

REGULATORY REFORM BULLETIN

Comparison of Detailed International Recommendations and Guidelines on Remuneration

As of July 20, 2009

Introduction

Of all the issues that have emerged since the start of the global banking crisis, perhaps none has been as emotive as the topic of pay and bonuses for senior executives of financial services institutions. Although there had been some political commentary on the apparent excess of bonus culture in the years running up to 2008, there was little, if any, serious political appetite to tackle the matter. Regulatory response also was muted.

However, headline-grabbing severance settlements for senior executives of failed financial institutions – combined with the global recession as well as recognition by many that certain incentive arrangements exacerbated excessive risk-taking in some financial institutions – have caused world political leaders, global standard-setters and local supervisory agencies to address remuneration in financial services institutions.

Initially, governments and regulators focused on financial services institutions benefiting from taxpayer-funded support. More recently, however, their focus has expanded to include all financial services institutions under the guises of improving risk management and tackling systemic risk.

Executive Summary

Various international and domestic policy-setters and regulators have published or updated recommendations and proposed guidelines to regulate the remuneration of individuals within financial services institutions.

This document (prepared by our regulatory team in London and New York) [compares the recommendations and proposals for the reform of remuneration practices within financial institutions](#) from the following organizations:

- **The Group of 20 leading economic countries (G20)** – Published recommended remuneration reforms among other recommendations for reform of financial supervision at the conclusion of the London meeting of G20 leaders in April 2009.

- **The Financial Stability Board (FSB)**¹ – “Principles for sound compensation policies” document published on April 20, 2009.
- **Committee of European Banking Supervisors (CEBS)** – “High-level principles for Remuneration Policies” published on April 20, 2009.
- **The Financial Services Authority (FSA)** – “Draft code on remuneration practices” updated on March 18, 2009, in line with the publication on March 18, 2009, of the Turner Review and FSA’s discussion paper on the reform of the regulatory system of the banking industry.
- **U.S. Treasury** - Announcements made on June 10, 2009, and subsequent draft legislation offered by the Treasury Department.

The comparison does not consider any additional remuneration requirements (including potential remuneration caps) imposed on banking institutions by national governments or regulatory authorities in order for those institutions to take advantage of taxpayer-funded asset guarantee programs or significant government-funded ownership introduced in response to managing systemic risks arising from the global financial crisis.

Not surprisingly, there is little divergence among the five sets of recommendations and guidelines, given international political pressure to address recognized failings within remuneration policy and practice. The key common themes within the recommendations and guidelines can be summarized as follows:

- Engagement and oversight by the board of directors and involvement of shareholders in setting and monitoring remuneration policy and practice
- The role of control functions in setting remuneration and their own independence from business areas on remuneration
- Alignment of all stakeholder (including employee) interests for the longer-term benefit of the organization as a whole, including the use of deferred incentive programs compared to a short-term (less than one year) view and only individual and/or team performance
- Risk-adjusting bonuses and bonus pools (for instance, having regard to the cost of capital employed or the opportunity cost to provide the appropriate level of liquidity)
- Making use of nonfinancial measures in assessing individual performance, including compliance with internal policies and procedures and attitudes toward risk management

Supporting commentary to some of the various recommendations and guidelines suggests supervisors should use their existing powers under Pillar 2 of the Basel II Capital Accord to increase capital requirements if they determine the recommendations/guidelines have been only partially addressed by the relevant firm.

The U.S. Treasury announcements were made in conjunction with those of the U.S. Securities and Exchange Commission (SEC), which proposes to amend legislation to require greater disclosure around remuneration policy. The Securities Industry and Financial Markets Association (SIFMA), a U.S.-based trade association representing international securities firms, U.S.-registered broker-dealers and asset managers, has also published remuneration guidance.²

SIFMA’s guidance, as well as being in line with U.S. Treasury proposals, also reinforces G20 and FSB recommendations on the independence of risk management professionals (in both their reporting lines and remuneration packages) and their role in setting remuneration policy and practice across the financial institution – two factors not included in the U.S. Treasury or SEC

¹ Note that the FSB was formerly known as the Financial Stability Forum (FSF).

² SIFMA “Guidelines for Compensation,” published June 10, 2009.

announcements. In the United States, compensation requirements will be further debated and refined as regulatory reform legislation is considered by the U.S. Congress.

It is perhaps inevitable that the FSA's guidelines are the most detailed given the FSA is the only front-line supervisor included in the comparison. FSA's approach is to lay out a number of high-level principles and provide the basis (in evidential provisions) by which a firm might comply, but leave it open for a firm to put forward an alternative approach if there is justification.

What's Next?

Firms should be actively considering their response to these and future proposals and announcements. In addition, they should be assessing not only whether they are – or will be – in compliance with them, but also addressing factors such as:

- The potential implications on their business model and ability to attract and retain key individuals
- Any changes to organizational structure and reporting lines for client-facing personnel, as well as compliance, risk and internal audit staff who also may be affected
- How to meet the varying demands and expectations of local requirements in cross-border, matrix-managed business units that can have many different and complex remuneration and incentive/retention schemes in operation

This may mean discussions with and the engagement of senior business individuals, other disciplines within firms such as human resources, and at the board level, including independent and nonexecutive directors.

European financial institutions will also want to consider: the implications of the European Commission's proposals put forward on July 13, 2009, to amend regulatory capital rules and give supervisors the powers to increase capital requirements if they are not satisfied that an institution's remuneration policy and its effectiveness will avoid excessive risk taking;³ and, in the United Kingdom, the wide ranging proposals for reform of corporate governance, including those on remuneration put forward by the Walker Review published on July 16, 2009.⁴ These proposals, as well as developing proposals in Europe and the United States, will be discussed in future updates of this Bulletin.

Please note that this information is not intended to be legal analysis or advice, nor does it purport to address every aspect or proposal relating to guidelines or legislation that may be adopted to govern compensation standards for financial services companies. Firms should seek the advice of legal counsel or other appropriate advisors on specific questions as they relate to their unique circumstances.

³ Further amendments to the Capital Requirements Directive, http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.

⁴ "A review of corporate governance in UK banks and other financial industry entities," http://www.hm-treasury.gov.uk/walker_review_information.htm.

About Protiviti

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<p>Recommendation 19 Large financial institutions should ensure their compensation frameworks are consistent with their long-term goals and with prudent risk-taking. As such, the boards of directors of financial institutions should set clear lines of responsibility and accountability throughout their organizations to ensure the design and operation of the remuneration system supports the firm's goals, including its overall risk tolerance. Shareholders may have a role in this process. Boards should also ensure there are appropriate mechanisms for monitoring remuneration schemes.</p>	<p>Effective governance of compensation Boards of directors of major financial firms should exercise good stewardship of their firms' compensation practices and ensure compensation works in harmony with other practices to implement balanced risk postures. The principles need to become ingrained over time into the culture of the entire organization.</p> <ul style="list-style-type: none"> i. The firm's board of directors must actively oversee the compensation system's design and operation. ii. The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended. iii. Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner independent of the business areas they oversee and commensurate with their key roles in the firm. (Principle 1) 	<p>Principle 1: General The financial institution should adopt an overall remuneration policy in line with its business strategy and risk tolerance, objectives, values and long-term interests. It should not encourage excessive risk-taking. The remuneration policy should cover the institution as a whole and contain specific arrangements that take into account the respective roles of senior management, risk-takers and control functions. Control functions should be adequately rewarded to attract skilled individuals.</p> <p>Principle 3: Governance The management body, in its supervisory function, should determine the remuneration of the management body in its management function. In addition, the management body, in its supervisory function, should approve the principles of the overall remuneration policy of the institution and maintain oversight of their application. The implementation of the remuneration policy should be subject to central and independent review.</p>	<p>Principle 1: Role of bodies responsible for remuneration policies and their members A remuneration committee should:</p> <ul style="list-style-type: none"> (a) exercise, and be constituted in a way that enables it to exercise, independent judgment (b) be able to demonstrate that its decisions are consistent with a reasonable assessment of the firm's financial situation and future prospects (c) have the skills and experience to reach an independent judgment on the suitability of the policy, including its implications for risk and risk management (d) be responsible for approving and periodically reviewing the remuneration policy and its adequacy and effectiveness <p>Principle 2: Procedures and input of the risk and compliance functions</p> <ul style="list-style-type: none"> • Procedures for setting remuneration within a firm should be clear and documented, and should include appropriate measures to manage conflicts of interest. 	<p>1. Compensation plans should properly measure and reward performance.</p> <ul style="list-style-type: none"> • Link incentives of executives with long-term value creation. • Conditioned on a wide range of internal and external metrics, not just stock price. • Encourage combination of the firm's results, individual performance and those of their business unit. <p>2. Compensation should be structured to account for the time horizon of risks.</p> <ul style="list-style-type: none"> • Seek to pay compensation in ways highly aligned with long-term value and soundness of the firm. • Potentially requesting stock to be held for longer or over a vesting period. • Scope to include all levels responsible for design, selling and packaging of simple and complex products.

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			<ul style="list-style-type: none"> • A firm's risk management and compliance functions should have significant input into setting remuneration for other business areas. <p>Principle 3: Risk and compliance function remuneration</p> <ul style="list-style-type: none"> • Remuneration for employees in risk management and compliance functions should be determined independently of other business areas. • Risk and compliance functions should have performance metrics based on the achievement of the objectives of those functions. 	<p>3. Compensation practices should be aligned with sound risk management.</p> <ul style="list-style-type: none"> • Conduct and publish a risk assessment of pay packages to ensure they do not encourage imprudent risk-taking. • Provide risk managers with the tools and authority to improve efficiency at managing the tension between incentives and risk-taking. <p>5. Transparency and accountability should be promoted in the process of setting compensation.</p> <ul style="list-style-type: none"> • Shareholders to be given nonbinding vote on compensation arrangements. • Compensation committees to be more independent akin to standards for audit committees under the Sarbanes-Oxley Act (including powers to have access to independent compensation consultants and outside counsel).

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<p>Recommendation 20 In order to promote incentives for prudent risk-taking, each financial institution must review its compensation framework to ensure it follows sound practice principles developed by the FSF. These include the need for remuneration systems to provide incentives consistent with the firm's long-term goals, to be adjusted for the risk taken by employees, and for the variable components of compensation to vary symmetrically according to performance.</p>	<p>Effective alignment of compensation with prudent risk-taking</p> <ol style="list-style-type: none"> i. Compensation must be adjusted for all types of risk. ii. Compensation outcomes must be symmetric with risk outcomes. iii. Compensation payout schedules must be sensitive to the time horizon of risks. iv. The mix of cash, equity and other forms of compensation must be consistent with risk alignment. (Principle 2) 	<p>Principle 4: Measurement Where the pay award is performance-related, remuneration should be based on a combination of individual and collective performance. When defining individual performance, factors apart from financial performance should be considered. The measurement of performance, as a basis for bonus awards, should include adjustments for risks and the cost of capital.</p> <p>Principle 5: Form There should be a proportionate ratio between base pay and bonus. Where a significant bonus is paid, the bonus should not be a pure up-front cash payment but contain a flexible, deferred component; it should consider the risk horizon of the underlying performance.</p>	<p>Principle 4: Profit-based measurement and risk-adjustment</p> <ul style="list-style-type: none"> • Assessments of financial performance used to calculate bonus pools should be based principally on profits. • A bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required. <p>Principle 5: Long-term performance measurement The assessment process for the performance-related component of an employee's remuneration should be designed to ensure assessment is based on longer-term performance.</p>	<p>4. Re-examine "golden parachutes" and supplemental retirement packages.</p> <ul style="list-style-type: none"> • Challenge whether such arrangements properly incent performance or reward individuals regardless of performance, even if shareholders lose value. <p>6. Shareholder "Say on Pay." Shareholders should be afforded a nonbinding vote on executive compensation packages.</p> <p>7. Compensation committee independence. Compensation committees of boards of directors should adhere to independence standards similar to those of audit committees.</p> <p>8. Compensation committee advisory. Compensation committees should have the responsibility and resources to engage independent consultants or counsel to advise them.</p>

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<p>Recommendation 21 Prudential supervisors should enhance their oversight of compensation schemes by taking the design of remuneration systems into account when assessing risk management practices. The Basel Committee on Banking Supervision (BCBS) should more explicitly integrate this dimension in its guidance for the assessment of risk management practices by national prudential supervisors.</p>	<p>Effective supervisory oversight and engagement by stakeholders</p> <ul style="list-style-type: none"> i. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action. ii. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders. (Principle 3) 	<p>Principle 2: Transparency and Disclosure The remuneration policy should be transparent internally and adequately disclosed externally.</p>		