

FSB Principles for Sound Compensation Practices
Implementation Standards

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Compensation at significant financial institutions is one factor among many that contributed to the financial crisis that began in 2007. Official action to address unsound compensation systems must therefore be embedded in the broader financial regulatory reform program, built around a substantially stronger and more resilient global capital and liquidity framework. Action in all major financial centres must be speedy, determined and coherent. Urgency is particularly important to prevent a return to the compensation practices that contributed to the crisis.

This report responds to the call by the G20 Finance Ministers and Governors to submit to the Pittsburgh Summit detailed specific proposals on corporate governance reforms, global standards on pay structure and greater disclosure and transparency, to strengthen adherence to the FSB Principles for Sound Compensation Practices, issued in April 2009.

The standards set out in this report focus on areas in which especially rapid progress is needed. They do not fully cover all aspects of the FSB Principles but prioritise areas that should be addressed by firms and supervisors to achieve effective global implementation of the Principles. Firms and supervisors should ensure the process of implementation is begun immediately and pursued rigorously in their respective jurisdictions.

Given the commitment to ensure a level playing field, these implementation standards must be rigorously and consistently implemented by significant financial institutions throughout the world.

The FSB will periodically review actions taken by firms and by national authorities to implement the FSB Principles and these standards and assess the extent to which implementation has occurred and has had the intended effects. It will propose additional measures as required no later than March 2010.

The Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO) should undertake all necessary measures to support and address prompt implementation of these standards.

The aim of these standards is to enhance the stability and robustness of the financial system. They are not to be used as a pretext to prevent or impede market entry or market access.

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 publicly. 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. 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.

Pay structure and risk alignment

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.
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, 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.
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 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.
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. Significant financial institutions should take the steps necessary to ensure immediate, prospective compliance with the FSB compensation standards and relevant supervisory measures.
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.

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 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.
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.
19. Supervisors need to coordinate internationally to ensure that these standards are implemented consistently across jurisdictions.