OLIVER WYMAN

Financial Services

March 2010

Banking compensation reform
Summary report of progress and challenges commissioned by the Financial Stability Board

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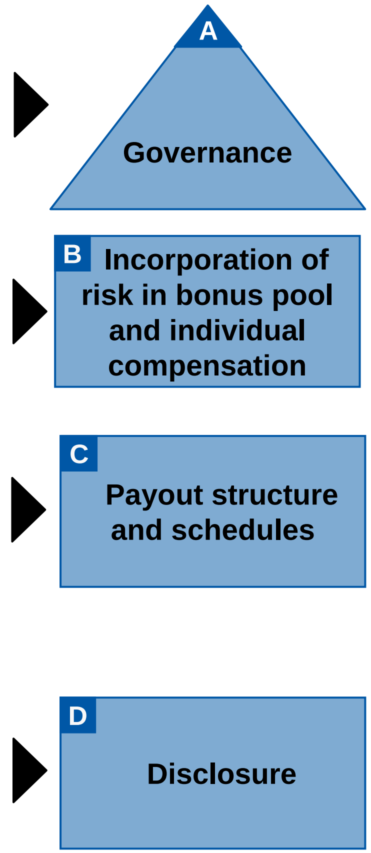
Oliver Wyman was commissioned to provide an independent assessment of issues in the implementation of the FSB’s requirements on compensation, based on an in-depth review of over 20 systemically relevant global firms with material businesses across the Americas, Europe and Asia

FSB key topics	Principles	Standards	Key topics
Governance of compensation	1 to 3	1 and 2	▪ Active board involvement ▪ Control of the compensation process ▪ Involvement of the risk function in compensation ▪ Independence and incentivisation of control functions
Alignment of compensation with prudent risk taking	4 and 5	3 to 5	▪ Risk adjustment of compensation ▪ Protection of appropriate capital position ▪ Bonus pool sizing linked to firm performance and risk profile
	7	6 to 9 11, 12, 14	▪ Alignment of payments schedules with activities’ risk horizon and future performance ▪ Deferral requirements ▪ Use of non-cash instruments ▪ Elimination of unconditional payouts
Supervisory oversight and engagement by stakeholders	8	10, 13 16 to 19	▪ New responsibilities and powers of local supervisors
	9	15	▪ Financial institutions’ quantitative and qualitative disclosure requirements on compensation

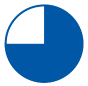
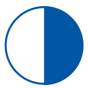


Excluded from the report as covered by the current FSB survey of supervisors

In September 2009, the FSB issued implementation standards, particularly around the payout structures, to level the playing field on compensation

	Key FSB principles	Implementation standards (released Sep 2009)
A Compensation governance	▪ Active Board involvement ▪ Involvement of the risk function ▪ Independence of control functions	▪ Remuneration Committee should involve majority non executives and work closely with the Risk Committee ▪ Remuneration for control staff should be adequate and independent
B1 Bonus pool calculation and funding	▪ Risk adjustment of compensation ▪ Link to group performance ▪ Implications for capital position	▪ Risk adjustments should reflect the cost and quantity of capital consumption as well as the liquidity risk ▪ A firm's financial performance should be reflected in bonus pool sizing ▪ Capital build up to take priority over compensation payouts – regulators to limit bonus payouts when it hinders build out of a sound capital base
B2 Determination of individual compensation	▪ Risk adjustments in bonus allocation ▪ Accountability in performance measurement	▪ No further guidance released in Sep 2009; previous guidance includes – Thorough measurement and stress testing of risk positions – Effective approach capital allocation for the risk exposure – Reliance on expert judgement to sufficiently incorporate opaque risks
C Payout structures and schedules	▪ Link to BU/individual performance ▪ Sensitivity of payouts to future performance ▪ Use of non-cash instruments ▪ No use of unconditional multi-year guaranteed bonuses	Specific guidelines introduced to level the playing field globally ▪ **Mandatory use of payout conditions** (e.g. malus clawbacks) ▪ **40-60% of bonus should be deferred; >60% for the senior-most management** (% should increase with level of pay/seniority) ▪ **At least 3 years deferral period;** should be higher for businesses with a higher risk holding period ▪ **>50% of bonus to be awarded in non-cash instruments**; stock based instruments should be subject to an appropriate vesting policy
D Disclosure	▪ Disclosure requirements	▪ Remuneration Committee should submit an "externally commissioned compensation review" to the regulators and public annually ▪ Detailed description of compensation framework (incl. indicators used for performance measurements and risk adjustments) and quantitative impact of current and deferred compensation required

Considerable progress has been made across the board, but more work needs to be done to ensure full implementation of the FSB recommendations (1 of 2)

Area		Progress status	Specifics
Payout levels **(not explicitly required by the FSB)**		**Firms managing political risk through levels adjustments; limited coherent link to capitalisation**	▪ Selected firms have set caps to 2009 bonuses as a proactive step to assuage political pressure ▪ Focus has been directed onto levels by political and media storm; Implementation of structural changes has been delayed by political uncertainties
Governance		**Most firms have made tangible progress to upgrade governance processes and capabilities** **Some (esp. smaller firms) still poor**	▪ Strengthened Board compensation oversight and expertise – Expanded (or clarified) mandate of remuneration/compensation committee – Improved quality/granularity of compensation data available to the board – Bolstered membership with risk and compensation expertise (challenging) ▪ Experts have frequently been drawn on throughout the last year; more formal annual arrangements now settling down ▪ Reinforcing autonomy of risk and control functions and strengthening links to Board-level committees; links between board committees (remuneration and risk) mostly require resolution ▪ Ensuring payments to risk and control functions are independent of the business areas they oversee ▪ Ex-ante back-testing of new compensation plans; ex-post behaviour monitoring ▪ Surprisingly, a continued absence of strong shareholder challenge
Incorporation of risk in bonus pool and individual compensation		**Core compensation principles adjusted for risk but often not in the finer details** **Further iterations expected after current bonus round**	▪ Economic profit or risk-adjusted performance systematically considered in compensation frameworks; but frameworks remain only as good as the risk measurement (liquidity risk especially missing) ▪ Judgment incorporated as a critical input to compensation via performance "gateways" and other mechanisms ▪ Increasing usage of non-linear payouts to limit extreme outcomes ▪ Implementation of "knock-outs" for risk rule-breaking behaviour at some firms ▪ Very few firms (or regulators) appear to be making coherent link between compensation levels and capital base

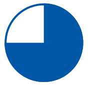
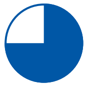
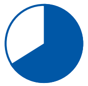
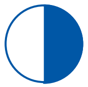
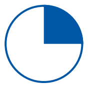
● Industry-wide implementation fully completed ○ Industry-wide implementation not progressed

Considerable progress has been made across the board, but more work needs to be done to ensure full implementation of the FSB recommendations (2 of 2)

Area	Progress status	Specifics
Payout structures and schedules	**Most firms have adopted the principle of payment deferrals, but gamesmanship continues**	▪ Increased deferral amounts and longer vesting periods; default currency appears to have been equity (notwithstanding weaknesses) ▪ Some firms with thoughtful schemes; others appear to be gaming the system with short vesting equity and similar ▪ Many firms placing a portion of deferred compensation at risk contingent on future performance (sometimes, misleadingly, called clawbacks) ▪ Apparent ongoing confusion over personal hedging ▪ Most firms moving to a ban on multi-year guarantees lacking risk adjustments ▪ Buy-outs of deferred compensation remains a critical weakness – no solution found
Disclosure	**First full cycle of regulatory disclosures currently underway** **Increasing transparency vis-à-vis external stakeholders**	▪ Submitting updated compensation policies to local regulators ▪ Preparing first round of upgraded annual compensation reporting to shareholders; best practice from early-reporters (esp. Australia) has included – Board statement of independence on remuneration matters; Description of independent expertise available – Summary of activities and agenda of the remuneration committee – Description of recent and planned changes to the compensation framework – Target vs. actual remuneration mix; multi-year analysis of short-term incentive payments vs. cash earnings – Presentation of impact analysis beyond Exco level (e.g. top 5 earners, top-earning senior executives recently departed) – Description of key processes and provisions (e.g. personal hedging compliance process; key termination provisions for Exco and top-earning senior executives etc.) – Recent usage of joining and severance awards

● Industry-wide implementation fully completed ○ Industry-wide implementation not progressed

Lack of regulatory consistency and ongoing "first mover" problems are seen as the key challenges for the industry

Key dimensions	Perceived degree of challenge	Challenge to sound regime	Implementation challenge – regulators can help solve	Implementation challenge – in industry's hands
Regulation		▪ Lack of regulatory consistency across jurisdictions – different philosophies or different specific guidance ▪ Limited consideration for internal controls supporting new comp. Structures – compensation can only be 2nd or 3rd line of defence	▪ "Moving regulatory goal posts" in some jurisdictions ▪ Insufficient cross jurisdiction coordination in some geographies ▪ Lack of regulatory expertise both in rule-setting and in inspection teams	▪ Limited pool of directors able/willing to serve on compensation committees
Competition		▪ Unregulated sector attractive for big-earners; but not the main issue	▪ Perception of opaque or weak regulatory enforcement ▪ Retaining top talent in a competitive environment – "first mover disadvantage"	
Operations				▪ Availability and quality of data for appropriate metrics[1] ▪ Lack of trust in complex metrics ▪ Legal/contractual timeline ▪ Implementation complexity
Finance		▪ Impact of unfunded deferrals on earnings volatility and shareholder dilution ▪ Insufficient link to capitalisation	▪ Tax-inefficiency of some logical solutions (e.g. deferrals)	▪ Increased cost of compliance
Organisation			▪ Lack of "proven" best practices	▪ Resistance to change among business heads ▪ Embedding expanded role of risk in business processes ▪ Employees' buy-in into new compensation structures[2]

1. esp. risk- and liquidity-related
2. esp. concerns about control over performance metrics

● Stumbling block ○ Limited challenge

Our assessment differs – while important challenges have been raised by the industry, some dimensions are being overplayed and others underestimated

	Oliver Wyman assessment
Regulatory challenges	▪ Regulatory inconsistencies exist but, while they are creating frictions and uncertainty, they can be overcome ▪ Leading global players have proven that where internal leadership and clear regulatory direction exist in particular from the home regulator, organisations are able to handle most discrepancies and solve most issues
Competitive challenges	▪ Clear risk of re-emergence of "first-mover disadvantage" as some institutions or jurisdictions appear to fall short of fully meeting requirements ▪ Firms will consistently test regulatory scrutiny and willingness; consequently rapid and visible reining-in of abuses is critical to protect the reform's momentum and eliminate first-mover disadvantage ▪ The competitive challenge from the unregulated sector is overplayed – senior managers continually emphasise key competitors as the source of competition for key talent
Financial challenges	▪ Economic model challenges are a more important issue than currently perceived by the industry – with the potential to create financial instability if left unresolved, ▪ Shareholders are persistently absent in establishing sufficient check and balance ▪ The link to capital has been underdeveloped ▪ Regulatory leadership will be critical to guide the industry in the area
Operational/ technical challenges	▪ Compensation reform represents a serious overhaul of business practices, operations and systems ▪ Reports of widespread implementation challenges reflecting the far-reaching nature of the reform, but strong leadership is clearly instrumental in overcoming this
Organisational challenges	▪ Since most issues are temporary operational and organisational frictions, resolution should be relatively rapid in compliant institutions – this feels to us like a fig leaf that should be rejected by regulators

Key challenges

We recommend fine tuning current principles, but also considering some important extensions

Fine-tuning current principles and delivery mechanism

- Delivery – reinforce home regulators as the primary enforcement authority and foster the adoption of stronger enforcement powers (esp. ability to veto/adjust bonus pools) where required
  - Centre regulatory efforts on a more robust top-down challenge on bonus pools and governance across jurisdictions rather than individual bottom-up case review
  - Build and disseminate "case-law" on disallowed compensation practices
  - Organise training and sharing of best regulatory practices to accelerate ownership by home regulator
  - Focus FSB-level oversight on some critical jurisdictions for pair-wise approach, initially focused on systemically relevant firms
- Fine-tune principles
  - Enact firmer liability requirements for CROs and Board Risk committee vis-à-vis external stakeholders (e.g. official signoff that risk-adjusted measures are sufficiently accurate)
  - Tighten principles and guidance around minimum criteria on deferred compensation
  - Clarify guidance on performance-adjusted deferred payment instruments (esp. suitability of equity) and their downward value adjustments mechanisms

Recommended "high impact" extensions

- Issue guidance on minimum capitalisation levels required before annual variable compensation can be paid
- Address deferred compensation buy-out problem
  - Greater focus on up-front risk charging
  - Consider capital charging mechanism to deter "buy-out"/ accelerated payment of deferred compensation for recruitment purpose
- Recommend deferred compensation funding mechanisms and issue guidance on minimum funding requirements
- Establish best compensation contractual practices and disseminate across the industry
- Consider some mechanisms to catalyse shareholder attention to compensation levels
  - For systemic institutions, consider some more formal involvement for the FSB given the general use of "FSB compliance" by the industry (e.g. watch-list, explicit sign-off by the FSB)
  - Consider formalising the Audit Committee's involvement in the oversight of the compensation process