

13 October 2008

Dear CEO

Remuneration policies

Introduction

1. There is widespread concern that inappropriate remuneration schemes, particularly but not exclusively in the areas of investment banking and trading, may have contributed to the present market crisis. In the private sector, bodies such as the Counterparty Risk Management Group (CRMPG) have identified remuneration structures as one of the possible driving forces behind current problems.¹ The International Institute of Finance (IIF) reached a similar conclusion and has issued Principles of Conduct which they think should be adopted by firms.²

2. The FSA shares these concerns. It would appear that in many cases the remuneration structures of firms may have been inconsistent with sound risk management. It is possible that they frequently gave incentives to staff to pursue risky policies, undermining the impact of systems designed to control risk, to the detriment of shareholders and other stakeholders, including depositors, creditors and ultimately taxpayers.

3. The FSA has no wish to become involved in setting remuneration levels: that is a matter for Boards, which should ensure that they have effective structures in place to set remuneration policies and monitor remuneration levels throughout the firm. However we want to ensure that firms follow remuneration policies which are aligned with sound risk management systems and controls, and with the firm's stated risk appetite.³

4. Note that our interest in this area (and the scope of this letter) does not extend to the remuneration of Board non-executive directors. Their remuneration (as well as their role, eg in overseeing employee remuneration) has been covered in the 2003 Higgs Review and earlier reviews.

Criteria for 'good' and 'bad' remuneration policies

5. It is difficult to be prescriptive about remuneration policies. They will vary widely between firms, and within firms between different levels of staff. They will also need to

¹ CRMPG III, Containing Systemic Risk: The Road to Reform, August 2008

² IIF, Final Report of the IIF Committee on Market Best Practices, July 2008.

³ Note that the FSA will separately control that the firm's stated risk appetite is consistent with the firm's obligation under Principle 4 to maintain adequate financial resources (including adequate capital and adequate liquidity)

reflect many factors including the nature of the business undertaken and the culture of each institution. Nevertheless we believe that it is possible to set out some high level criteria against which policies can be assessed. An illustration of our current thinking is set out in the attached annex.

Action for firms

6. Many firms have a remuneration process with a year end review. Planning for that review may already be underway. I urge all firms, whatever the timing of their remuneration reviews, to consider carefully their remuneration policies, especially in light of recent market developments. If the policies are not aligned with sound risk management, that is unacceptable. Immediate action will be required to change the policies.

7. The criteria set out in the annex provide a benchmark for this exercise. We would expect firms to avoid (or to be implementing plans to eliminate) bad or poor practices concerning the measurement of performance, the composition of the remuneration and governance arrangements.

8. We would further expect firms to be moving towards good practice. We recognise that performance-adjusted, deferred compensation arrangements are complex to design: nevertheless, if they are not already in place we expect firms to be considering actively how they might be incorporated into remuneration structures within a specified time period.

Action by the FSA.

9. During September the FSA held a number of high level discussions with London-based firms about remuneration policies. Between now and the end of the year we will arrange a further round of visits to all recipients of this letter. Our aim will be to gather more specific information about remuneration practices in your firm to assure that bad practices are not present and to seek further input on what would constitute good practice.

10. In the early part of next year we will communicate our findings regarding good practice to you, and have a further discussion with you about them, if appropriate. We will also publish our general findings about remuneration structures in the London market, on a no-names basis.

11. We believe that given the events of the past year firms recognise the need to review their remuneration policies and to take steps to change them if necessary. We believe that in working with the industry we can assist and encourage this process.

12. Changes to remuneration policies formed part of the recommendations of the report of the Financial Stability Forum⁴, and the subject remains under active discussion internationally. The FSA is taking a prominent part in those discussions. We are mindful that to be effective action on this subject needs to be taken internationally. We hope to be able to report on the international work in our published report early next year.

Conclusion

13. This letter does not constitute formal Guidance from the FSA but is intended to update you in regard to our work on remuneration policies and to inform you as soon as possible of

⁴ Report of the Financial Stability Forum on enhancing market and institutional resilience, April 2008.

our initial thinking in this area. We would encourage firms to review compensation policies throughout the firm (not just in trading and investment banking areas) to be sure that they are consistent with sound risk management. We will update firms early in the new year on the result of our further work as well as progress in international forums, such as the FSF.

Sincerely,

Hector Sants

Chief Executive
Financial Services Authority

ANNEX: Criteria for good and bad remuneration policies

a) Measurement of performance for the calculation of bonuses

Bad or poor practice (firm view)	Good practice (initial thoughts)
Calculated on the basis of revenues, without any counterbalancing risk controls	Calculated on profits, and by reference to other business goals if appropriate
Does not take risk or capital cost into account	Uses a measure of risk-adjusted return. Measure likely to be based upon economic capital calculation, and should take proper account of a range of risks including liquidity risk.
Performance assessed entirely on the results for the current financial year	Performance assessed on a moving average of results (link to deferred compensation, see below)
Employee bonuses calculated solely on the basis of financial performance	Bonuses awarded take into account appraisal of other performance measures, including risk management skills, adherence to company values and other behaviours

b) Composition of the remuneration

Bad or poor practice (firm view)	Good practice (initial thoughts)
Remuneration which has little or no fixed component.	Fixed component of the remuneration package to be large enough to meet the essential financial commitments of the employee.
Paid wholly in cash	Appropriate mix of cash and components which are designed to encourage corporate citizenship and alignment of interests between those of the employee and those of the firm. (For example shares, or appropriately priced share options).
No deferral in the bonus element	A major proportion of the bonus element is deferred so that the impact of the performance (see 1 above) in one year on the firm/unit's long term profits can be established

c) Performance adjusted deferred compensation

Bad or poor practice (firm view)	Good practice (initial thoughts)

Payout of the deferred element is not linked to the future performance of business undertaken in previous years.	A significant proportion of the deferred compensation element to be held in a trust or escrow account, from which funds can only be vested according to rules which take account of the performance of business undertaken in earlier years. Deferred compensation is determined by a performance measure which is calculated on a moving average over a period of several years.
Performance adjusted deferred compensation schemes can be waived/ not enforced despite evidence of poor performance or wrong doing.	Performance adjusted deferred compensation schemes are legally robust and contractually enforced.

d) Governance

Bad or poor practice (firm view)	Good practice (initial thoughts)
No independent oversight of remuneration policies or of remuneration awards to executives or senior staff	Board level remuneration committee with majority of non-executives. Committee has effective control of remuneration policies across the firm and of individual remuneration awards above a certain threshold
No process, or no transparent process for managing conflicts of interest	Areas such as HR and Risk have strong and independent role in setting compensation for the business areas.
Business areas can determine the compensation of staff in risk and compliance	Compensation for staff in risk and compliance is determined independently of the business areas.
Staff have an ability to influence unduly the valuation of their own positions and hence the determination of performance measures. Ability also to front load profit from transactions	Valuations and risk reporting subject to independent verification
Incomplete separation of duties between front and back office: ability of the front office to influence back office procedures. (See also SYSC 5.1.6R to 5.1.11G on the segregation of functions).	Overall control of the back office vested in operations.