FINANCIAL STABILITY BOARD

Thematic Review on Compensation

Peer Review Report

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Foreword

The Financial Stability Board (FSB) decided in September 2009 to conduct a peer review of implementation of the Financial Stability Forum's (FSF) *Principles for Sound Compensation Practices* and their *Implementation Standards*. The Principles and Standards were endorsed by the G20 Leaders at their Summits in London in April 2009 and Pittsburgh in September 2009. In their Pittsburgh statement, the G20 Leaders tasked the FSB "to monitor the implementation of FSB standards and propose additional measures as required by March 2010."

This report provides the findings and conclusions of the peer review. It was prepared by a Team comprising members from Australia, Canada, the Netherlands, Singapore, South Africa, Switzerland, the Basel Committee on Banking Supervision and the Organisation for Economic Co-operation and Development, supported by the FSB Secretariat.

The peer review on compensation examines the steps being taken or planned by FSB member jurisdictions to ensure effective application of the Principles and Standards, as well as progress to date in implementation by significant financial institutions. Consistent with the Principles and Standards, the focus is authorities' and firms' actions aimed to align the compensation policies of significant financial institutions with sound risk management and ensure they do not encourage or reward excessive risk-taking. The review provides an overall assessment of the status of implementation and makes recommendations of additional measures to deliver effective and sustained changes in industry practices.

The findings of this review are based on responses to a template designed to gather information from FSB member jurisdictions on their national initiatives and on evidence of the evolution in industry practice, stemming primarily from supervisors' engagement with individual firms. As part of the review, financial institutions and other stakeholders were encouraged to provide input directly to the FSB on practical experiences in implementing the Principles and Standards, as well as on the application of national rules. The review also benefited from an informed, independent assessment of implementation progress and challenges from external consultants.

The peer review on compensation is the first such review under the new FSB *Framework for Strengthening Adherence to International Standards*.[1]

[1] A note describing the framework is at http://www.financialstabilityboard.org/publications/r_100109a.pdf.

Executive summary

Significant changes in regulatory and supervisory frameworks to implement the *FSF Principles for Sound Compensation Practices* and their *Implementation Standards* have taken place across the FSB membership over the past year and are expected to continue into 2010 and beyond. Notwithstanding different starting points in terms of pre-existing national frameworks addressing compensation issues and the degree of misalignment with prudent risk-taking, there has been, on the whole, material progress and a movement towards convergence across jurisdictions. However, it is relatively early in the process; some key issues are yet to be resolved and effective implementation is far from complete. There are differences in the approach to and pace of implementation and a sustained and cooperative effort will be required from supervisors and financial institutions to implement fully the Principles and Standards by the end of 2010. Greater progress has been achieved in the areas of governance, establishing supervisory oversight and promoting disclosure of compensation. Further work needs to be done to raise standards of risk adjustment of pay structures across the industry.

Hence, this review recommends additional measures in areas where they are necessary to support the emergence of sound practice and further convergence. In addition to continuing to roll out national policies, such measures include enhanced supervisory cooperation on compensation with regard to cross-border firms, especially across the major financial centres; support in the development of sound industry practices, notably in the area of risk-adjustment of compensation (both ex-ante adjustments of bonus pools and ex-post deferral and malus mechanisms); and increased coverage of significant nonbank financial institutions. This work needs to be progressed on a rapid timetable so that the results can be reflected in the outcomes of the compensation reviews that most firms will be undertaking at the end of 2010.

This review is a point-in-time assessment of a process in motion, and pressure will need to be maintained to ensure that the Principles and Standards, and the respective national rules and supervisory oversight, are fully effective at delivering change in industry practices. For this reason, the FSB will conduct a follow-up review on compensation in one year, by which time more information will have become available from which to judge the change in the industry and the impact of national implementation. To support the next review, the FSB will also develop criteria to assess implementation progress.

This thematic review spans all FSB members and their significant financial institutions. Compensation issues, however, vary across firms and jurisdictions. The degree of change required to effectively align a firm’s compensation practices with prudent risk taking will be a function of their initial misalignment. In drawing its recommendations, this review acknowledges these differences, while reaffirming the need for authorities to ensure coordination of approaches and consistency of outcomes across jurisdictions.

List of recommendations

1. FSB members should finalise and implement regulatory and/or supervisory initiatives related to the Principles and Standards in 2010.
2. Firms should continue to make progress on risk and performance alignment of compensation schemes through 2010 and beyond. This would include the ability to demonstrate how their compensation schemes incorporate risk adjustments.
3. International colleges of supervisors should enhance information exchange and cooperation on compensation issues and practices at significant, cross-border financial institutions. Risk management (including as needed compensation practices) should be a standing agenda item in the supervisory colleges.
4. Where a jurisdiction hosts a number of significant institutions from another jurisdiction with substantial activity, relevant supervisors should bilaterally coordinate to ensure consistency of approach across firms.
5. FSB members should work to ensure that all significant financial institutions across the financial services sector in their jurisdiction (as identified by the relevant national authorities), irrespective of their legal form, follow sound compensation practices.
6. Supervisors should actively check that the composition of compensation committees meets appropriate standards of expertise and of independence.
7. The Basel Committee should develop for consultation by the end of October 2010 a report on the range of methodologies for risk and performance alignment of compensation schemes and their effectiveness in light of experience to date. It should cover the following areas:

   (i) methods for incorporating risk and performance into bonus pool and individual compensation;

   (ii) the design of deferred compensation, such as adequate performance measures; the relation between performance measures and ultimate value of deferred compensation instruments; malus triggers; the sensitivity of payout schedules to the time horizon of risks; and the funding of deferrals; and

   (iii) proportionality in the application of rules, taking into account the size and complexity of the institutions, business models and risk tolerance.

   This report could be used as a basis for guidance.
8. The Basel Committee in consultation with the FSB should consider incorporating disclosure requirements for compensation into Pillar 3 of Basel II, to add greater specificity to the current requirements for compensation disclosure under Pillar 2, by the end of 2010.
9. The FSB should conduct a follow-up review on compensation in the second quarter of 2011, to assess the impact to date of measures put in place by jurisdictions and the progress in industry compliance with the Principles and Standards and the respective national rules.
10. To support this review, the FSB, working through its members, should develop criteria for use by the review team in assessing progress towards implementation of the Principles and Standards.

1. Overview of implementation by national authorities

1.1 General approach

Many jurisdictions have adopted an implementation model that includes a mix of enforceable regulation and supervisory oversight (see Annex A). Australia, France, Germany, Italy, the Netherlands, Saudi Arabia, Switzerland, and the UK have issued separate regulations, or incorporated the Principles and Standards into existing regulations. New regulations are often supported by supervisory guidance that illustrates how the rules can be met.

Other jurisdictions follow a primarily supervisory approach to implementation, involving principles and guidance and the associated supervisory reviews. These include, for instance, China, Hong Kong, Korea, Japan and the US. In Canada and Spain, the approach is to include the review of compliance with the Principles and Standards directly into the regular supervisory work on significant activities, controls and oversight functions (see below for a more detailed description of supervisory activities).

The choice between regulatory and supervisory approaches largely depends on national preference. National authorities will have to achieve a robust framework for ensuring compensation policies consistent with prudent risk taking under either one or the other of these developing approaches.

Regulations or supervisory guidance are at the preparatory stage in Brazil, Mexico, Singapore (all expected by mid-2010), Argentina, South Africa and Turkey. Possible implementation initiatives are under consideration in India, Indonesia and Russia. In addition, some jurisdictions are in the process of incorporating the requirements contained in Pillar 2 of the enhancements to the Basel II framework, issued by the Basel Committee in July 2009, into the national supervisory frameworks. A number of European countries note that with the expected approval of the proposed amendment to the EU Capital Requirements Directive in 2010, the Principles and Standards are expected to be almost entirely transposed into national regulation.

In some jurisdictions, authorities are discussing legislative amendments that will incorporate requirements related to compensation into national law. This is particularly the case for aspects of the Principles or Standards that would require an explicit national legal basis, such as in Germany, to link bonus payments to a sound capital base; and in the Netherlands, to lay the basis for malus arrangements into the law. In the UK, changes to the FSA’s powers in relation to remuneration are currently before Parliament that, among other things, would enable it to make rules that (prospectively) render void provisions of a contract which breach specified regulatory provisions. At the European level, the proposed amendment to the Capital Requirements Directive will require banking supervisors to oversee compensation policies and strengthen sanctioning powers in this area; the draft directive on Alternative Investment Fund Managers also includes provisions on compensation of these managers. The European Commission is seeking to introduce the same rules in the directive on Undertakings for Collective Investment in Transferable Securities (UCITS) with a view to covering the whole European asset management sector. Similar provisions on remuneration policies at EU level are also expected for the insurance sector in the course of 2010. Requirements with respect to board members' compensation have been incorporated into law for all listed companies in a number of jurisdictions (e.g., Germany, India, Spain).

National industry initiatives include a self-commitment to comply with the Principles and Standards signed by large banks and insurers in Germany; a commitment by large banks in the UK to a national rule and code; and a Corporate Governance Code and a Banking Code agreed by the Dutch industry.[2] In France, regulation requires credit institutions' and investment firms' compensation policies to be consistent with the professional rules adopted by the French banking industry, thereby granting them full regulatory force. The French asset management industry is exploring the same avenue.

In most jurisdictions, existing legislation provides the relevant authorities with wide powers to take timely and appropriate supervisory actions, which range from requiring firms to adopt remedial measures and imposing disciplinary sanctions to raising minimum capital requirements. Many relevant national authorities also have the necessary powers to restructure compensation in the event of exceptional government intervention.

In some jurisdictions, regulatory initiatives on compensation had pre-dated the crisis, but requirements were seen more from a code of conduct than from a prudential perspective – focused on public disclosure, corporate governance and specific control or review requirements for the remuneration of senior management and executive board members – and were applicable to all listed companies rather than being specific to the financial sector. European Union member states have also developed rules on compensation of investment firms and asset management companies with a view to addressing potential conflicts of interest (implementation of existing Market in Financial Instruments and UCITS directives).

Scope of application

In terms of institutional coverage, FSB members divide quite evenly between those that apply the Principles and Standards or the respective national rules to a predefined subset of significant institutions, and those that apply them to all – often subject to "proportionality". Brazil, Canada, Germany and Italy use a mixed approach, whereby provisions related to the Principles apply to all institutions, whereas additional provisions (often related to the Standards) apply to a subset of large institutions or conglomerates. In Switzerland, provisions are mandatory for large institutions; for smaller institutions, the Swiss rules serve as guidance and adherence to those will be discussed as part of the usual supervisory process.

Overall, and subject to the mixed approach noted above, size thresholds to determine the scope of application are in place (or planned) in Argentina, Brazil, Canada, Germany, Italy, Japan, Switzerland, and the UK.[3] Jurisdictions where provisions apply (or are planned to

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[2] The Dutch authorities are working to give the Banking Code, which came onto effect on 1 January 2010, a legal basis (retrospectively), similar to that of the Corporate Governance Code. A monitoring commission is in place for the Corporate Governance Code and the Banking Code.

[3] Jurisdictions use different size thresholds: in Argentina, market share of deposits above 2 percent (80 percent of supervised institutions), in Brazil, institutions for which one of the following applies: (i) publicly traded; (ii) regulatory capital in excess of R$ 1 billion; (iii) third parties assets in excess of R$ 1 billion; (iv) more than R$ 5 billion in deposits and third parties assets (77 financial institutions in total); in Canada, six large banking and three insurance conglomerates (representing 90/80 percent of the market based on assets /premiums); in Japan, major banking groups and internationally active financial institutions; in Italy, six large banking groups; in Switzerland, six banks and five insurers with capital above CHF 2 billion.

apply) to all institutions include Australia, China, France, Hong Kong, Korea, the Netherlands, Saudi Arabia, South Africa, Spain and the US (for banking organisation supervised by the Federal Reserve). In Hong Kong, the Netherlands and Spain, this is subject to proportionality.

Rules apply at the consolidated group level and, typically, to foreign affiliates and branches. Exceptions to the latter are Spain (which fully relies on home supervisors for foreign affiliates and branches) and Korea and Singapore.[4] Within the European Union, in line with the home country control principle of the EU legislative framework, local regulations cannot apply to branches of financial firm headquartered in an EU member state.

As noted, nonbank financial institutions are generally covered to the extent that they are part of a banking group. In addition:[5]

- *Insurance companies* are covered (or planned, subject where relevant to the size threshold noted above) in Australia, Canada, Germany, Italy, Japan, Korea, the Netherlands (including pension funds), Singapore (expected mid-2010), Switzerland and Turkey (planned). Hong Kong plans to issue local rules upon promulgation of the relevant IAIS Standards and Guidance (see below), and has requested insurers to review their compensation framework to ensure that it is in line with the Principles.
- *Investment firms and asset management companies* are included under the general approach (or planned, subject where relevant to the size threshold noted above) in France, Japan, Korea, Mexico, the Netherlands, Switzerland and Turkey. Large broker-dealers are included in the UK. Some general principles are in place in Italy. In Hong Kong, letters were sent drawing attention to the need to observe the FSB Principles. In the European Union, the draft directive on Alternative Investment Fund Managers includes provisions on compensation. These will be extended to traditional asset management companies through amending the UCITS directive.

It should be noted that in the area of insurance, the International Association of Insurance Supervisors (IAIS) recently released a draft of its *Standards and Guidance on Remuneration* for consultation among IAIS members and observers, with final publication as part of broader work on governance scheduled for autumn this year. This IAIS work supports the consistent implementation of the FSB Principles and Standards and highlights remuneration issues that are more specific to the insurance industry, such as the nature and complexity of an insurer's risk profile and the alignment with the long term interests of policyholders and beneficiaries.

Categories of employees covered are generally broadly defined to at least include senior management, material risk-takers and staff performing important risk management and

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[4] Singapore applies local rules to foreign subsidiaries only. As part of their consolidated supervision, home supervisors are expected to ensure that their banks' group compensation policies applicable to their Singapore branches comply with the FSB Principles and Standards. Compensation schemes of foreign branches are also examined as part of Singapore's risk-based supervisory activities.

[5] The UK FSA Feedback Statement in December 2009 noted that although there were issues to be addressed relating to remuneration policies and practices in other parts of the financial sector, they were not so urgent as to warrant action by the FSA ahead of other authorities. It was decided to wait until there was more clarity about the outcome of potential developments at the EU level. These may lead to the introduction of requirements on remuneration policies for other parts of the financial sector (asset management, insurance).

control functions.[6] Some jurisdictions also explicitly refer to groups of employees who may together take material risks, even if no individual employee is likely to expose the firm to material risk. Other jurisdictions, such as Argentina, the Netherlands and the UK, cover all employees with significant variable compensation.[7] Finally, a number of jurisdictions cover all employees, subject to proportionality (e.g., Switzerland) – that is, the more senior an employee is or the higher risk such employee represents, the longer, for instance, the deferral or vesting period and the risk adjustment for such employee's variable compensation.

Supervisory activity

Many FSB members have performed substantial supervisory activity to communicate to institutions expectations with respect to compliance with the Principles and Standards or the respective national rules, and to determine the status of compliance.

Reviews of significant financial institutions' self-assessments against the Principles and Standards or national rules and plans to address deficiencies, including on-site visits and interviews with senior management and board members, and recommendations for improvement where necessary, were conducted in Australia, Canada, Italy, Singapore, Spain and the UK. In the US, such self-assessments were submitted by the largest firms in early 2010 and are currently being analysed; firms whose plans supervisors judge to be inadequate will be required to improve them.[8] Reviews of implementation of regulatory provisions and professional standards, including through on-site inspections, were conducted in France.

South Africa is planning a self-assessment with respect to the Principles and Standards. Hong Kong and Japan have requested self-assessments against local guidance, to be followed by a review of compliance in the second half of 2010, including on-site examination for the largest firms. A supervisory review of large banks in China is planned for 2010.

Close dialogue with the industry and reviews of firms' practices, including on-site visits, took place in several jurisdictions. In Germany, supervisors will in 2010 analyse end-year 2009 audit reports for potential gaps identified in existing compensation policies, evaluate compensation practices as part of Pillar 2 on-site examinations, and survey firms on the implementation of the new provisions. Surveys of practices were also conducted in Argentina, Brazil, Saudi Arabia and South Africa (the latter in 2008).

Enhanced supervision of compensation practices will continue during 2010, and most FSB members expect that monitoring of compensation practices will become part of ongoing on- and off-site supervision going forward.

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[6] Canada asked its significant financial institutions to determine the employees or groups of employees that may have a material impact on their risk exposure. In Germany, firms were asked to make a similar self-assessment, subject to the following criteria: size and nature of the business activity (e.g., investment banking), business volume, size of the risks and the income of an organisational unit; an employee's activity (e.g., trader), his positions, the amount of his remuneration to date and peer labour market comparisons.

[7] The UK FSA has defined the group as (i) 'significant influence function' employees registered as such with the FSA (ii) other employees deemed as significant risk takers by the firm and (iii) a presumption (by the FSA) that staff whose total remuneration for 2009 was expected to exceed £1m could have a material impact on the firm's risk profile.

[8] In Canada and the US, review work has thus far focused on the largest institutions. Reviews of practices at smaller banks will begin later in 2010.

The UK plans to review its remuneration policy in mid-2010, focusing on the experience so far with local provisions; progress in achieving international alignment in the implementation of the Principles and Standards; developments at the EU level; and the question of whether to extend the new rules to other firms in the financial sector, and if so to what extent (see above).

The Netherlands and Switzerland have launched a programme of internal training for examining officers in the area of compensation. This is important given the complexities of risk-adjustment in large and complex institutions, and the need to be vigilant against potential "gaming" of compensation rules.

1.2 Governance of compensation

In the area of governance, there has been significant progress in terms of rule-making. Many jurisdictions issued in 2009 domestic rules that were largely aligned with the relevant FSB Principles and Standards. For most of these jurisdictions, the rules have already come into effect. A number of the remaining jurisdictions (e.g., Singapore, South Africa) expect to issue similar rules in the first half of 2010. Governance was also covered in the thematic reviews conducted by some jurisdictions (e.g., Canada, France) in the second half of 2009, and a peer review on this topic is currently underway by the OECD Corporate Governance Committee.

On the whole, the new rules extend existing corporate governance requirements, which in a number of jurisdictions (e.g., Singapore) already impose statutory obligations on the board with respect to the oversight of compensation systems, as well as supervisory expectations on the need for staff in financial and risk control functions to be independent of business units. In some jurisdictions, the new rules were implemented (or will be implemented) within the context of a broader review of existing corporate governance standards (e.g., Australia, Singapore).

As mentioned above, many jurisdictions are implementing the FSB Principles and Standards by way of a mix of enforceable rules and supervisory oversight (e.g., with regards to governance, Australia, France, Germany, Italy, the Netherlands, Saudi Arabia, Singapore, Switzerland, UK). In these jurisdictions, the new rules pertaining to compensation governance take the form of legally binding requirements. In other jurisdictions, implementation is primarily by way of supervisory guidance and expectations backed by supervisory reviews.

While there is significant convergence in the implementation of Principles 1, 2 and 3, as well as Standard 2, some differences in implementing certain requirements under Standard 1 are noted.[9] For example, not all jurisdictions require significant financial institutions to set up a dedicated sub-committee of the board to oversee compensation as required under Standard 1, although it is noted that most large firms already have such sub-committees in place. There are also varying requirements on the composition of the remuneration committee. In implementing Standard 1, some jurisdictions (e.g., Australia, Canada) require the committee to consist entirely of non-executive directors, a majority of whom are to be independent,[10]

[9] It should be noted that the implementation of the FSB Principles and Standards must be seen in the context of a country's general corporate governance approach (e.g. one-board vs. two-board system).

[10] In a number of jurisdictions (e.g., US), this was a requirement predating the crisis.

while others only require a majority of members to be non-executive or do not prescribe any quantitative rules (e.g., Japan). Korea requires that more than one of the directors on the risk management committee participate in the remuneration committee.

Only some jurisdictions require annual compensation compliance reviews (e.g., Hong Kong, Korea, UK, France as part of the bank's annual report on internal control) and/or board attestations (e.g., Australia, France) to be submitted to the relevant national authorities in their new rules as required under Standard 1. Jurisdictions also differ in the degree of specificity in rules concerning remuneration policies. Hong Kong requires the key principles underpinning the remuneration policy to be made accessible to all employees, while others (e.g., Italy, UK) are considering requiring board remuneration policy statements to be submitted to the relevant national authorities on an annual basis.

While there is broad consensus on the need for the new rules to be backed by vigorous review and enforcement, there are differences in actions planned. Notwithstanding these different approaches, most jurisdictions plan to include governance in their compliance reviews for 2010. Some jurisdictions have also indicated that they will review existing rules to take account of evolving international or regional standards; and in the UK, to implement the recommendations of an independent review of corporate governance standards that reported in November 2009.[11]

1.3 Alignment of compensation with prudent risk-taking

Most FSB members have incorporated in their regulatory and supervisory frameworks the requirement that compensation be aligned with prudent risk-taking, though differences remain in approach, emphasis and degree of detail. This is not an area currently addressed in India, Indonesia and Russia, though possible measures are under consideration.

Ex-ante risk adjustment

Most jurisdictions have included (or are in the process of including) in their regulatory and supervisory frameworks the principle that compensation must be adjusted for risks (Principle 4), and are working to ensure that financial institutions have an appropriate method in place to account for the full range of risks, including the elements specified in Standard 4.

Respondents note that while many firms claim to be already risk-adjusting bonus awards, this is an area where there is significant room for improvement. Hence the quality of risk adjustments will be a major focus of detailed supervisory work over the coming months. Relevant national authorities will assess the extent to which the measures adopted for adjusting remuneration to risk (including future risks not identified or measured by accounting profits), for various categories of employees covered by the firm's remuneration policy, are appropriate and effective. It is envisaged that the current developments on risk management as well as capital and liquidity requirements will lead to significant changes and extensions of the firms' risk management frameworks. These developments should also be reflected in the methods used for ex-ante risk adjustment of compensation.

[11] Walker Review of Corporate Governance in UK Banks and Other Financial Industry Entities.

Variable pay and capital conservation

About half of FSB member jurisdictions have the authority to ensure that banks limit variable compensation when it is inconsistent with the maintenance of a sound capital base, consistent with Standard 3. While in some cases (e.g., Italy), the law does not explicitly entrust the supervisors with a specific power to impose limits to banks' variable compensation, it is believed that the enforcement of this provision is made possible by the broad range of corrective and sanction powers. In other jurisdictions, authorities have required banks to consider the features of their remuneration systems as part of their capital and liquidity planning (Singapore, Switzerland, UK). Others plan to include this consideration into legislation (Germany), regulation (Netherlands), or the supervisory methodology (Canada).

Symmetry with risk outcomes

The requirement that compensation outcomes be symmetric with risk outcomes is a regular feature of existing regulatory and supervisory frameworks on compensation. Consistent with Principle 5, jurisdictions typically require financial institutions to have a process in place to ensure that total compensation is flexible both upwards and downwards, and in particular that subdued or negative financial performance of the firm leads to a considerable contraction of the firm's total variable compensation, in some cases down to zero.[12]

Most jurisdictions do not dictate the share of compensation that is variable (which Standard 6 states should be "substantial"), requiring instead an appropriate balance between base pay and the incentive-based component. Supervisors expect, and generally encourage, compensation schemes where variable pay increases significantly with seniority and becomes a substantial proportion of compensation for top management. This is incorporated in regulation in some cases (e.g., Brazil, France, Switzerland). On the other hand, guidance in Australia notes that it is desirable that the base pay comprises a sufficient proportion of total remuneration to enable the incentive-based remuneration to be genuinely discretionary. Some authorities (e.g., European Commission, Italy, Japan, UK) also note that requiring a "substantial" portion of compensation to be variable could send the wrong message and ultimately encourage, rather than discourage, excessive risk taking. These considerations suggest the need for a balanced approach.

Payout structures and schedules

Several jurisdictions have incorporated deferral and malus features into their (existing or planned) regulatory frameworks. In some cases, such as Brazil, China, France, Germany and the UK, this includes specific minimum expectations for amounts that are to be deferred, and for the deferral period (Standards 6–7).[13] In other cases, reference is to "substantial" deferrals for an "appropriate" or "extended" time period. US guidance suggests that risk adjustment is

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[12] In certain circumstances, there can be a question over whether to reward individuals and business units that perform well when the regulated entity as a whole, or one or more of its large business units, fails to perform well. Due to this, Australia requires firms to define in advance how they will respond to uneven performance across the entity, including circumstances where the whole entity faces material adversity.

[13] Some have noted a need to clarify the proportions to be deferred and the vesting period under Principle 7. For instance, whether it is intended that the total deferral period should be at least three years, but that part of an award may vest sooner (as soon as one year) albeit no faster than on a pro-rata basis.

unlikely to be an effective balancing feature in the compensation arrangements of senior executives, and thus that deferred compensation should be a substantial share of total compensation for senior executives (with risk-performance-related malus). For other employees, the relative importance of risk adjustment and deferral is expected to vary. In jurisdictions following primarily a supervisory approach, such as Canada and Spain, supervisors indicate that they have been actively inducing firms to increase the deferred portion of variable pay, where existing deferral proportions were below the 40–60 percent target range .

Not only do deferral arrangements delay the payout or vesting of compensation during the deferral period. In most cases, they also make the ultimate value of payout subject to performance conditions. This relation contributes to the risk symmetry of compensation. Accordingly, many jurisdictions include a requirement that deferred amounts be kept at risk, and negative performance at the individual, business unit or firm level is to be reflected in the amount of variable pay through performance adjustments (Standard 9). This would typically apply to both cash and non-cash deferrals. In the UK, the specific expectation is that at least 75 percent of deferred compensation for specified employees is to be subject to performance adjustment. In Switzerland, deferred compensation must be subject to performance adjustments in all cases.

The method of such a performance adjustment depends on the design of the deferred compensation instrument. Several jurisdictions at least partly require explicit malus arrangements, where pre-defined events lead to a considerable reduction of the original grant.[14] More general options include equity or synthetic compensation instruments (cash and non-cash) with an ultimate value contingent on performance conditions. These long-term incentive instruments often also include an "upside" where a positive development of performance indicators leads to an appreciation of the deferred compensation instrument. In any case, the actual leverage between the performance conditions and the ultimate value of deferred compensation is a key criterion in regard to risk symmetry, capital impact and the employees' incentives. They therefore should be carefully designed and should also be covered by regulation and the supervisory process. However, only few jurisdictions explicitly touch this topic in their rules or appear to explicitly include this aspect in their supervisory reviews. Jurisdictions which did so reportedly struggled to give firms consistent guidance in this area.

Jurisdictions typically require that an appropriate balance be established across forms of payout – cash, equity and other forms of compensation – into national regulation and/or supervisory actions (either existing or planned).[15] The degree of specificity, however, varies

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[14] The Basel Committee Compensation Assessment Methodology notes that "the precise meaning of the terms 'clawback' or 'malus' may differ across jurisdictions, and their legal feasibility and usefulness may also vary. For example, in some jurisdictions, a 'clawback' requires that an employee (or ex-employee) return to the firm compensation that was previously paid out. Such arrangements can sometimes be difficult to enforce. A 'malus' is often a feature of a compensation arrangement that reduces the amount of a deferred bonus, so that the amount of the payout is less than the amount of the bonus award. What is important is that firms' compensation policies include practical and enforceable ways to reduce amounts of awards of variable pay that are ultimately paid to, and retained by, employees when risk outcomes are worse than expected."

[15] In the UK, authorities have required that share awards be by number of shares rather than by value, so that the risk of poor share performance is taken by the beneficiary rather than the firm. Moreover, they have

(Standard 8). Germany, for instance, requires half of deferred compensation to be "dependent on the firm's long-term value creation;" France requires that the compensation awarded in the form of shares or equivalent instruments shall represent "at least 50 percent of the total amount of variable compensation awarded to the professionals;" Brazil's proposed regulations are along similar lines. Most other jurisdictions do not specify the proportion of variable compensation that must be awarded in shares or share-linked instruments, referring instead to a "substantial" proportion. US guidance is focused more on risk-performance-related malus arrangements than on the fraction of incentive compensation that is paid in equity. However in practice, the fraction paid in equity is substantial for senior executives of large banking organisations.

There are a number of concerns raised with respect to awarding compensation through equity-based instruments, including the possible dilution of existing shareholders if these mechanisms are further enhanced; the ability of these instruments to create incentives for long-term value creation; and the treatment of unlisted companies that do not issue equity.

Requirements to subject incoming and termination payments to performance hurdles have been introduced in many jurisdictions, in line with Standards 11–12, though the degree of specificity varies. In a few cases this takes the form of outright prohibition of guaranteed payments; more often, it is accompanied by the possibility to grant exceptional minimum bonuses in the context of hiring new staff and be limited to one year (e.g., France). Jurisdictions have also put in place requirements to align entry bonuses and severance pay to prudent risk management. In the UK, multi-year guarantees are actively discouraged, while on termination payments supervisors have focused thus far mainly on responding to cases that have been brought to their attention.

About half of respondents have incorporated Standard 14 on hedging strategies and insurance in their compensation regulations and supervisory activities. Among those jurisdictions that do not currently address this area in their regulation and/or supervisory activities, Argentina, Mexico, the Netherlands Singapore, South Africa and Turkey plan to do so, and measures are under consideration in India, Indonesia, Russia, Switzerland and the US. It should be noted that in some jurisdictions, firms had compliance provisions banning employees' speculation on their stock (including hedging) that predated the crisis.

Some respondents note that payout structure is one area where the speed of firms' implementation will depend on the legal ability of employers to change existing labour contracts. In some jurisdictions (e.g., Germany), labour law hinders institutions' ability to change existing labour contracts against the will of affected employees.[16]

encouraged firms to provide shares via new issues rather than by buying them from the market, in order that share awards assist with the retention and rebuilding of capital.

[16] Australia has allowed a transitional period in relation to existing contracts (contracts grandfathered until such time as they are due for renewal, or end-March 2013 whichever is sooner).

1.4 Disclosure

There has also been fairly good progress in the area of disclosure. Many jurisdictions have introduced (or will be introducing) new rules to implement Principle 9 and Standard 15 (e.g., Australia, China, France, Germany, Hong Kong, Japan, Korea, Mexico, Saudi Arabia, Singapore, South Africa, Switzerland). For listed financial institutions in these countries, the new rules are in addition to existing public disclosure requirements (which include rules concerning compensation) that apply across all listed companies. Most of these jurisdictions plan to include disclosure in their compliance reviews for 2010.

It is too early to evaluate the quality of improvement in firms' compensation disclosures, as most such new disclosures are yet to be published. At the same time, existing requirements across jurisdictions point to some differences that may hamper the comparability of the disclosed facts and therefore the effectiveness of disclosure as a whole.

Some jurisdictions (e.g., UK, US) note that disclosure does not come under the purview of prudential supervisors. The US Securities and Exchange Commission has adopted amendments to its disclosure rules which require all listed companies to discuss their compensation policies and practices as they relate to risk management for all employees, if those policies and practices are reasonably likely to have a material adverse effect on the company. The UK introduced legislation in November 2009 to give it the powers to implement the relevant FSB Principle and Standard on disclosure and the relevant recommendations of an independent review of corporate governance Standards (Walker review). Notwithstanding local jurisdictional issues, all FSB members are expected to implement disclosure standards that meet the higher of national or FSB standards.

It should be noted that the International Organization of Securities Commissions (IOSCO) issued in February 2010 a set of *Principles for Periodic Disclosure by Listed Entities* that provide for annual disclosures to help investors to assess the incentives created by compensation and risk management practices, whether the incentives of the compensation are aligned with investors' interests and how performance may be oriented to the returns generated for shareholders. These principles apply to all listed companies.

2. Industry progress to date

Members generally note that material changes have taken place in the compensation practices of financial institutions in their jurisdictions. Significant financial firms have engaged in major reviews of their compensation practices and are introducing substantial changes, though some are farther along in the process than others. Overall, practices remain diverse and are evolving, with new bodies of practice being developed, particularly in the area of pay structures. Thus, many agree that this is work in progress and it is too early to assess how effectively the Principles and Standards, and the respective national rules, are delivering change in the industry.

From a practical standpoint, some of the Principles and Standards, and national rules, will be hard to test immediately. For example, institutions could have a malus policy in place but they may not have had to use it yet. Annual compensation reviews as required under Standard 1 are yet to be completed in most cases, while improvements in the public disclosure of compensation will only be tested, in a majority of jurisdictions, in approximately one year.

Progress to date can be broken down in the three main areas of governance, risk-alignment and disclosure.

Firms are moving fairly quickly to improve their corporate governance practices that relate to compensation:

- Compensation committees of boards are paying more attention to risk incentives and to compensation arrangements for employees below the senior executive level. Many firms have restated compensation policies to embed a clear link with risk appetite and firms' performance.
- The composition of compensation committees has been modified to increase the involvement of control functions, including through cross-membership between the compensation and board risk committees.
- Risk management has become more involved in compensation design and the decision-making process related to compensation outcomes. Many institutions have formalised interactions between the compensation committee and the risk function or risk committee.
- Compensation programmes for control function staff have been changed to ensure they are not based on business unit financial results (for instance, if financial metrics are used it would be based on bank-wide results rather than business unit results).
- Many firms have created specific monitoring processes to test the resilience of proposed compensation changes before implementation, and control the impact of new policies after implementation to identify and correct possible adverse incentives.

On risk-alignment, many banks are still in the process of considering how their compensation systems can better adjust for all material risks. Evidence from some large institutions suggests that risk is playing a greater role in both the design of remuneration schemes as well in actual decisions. Various approaches are being taken to adjust for risk. Some firms have developed a high-level, subjective overview of how their bonus pools are adjusted for risk, with board compensation committees using their discretion to risk-adjust compensation if need be. Other firms have started to apply a more formulaic approach, such as risk-adjusted rates of return on economic capital or economic profit measures. Most firms do not explicitly take into account long tail risks and whilst some firms try to account for the potential future impact within their bonus pools by making additional "provisions" against uncertain and illiquid revenue streams, there are few firms who actually adjust future bonus pools for the retrospective performance of an area or division. Additionally, few firms calculate and risk-adjust their bonus pool much below the divisional level. Overall, there is much room for improvement in this area, including on risk-based funding. Other areas where it is perceived that more needs to be done include linking the determination of the total discretionary compensation pool to capital planning processes;[17] and developing mechanisms for the funding of deferred compensation, notably as regards the impact of unfunded deferrals on earnings volatility and shareholder dilution.

More progress is taking place in the area of performance-adjusted deferrals (malus arrangements). Pay structures and payout arrangements have focused a lot of the firms' efforts in 2009. While a few firms in the major financial centres were already in line with the newly introduced rules or guidance, especially for top earners, others have also been redesigning their deferral arrangements to meet the new rules and supervisory expectations. In particular, many firms have increased the proportion of deferred compensation, lengthened the deferral period and expanded the share of employees eligible for deferrals (e.g., based on seniority levels and/or bonus amounts). Many firms are in the process of designing malus provisions for the deferred amounts,[18] although existing mechanisms appear to be primarily applied to equity awards, while cash deferrals at-risk remain relatively less common. Increased portions of deferred compensation at risk and longer deferrals have been accompanied, in some cases, by base salary raises – partly justified by the need to increase true bonus flexibility. In some jurisdictions, deferral arrangements (e.g., Turkey) and malus mechanisms (e.g., Indonesia, Saudi Arabia, Spain) are uncommon, although they are currently under consideration.

The trend in the industry appears to be towards a more varied mix of payment instruments than in the past – from the predominant use of cash, equity and options to an increased use of equity-linked instruments – though information on the latter is limited at this stage. In several jurisdictions, senior staff and those with larger variable compensation continue to receive a significant proportion of compensation in the form of equity. Equity or equity-linked instruments are not currently used as part of variable compensation in a number of jurisdictions (e.g., China).

There are clear signs that firms are beginning to tighten their approach to guaranteed bonuses – upon both entry and termination. The majority of the industry appears to have abandoned

[17] It should be noted that the current proposals put forth by the Basel Committee in the December 2009 consultation paper on the capital conservation buffer include constraints imposed on distributions when capital levels fall within this range, which include restrictions on discretionary bonus payments to staff.

[18] Performance mechanisms for at-risk deferrals include value adjustments – where mark-ups and mark-downs are applied to future payouts based on firm and/or business unit performance; and binary payments – where minimum firm and/or business unit targets returns need to be reached for pre-agreed deferred compensation to vest. In both cases, the mechanism is only applicable to future payments of deferred compensation.

multi-year unconditional bonus guarantees and is waiting for existing legacy contractual obligations to lapse. When offered for recruitment purposes, it is becoming more common for entry bonuses to require certain performance targets and/or risk constraints to be met, and rarely extend beyond one year. In some jurisdictions, guaranteed bonuses were not part of banks' compensation programs or have been limited to one year (e.g., Canada, France, Singapore, Spain and Turkey). In Switzerland, multi-year guarantees seem to be extended only in very rare cases, and this is an issue that supervisors will review in greater depth in the months to come.

Tightening of severance pay also appears to be progressing. Financial institutions have started to impose stricter conditions on severance payments offered to top executives ("golden parachutes"), and new contracts now typically exclude guaranteed severance pay provisions.

Improvements are also expected in transparency and disclosure, though for most institutions, annual reports that include the new, more granular compensation information will only become available in the coming months. In response to regulatory changes and political pressure, firms have become more open on communicating on what was previously regarded as sensitive competitive information. Enhanced disclosures are expected, in particular, with regard to coverage of firms, levels of employees and details of remuneration policies. With many extra disclosures not likely to take place until later in 2010 or 2011, credibility about future changes would be enhanced of firms were to make concrete commitments today to the future disclosures that they will make.

Industry other than banking has also engaged with regulators (e.g., France) to develop standards inspired from FSB ones but adapted to specificities of non banking sectors, such as asset management.

3. Recommended next steps

National authorities and the major financial firms have made material progress in implementing the Principles and Standards, as described in the previous sections. As a result, there is evidence that industry practices, overall, are changing in the right direction. At the same time, this is in many cases work in progress and there are gaps, differences in approaches and technical difficulties that will require time and efforts to be resolved. Authorities and firms will have to address these challenges.

Authorities and firms should maintain momentum in the implementation of the Principles and Standards.

National authorities are at different stages in their implementation of the Principles and Standards. In some jurisdictions, regulatory initiatives on compensation had pre-dated the crisis, but requirements were from a code of conduct rather than a prudential perspective, and were applicable to all listed companies and not specific to the financial sector. Recent initiatives have therefore focused on ensuring that the right incentives are created for effective risk management, and that excessive risk-taking is avoided.

Most FSB members have adopted an approach to implementing the Principles and Standards based on regulatory requirements, supervisory oversight, or a mix thereof. In several jurisdictions, initiatives have only been launched recently and will be rolled out during 2010; in a few cases, rules or guidance are still in the preparation stage or remain under consideration. Many of these differences are likely to be resolved over time, as supervisors press ahead to assess practices and enforce change, and improved disclosures on industry practices become available.

As noted earlier, the choice between regulatory and supervisory approaches largely depends on national preference. National authorities will have to achieve a robust framework for ensuring compensation policies consistent with prudent risk taking under either one or the other of these developing approaches. Those countries relying on enforceable regulation need to ensure that rules can accommodate the diversity of firms and employees; while those using a supervisory approach will need to ensure that a more flexible approach results in even handed application and firm-level outcomes that are globally consistent and transparent.

***Recommendation 1**: FSB members should finalise and implement regulatory and/or supervisory initiatives related to the Principles and Standards in 2010.*

In addition to the continued rolling out of regulatory and supervisory policies, evidence of strong enforcement of existing rules and guidance would send a strong message to the industry. Supervisors should also see that they have the requisite resources and expertise to oversee the risks associated with compensation practices.

In their regulatory and supervisory efforts to link compensation to the firms' overall control and risk management frameworks, jurisdictions should pay due attention to the underlying quality of these frameworks, which are the first line of defence against excessive risk-taking.

The risk alignment of compensation will only be as good as the underlying risk controls and risk management systems.

Recommendation 2: *Firms should continue to make progress on risk and performance alignment of compensation schemes through 2010 and beyond. This would include the ability to demonstrate how their compensation schemes incorporate risk adjustments.*

Among other issues, and as noted in the Principles and emphasised by a number of FSB members, “golden handshake” payments that reimburse unvested compensation foregone at the employee’s predecessor firm may be problematic and should be discouraged. Such practices may weaken the incentive effects of deferred compensation structures by removing the employee’s exposure to risk outcomes. While firms may not be in a position to alter the hiring practices of other firms, they should consider the impact of the buy-out problem on their efforts to constrain excessive risk taking by employees, and if necessary make changes to their incentive compensation policies to minimise the problem, including but not limited to a greater focus on ex-ante adjustments.

Authorities' exchange of information and cooperation on matters related to compensation should be improved.

National requirements on compensation typically apply not only to national firms at the consolidated group level, but also to foreign affiliates and branches operating within the jurisdiction. Because labour markets are largely local, host country supervisors have an interest in controlling compliance with local rules, on top of the home country supervisors’ responsibility for controlling compliance at the consolidated group level. These home-host issues can be significant, and international banks have emphasised the difficulties – and compliance costs – that arise as a result of differences in home and host requirements. This emphasises the importance of further convergence, but also of systematic engagement of both home and host supervisors and cross-border supervisory cooperation in this area – notably through supervisory college arrangements, but also on an industry-wide level, to assure greater consistency across firms. Indications are that, to date, cross-border communication between supervisors across the major financial centres on compensation issues has worked unevenly and that it is necessary that supervisory exchange of information on compensation practices at significant financial institutions improves.

Home supervisors should, in accordance with international supervisory standards, supervise financial institutions on a consolidated basis, applying compensation rules on a group-wide basis and adequately monitoring for compliance. Host supervisors, as part of their supervisory review process, should review compensation structures of foreign affiliates and branches and raise any instances of inappropriate compensation practices with home supervisors.

Recommendation 3: *International colleges of supervisors should enhance information exchange and cooperation on compensation issues and practices at significant, cross-border financial institutions. Risk management (including as needed compensation practices) should be a standing agenda item in the supervisory colleges.*

Issues and trends related to compensation practices that arise in college discussions should be brought as appropriate to the attention of the Basel Committee and contribute to its work towards greater convergence in this area (see Recommendation 7 below).

Recommendation 4*: Where a jurisdiction hosts a number of significant institutions from another jurisdiction with substantial activity, relevant supervisors should bilaterally coordinate to ensure consistency of approach across firms.*

Authorities should work towards greater regulatory and supervisory coverage of significant financial institutions that are not banks, consistent with the scope of application of the FSB Principles and Standards.

There is significant diversity in the sectoral coverage of financial institutions under existing regulatory and supervisory initiatives on compensation across the FSB membership. While nonbank financial institutions are generally covered to the extent that they are part of a banking group (on which regulations and supervision apply at the consolidated level), the treatment of significant financial institutions that are not part of a banking group – potentially including insurance and pension funds, asset management companies (including hedge fund operators) and investment firms – is uneven across jurisdictions, though these firms can have different risk and incentive structures.

Recommendation 5: *FSB members should work to ensure that all significant financial institutions across the financial services sector in their jurisdiction (as identified by the relevant national authorities), irrespective of their legal form, follow sound compensation practices.*

Consistent with the approach taken by the Principles and Standards, the scope of application of national initiatives should encompass all significant financial institutions. While the exact scope – and choice of institutions that are "significant" – will depend on national circumstances, there should be an expectation that this covers all large, cross-border, systemically important financial institutions.

Authorities should continue to monitor how changes in firms' governance effectively deliver strengthened board oversight of compensation processes.

In the area of governance, there has been significant progress in many jurisdictions in terms of rule-making, though it is too early to assess whether the new requirements, which are procedural in nature, will lead to effective and sustained improvements in the governance of compensation processes and ultimately to improved compensation practices.

A major challenge for firms in this area remains available expertise – ensuring that board-level compensation committees have the appropriate level of experience and expertise on compensation policies and practices in general, and on the incentives created for managing risk, capital and liquidity in particular. Industry participants have cited the limited pool of directors with the requisite expertise to serve on compensation committees as well as increased expectations on and accountability of board members as key challenges to efforts to strengthen compensation committees.

Recommendation 6: *Supervisors should actively check that the composition of compensation committees meets appropriate standards of expertise and of independence.*

Authorities should develop guidance to promote greater convergence of practices in the area of risk alignment and payout structures.

Most FSB members have incorporated in their regulatory and/or supervisory frameworks the requirement that compensation be aligned with prudent risk-taking, though differences remain in approach, emphasis and degree of detail. Ex ante risk adjustment at the level of firms, business units and individuals is an area where best practices are yet to emerge and where there is significant room for improvement. Partly as a result, a lot of the supervisory focus to date has been on payout structures and schedules (e.g., the incorporation of at-risk deferrals), and less so on the ex ante risk adjustment of bonus awards.

Industry participants note the need for further convergence in payout structures and schedules, especially as concerns performance-adjusted deferred payments (at-risk deferrals or malus arrangements) and the instrument mix (cash versus non-cash). Because remuneration structures are used by firms as competitive tools to hire and retain key staff, there is extreme sensitivity in the industry about the uneven application of rules in this area. Additional steps by national authorities to converge rules and develop guidance in this area are necessary to address competitive challenges in the industry – especially from the key competitors within the regulated sector.[19]

In the absence of leadership from the official sector in fine-tuning principles and clarifying guidance, there is a risk that practices in this area will be slow to emerge and fail to converge substantially. Supervisors, working through the Basel Committee, should support at the technical level the development of sound practices on risk adjustment – both ex ante and ex post – ahead of the next compensation review. Over time, this may also lead to greater reliance by firms and greater focus by supervisors on ex ante risk adjustments.

As progress is made on the risk adjustment of bonus pools and the enhancements to the Basel capital framework are concluded, it will be possible to draw up more precise supervisory guidance to operationalise the link between compensation and capital planning.

Recommendation 7: *The Basel Committee should develop for consultation by the end of October 2010 a report on the range of methodologies for risk and performance alignment of compensation schemes and their effectiveness in light of experience to date. It should cover the following areas:*

[19] While the risk of regulatory arbitrage and competition for talent from the unregulated sector exists, this appears to have been overplayed. For instance, performance- and risk-adjustments and malus arrangements have been common practice in the hedge fund industry for some time.

(i) *methods for incorporating risk into the bonus pool and individual compensation;*

(ii) *the design of deferred compensation, such as adequate performance measures; the relation between performance measures and ultimate value of deferred compensation instruments; malus triggers; the sensitivity of payout schedules to the time horizon of risks; and the funding of deferrals; and*

(iii) *proportionality in the application of rules, taking into account the size and complexity of the institutions, business models and risk tolerance.*

This report could be used as a basis for guidance.

The issue of proportionality is especially important in jurisdictions that have elected to apply the Principles and Standards to all financial institutions, as well as in jurisdictions whose domestic financial institutions tend to be relatively smaller and are not internationally active.

Authorities should review and, where necessary, strengthen disclosure requirements for compensation with a view to achieving greater convergence in practices.

Many jurisdictions have introduced, or are about to introduce, enhanced disclosure requirements for compensation in significant financial institutions. In addition, the enhancements to Basel II introduced in July 2009 incorporated within Pillar 2 a requirement from the FSB Principles that firms disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders, including in particular shareholders. As a result, significantly more information is now expected, and firms have been more open to communicating, on what was previously regarded as "sensitive competitive information." At the same time, most financial institutions are yet to produce such enhanced disclosures, hence it is too early to draw detailed conclusion on the effectiveness of the Principles and Standards and the respective national rules in this area. As such disclosures become available, authorities should review them to ensure that the information disclosed allows investors to make meaningful assessments and is not excessive or non-specific.

As comparability of disclosures is a precondition for effective insight into the changes taking place in the industry, more convergence could be helpful. Existing disclosure requirements across jurisdictions point to some differences that may hamper the comparability of the disclosed facts and therefore the effectiveness of disclosure as a whole. It may be necessary to explore how disclosure standards can be better aligned across jurisdictions, thereby enhancing local rules.

Recommendation 8: *The Basel Committee in consultation with the FSB should consider incorporating disclosure requirements for compensation into Pillar 3 of Basel II, to add greater specificity to the current requirements for compensation disclosure under Pillar 2, by the end of 2010*.

The FSB should continue to monitor progress towards implementation of the Principles and Standards and conduct another thematic review on compensation in a year's time.

Recommendation 9: *The FSB should conduct a follow-up review on compensation in the second quarter of 2011, to assess the impact to date of measures put in place by jurisdictions and the progress in industry compliance with the Principles and Standards and the respective national rules.*

In the coming months, pressure will need to be maintained both nationally and internationally towards the effective implementation of the Principles and Standards, and to ensure continued progress by firms.

To this end, a follow-up review should be conducted in a year's time across the FSB membership to assess the impact of measures put in place by jurisdictions and how firms' practices have changed in response to the Principles and Standards and national initiatives. This review should be timed to allow for sufficient information to be available – including through the firms' own disclosures – from which to evaluate change and the impact of authorities' measures. Because, for many large financial institutions, annual compensation disclosures take place during the first quarter or at the beginning of the second quarter each year, a suitable timing for such review would be the second quarter of 2011. At the same time, it should be recognised that while practices are expected to be well advanced by the time of the next review, they are likely to be still evolving.

Recommendation 10: *To support this review, the FSB, working through its members, should develop criteria for use by the review team in assessing progress towards implementation of the Principles and Standards.*

By the beginning of work on the follow-up review, the FSB, working through its members, should develop criteria for use in the follow-up review. The criteria should recognise the variety of compensation designs that may meet the objectives and benchmarks of the Principles and Standards, and take account of the specific characteristics of all significant financial institutions – both banks and nonbanks.

Annex A

Status of national implementation

The table below provides a preliminary snapshot of implementation initiatives in FSB member jurisdictions. The table does not provide an assessment of the degree of compliance with the particular Principle or Standard, rather an indication of whether regulatory or supervisory initiatives are underway to implement a Principle or Standard (or elements thereof);[20] initiatives are at the preparatory stage (i.e., regulation or supervisory guidance being drafted or under consultation); under consideration; or not currently underway. The table was developed by the FSB Secretariat based on the responses to the template provided by members, and national entries have been checked for accuracy by the relevant authorities.

The Principles and Standards are listed in the order followed in the compensation review template (Annex B). For the full text of the Principles and Standards, see Annexes C–D.

	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
Effective governance of compensation																								
P1	IP	R	IP	S	S	R	R	S	R	IP	R	S	S	IP	R	S	R	R	IP	S	R	IP	R	R
P2	IP	R	IP	S	S	R	R	S	R	IP	R	S	S	IP	R	S	R	S	IP	S	R	IP	R	S
S1	IP	R	IP	S	S	R	R	S	UC	IP	R	S	S	IP	R	S	R	R	IP	S	R	IP	R	R
P3	IP	R	IP	S	S	R	R	S	UC	IP	R	S	S	IP	S	R	R	R	IP	S	R	IP	R	S
S2	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	S	S	R	R	IP	S	R	IP	R	S
Effective alignment of compensation with prudent risk taking																								
P4	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	R	IP	S	R	IP	R	S
S3	IP	R	IP	S	S	R	IP	S	UC	UC	R	S	S	IP	S	UC	R	R	IP	S	R	IP	S	R
S4	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	S	UC	R	S	IP	S	R	IP	R	S
P5	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
S5	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S

[20] As stated elsewhere in this report, effective implementation of the Principles and Standards can be achieved through a variety of approaches, including different mixes of regulation and supervisory oversight.

	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
P6	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
S6	IP	S	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
S7	IP	S	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
P7	IP	S	IP	S	IP	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	S	S
S8	IP	S	IP	S	IP	R	R	S	UC	UC	S	S	S	IP	IP	UC	R	S	IP	S	R	IP	UC	S
S9	IP	S	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
S11	IP	S	IP	S	S	R	R	S	UC	UC	S	S	S	IP	R	UC	R	S	IP	S	R	IP	S	S
S12	IP	S	IP	S	S	R[i]	R	S	UC	UC	R	S	S	IP	IP	UC	R	S	IP	S	R	IP	S	S
S14	IP	S	NA	S	S	R	R	S	UC	UC	R	S	S	IP	IP	UC	S	IP	IP	S	UC	IP	NA	UC
Effective supervisory oversight and engagement by shareholders																								
P8	IP	S	IP	S	S	R	S	S	UC	S	S	S	S	IP	S	S	S	S	IP	S	R	IP	S	S
S10	IP	NA	IP	UC	S	R	R	R	UC	R	R	R	S	IP	R[ii]	R	R	R	NA	UC	R	R	R	R
S13	IP	S	IP	S	S	R	R	S	UC	UC	R	S	S	IP	S	S	S	S	IP	S	S	IP	S	S
S16	IP	S	IP	S	S	R	S	S	UC	S	S	S	S	IP	S	S	S	S	IP	S	S	IP	S	S
S17	IP	R	IP	S	S	R	R	S	UC	UC	S	S	S	IP	R	S	S	S	IP	S	R	IP	S	S
S18	IP	S	IP	S	S	R	R	S	UC	UC	S	S	S	IP	S	S	R	S	IP	S	R	IP	R	S
P9	IP	R	IP	S	S	R	R	S	UC	R	R	R	S	IP	R	R	R	S	IP	S	R	IP	R	R
S15	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	R	R	IP	IP	S	R	IP	IP	R

Legenda: R – regulatory approach (including applicable laws, regulations, and a mix of both regulation and supervisory oversight); S – supervisory approach (including supervisory guidance and/or oversight); IP – initiatives under preparation; UC – initiatives under consideration; NA – not addressed or not relevant. *(S19 not included.)*

Acronyms: AR – Argentina; AU – Australia; BR – Brazil; Ca – Canada; CN – China; FR – France; DE – Germany; HK – Hong Kong; IN – India; ID – Indonesia; IT – Italy; JP – Japan; KR – Korea; MX – Mexico; NL – Netherlands; RU – Russia; SA – Saudi Arabia; SG – Singapore; ZA – South Africa; ES – Spain; CH – Switzerland; TR –Turkey; UK – United Kingdom; US – United States.

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i Regulation applies only for corporate executives but not for market operators.

ii The provision is laid down in an agreement between the government and the financial sector.

Annex B

Thematic review on compensation: review template

This template guides member jurisdictions in providing input for the thematic review on the implementation of the UU[FSB Principles for Sound Compensation Practices]() and [Implementation Standards](). The template is structured in two parts:

- *general questions on the overall approach and scope of application of the Principles and Standards in each member jurisdiction; and*
- *a template on progress being made by firms and national authorities with respect to each element of the Principles and Standards, and planned next steps.*

Member jurisdictions are kindly requested to return the completed template to the FSB secretariat (fsb@bis.org; tel. +41 61 280-8080) by 25 January 2010.

I. General questions

- Do significant financial institutions in your jurisdiction make material use of incentives-based compensation (variable compensation, or bonuses)? Please explain, for instance in terms of an estimate of the fraction of variable-to-fixed compensation, on average, for relevant employee categories (i.e., executives, senior management, other risk takers) and by type of financial activity (e.g., investment banking, commercial banking, other).
- What is your jurisdiction's overall approach to implementing the Principles and Standards? Please specify whether legislative, regulatory, supervisory or the specific mix. How is compliance checked and enforced?
- How many financial institutions (domestic, foreign) operating in your jurisdiction are required to conform to the Principles and Standards or the respective national rules? Please specify the number of such institutions, their sector of activities (e.g., banking, insurance) and the share of the relevant market segment they represent. What is your process to determine which financial institutions are required to conform to the Principles and Standards?
- Do the measures taken to implement the Principles and Standards apply at the group level for institutions headquartered in you jurisdiction? Do they also apply to foreign affiliates (and branches) operating in your jurisdiction?
- What categories of employees do the measures taken in your jurisdiction to implement the Principles and Standards apply to?
- How much supervisory activity (e.g., policy frameworks, engagement with individual firms, information collection on firms' practices) with respect to the Principles and Standards has occurred in the jurisdiction? How much is planned during 2010 and what are the priorities? For instance, of the number of relevant financial institutions noted above, what fraction has experienced a supervisory review of compensation practices? What fraction will undergo one by end-2010?
- Has the adoption of the Principles and Standards led to any material changes to date in the compensation practices of financial institutions operating in your jurisdiction? Please provide supporting information (see also template below).
- Are there any unexpected implementation issues that have been encountered to date?

II. Review template

Please provide in the table below a detailed description of the steps being taken in your jurisdiction to ensure effective application of the FSB Principles and Standards and the evidence about whether the Principles have been or are being implemented by firms. The table maps Standards to the relevant Principles following the approach of the Basel Committee Compensation Assessment Methodology.

Insofar as possible and relevant, the description should include information on (i) relevant laws and regulations, including major tax provisions, as applicable, and those that are being planned and their expected timeframe; (ii) supervisory tools and activities, including those that are being planned and their expected timeframe; and (iii) current evidence of implementation by financial firms, including gaps identified by the supervisory authority and firms' action plans to address them.

Please ensure answers are brief and respond directly to the points made in the Principles and Standards. Where the answer is a negative, or not known, please say so. Where there is a degree of overlap, and your answer is adequately adequately covered in another response, a cross reference is encouraged.

a. Effective governance of compensation

Principle 1.	The firm's board of directors must actively oversee the compensation system's design and operation. The compensation system should not be primarily controlled by the chief executive officer and management team. Relevant board members and employees must have independence and expertise in risk management and compensation.
Steps taken to date	
Actions planned	
Firms' evidence	
Principle 2.	The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended. The compensation system should include controls. The practical operation of the system should be regularly reviewed for compliance with design policies and procedures. Compensation outcomes, risk measurements, and risk outcomes should be regularly reviewed for consistency with intentions.
Steps taken to date	
Actions planned	
Firms' evidence	
Standard 1.	Significant financial institutions should have a board remuneration committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation on behalf of the board of directors. The remuneration committee should: ▪ be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives created for managing risk, capital and liquidity. In addition, it should carefully evaluate practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain. In so doing, it should demonstrate that its decisions are consistent with an assessment of the firm's financial condition and future prospects; ▪ to that end, work closely with the firm's risk committee in the evaluation of the incentives created by the compensation system; ▪ ensure that the firm's compensation policy is in compliance with the FSB Principles and Standards as well as complementary guidance by the Basel Committee, IAIS and

	IOSCO, and the respective rules by national supervisory authorities; and ▪ ensure that an annual compensation review, if appropriate externally commissioned, is conducted independently of management and submitted to the relevant national supervisory authorities or disclosed publicly. Such a review should assess compliance with the FSB Principles and Standards or applicable standards promulgated by national supervisors.
Steps taken to date	
Actions planned	
Firms' evidence	
Principle 3.	Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm. Effective independence and appropriate authority of such staff are necessary to preserve the integrity of financial and risk management's influence on incentive compensation.
Steps taken to date	
Actions planned	
Firms' evidence	
Standard 2.	For employees in the risk and compliance function: ▪ remuneration should be determined independently of other business areas and be adequate to attract qualified and experienced staff; ▪ performance measures should be based principally on the achievement of the objectives of their functions.
Steps taken to date	
Actions planned	
Firms' evidence	

b. Effective alignment of compensation with prudent risk-taking

Principle 4.	Compensation must be adjusted for all types of risk. Two employees who generate the same short-run profit but take different amounts of risk on behalf of their firm should not be treated the same by the compensation system. In general, both quantitative measures and human judgment should play a role in determining risk adjustments. Risk adjustments should account for all types of risk, including difficult-to-measure risks such as liquidity risk, reputation risk and cost of capital.
Steps taken to date	
Actions planned	
Firms' evidence	
Standard 3.	Significant financial institutions should ensure that total variable compensation does not limit their ability to strengthen their capital base. The extent to which capital needs to be built up should be a function of a firm's current capital position. National supervisors should limit variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.
Steps taken to date	
Actions planned	
Firms' evidence	

Standard 4.	For significant financial institutions, the size of the variable compensation pool and its allocation within the firm should take into account the full range of current and potential risks, and in particular: ▪ the cost and quantity of capital required to support the risks taken; ▪ the cost and quantity of the liquidity risk assumed in the conduct of business; and ▪ consistency with the timing and likelihood of potential future revenues incorporated into current earnings.
Steps taken to date	
Actions planned	
Firms' evidence	
Principle 5.	Compensation outcomes must be symmetric with risk outcomes. Compensation systems should link the size of the bonus pool to the overall performance of the firm. Employees' incentive payments should be linked to the contribution of the individual and business to such performance. Bonuses should diminish or disappear in the event of poor firm, divisional or business unit performance.
Steps taken to date	
Actions planned	
Firms' evidence	
Standard 5.	Subdued or negative financial performance of the firm should generally lead to a considerable contraction of the firm's total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.
Steps taken to date	
Actions planned	
Firms' evidence	
Principle 6.	Compensation payout schedules must be sensitive to the time horizon of risks. Profits and losses of different activities of a financial firm are realized over different periods of time. Variable compensation payments should be deferred accordingly. Payments should not be finalized over short periods where risks are realized over long periods. Management should question payouts for income that cannot be realized or whose likelihood of realisation remains uncertain at the time of payout.
Steps taken to date	
Actions planned	
Firms' evidence	
Standard 6.	For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm: ▪ a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance; ▪ a substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years; and ▪ these proportions should increase significantly along with the level of seniority and/or responsibility. For the most senior management and the most highly paid employees, the percentage of variable compensation that is deferred should be substantially higher, for instance above 60 percent.
Steps taken to date	
Actions planned	

Firms’ evidence	
Standard 7.	The deferral period described above should not be less than three years, provided that the period is correctly aligned with the nature of the business, its risks and the activities of the employee in question. Compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis.
Steps taken to date	
Actions planned	
Firms’ evidence	
Principle 7.	The mix of cash, equity and other forms of compensation must be consistent with risk alignment. The mix will vary depending on the employee’s position and role. The firm should be able to explain the rationale for its mix.
Steps taken to date	
Actions planned	
Firms’ evidence	
Standard 8.	A substantial proportion, such as more than 50 percent, of variable compensation should be awarded in shares or share-linked instruments (or, where appropriate, other non-cash instruments), as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk. Awards in shares or share-linked instruments should be subject to an appropriate share retention policy.
Steps taken to date	
Actions planned	
Firms’ evidence	
Standard 9.	The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually. In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line.
Steps taken to date	
Actions planned	
Firms’ evidence	
Standard 11.	Guaranteed bonuses are not consistent with sound risk management or the pay-for-performance principle and should not be a part of prospective compensation plans. Exceptional minimum bonuses should only occur in the context of hiring new staff and be limited to the first year.
Steps taken to date	
Actions planned	
Firms’ evidence	
Standard 12.	Existing contractual payments related to a termination of employment should be re-examined, and kept in place only if there is a clear basis for concluding that they are aligned with long-term value creation and prudent risk-taking; prospectively, any such payments should be related to performance achieved over time and designed in a way that does not reward failure.
Steps taken to date	
Actions planned	
Firms’ evidence	

Standard 14.	Significant financial institutions should demand from their employees that they commit themselves not to use personal hedging strategies or compensation- and liability-related insurance to undermine the risk alignment effects embedded in their compensation arrangements. To this end, firms should, where necessary, establish appropriate compliance arrangements.
Steps taken to date	
Actions planned	
Firms' evidence	

c. *Effective supervisory oversight and engagement by stakeholders*

Principle 8.	Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action. Supervisors should include compensation practices in their risk assessment of firms, and firms should work constructively with supervisors to ensure their practices conform with the Principles. Regulations and supervisory practices will naturally differ across jurisdictions and potentially among authorities within a country. Nevertheless, all supervisors should strive for effective review and intervention. National authorities, working through the FSF, will ensure even application across domestic financial institutions and jurisdictions.
Steps taken to date	
Actions planned	
Standard 10.	In the event of exceptional government intervention to stabilise or rescue the firm: ▪ supervisors should have the ability to restructure compensation in a manner aligned with sound risk management and long-term growth; and ▪ compensation structures of the most highly compensated employees should be subject to independent review and approval.
Steps taken to date	
Actions planned	
Standard 13.	Significant financial institutions should take the steps necessary to ensure immediate, prospective compliance with the FSB Standards and relevant supervisory measures.
Steps taken to date	
Actions planned	
Standard 16.	Supervisors should ensure the effective implementation of the FSB Principles and Standards in their respective jurisdiction.
Steps taken to date	
Actions planned	
Standard 17.	In particular, they should require significant financial institutions to demonstrate that the incentives provided by compensation systems take into appropriate consideration risk, capital, liquidity and the likelihood and timeliness of earnings.
Steps taken to date	
Actions planned	
Standard 18.	Failure by the firm to implement sound compensation policies and practices that are in line with these standards should result in prompt remedial action and, if necessary, appropriate corrective measures to offset any additional risk that may result from non-compliance or partial compliance, such as provided for under national supervisory frameworks or Pillar 2 of the Basel II capital framework.

Steps taken to date	
Actions planned	
Standard 19.	Supervisors need to coordinate internationally to ensure that these standards are implemented consistently across jurisdictions.
Steps taken to date	
Actions planned	
Principle 9.	Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders. Stakeholders need to be able to evaluate the quality of support for the firm's strategy and risk posture. Appropriate disclosure related to risk management and other control systems will enable a firm's counterparties to make informed decisions about their business relations with the firm. Supervisors should have access to all information they need to evaluate the conformance of practice to the Principles.
Steps taken to date	
Actions planned	
Firms' evidence	
Standard 15.	An annual report on compensation should be disclosed to the public on a timely basis. In addition to any national requirements, it should include the following information: ▪ the decision-making process used to determine the firm-wide compensation policy, including the composition and the mandate of the remuneration committee; ▪ the most important design characteristics of the compensation system, including criteria used for performance measurement and risk adjustment, the linkage between pay and performance, deferral policy and vesting criteria, and the parameters used for allocating cash versus other forms of compensation; ▪ aggregate quantitative information on compensation, broken down by senior executive officers and by employees whose actions have a material impact on the risk exposure of the firm, indicating: – amounts of remuneration for the financial year, split into fixed and variable compensation, and number of beneficiaries; – amounts and form of variable compensation, split into cash, shares and share-linked instruments and other; – amounts of outstanding deferred compensation, split into vested and unvested; – the amounts of deferred compensation awarded during the financial year, paid out and reduced through performance adjustments; – new sign-on and severance payments made during the financial year, and number of beneficiaries of such payments; and – the amounts of severance payments awarded during the financial year, number of beneficiaries, and highest such award to a single person.
Steps taken to date	
Actions planned	
Firms' evidence	

Annex C

FSF Principles for Sound Compensation Practices[21]

The FSF Principles for Sound Compensation Practices aim to ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation. The benefits of sound compensation practices will be achieved only if there is determined and coordinated action by national regulators, facilitated if necessary by suitable legislative powers and supported by national governments.

Effective governance of compensation

The board of directors of major financial firms should exercise good stewardship of their firms' compensation practices and ensure that 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 organisation.

1. **The firm's board of directors must actively oversee the compensation system's design and operation.** The compensation system should not be primarily controlled by the chief executive officer and management team. Relevant board members and employees must have independence and expertise in risk management and compensation.
2. **The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.** The compensation system should include controls. The practical operation of the system should be regularly reviewed for compliance with design policies and procedures. Compensation outcomes, risk measurements, and risk outcomes should be regularly reviewed for consistency with intentions.
3. **Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.** Effective independence and appropriate authority of such staff are necessary to preserve the integrity of financial and risk management's influence on incentive compensation.

Effective alignment of compensation with prudent risk taking

An employee's compensation should take account of the risks that the employee takes on behalf of the firm. Compensation should take into consideration prospective risks and risk outcomes that are already realised.

[21] The full text of the Principles is at http://www.financialstabilityboard.org/publications/r_0904b.pdf

4. **Compensation must be adjusted for all types of risk.** Two employees who generate the same short-run profit but take different amounts of risk on behalf of their firm should not be treated the same by the compensation system. In general, both quantitative measures and human judgment should play a role in determining risk adjustments. Risk adjustments should account for all types of risk, including difficult-to-measure risks such as liquidity risk, reputation risk and cost of capital.
5. **Compensation outcomes must be symmetric with risk outcomes.** Compensation systems should link the size of the bonus pool to the overall performance of the firm. Employees' incentive payments should be linked to the contribution of the individual and business to such performance. Bonuses should diminish or disappear in the event of poor firm, divisional or business unit performance.
6. **Compensation payout schedules must be sensitive to the time horizon of risks.** Profits and losses of different activities of a financial firm are realized over different periods of time. Variable compensation payments should be deferred accordingly. Payments should not be finalized over short periods where risks are realized over long periods. Management should question payouts for income that cannot be realized or whose likelihood of realisation remains uncertain at the time of payout.
7. **The mix of cash, equity and other forms of compensation must be consistent with risk alignment.** The mix will vary depending on the employee's position and role. The firm should be able to explain the rationale for its mix.

Effective supervisory oversight and engagement by stakeholders

Firms should demonstrate to the satisfaction of their regulators and other stakeholders that their compensation policies are sound. As with other aspects of risk management and governance, supervisors should take rigorous action when deficiencies are discovered.

8. **Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.** Supervisors should include compensation practices in their risk assessment of firms, and firms should work constructively with supervisors to ensure their practices conform with the Principles. Regulations and supervisory practices will naturally differ across jurisdictions and potentially among authorities within a country. Nevertheless, all supervisors should strive for effective review and intervention. National authorities, working through the FSF, will ensure even application across domestic financial institutions and jurisdictions.
9. **Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.** Stakeholders need to be able to evaluate the quality of support for the firm's strategy and risk posture. Appropriate disclosure related to risk management and other control systems will enable a firm's counterparties to make informed decisions about their business relations with the firm. Supervisors should have access to all information they need to evaluate the conformance of practice to the Principles.

FSB Principles for Sound Compensation Practices Implementation Standards[22]

Governance

1. Significant financial institutions should have a board remuneration committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation on behalf of the board of directors. The remuneration committee should:
   - be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives created for managing risk, capital and liquidity. In addition, it should carefully evaluate practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain. In so doing, it should demonstrate that its decisions are consistent with an assessment of the firm's financial condition and future prospects;
   - to that end, work closely with the firm's risk committee in the evaluation of the incentives created by the compensation system;
   - ensure that the firm's compensation policy is in compliance with the FSB Principles and standards as well as complementary guidance by the Basel Committee, IAIS and IOSCO, and the respective rules by national supervisory authorities; and
   - ensure that an annual compensation review, if appropriate externally commissioned, is conducted independently of management and submitted to the relevant national supervisory authorities or disclosed to shareholders. Such a review should assess compliance with the FSB Principles and standards or applicable standards promulgated by national supervisors.
2. For employees in the risk and compliance function:
   - remuneration should be determined independently of other business areas and be adequate to attract qualified and experienced staff;
   - performance measures should be based principally on the achievement of the objectives of their functions.

Compensation and capital

3. Firms should ensure that total variable compensation does not limit their ability to strengthen their capital base. The extent to which capital needs to be built up should be a function of a firm's current capital position. National supervisors should limit variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.

[22] The full text of the Standards is at http://www.financialstabilityboard.org/publications/r_090925c.pdf

Pay structure and risk alignment

4. The size of the firm's variable compensation pool and its allocation within the firm should take into account the full range of current and potential risks, and in particular:
   - the cost and quantity of capital required to support the risks taken;
   - the cost and quantity of the liquidity risk assumed in the conduct of business; and
   - consistency with the timing and likelihood of potential future revenues incorporated into current earnings.
5. Subdued or negative financial performance of the firm should generally lead to a considerable contraction of the firm's total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.
6. For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm:
   - a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance;
   - a substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years; and
   - these proportions should increase significantly along with the level of seniority and/or responsibility. For the most senior management and the most highly paid employees, the percentage of variable compensation that is deferred should be substantially higher, for instance above 60 percent.
7. The deferral period described above should not be less than three years, provided that the period is correctly aligned with the nature of the business, its risks and the activities of the employee in question. Compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis.
8. A substantial proportion, such as more than 50 percent, of variable compensation should be awarded in shares or share-linked instruments (or for non-listed firms other non-cash instruments), as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk. Awards in shares or share-linked instruments should be subject to an appropriate share retention policy.
9. The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually. In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line.
10. In the event of exceptional government intervention to stabilise or rescue the firm:
    - supervisors should have the ability to restructure compensation in a manner aligned with sound risk management and long-term growth; and
    - compensation structures of the most highly compensated employees should be subject to independent review and approval.

11. Guaranteed bonuses of more than one year are not consistent with sound risk management or the pay-for-performance principle and should not be a part of prospective compensation plans at financial institutions. Other guaranteed minimum bonus-like payments are only to be granted under exceptional circumstances and only in the context of hiring new staff.
12. Existing contractual payments related to a termination of employment should be re-examined, and kept in place only if there is a clear basis for concluding that they are aligned with long-term value creation and prudent risk-taking; prospectively, any such payments should be related to performance achieved over time and designed in a way that does not reward failure.
13. Firms should take the steps necessary to ensure immediate, prospective compliance with the FSB compensation standards and relevant supervisory measures.
14. Firms should demand from their employees that they commit themselves not to use personal hedging strategies or compensation-related insurance to undermine the risk alignment effects embedded in their compensation arrangements. To this end, firms should, where necessary, establish appropriate compliance arrangements.

Disclosure

15. An annual report on compensation should be disclosed to the public on a timely basis. In addition to any national requirements, it should include the following information:
    - the decision-making process used to determine the firm-wide compensation policy, including the composition and the mandate of the remuneration committee;
    - the most important design characteristics of the compensation system, including criteria used for performance measurement and risk adjustment, the linkage between pay and performance, deferral policy and vesting criteria, and the parameters used for allocating cash versus other forms of compensation;
    - aggregate quantitative information on compensation, broken down by senior executive officers and by employees whose actions have a material impact on the risk exposure of the firm, indicating:
        - amounts of remuneration for the financial year, split into fixed and variable compensation, and number of beneficiaries;
        - amounts and form of variable compensation, split into cash, shares and share-linked instruments and other;
        - amounts of outstanding deferred compensation, split into vested and unvested;
        - the amounts of deferred compensation awarded during the financial year, paid out and reduced through performance adjustments;
        - new sign-on and severance payments made during the financial year, and number of beneficiaries of such payments; and
        - the amounts of severance payments awarded during the financial year, number of beneficiaries, and highest such award to a single person.

Supervisory oversight

16. Supervisors should ensure the effective implementation of the FSB Principles and standards in their respective jurisdiction.
17. In particular, they should require firms to demonstrate that the incentives provided by compensation systems take into appropriate consideration risk, capital, liquidity and the likelihood and timeliness of earnings.
18. Failure by the firm to implement sound compensation policies and practices that are in line with these standards should result in prompt corrective action and, if necessary, the appropriate sanctions necessary to offset any additional risk that may result from non-compliance or partial compliance, as provided for under Pillar 2 of the Basel II capital framework.
19. Supervisors need to coordinate internationally to ensure that these standards are implemented consistently across jurisdictions.