Instead, he suggests that it is preferable to take the approach of developing a framework which stipulates that, if a specific range of circumstances exist about any individual, then that should be regarded as “a matter of concern.” In addition, a policy should be set which outlines the type of action which would be appropriate to deal with such matters of concern.

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