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Pay and bonuses in the financial sector

A summary of UK regulation

Background to the FSA Remuneration Code

The Financial Services Authority's Remuneration Code was first published in August 2009 following the G20 summits in London and Pittsburgh, and the publication of the Financial Stability Board's remuneration principles. The rules came into effect on 1 January 2010, but covered performance in 2009.

The remuneration code covered 27 of the largest banks, building societies and broker dealers. Following discussions with HM Treasury, three significant branches of overseas banks also agreed to abide by them.

Changes to the Code

A new Remuneration Code came into force on 1 January 2011, covering pay awards made in 2010 and paid in 2011. The Code has been amended to reflect the provisions (approved in July 2010) of the European Union's Capital Requirements Directive (CRD).

These changes bring more than 2,500 firms within the scope of the Code. These include all banks and building societies, asset managers, hedge fund managers, Undertakings for Collective Investment in Transferable Securities (UCITS) investment firms, and some stockbrokers and firms that engage in corporate finance, venture capital and the provision of financial advice.

Specific amendments to the Code

Scope of the Code: the FSA has categorised firms into the following tiers:

- ***Tiers one and two*** – credit institutions and broker dealers that engage in significant proprietary trading/investment banking activities.
- ***Tier three*** – primarily small banks and building societies and firms that may occasionally take overnight or short-term risk with their balance sheets.
- ***Tier four*** – firms which generate income from agency business without putting their balance sheets at risk.

Firms categorised as tier one and two have to adhere to strict requirements including the need to have a remuneration committee, rules on deferral and rules on the proportion of remuneration which must be paid in shares or share equivalents. Small and low risk firms are subject to different requirements.

Application: the FSA has set out examples of key positions in firms that it believes should be subject to the Code: senior management, control functions (audit, risk and compliance) and employees who have an impact on the risk profile of the firm.

Deferral: for tier one and two firms, at least 40 per cent of variable pay must be deferred over a period of at least three years, and up to five years, for all staff to whom the Code applies. At least 60 per cent must be deferred should variable pay be more than £500,000.

Proportion in shares: at least 50 per cent of any variable remuneration components (both deferred and non-deferred) must be made in shares (or share-linked instruments or other equivalent non-cash instruments of the firm) subject to deferrals and a minimum retention policy.

Retention periods: the Code imposes a requirement that instruments must be subject to an "appropriate" retention policy to align incentives with the longer-term interests of the firm. The FSA will expect a minimum of six months' retention by the employee after vesting (i.e. title to the shares or share equivalents has passed from employer to employee).

Performance criteria: the assessment of performance will not simply be in financial terms but will also consider other aspects of an individual's contribution to the firm.

Long-term performance (bonus/malus and clawback): firms can withhold payment if performance criteria, both financial and non-financial, are not met or there is a misstatement. The financial year 2011/12 will be the third year in which clawback measures have been in place.

Guarantees: firms must not offer guaranteed bonuses of more than one year, and these may only be given in exceptional circumstances to new hires for the first year of service. This can apply to all members of staff.

Strengthening of capital base: firms must ensure that their total variable remuneration does not limit their ability to strengthen their capital base. The FSA signs off distributions (i.e. dividends to investors and variable pay to employees) to ensure that the firm's capital ratios are sound.

Voiding provisions: a new rule defines instances where breaches of the Code may render a contract void and/or require recovery of payments made.

Severance payments: these should reflect performance over time, and failure must not be rewarded.

Pensions: enhanced discretionary pension benefits should be held for five years in the form of shares or share-like instruments.

The Code in practice: examples of how it will work

Take, for example, variable pay for the year 2011, to be paid in the spring of 2012:

(i) when the end-of-year accounts books have closed and been processed, the finance department of the bank advises the board and control functions of any distribution of variable pay to employees.

(ii) The firm's control functions check on adherence to the FSA rules and in-house procedures and the board's remuneration committee reviews the compliance checks and calculations. The review includes non-financial metrics.

(iii) The firm advises the FSA of any distributions approved by the board, including both dividends to shareholders and bonuses to staff. The FSA checks if the pay-outs are sustainable and do not pose a risk to prudential soundness.

(iv) If the individual pay-out is equal to or less than £500,000, then 100 units of variable pay will typically be delivered as:

- **30** immediate cash
- **30** immediate shares, but with a(n employee) retention period of at least six months

- **20** deferred cash (held by the employer for three years)
- **20** deferred shares (held by the employer for three years and then held by the employee for at least six months)

(v) if the individual's pay-out is more than £500,000 and/or the employee is categorised as "Code staff", then 100 units of variable pay will typically be delivered as:

- **20** immediate cash
- **20** immediate shares, but with a(n employee) retention period of at least six months
- **30** deferred cash (held by the employer for five years)
- **30** deferred shares (held by the employer for five years and then held by the employee for at least six months)

During the vesting period (when the cash and shares are held by the employer), it is possible for the employee to lose his or her entitlement in the case of poor financial performance, misconduct or misstatement.

Tax treatment

The various Code requirements for pay as described above involve several different measures relating to tax. Briefly these are as follows:

- 50% top rate of Income Tax plus 2% employees National Insurance Contribution (NIC) on initial cash salary and cash element of bonus. Employers NIC of 13.8% is also due.

- 50% top rate of Income Tax and 2% employees NIC due on value of deferred shares, typically at the point of vesting. That is, if awards are made when the share price is £1 but the share price is £2 at the time of vesting, tax is due on the value at vesting of £2. Employers NIC at 13.8% will also be due. The tax/NIC is usually settled by selling the relevant value of the shares. This provision means that the government shares the benefits of any increase in value of the deferred shares.

- Tax/NIC will also be due on any immediate shares (with an employee retention period). Typically the tax point will be when the shares are awarded but the exact treatment will depend on the specific structure of the awards.

- In addition, any capital gains made on a subsequent sale of the shares are subject to Capital Gains Tax at either 18% or 28% depending on personal circumstances.

Disclosure rules

The FSA has also published new rules to implement the Capital Requirements Directive conditions on the disclosure of remuneration.

Firms must disclose details of their remuneration policies on at least an annual basis.

In addition to the FSA's disclosure requirements, the Project Merlin agreement between the four major UK high street banks and the government, led to the voluntary disclosure of the remuneration of the five most senior non-board staff. This will soon be superseded by rules HMT is making under the Financial Services Act 2010. This will require banks based in the UK with greater than £50 billion of assets and the UK subsidiaries of overseas banks with greater than £50 billion of assets in the UK to disclose the remuneration of their eight most highly remunerated executives.

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The BBA view

The banking industry in the UK absolutely understands concern over pay.

In the UK we have two financial services industries: one is our domestic industry, serving UK customers; the other is the global industry which is centred in the City, and which competes globally for business and talent. This industry trades globally but pays tax locally - more tax than any other business sector. Until there is a genuinely global consensus on pay in financial services, the challenge for policy makers will be to ensure the UK continues to attract this valuable business.

The banks meet regularly with a wide range of stakeholders to discuss these and many other issues. We believe it is essential that there is a sustainable, cooperative relationship between lenders and government to support economic recovery in 2012 and beyond.

British Bankers' Association
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