

Guidance consultation 15/2

GENERAL GUIDANCE ON THE APPLICATION OF EX-POST RISK ADJUSTMENT TO VARIABLE REMUNERATION

March 2015

1 Introduction

- 1.1 This guidance consultation sets out proposals to amend the draft guidance on the application of ex-post risk adjustment. This is the adjustment of variable remuneration to take account of a specific crystallised risk or adverse performance outcome and would apply for firms within scope of the proposed Dual-regulated firms Remuneration Code (SYSC 19D). Both the draft guidance and the proposed SYSC 19D were consulted on in FCA CP14/14 /PRA CP15/14/ *Strengthening the alignment of risk and reward: new remuneration rules*¹.
- 1.2 The primary purpose of the proposed Dual-regulated firms Remuneration Code is to ensure greater alignment between risk and individual reward, to discourage excessive risk taking and short-termism, and encourage more effective risk management, and in turn to support positive behaviours and a strong and appropriate conduct culture within firms. This supports the Financial Conduct Authority's (FCA's) statutory objectives of enhancing market integrity and protecting consumers by ensuring incentives do not encourage excessive risk-taking or misconduct.
- 1.3 The aim of this draft guidance is to clarify the FCA's expectations of how firms should comply with the Dual-regulated firms Remuneration Code requirements on ex-post risk adjustment. The proposed guidance is intended to ensure that, when complying with

¹ FCA CP 14/14 PRA CP15/14 *Strengthening the alignment of risk and reward*
<http://www.fca.org.uk/static/documents/consultation-papers/cp14-14.pdf>

these requirements, firms take an approach that is sufficiently robust, transparent and wide-ranging to foster and develop positive behaviours and culture.

2 Background

- 2.1 In July 2014, the FCA, jointly with the PRA, published Consultation Paper FCA CP14/14/PRA CP15/14/ *Strengthening the alignment of risk and reward: new remuneration rules* ("CP14/14").
- 2.2 CP14/14 primarily set out proposed changes to the FCA remuneration regime by creating the Dual-regulated firms Remuneration Code in SYSC 19D (among other amendments). This was intended to address weaknesses in the alignment between risk and reward that were highlighted in the final report of the Parliamentary Commission on Banking Standards (PCBS), *Changing Banking For Good* (June 2013)².
- 2.3 CP14/14 also included FCA-only *General guidance on the application of malus to variable remuneration and ex-ante risk adjustments* in Appendix 6. The consultation period closed on 31 October 2014. We did not receive any formal responses specific to Appendix 6.
- 2.4 Following our annual review of the remuneration policies and practices of the proportionality Level 1 firms, we are consulting on revised general guidance on the application of ex-post risk adjustment to variable remuneration. This is intended to amend and replace the guidance consulted on in Appendix 6 of CP14/14.
- 2.5 This revised guidance consultation proposes to set out more clearly our expectations on how firms should implement the requirements of the Dual-regulated firms Remuneration Code on ex-post risk adjustment and to share good practice observed in the 2014 remuneration round.
- 2.6 We recognise the importance of the regulation of remuneration to firms and this guidance consultation provides a further opportunity for respondents to provide feedback to the FCA.

² PCBS *Changing Banking For Good* <http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf>

3 Summary of proposals

3.1 This guidance consultation sets out our proposals on how we would expect firms to comply with the requirements on ex-post risk adjustment. Our proposals for consultation cover the following five areas:

1. **Scope (within firms)** – Adjustments are sufficiently wide-ranging to include all those whose roles and responsibilities include areas where failures or poor performance contributed to, or failed to prevent, the crystallisation of risk, including up the management chain and to control functions.
2. **Expectations in relation to the application of ex-post risk adjustment** – Individual and collective adjustments reflect the magnitude of the event based on a range of financial and non-financial factors, the degree of involvement or responsibility and are effective at driving positive behaviours and culture.
3. **Timing and consideration of ex-post risk adjustment** – Adjustments are considered once events have been identified, and reductions applied, as soon as reasonably possible, with awards frozen where investigations remain ongoing.
4. **Procedure for considering ex-post risk adjustment** - Events are considered using a clearly defined, robust and well-documented process that considers a range of relevant factors. This includes applying ex-post adjustments separately from other factors at the end of the process and clearly communicating the impact of ex-post adjustments to staff in writing, and as a group.
5. **Co-operation with the FCA** – Firms under review submit all relevant information early and in line with the FCA's requested timetable.

Q1: Do you agree with the proposals in each of the five areas set out in this guidance consultation?

3.2 **Application of FCA guidance:** it is proposed that this draft guidance would apply to firms in scope of the proposed SYSC 19D which would also be subject to the proposed *General Guidance on Proportionality: The dual-regulated firms Remuneration Code* (SYSC 19D). This is a change of approach from the draft guidance previously consulted on in Appendix 6 of CP14/14, which also proposed the application to solo-regulated firms under the scope of the proposed amendments to SYSC 19A (Remuneration Code). Nevertheless, firms outside the scope of SYSC 19D may also wish to consider the principles of good practice set out here when seeking to apply ex-post risk adjustment.

- 3.3 The European Banking Authority (EBA) is also consulting on guidelines on sound remuneration policies in EBA/CP/2015/03³ which explain how the remuneration provisions of CRD IV should be applied by competent authorities. Once finalised, these guidelines may lead to consequential changes in the FCA's approach that affect the extent to which firms in SYSC 19D are required to apply this guidance.

Q2: Do you agree with the proposal to revise the scope of application?

4 Cost benefit analysis

- 4.1 As part of CP14/14, the FCA previously commissioned Europe Economics (EE), a specialist economics consultancy, to assess the likely impacts of the package of accountability and remuneration measures in a single external report, including on the application of malus.
- 4.2 The baseline for the cost benefit analysis (CBA) is what firms do to meet the current Remuneration Code in SYSC 19A. However, EE also took into account any activities that have been undertaken in anticipation of the new regime being introduced. In the CBA, the FCA focused on the incremental impact of the remuneration proposals. The FCA asked EE to judge the additional impact of the remuneration proposals within its overall analysis.
- 4.3 The EE report indicated the direct compliance costs for firms to be relatively modest (and particularly so in respect of deferral and clawback rather than the new guidance). The EE report also found the proposals were likely to have indirect costs, potentially on the balance of fixed and variable pay within remuneration structures and on the flexibility of the labour market for individuals within the scope of the regulatory remuneration regime.
- 4.4 For firms within scope of the proposed SYSC 19D, we do not believe the costs of the proposals of this guidance consultation materially change the CBA previously undertaken.

³ <http://www.eba.europa.eu/regulation-and-policy/remuneration/guidelines-on-sound-remuneration-policies/-/regulatory-activity/consultation-paper>

5 Responses and next steps

5.1 This consultation closes on Thursday 7 May. Views are welcomed on all areas of the guidance consultation, including in response to the specific questions posed.

5.2 Please send your responses to: remuneration-code@fca.org.uk

Or in writing to:

Peter Curtis
Specialist Supervision
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS
Telephone: 020 7066 2516

5.3 We expect to publish final guidance as part of the policy statement to CP14/14.

5.4 We intend that this new guidance will take effect in Summer 2015 alongside the Dual-regulated firms Remuneration Code in SYSC 19D.

6 General guidance on the application of ex-post risk adjustment to variable remuneration

[date]

1 Introduction

- 1.1 This statement is general guidance under section 139A(1) of the Financial Services and Markets Act 2000 (FSMA). This guidance statement has effect from [Expected *Summer 2015*].
- 1.2 This guidance is aimed at all firms to whom the Financial Conduct Authority's Dual-regulated firms Remuneration Code in SYSC 19D⁴ applies. Its main purpose is to set out the FCA's expectations of the way in which firms comply with the requirements on ex-post risk adjustment (also referred to as performance adjustment). Where firms consider an alternative approach to be justified in meeting the requirements on ex-post risk adjustment in the Dual-regulated firms Remuneration Code, this should be consistent with the general requirement to promote sound and effective risk management set out in SYSC 19D.2.1R.
- 1.3 The Prudential Regulation Authority (PRA) has also issued a Supervisory Statement (SS2/13) entitled 'PRA expectations regarding the application of malus to variable remuneration' published in October 2013⁵.
- 1.4 The primary purpose of the Dual-regulated firms Remuneration Code is to ensure greater alignment between risk and individual reward, to discourage excessive risk taking and short-termism, and encourage more effective risk management, and in turn to support positive behaviours and a strong and appropriate conduct culture within firms. This advances our objectives of securing an appropriate degree of protection for consumers and protecting and enhancing the integrity of the UK financial system.
- 1.5 The effective, meaningful and timely use of ex-post risk adjustment including malus, is essential to these aims.
- 1.6 Ex-post risk adjustment refers to the adjustment of variable remuneration to take account of a specific crystallised risk or adverse performance outcome including those relating to misconduct (a 'relevant event'). Ex-post risk adjustments include reducing current year awards, the application of malus (reducing or cancelling deferred incentive awards that have not yet vested), and clawback (recouping already vested awards).
- 1.7 The FCA expects firms to consider the application of ex-post risk adjustment for relevant events where there has been a materially adverse impact on any of the relevant criteria

⁴ The creation of SYSC 19D has been consulted on in CP14/14.

⁵ PRA expectations regarding the application of malus to variable remuneration (October 2013) is available at: <http://www.bankofengland.co.uk/pradocuments/publications/policy/2013/appofmalusss2-13.pdf>.

set out in 3.8. Ex-post risk adjustment should be applied as a minimum in the event of circumstances that fall within the meaning of SYSC 19D.3.62R - SYSC19D.3.64R including for material cases of misconduct.

- 1.8 The importance of ex-post risk adjustment has been underscored both in Directive 2013/36/EU (the Capital Requirements Directive or CRD), which requires up to 100% of the total variable remuneration to be subject to malus or clawback arrangements, and the Parliamentary Commission on Banking Standards' final report.
- 1.9 Firms should comply with the Dual-regulated firms Remuneration Code's provisions on risk and performance adjustment in their spirit as well as to the letter.
- 1.10 Where a firm has a Remuneration Committee, the FCA expects the Chair to ensure that the decisions taken by this committee on ex-post risk adjustment support the purpose and objectives of the Dual-regulated firms Remuneration Code to promote positive behaviours and culture within the firm.

2 Scope

- 2.1 All unvested variable remuneration should, in principle, be capable of forfeiture or recovery through ex-post risk adjustment. Deferred remuneration for the purposes of adjustment includes Long-Term Incentive Plans (LTIPs).
- 2.2 The use of ex-post risk adjustment should not be limited to employees who engaged directly in misconduct. In all cases, the FCA expects firms to consider applying ex-post risk adjustment to those employees whose roles and responsibilities include areas where failures or poor performance contributed to, or failed to prevent, the crystallisation of risk including cases of misconduct. Ex-post risk adjustment should be applied for individuals who:
 - a. could have been reasonably expected to be aware of the failure, misconduct or weakness in approach that contributed to, or failed to prevent, the crystallisation of risk at the time but failed to take adequate steps to promptly identify, assess, report, escalate or address it; or
 - b. by virtue of their role or seniority are indirectly responsible or accountable for the relevant event, including senior staff who drive the firm's culture and set its strategy.
- 2.3 Section 2.2 above includes individuals within control functions (e.g. compliance, risk, internal audit etc.) for the weaknesses and failings identified within these functions. The FCA expects firms to place primary responsibility on the business for meeting standards expected of them and expects the amount and nature of adjustments made to control functions to reflect that allocation of responsibility.
- 2.4 The FCA expects all firms subject to ex-post risk adjustment to have a firm-wide policy on the application of ex-post risk adjustment (and group-wide policy, where appropriate) for staff subject to the relevant Dual-regulated firms Remuneration Code for whom the latter can be partially dis-applied due to their level of earnings under the proportionality rule.

3 Expectations in relation to the application of ex-post risk adjustment

- 3.1 Firms' remuneration policies and employment contracts should make it clear that variable remuneration awards are conditional, discretionary and contingent upon a sustainable

and risk-adjusted performance. They are therefore capable of forfeiture or reduction at the employer's discretion.

- 3.2 Ex-post risk adjustment can be applied collectively at bonus pool level, to groups of employees and to individuals. Firms should apply an appropriate balance of ex-post risk adjustments across these levels.
- 3.3 The primary focus in applying ex-post risk adjustments should be on individuals. Collective ex-post risk adjustments are likely to be appropriate where there are widespread failings or to meet all or a significant part of the cost of regulatory action and fines, redress and other associated costs from bonus pools. Where a relevant event has a material impact on any of the relevant criteria in paragraph 3.8, the FCA expects to see a similarly material adjustment as a proportion of a firm's bonus pool.
- 3.4 Where the misconduct, failings or poor performance which led to a relevant event occurred primarily in particular business units or divisions, collective adjustments should be weighted towards those areas.
- 3.5 Firms should ensure that individuals do not profit from a relevant event. Firms should consider the extent to which past bonuses were earned as a result of identified failings and also give appropriate consideration to the cost of consequent redress and other financial impacts. Firms should apply further ex-post risk adjustment to reflect this and should do so robustly and fairly.
- 3.6 In considering how much further ex-post risk adjustment to apply to individuals, the FCA expects firms to consider the degree of culpability, involvement or responsibility of an individual and the relevant criteria listed in paragraph 3.8.
- 3.7 For cases with a high degree of personal responsibility and a high impact in relation to any of the relevant criteria in paragraph 3.8, up to 100% ex-post risk adjustment should be the starting point. For lower degrees of responsibility and impact, proportionately less ex-post risk adjustment may be applied. In all cases, firms should ensure that the size of ex-post reductions reflect the severity of the crystallised risk event, are material in size and are sufficient to drive positive individual behaviours and culture within the firm.
- 3.8 When deciding the amounts to be adjusted, the FCA expects firms to take into account all relevant criteria, including:
 - a. The impact on the firm's customers, counterparties and the wider market;
 - b. The impact of the failure on the firm's relationships with its other stakeholders including shareholders, employees, creditors, the taxpayer and regulators;
 - c. The cost of fines and other regulatory actions (e.g. Section 166 of FSMA reviews);
 - d. Direct and indirect financial losses attributable to the relevant failure; and
 - e. Reputational damage.

4 Timing in the consideration of ex-post risk adjustment

- 4.1 Firms should start to consider ex-post risk adjustment once relevant events have been identified and impose reductions as soon as reasonably possible.

- 4.2 Where ex-post risk adjustments are made to current or prior year awards before the full impact of the relevant event is known, subsequent consideration and, where appropriate, subsequent adjustments should be made to ensure the final value of the adjustment fully reflects the impact of the incident.
- 4.3 Firms should update the FCA on any relevant pending investigations and ahead of any payment of outstanding awards to individuals under investigation for misconduct.
- 4.4 Risk management failures and misconduct can take years to come to light. This should not prevent firms from applying ex-post risk adjustment to the extent that the relevant individuals have variable remuneration capable of reduction, even where this does not relate to performance in the year in which the relevant event occurred or came to light.
- 4.5 Firms should freeze the vesting of all variable remuneration potentially due to individuals undergoing internal or external investigation that could result in material ex-post risk adjustment until such an investigation has concluded and the firm has made a decision and communicated it to the relevant employee(s).

5 Procedure for considering ex-post risk adjustment

- 5.1 The FCA expects firms to develop and maintain an adequate procedure for deciding cases that could result in the use of ex-post risk adjustment as part of or alongside regular internal performance management and disciplinary proceedings. This procedure should:
 - a. Identify which roles, departments, functions and committees are responsible for identifying, escalating and deciding cases that may trigger the use of ex-post risk adjustment.
 - b. Ensure that control functions including Internal Audit, Compliance, Finance, Human Resources, Legal, Reward and Risk provide relevant information and contribute to discussions as required.
 - c. Set out clear criteria on the kind of cases that may trigger the use of ex-post risk adjustment. These criteria should be indicative and non-exhaustive. Remuneration Committees should retain full discretion to introduce additional criteria where appropriate.
 - d. Set out a clear process for determining the degree of culpability, responsibility or accountability, including allowing individuals under investigation to make representations.
 - e. Promote consistency, fairness and robustness in the application of ex-post risk adjustment.
 - f. Firms should ensure that the initial process for determining bonus pools is sufficiently transparent to enable them to quantify and articulate clearly the impact of any ex-post risk adjustments they might make prior to them being approved.
 - g. Clearly record the value of awards and the rationale for why they are that size prior to and following ex-post risk adjustments being applied.
 - h. Clearly record the value of the adjustments made at individual, business unit and firm levels so that it is possible to determine the value of each adjustment per incident and at the individual employee level. Firms should make consistent judgments and be able to explain how adjustments have been made and why any differences exist between incidents or the individuals concerned.

- i. Ex-post risk adjustments should be applied separately after all other factors relevant to setting awards (including those set out in Principle 8 - Profit-based measurement and risk adjustment- and Principle 12b –Remuneration structures – assessment of performance) have been considered to ensure that subsequent adjustments are not made that would reduce or undermine the effect of ex-post risk adjustment at bonus pool or individual level.
 - j. Firms should ensure that the value of ex-post risk adjustments made to an individual's variable remuneration and the reasons for the adjustments are clearly communicated to the affected individuals in writing and that the value and reasons for collective adjustments are clearly communicated to staff as a group.
- 5.2 The operation of an effective procedure for considering ex-post risk adjustment is not a substitute for taking account of known increases in risk as they arise, including those relating to conduct. The FCA would expect firms to take these risks into account including for example, where weaknesses in systems and controls have been identified or where there is an increased level of customer complaints, when determining the appropriate size and value of new awards.

6 Co-operation with the FCA

- 6.1 Firms are expected to provide the FCA with information on their application of ex-post risk adjustment as requested. This information should be sufficient for the FCA to assess the firm's ex-post risk adjustment decisions.
- 6.2 Where a firm's policies and practices on variable remuneration are under review by the FCA, these firms should comply with the timetable set by the regulators, providing sufficient time for the FCA to form a view before the date by which they intend to communicate and distribute their awards. Please refer to the FCA and PRA websites for the most up to date data collection templates and review timetable.
- 6.3 Where a firm does not meet the timetable set by the regulators, there is likely to be a commensurate impact in the provision of the FCA's view to the firm which may delay the firm's own timetable for communicating and distributing awards.