Basel Committee
on Banking Supervision

Compensation Principles and Standards Assessment Methodology

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Introduction

1. This assessment methodology aims to guide supervisors in reviewing individual firms' compensation practices and assessing their compliance with the FSB Principles for Sound Compensation Practices ("the Principles") and their implementation standards ("the Standards"). The objective is to foster supervisory approaches that are effective in promoting sound compensation practices at significant financial firms and help support a level playing field.

2. The supervisory review framework has been defined with regard to the three issues addressed by the FSB Principles: (i) effective governance of compensation, (ii) effective alignment of compensation with prudent risk-taking, and (iii) effective supervisory oversight and engagement by stakeholders. For each of the FSB Principles and Standards, the assessment methodology proposes various approaches as well as information that could be used by supervisors in conducting reviews. Given the relatively new dimension of the issue of compensation policies, it is likely that this methodology will expand and change over time as more practical knowledge is gained.

3. This methodology refers to the FSB Principles and Standards as they set internationally agreed objectives, high-level principles and more specific benchmarks. The Basel Committee stresses the importance of translating international guidance into domestic rules and recognises that in many countries, domestic rules represent the key reference point for supervisors both in practice and in a legal sense. Indeed, many initiatives are underway at the national and regional level to implement the FSB Principles and Standards.

A. Use of the methodology

4. At the moment, compensation practices in the industry are diverse and evolving, and the nature of some details of sound practice remains uncertain. While the FSB Standards already provide clear references and benchmarks in some areas, best practices in other areas are still under development. Hence, this methodology is not meant, at this stage, to be used to assess the extent to which best practices are taken into account by significant financial institutions. This methodology rather proposes a series of clear and common elements on which compliance (or progress made) could be assessed.

5. The use of this methodology by supervisors will contribute to a better understanding of bank remuneration practices and to the identification of best risk management practices in this area. It is expected that over time, it will contribute to the convergence of bank practices towards best practices. Supervisors should assess compensation practices with the ultimate objective to ensure that the right incentives are created for effective risk management and excessive risk-taking is avoided.

6. This assessment methodology has been designed so as to provide sufficient flexibility to supervisors to ensure effective application of the FSB principles, taking account of individual national circumstances. Proportionality will be important in applying the methodology, taking into account the size and complexity of institutions (when applied beyond the limited set of international significant institutions), the nature of their business model and activities, and risk tolerance. The supervisory review of each firm will need to be tailored to firm characteristics, and also reflect existing supervisory knowledge and

information, as well as more general factors such as local market conditions and environment.

7. The methodology is also intended to serve as a tool to conduct the thematic FSB peer review on compensation scheduled for the beginning of 2010, although this assessment methodology is broader and sets out a work agenda that will extend beyond early 2010.

8. A near-term practical challenge for supervisors is that as firms take steps now to reform their pay practices, actual changes will be completed over time. For example, a review of compensation outcomes for 2009 may not be indicative of a firm's practices in 2010 and beyond. Thus, supervisors may have to assess the likely effectiveness of new policies and procedures that are as yet neither fully implemented nor tested. Similarly, because this methodology is intended to evolve over time, any review of compensation practices in the short term may need to be less ambitious than what would be expected in the longer term by a supervisory review.

B. Scope of the assessments

9. When conducting an efficient and effective review of individual firms' compensation practices and assessing their compliance with the FSB Principles and Standards, an essential prerequisite is a well-defined scope of application. The following discussion sets out some of the factors to be considered when defining the scope of the assessments but beyond these general observations, the Basel Committee considers that further convergence in the definition of the scope of application is a key priority for the medium term agenda mentioned above.

Scope of application

What type of firms?

10. Consistent with the approach taken in the FSB Principles, the type of firms primarily targeted by the assessment methodology is significant financial institutions, particularly large, systemically important firms. National jurisdictions may choose to extend the scope of application to a larger set of financial institutions. For example, one justification for the inclusion of a broader range of banking institutions beyond significant banks could be if a supervisory authority were to assess a bank's compliance with the FSB Principles as part of supervisory review process of the Basel II capital framework. Basel II, which incorporated the Principles as supplemental Pillar 2 guidance in July 2009,[1] has already been implemented in a large number of jurisdictions.

Which employees?

11. The ultimate intention of the FSB Principles is to reduce individuals' incentives for taking excessive risk. The experience of the financial crisis that began in mid 2007 has shown that such incentive had arisen from the structure of compensation policies and schemes. The Principles should therefore apply to those policies and schemes that relate to the categories of staff whose professional activities have a material impact on the bank's risk profile, with the possibility of expansion to other staff where appropriate. These categories of staff should at least include:

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[1] *Enhancements to the Basel II framework,* Basel Committee on Banking Supervision, July 2009.

- individuals, such as senior management, material risk-takers and staff performing important risk management and control functions; and
- groups of employees who may together take material risks, even if no individual employee is likely to expose the firm to material risk (eg loan officers who, as a group, originate loans that account for a material amount of the organisation's credit risk).

Home-Host issues

12. Effective implementation of the FSB Principles and Standards requires oversight by supervisors at both a home and a host country level.

13. In general, the FSB Principles and Standards are to be applied by the banks at the group level. In line with the framework established for the cross-border implementation of the Basel II framework,[2] a bank's home country supervisor, as part of its overall risk assessment of a consolidated banking group, is responsible for evaluating the banking group's compensation policies. However, depending on the banking group's organisation and the importance of activities within the host country, host country supervisors may provide input into the home country assessment of compensation practices. Home country supervisors should therefore seek host country input, where appropriate.

14. The review of individual firms' compensation practices will indeed raise the issue of compensation schemes in foreign affiliates and branches. Home country supervisors should ensure that headquarters are able to form a clear and accurate view of compensation practices in foreign affiliates and branches. Headquarters should ensure that their foreign affiliates and branches take steps to ensure that the compensation practices are compliant with the policy defined at the group level. Such steps should include controlling compliance with local rules that apply to the compensation schemes of their affiliates and branches.

15. Banks operating as foreign affiliates (and in some cases branches) will also need to satisfy the supervisory and legal requirements of the host jurisdiction with respect to compensation. Host country supervisors have an interest in accepting the methods and approval processes that the bank uses at the consolidated level, in order to ensure a level playing field, to reduce compliance burdens and avoid regulatory arbitrage. Host supervisors may also have legitimate reasons for controlling compliance with local rules on compensation directly, for example, due to limitations imposed by their legal obligations.

16. Like other supervisory issues having significant home-host implications, the assessment of banks' compensation practices could in some cases benefit from the use of supervisory colleges if the home supervisor deems it convenient.

C. Current bank practices to be taken into account by supervisors

17. Banks might broadly apply two conceptually different strategies when defining their compensation policies. These two approaches are presented below. While these two approaches are not expected to be applied in their pure formulation by firms, they represent useful reference points for understanding banks' approaches to remuneration that need to be taken into account by supervisors when performing their assessments.

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[2] *High-level principles for the cross-border implementation of the New Accord*, August 2003.

18. In a “**top-down**” or “**award-focused**” strategy, a firm chooses the amount of its overall bonus pool for a given year depending on the firm’s performance and then allocates the pool among employees, with the allocation depending to a greater extent, but not entirely, on the contributions of business units and employees to short-term profit. A portion of bonuses may be deferred, and a portion of deferred bonuses may be paid in equity-linked instruments like restricted stock or options. Vesting, malus, or clawback features of the deferral arrangement would generally not be linked to the ultimate outcomes of individual employees’ activities during the performance year. As has been observed during the financial crisis, the award-focused architecture does not reliably reduce firm-wide employee compensation when large losses are experienced on legacy assets. This is because bonus awards depend on activity during the performance year, not on legacy losses, and deferred payouts are reduced for poor performance only if the portion paid in equity-linked instruments is large and if the firm’s stock price falls.

19. To make firm-wide compensation more variable downward, a strategy that takes the award-focused architecture as given must change either the way awards are made so that legacy losses matter to bonus awards, or must change deferral arrangements to make ultimate payouts more sensitive to poor firm-wide performance, or both. Under the award-focused approach, FSB Principle 5 (symmetry) is central, because it emphasises the importance of making awards sensitive to losses. Principle 7 would tend to push for a higher proportion of compensation to be deferred and to be paid in equity-linked instruments (so that more is at risk, at least in cases where firm-wide losses are large and the firm’s stock price falls). Principle 4 might refer not only to adjustments of awards for ex ante risks, but also to adjustments for ex post risk outcomes on legacy positions.

20. The second, “**bottom-up**” or “**payment-focused**” strategy is based on two assumptions. First, that incentives operate at the level of individual employees; and second, if unsound risk-taking incentives due to an excessive focus on short-term results are the problem, then individual employees’ compensation arrangements must be altered so that risk influences the amount of compensation that employees ultimately receive, not just short-term profit. Employee risk-taking behaviour will change only if employees expect *their* pay to be reduced as *they* take more risk. Linking pay to risk-taking may be done by linking bonus awards to risk or by reducing deferred payouts when risk outcomes are bad. At a financial firm following the bottom-up strategy, the firm-wide bonus pool will not necessarily be fixed at some fraction of net revenue. The size of the pool will simply be the sum of individual employees’ awards. That is, the awards will determine the pool, rather than the pool determining the awards.

21. Under the bottom-up strategy, FSB Principles 4 and 6 are central because they are most focused on ways to make individual employee-pay sensitive to risk. Any given employee’s pay can be risk-adjusted either by reducing the bonus award as risk rises or by making the ultimate amount of deferred payouts sensitive to the long-run outcomes of that employee’s own risk choices, or both. Risk adjustments are purely for ex ante risk – bonus awards do not necessarily fall when risk outcomes are bad for legacy positions. Ex post risk outcomes have an impact on pay through malus or clawback provisions of deferred pay, which depend more on outcomes of risks the individual employee imposed on the firm during earlier performance years than on current performance of the firm as a whole (except in the case of senior executives, whose choices usually affect the whole firm). The interpretation of Principle 5 is different for the payment-focused approach than for the award-focused approach because symmetry may be achieved largely by reducing deferred pay rather than by reducing bonus awards, and because the focus is on symmetry for individual employees rather than on symmetry at the level of the firm as a whole.

22. In practice, the top-down and bottom-up approaches are in many ways complementary, and a combination of both might reach the optimal incentive alignment in

firms, to the extent that both approaches are applied in a consistent manner over time. The advantage of the payment-focused approach is its greater potential to change risk-taking behaviour. However, it requires substantial changes in pay practices, and its success depends on the development of effective risk-adjustment and malus/clawback provisions that are customised to individual employees (or at least to business units). The advantage of the award-focused approach is that it requires less work and innovation on the part of firms and thus may be more feasible, especially in the short run. The disadvantage is that it may have little impact on the risk-taking incentives of most employees. It should also be noted that the implications of the two approaches differ the most for mid-level and lower-level employees. At the level of senior executives, the two approaches may be rather similar operationally. However, for each of the various FSB Principles, the appropriate mix or balance between the top-down and the bottom-up approaches may vary.

23. As firms and supervisors gain experience, a judgment about which combination of approaches is preferable may become possible. This may lead to more effective compensation practices at firms and to more effective supervisory reviews. Assessments should determine whether the chosen combination does not lead to inconsistent practices and that it is being implemented well in line with the FSB Principles and Standards.

D. Nature of the assessment methodology

24. The assessment methodology has two main components. It contains *additional supervisory guidance* which clarifies expectations about how in practice the FSB Principles and Standards should be implemented by firms. This guidance represents examples of criteria upon which firms could be assessed.

25. The methodology also contains, for each Principle, a *supervisory review section* which presents a toolkit that should be adapted to existing supervisory approaches as well as to the institution being reviewed. The contents of the review sections do not represent minimum requirements for supervisors. As noted above, the supervisory review of each individual firm needs to be tailored to fit the firm's specific characteristics, but it will also reflect existing supervisory knowledge and information, as well as more general factors such as local market conditions and environment. Therefore, there may be circumstances in which supervisors consider that it may not be appropriate to apply all of the actions proposed.

E. Structure of the document

26. The paper has three chapters. In line with the FSB Principles, chapter I focuses on governance (Principles 1 to 3), chapter II on effective risk alignment of compensation (Principles 4 to 7), and chapter III on supervisory review and disclosure (Principles 8 and 9). In each chapter, Standards are mapped to the relevant Principles.

27. The assessment methodology for each FSB principles (and associated standards) takes the form of:

- **Supervisory objectives**, which explain the rationale for the principles and standards.
- **Additional supervisory guidance**, which supplements what is specified in the FSB standards.
- **Supervisory review**, which sets out actions that supervisors should consider taking in their review of firms' practices.

I. Effective governance of compensation

28. FSB Principles 1, 2 and 3 focus on governance issues regarding compensation. The first two Principles relate to the involvement of the firm's board of directors in the design and the regular monitoring of the compensation system's operation. Because these two Principles are closely related, their mapping to the Standards and associated guidance is presented collectively. Principle 3 focuses on the necessary independence of the control unit to ensure that the compensation system is effectively reviewed.

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.

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.

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.

Supervisory objectives

29. Principles 1 and 2 define the role and responsibility of the board of directors, while Standard 1 requires the establishment of a remuneration committee and defines its mandate. The general objective of supervisors is to ensure that there is an effective governance of the compensation policy, by answering in particular the following questions:

- Is the board of directors effectively taking overall responsibility for the compensation system, including by participating directly in the design and operation of this system?

- Are there controls in place to regularly oversee the compliance of the compensation system (one of them being the remuneration committee)?

Additional supervisory guidance

30. The following additional guidance represents criteria against which compliance with Principles 1 and 2 and Standard 1 could be assessed:

(a) The compensation policy should be aligned with the risk management framework of the institution.

(b) The board of directors should approve and periodically review the compensation policy.

(c) The board remuneration committee should be responsible for the preparation of recommendations to the board regarding compensation, including those which have implications for the risk and risk management of the firm.

(d) The board remuneration committee should make recommendations to the Board on the compensation to be paid to the highest paid employees in the firm, based on a pre-determined materiality threshold.

(e) In order that the board remuneration committee is able to operate independently from the senior executives, it should be composed, at a minimum, of a majority of independent, non-executive members.

(f) The board remuneration committee should have the skills and experience to reach an independent judgement on the compensation policy.

(g) The board remuneration committee should have access to advice, either internal or external, that is independent of advice provided to senior management.

(h) The board remuneration committee should have unfettered access to information and analyses from risk and control function personnel (eg risk management, finance, compliance, internal audit and human resources[3]).

(i) The board remuneration committee should engage appropriate control function personnel in its deliberations.

(j) Control functions should have input in the structure and determination of compensation.

(k) The board remuneration committee should formally review a number of possible scenarios to test how their compensation system will react to future external and internal events, and back test it as well.

(l) The annual compensation review should assess the compensation policy's compliance with the FSB Principles and Standards, or applicable standards promulgated by national supervisors, including:

  - ensuring that all material compensation plans/programs (including those for executives and employees whose actions have a material impact on the risk exposure of the firm) are covered;

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[3] Human resources, while traditionally not seen as a control function, plays an essential role in the control of the compensation policies developed by the board.

- assessing the appropriateness of the plans/programs relative to organisational goals, objectives and risk profile of the firm; and
- assessing the appropriateness of compensation payouts in relation to the risks in the business undertaken.

Supervisory review

31. Supervisors may:

(a) Review the compensation policy to ensure that one of its objectives is to not provide incentives for excessive risk-taking.

(b) Review the firm's compensation policy scope of application, particularly with respect to core businesses, foreign subsidiaries and branches.

(c) Review the composition of the board remuneration committee to ensure that, at a minimum, a majority of its members are independent, non-executive directors.

(d) Review the engagement process for commissioning external advisers for this process and confirm that these advisers are reporting directly to the board remuneration committee.

(e) Review the composition and charter of the board remuneration committee to ensure it has the appropriate skills or access to advice to perform its function. Supervisors should particularly look to see if committee members have sufficient expertise to assess risk management issues related to compensation.

(f) Review the charter/ terms of reference of the board remuneration committee to ensure that it has sufficient powers to perform its functions.

(g) Assess the collaboration between the board remuneration committee and other board committees, including the risk committee, and/or the risk management and control functions as part of overall reviews of corporate governance at the firm to confirm that the compensation policy aligns with the firm's risk management framework.

(h) Review the arrangements under which the board remuneration committee receives advice from the risk management function for setting up the compensation policy.

(i) Review the process developed for conducting the annual compensation review.

(j) Review the minutes of the deliberation of the board of directors on the compensation policy, in particular with respect to the results of the oversight of the compensation system's design and operation conducted by the remuneration committee.

(k) Review the minutes of the remuneration committee and other committees, including the risk committee, involved in the oversight of the compensation system's design and operation.

(l) Assess the results of the self-assessment done by the firm with the FSB Principles and Standards or applicable standards promulgated by national supervisors and assess the effectiveness of the board remuneration committee's follow up to ensure compliance.

Observations

32. The obligations of boards of directors may be larger for the bottom up portion of a firm's approach, because instead of only having to set policies and monitor actions for firm-wide bonus pools, the board must set policies that make compensation vary with risk at the

level of individual employees or low-level business units. However, good governance of both approaches is important.

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.

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.

Supervisory objectives

33. Principle 3 and Standard 2 focus on the effectiveness of the control function. The question for supervisors is whether control function staff engaged is acting and being compensated in a manner which is independent from the business line they oversee.

Additional supervisory guidance

34. The following additional guidance represents criteria against which compliance with Principle 3 and Standard 2 could be assessed:

(a) The compensation structure of control function personnel should not compromise their independence or create conflicts of interest in either carrying out an advice function to the board remuneration committee or their control functions.

(b) Compensation of control function personnel should be based on function-specific objectives and not be determined by the individual financial performance of the business areas they monitor.

(c) Control function personnel should not be placed in a position where, for example, approving a transaction, making decisions or giving advice on risk and financial control matters could be linked to an increase in their performance-based compensation.

(d) The control function management, as opposed to business line management, should have the responsibility for the performance appraisal process, including preparation and sign off on the performance appraisal documents, for control function personnel.

(e) The board of directors should actively engage in control function personnel performance reviews (eg Chair of the board risk committee should provide input into the Chief Risk Officer's performance review).

(f) The compensation levels of control function personnel and those of the professionals of the monitored business areas should be sufficient to carry out their function effectively.

(g) The mix of fixed and variable compensation for control function personnel should be weighted in favour of fixed compensation.

Supervisory review

35 Supervisors may:

(a) Review the operating structure of the control function team, where such a review has not already been undertaken for other purposes.

(b) Review that the objectives for control function personnel are function-specific and include qualitative criteria.

(c) Review the performance metrics or performance indicators developed for control function personnel to confirm that these metrics or indicators are not linked to the performance of the portfolios they monitor.

(d) Review the performance appraisal documents for control function personnel to determine that they are signed off by risk and control function management.

(e) Review the compensation policy to ensure that the compensation of control function personnel is not determined by either the personnel or the financial performance of the business areas they oversee.

II. Effective alignment of compensation with prudent risk-taking

36. FSB Principles 4 through 7 focus on compensation practices that reduce employees' incentives to take excessive risk. To date, it has been common for amounts of incentive compensation for a performance year to be based mostly on the level of short-term revenue or profit that was achieved during the year. Principles 4 (risk adjustment), 6 (deferral of payment) and 7 (method of payment) focus on methods that may be used to alter compensation arrangements to provide more balanced risk-taking incentives. Principle 5 (symmetry) describes a characteristic of compensation outcomes that should be achieved if incentives are sound.

37. Because Principles 4 through 7 are so closely related, many possible ways exist for associating paragraphs of the FSB Standards with individual FSB Principles. One mapping is shown below, but other mappings are valid. For these Principles which present in practice significant implementation challenges, observations regarding some issues requiring a special attention from supervisors or creating particular challenges for them are also presented.

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.

> **Standard 3: (a)** 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. […][4]
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> **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.

Supervisory objectives

38. Standard 3 focuses on the overall size of the variable compensation, at firm level, in order to ensure that the recognition and accrual of variable compensation will not compromise the financial soundness of the institution. The ability to strengthen their capital base is critical for banks, especially in the current environment with the recent changes to the regulatory capital requirements just introduced (*Enhancements to the Basel II framework*, July 2009) and the potential changes currently under discussion.

[4] The remainder of Standard 3 is mapped under Principle 8.

39. Principle 4 and Standard 4 are concerned with the manner in which values of short-term performance (like short-term profit or revenue) affect variable pay awards and with the quality of any risk adjustments that affect awards. The relationship between performance measures and awards is also relevant for other Principles, but for brevity the main discussion of performance measures is here.

40. The broad question for supervisors is whether risk adjustments, if used, are likely to be adequate. To answer this question, answers to three subsidiary questions are likely to be needed:

- Are all material types of risk taken into account by a risk adjustment?
- Are severe risk outcomes considered or ignored? If ignored, incentives might be to take bad-tail risks, which might be particularly undesirable as a matter of public policy.
- Is the risk adjustment strong enough to adequately reduce excessive risk-taking incentives provided by short-term performance measures? The stronger the tendency of compensation arrangements to reward risk-taking, the stronger must be the offsetting risk adjustment.

Additional supervisory guidance

41. The following additional guidance represents criteria against which compliance with Principle 4 and Standards 3 and 4 could be assessed:

(a) Firms should include the impact of compensation recognition and accrual on their capital planning and in their overall capital assessment process, taking also into account their current capital position.

(b) Firms should take into account all material risks, differentiating among risks affecting the firm, the business unit and the individual. When evaluating whether all material types of risk are taken into account, the context and approach matters. Though significant firms usually bear all types of risk, at the level of individual employees or business units only some types of risk may be material (usually, credit, market, liquidity and operational risks).

(c) Firms should take into account all the risk management results and outputs to adjust compensation policies.

(d) A wide variety of measures of credit, market and liquidity risk may be used by firms in implementing risk adjustments. For example:

  – Adjustments for credit and market risk can be done by economic capital allocations, combined with a cost-of-capital. An example of a performance measure that incorporates this risk-adjustment is Profits Adjusted for the Cost of Capital Employed.

  – Adjustment for liquidity risk can be done by calculating stressed liquidity coverage ratios, combined with a cost-of-liquidity, where the cost of liquidity is the cost of unsecured funds matching the liquidity characteristics of the assets funded. A performance metric that incorporates this risk-adjustment is Profits Adjusted for the Cost of Liquidity Employed.

(e) Firms should have in place measures or strategies to treat the “difficult-to-measure” risks. Reputational and other risks may also be material but may be especially challenging to include in risk adjustments. Even for the main risks, in some situations, risk measurements may not be reliable enough to support good risk adjustments. In these cases, supervisors may wish to look at whether other strategies are used to align risk-taking incentives, such as deferral.

(f) Risk measures should take severe risks or stress conditions into account. For example, conventional historical-simulation value-at-risk measures based on short historical periods of data are known to understate the severity of bad-tail risks in many situations. Stress-scenario measures are an alternative if the scenarios are severe.

(g) Risk adjustments should take into consideration the time horizon used to measure performance and the quality of the performance measure used. Stronger risk adjustments may be needed where measurement periods are short and few losses are taken into account than where measurement periods are long and a large proportion of ultimate losses are already taken into account in the performance measure.

(h) The strength of risk adjustment that is needed should vary according to the nature of performance measures that influence variable pay awards. Financial performance measures are particularly important because they are often short-term.

(i) Performance measures should effectively take into account the quality of revenues that are used in constructing these measures, and, in particular, special attention must be paid to cases in which the performance measures have the effect of accelerating future revenues forward in time. Treating uncertain, long-term revenues as though they are certain and already received can increase the tendency of performance measures to give employees incentives to take long-term risk. In that case, stronger risk adjustments may be needed.

(j) Bonus awards should also be sensitive to employees' performance with respect to non-financial aspects of behaviour. Bad non-financial performance (in particular, unethical or non-compliant behaviour) should be enough to override good financial performance and diminish compensation. Compensation should be fully aligned (provide the right incentives) with the institution's risk policy in the medium and long term.

(k) Both performance measures and risk adjustments should be tailored to the level and duties of employees and the approach. For example, under the bottom-up approach, performance measures and risk adjustments for a specialised employee such as a trader are likely to work best when they focus on the employee's own activities. For the director of a business line, measures and adjustments for the business line as a whole are appropriate, perhaps with the addition of measures and adjustments for the firm as a whole. For senior executives, measures and adjustments should be for the firm as a whole.

(l) Total shareholders return for the period may be used in the case of senior executives or in setting the size of a firm-wide bonus pool. However, these measures do not fully take risk into account and should be used in conjunction with other measures. Relative measures amongst or across peer groups do not take into account absolute performance and thus could result in perverse bonus payments in market downturns.

(m) Firms' risk adjustment methods should have both quantitative and judgmental elements.

Supervisory review

42. Supervisors may:

(a) Examine the firm's internal capital assessment process to check that the impact of compensation recognition and accrual has been included.

(b) Examine a firm's annual compensation report, the records of board-level compensation committee or individual employees information from the firm's IT systems, in order to assess the firm's overall approach and the role of risk adjustment in that approach.

(c) Expand the scope of routine on-site examinations of business lines within banks to include documentation of the performance measurement system used by the firm for the business.

(d) Check the compliance of the firm's compensation policy with its risk-taking policy and its long term strategic plans.

(e) Review the indicators used to measure financial performance (revenue, profits using management or accounting figures, measures linked to the market, economic capital for the firm/business, return on economic capital, profits adjusted for cost of capital or cost of liquidity…) taking into account that practices that base bonus pools directly on revenues or profits alone are not satisfactory.

(f) Check the quality of the revenues used in producing performance measure, in regards to the likelihood and timing of receipt of the underlying cash. In order of declining quality, revenues might be categorised as: (a) realised, (b) unrealised – but able to realise at discretion due to high liquidity or locked in via hedging; and (c) unrealised with no certainty of receipt via capacity to buy/sell or ability to hedge (net open risk). Specifically identify performance schemes that include material balances of income of the lowest quality, in order to avoid a wide disparity between the recognition of revenue in accounting and both the timing and likelihood of receiving the associated cash.

(g) Obtain and review records of changes in policies and practices and of exceptions to policies in order to detect any removal or reallocation of costs from performance measures when revenues fall or losses are large.

(h) Review bonus accrual rates for the different classes of performance income considered, in order to detect any possible shift of the recognition of performance income to the higher accrual class.

(i) Review the indicators used to measure non financial performance (compliance with the institution's systems and controls and internal audit recommendations, commitment to the business, skills acquired…).

(j) Review the risk management results and outputs used to adjust compensation policies.

(k) Investigate adjustments (quantitative or judgmental), if any, to the performance measurement process for risk taken.

(l) Investigate adjustments (eg transfer pricing mechanisms, liquidity surcharges), if any, for the liquidity risk assumed in the conduct of business. In some cases it may require assessing the adequacy of the contingent liquidity plan of the firm.

(m) Review transfer pricing practices to evaluate the strength of risk adjustments (for example, if a loan originator's bonus is not affected by the risk of a loan that is transferred to a portfolio manager, it is important that the portfolio manager's compensation be risk-adjusted appropriately, and that the transfer price reflects the risk).

(n) Review a firm's policies and procedures to ensure that the firm actually applies an adjustment that is big enough to materially reduce the size of the pool in bad times.

(o) For a firm that uses risk adjustments customised for individual employees, additional detailed information may be helpful, especially if it can be obtained in machine-readable form from the firm's information technology (IT) systems.

(p) Check the institution's policy regarding comparison to a peer's group when determining the compensation.

Observations

43. The nature of the firm's overall approach to aligning risk incentives may influence supervisory strategies for conducting effective reviews. At an early stage, supervisors may wish to examine a firm's compensation policy statement or records of board-level remuneration committee activity in order to assess the firm's overall approach and the role of risk adjustment in that approach. It is important to note that many firms may use a mixed approach that has some elements of the top-down approach and some elements of the bottom-up approach. Where this is the case, conducting supervisory reviews may be a more challenging task because of a need to address a larger range of questions and to determine which questions must be answered in which contexts.

44. The sources and nature of information that supervisors use may vary with the firm's strategy. For example, for a firm that uses risk adjustments mainly to set the size of the firm-wide bonus pool, much of the necessary information may be available from policy documents and board-level remuneration committee records. For a firm that uses risk adjustments customised for individual employees, additional detailed information may be helpful, especially if it can be obtained in machine-readable form from the firm's IT systems. In all cases, supervisor may look also at the annual compensation report or at documentation sent to third parties (eg fiscal authorities).

45. The burden on supervisors may differ for top-down and bottom-up approaches. Under the top-down approach, if risk adjustments are applied only in setting the firm-wide bonus pool or pools for broad business lines, the number of risk adjustments to be considered will be relatively small and will be focused on relatively aggregated risks. Under the bottom-up approach, where risk adjustments may be customised for individual employees or lower-level business units, the number of risk adjustments to review may be large. In the latter case, strategies for making the size of the supervisory job manageable will be needed.

46. Both the top-down and the bottom-up approaches present challenges to supervisors reviewing risk adjustment practices. For the top-down part, to the extent a risk adjustment is applied in determining the size of an overall bonus pool, it is difficult to know whether the firm will actually apply an adjustment that is big enough to materially reduce the size of the pool in bad times. Supervisors may wish to review a firm's policies and procedures for credibility in this regard.

47. Another challenge for supervisors is the possibility of mid-course changes in a firm's practices. If the details of performance measures or risk adjustments are changed during or after a performance year in ways that tend to inflate performance or conceal risk, the incentives that are provided may differ from what is implied by the firm's long-run policies. For example, a practice of removing some costs from performance measures when revenues fall or losses are large (for instance by reallocating them from business units to the corporate centre) tends to keep measured performance high even if actual performance is not good. Thus, supervisors may wish to obtain records of changes in policies and practices and of exceptions to policies.

48. Supervisors might employ both backward-looking and forward-looking strategies in evaluating adequacy of the strength of risk adjustments. Under the top-down approach, the main backward-looking indicator of the adequacy of risk adjustments is whether bonus awards for the whole firm, or for broad business lines, vary appropriately with the performance of the firm as a whole or of broad business units. Simple forward-looking indicators are difficult to find because of the possibility that the firm may change the way risk adjustments are applied when bad times come, as described below in the context of Principle 5.

49. Under the bottom-up approach, the main backward-looking indicator is whether business-unit or individual-employee bonus awards vary appropriately with risk measures. The main forward-looking indicator is whether awards are likely to vary appropriately with risk measures. Scenario analysis may be helpful in assessing prospective adequacy of risk measures. Scenario analyses would look at how bonus awards would vary under different joint assumptions about revenue and risk.

50. Finally, concerning market-based performance measures (eg, total shareholders return), supervisors may wish to check the institution policy regarding comparison to a peer's group and reward determination.

An example of an approach to reviewing performance measures and credit, market and liquidity risk adjustments is reported in the Annex.

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.

> **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.
>
> **Standard 6: (a)** 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;
> - […][5]
> - these proportions should increase significantly along with the level of seniority and/or responsibility […]
>
> **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.

5 The remainder of Standard 6 is mapped under Principle 6.

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.

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.

Supervisory objectives

51. Unlike Principles 4, 6 and 7, which focus on methods of aligning risk incentives, Principle 5 focuses on compensation outcomes. Most of the Standards that have been mapped to Principle 5 focus on practices that might undermine the alignment of risk incentives by altering compensation in ways that keep compensation high even when risk outcomes are bad.

52. In evaluating symmetry, supervisors should seek to answer two broad questions:

- Are appropriate reductions in compensation likely to occur in the future if risk outcomes are bad?
- During years when risk outcomes actually are bad, does compensation decline significantly?

53. As a practical matter, much of the work of answering these questions is likely to be done by answering the questions associated with Principles 4, 6 and 7. Effective risk adjustments, deferral arrangements, and forms of compensation are likely to be the primary vehicles by which compensation is reduced in bad times. Rather than repeating the discussion for those Principles, this section focuses on other features of compensation systems that might interfere with symmetry.

Additional supervisory guidance

54. Given the specific and detailed nature of Principle 5 and its related Standards, no additional supervisory guidance is presented for these. They are instead covered by the broad additional supervisory guidance developed in the rest of section II and, in particular for Principle 4.

Supervisory review

55. Supervisors may:

(a) Review a significant sample of core employees' contracts.

(b) Check accounting to detect write-offs of loans (and specially after dismissal of core employees), as well as, review compensation practices of the firm's group, in order to identify non-standard forms of compensation that would avoid risk symmetry.

(c) Check golden parachutes (including computing how many years are paid in golden parachutes) by reviewing senior management contracts and their subsequent modifications to.

(d) Review new sign-on and a sample of severance payments made during the financial year, and number of beneficiaries of such payments.

(e) Review any guaranteed bonus arrangements.

(f) Review anti-hedging policies and associated compliance arrangements.

(g) Check compensation arrangements and outcomes for senior executives. These should include the Chief Executive Officer, Chief Operating Officer, Chief Risk Officer, other executive members of the Board, and perhaps direct reports of the executive members of the Board, as well as Heads of Market, Credit, and Operational Risk if not covered by the above categories.

(h) Check whether compensation was drastically reduced for the employees and business units that have caused substantial losses, taking into account both risk adjustments and the impact of clawbacks[6]/maluses on the value of deferred compensation.

(i) In good times, check whether clawback or malus arrangements are likely to reduce compensation by appropriate amounts in the event of bad risk outcomes.

(j) Examine whether signing bonuses incorporate deferral with maluses or clawbacks.

(k) Review:

- compensation functions (the algorithm or rule that, using risk and performance as inputs, determines a compensation) and assess whether the combination of performance measures, risk adjustments and deferral arrangements will achieve a reasonable degree of symmetry between compensation and risk.
- the size of variable compensation with respect to fixed compensation, especially:
  - ➢ to determine that a substantial proportion of compensation is variable, and this proportion should increase significantly along with the level of seniority and/or responsibility;
  - ➢ ways in which firms or employees might avoid symmetry in the event of large losses. An example would be increasing the fixed portion of compensation during bad years in order to offset any reductions in variable compensation.

(l) In cases where the variable compensation makes up a substantial proportion of total compensation, assess that the extent to which the variable component would be reduced in the event of poor performance of the firm, division or business unit. Consider also whether the size of the variable component of total compensation is

[6] 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.

such as to encourage employees to take excessive risks in order not to lose the variable portion.

Observations

56. Supervisors should be alert for non-standard forms of compensation that might be used in bad years to keep total payments to employees at a high level even though amounts of the usual forms of variable compensation have fallen. Examples include loans not expected to be repaid (which could be reviewed by checking at accounting when there is some dismissal of core employees to detect write-offs of loans) or payments made by foreign subsidiaries. This is one reason why checking policies and practices of the group as a whole is important.

57. Standard 5 is particularly relevant under the top-down approach because it focuses on compensation for the firm as a whole and for senior executives. Checking whether risk symmetry is actually achieved is relatively easy in bad times because the main focus of supervisors can be on the size of the actual bonus pool, as well as on how deferred payouts change. However, in normal years, assessing whether risk symmetry is likely to be achieved in future is problematic in the absence of clear evidence of the extent to which a firm's total bonus pool would reduce in the event of poor performance outcomes.

58. Under the bottom-up approach, where the focus is on individual employees, it is possible that, in bad times, the firm-wide bonus pool may not decline very much if only a small number of employees or business units were responsible for most of the firm's losses. Attention therefore needs to be paid to the extent to which the risk decisions of individual employees contributed to losses in a particular segment of the business.

59. Standards 11, 12 and 14 address some particular ways in which firms or employees can avoid achieving symmetry ex post even though their compensation systems appear likely to achieve symmetry ex ante. Standard 11 deserves special comment because the nature of the problem posed by guaranteed bonuses differs according to whether the compensation scheme favours a top-down or a bottom-up approach. Under the top-down approach, the major concern is that firms will shift from unguaranteed to guaranteed bonuses in bad times in order to keep employee compensation high. Under the bottom-up approach, the problem is more subtle. Deferral of a portion of bonuses with clawback or malus is likely to be a very important element of the bottom-up approach. In recent years, it has been common for firms to offer substantial sign-on bonuses to employees recruited from other firms sufficient to compensate them for having to leave unvested deferred compensation that would become due to the employee at his previous employer. However, if employees know that they can receive their deferred pay by jumping to another firm, the beneficial effect on incentives of deferral with maluses or clawbacks is weakened. The second firm does not directly harm itself by paying the signing bonus, but it contributes to a market practice that weakens risk discipline at all firms.

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 realised over different periods of time. Variable compensation payments should be deferred accordingly. Payments should not be finalised over short periods where risks are realised over long periods. Management should question payouts for income that cannot be realised or whose likelihood of realisation remains uncertain at the time of payout.

Standard 6: (b) For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm:

- o […][7]
- o a substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years; and
- o 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.

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.

Standard 9: (a) 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.

Supervisory objectives

60. Deferred compensation arrangements are the focus of Principle 6 and associated Standards. Under both the top-down and bottom-up approaches, a primary benefit of deferral arrangements is that they permit payment to be delayed until risk outcomes are better understood. This is particularly beneficial where good risk adjustments are not available. If an employee knows that the amount the employee will ultimately receive will be reduced if risk outcomes are bad, the employee is less likely to take excessive risk.

61. The broad question for supervisors is whether deferred-pay arrangements are likely to adequately reduce the value of payouts when losses occur. To answer this question, answers to three subsidiary questions are likely to be needed:

- Do the measures that are used to trigger reductions in the value of payouts capture an appropriate range of types and severities of risk outcomes?
- Is the number of years over which payments are deferred, and the proportion paid out in each year (like a vesting rate), appropriate?
- Is rate at which payouts are reduced as losses increase appropriate?

Additional supervisory guidance

62. The following additional guidance represents criteria against which compliance with Principle 6 and its related Standards could be assessed. Supervisors should scrutinise the design of deferred compensation arrangements including examining whether:

(a) The value of ultimate payouts is sensitive to risk outcomes, as well as to performance, during the whole of the deferral period . Such arrangements might increase payouts if risk outcomes are unusually good, but they should substantially reduce payouts if risk outcomes are unusually bad. The criteria for increased payouts should be sufficiently demanding to ensure that the payouts are not disproportionate to the improved risk and performance outcomes.

[7] The remainder of Standard 6 is mapped under Principle 5.

(b) In general, the deferral period and the manner in which payouts are spread over time should match the time horizons of risks and the objective of a particular deferred compensation instrument. Consequently, deferred compensation used as long-term incentive should consider the development of risk and performance over several years.

(c) Usually deferral arrangements will have top-down and bottom-up elements, with the relative importance of the two elements depending upon the employee's organisational level, functional level, and pay level. The top-down elements will link payouts to the performance and risk outcomes for the whole institution. The bottom-up elements will link payouts to outcomes for the individual employee's activities or those of the employee's specific business unit.

Supervisory review

63. Supervisors may:

(a) Review deferred compensation arrangements for senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm, in order to ensure that a substantial portion of variable compensation, such as 40 to 60 percent, is payable under deferral arrangements over a period of years. Examine whether these proportions increase significantly with the level of seniority and/or responsibility.

When reviewing the likely effect of deferral arrangements going forward, scenario analysis may be helpful. Supervisors should ask firms to analyze the impact of large losses on the fraction of deferred award amounts that are ultimately paid out. When reviewing the impact of deferral arrangements on compensation in the past, supervisors should compare amounts of awards with the value of payouts, taking actual risk outcomes into account.

(b) Review that deferral periods are typically no less than three years.

(c) Review vesting processes (speed) to check whether vesting periods have the appropriate length and are correlated with the time span when losses historically have realised, and whether the vesting speed is adequate and in line with performance (in general they should not best faster than on a pro rata basis),

(d) Review clawback clauses and malus arrangements, especially whether these take risk outcomes into account and the adequacy of measures of risk outcomes.

(e) Review pension arrangements for the senior employees, including any non-standard arrangements.

(f) Check that commitments by institutions to make deferred payouts in the future will not compromise the entity’s solvency at the time payments are made.

(g) Look at annual compensation reports or similar sources and check:

- amounts of outstanding deferred compensation, split into vested and unvested;
- amounts of deferred compensation awarded during the financial year paid out and reduced through performance adjustments.

(h) Check that bad performance is followed by reductions in the value of deferred pay, such as by triggering a clawback arrangement.

(i) Check a sample of contracts for senior executives and other core risk-taking and risk management positions.

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.

> **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.
>
> **Standard 9: (b)** The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually.

Supervisory objectives

64. Principle 7 focuses on the form of compensation paid to employees and seeks to ensure that the form adopted aligns with risks. The main question for supervisors is whether the form of compensation paid to a given employee creates the right incentives and is consistent with risks taken..

Additional supervisory guidance

65. The following additional guidance represents criteria against which compliance with Principle 7 and its related Standards could be assessed:

(a) Firms should have indentified which instruments create incentives aligned with long-term value creation and the time horizons of risk. These instruments might not be the same for all employees.

(b) Firms should have in place procedures and/or indicators to be able to explain the rationale for its mix.

Supervisory review

66. Supervisors may:

(a) Review a significant sample of core employees' contracts.

(b) Review annual compensation reports and look at documentation sent to third parties such as fiscal authorities. This information should be compared with the institution's peer group.

(c) Review which instruments create incentives aligned with long-term value creation and the time horizons of risk.

(d) Review the share retention policy.

(e) Where the top-down approach is followed, check that the fraction of deferred compensation paid in equity is large enough to have the intended impact, taking any malus or clawback features into account.

(f) Where the bottom-up approach is followed, check to see if the firm is relying too much on payments in equity-based compensation rather than using well-designed malus or clawback arrangements.

(g) Review the way compensation is paid by looking at all possible components of compensation, including:

- Cash
- Shares
- Options
- Fringe benefits
- Health insurance
- Cancellation of loans to employee at dismissal

Observations

67. As noted previously, the form in which compensation is paid is particularly important under the top-down approach because, under the bottom-up approach, malus or clawback arrangements can do much of the work of aligning pay with risk outcomes. Under the top-down approach, equity-based compensation is one means of reducing employee payouts for poor risk outcomes, as poor performance at the level of the firm as a whole is very likely to reduce the stock price. Under the bottom-up approach, a malus or clawback arrangement is particularly useful for ensuring that poor performance outcomes resulting from an employee's or business unit's earlier activities will result in meaningful reductions in deferred compensation. Thus, under the bottom-up approach, evaluation of malus and clawback arrangements and their likely effect on employee risk incentives is of great importance. In addition, malus or clawback should be applied to deferred, equity-based compensation in cases where subsequent individual or business unit results are below expectation. Equity-based compensation is not especially helpful in aligning incentives for some employees because losses they generate may not impact the firm as whole.

III. Effective supervisory oversight and engagement by stakeholders

68. Section III differs from the previous two sections as it does not refer to actual compensation practices but rather focuses on external elements and parties that could foster the adoption and the use of sound compensation practices within institutions. Principle 8 concerns supervisory review and Principle 9 transparency and disclosure. Because of the particular nature and content of these Principles, the assessment methodology takes a different form for these two Principles.

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.

> **Standard 3: (b)** […][8] 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.
>
> **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.
>
> **Standard 13:** Significant financial institutions should take the steps necessary to ensure immediate, prospective compliance with the FSB Standards and relevant supervisory measures.
>
> **Standard 16:** Supervisors should ensure the effective implementation of the FSB Principles and Standards in their respective jurisdiction.
>
> **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.
>
> **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.
>
> **Standard 19:** Supervisors need to coordinate internationally to ensure that these standards are implemented consistently across jurisdictions.

[8] The remainder of Standard 3 is mapped under Principle 4.

69. Principle 8 and its associated Standards have a very different nature than the other Principles and Standards given that they apply directly to supervisors (or policy-makers when supervisory powers are concerned) and not to firms. These Principles and Standards are thus not supposed to be directly used by supervisors when assessing firms' compensation practices and compliance with the other FSB Principles and Standards. Principle 8 and its Standards are considered as prerequisites or preconditions. For these reasons, limited additional guidance and no indications for supervisory review are presented here.

70. However, in order to promote consistency of supervisory actions taken in relation to the supervision of compensation, and in order to support self-assessment that some supervisors or countries could be willing to undertake, below is a list of practical actions that represent possible ways to implement Principle 8 and its related Standards:

(a) Existence of a national framework of formal rules or supervisory guidance ensuring that the FSB Principles and Standards on sound compensation practices are effectively transposed into the national regulatory and supervisory framework and applicable to at least all significant institutions. The assessment of the consistency of the implementation of the FSB Principles across jurisdictions can be based on the following main information:

- Scope of application of the framework (eg type of institutions, employees concerned);
- material equivalence of the national rules to the FSB Principles and Standards;
- existence of supervisory arrangements to ensure compliance of institutions with compensation regulation;
- In case of non-compliance with the FSB Principles and Standards: reasons for non-compliance (eg material legal constraints), impact of non-compliance, measures to mitigate potential negative effects of non-compliance.

(b) Incorporation of compensation into the supervisory risk assessment of (at least) significant financial institutions.

(c) National authorities have the power to impose either financial (eg extended capital requirements) or non-financial measures or penalties in case of non-compliance with compensation regulation. Those measures and penalties should be effective, proportionate and dissuasive.

(d) National authorities have the power to effectively constrain variable compensation, when it is inconsistent with the maintenance of a sound capital base.

(e) National supervisors should have the right to examine individual employment contracts and compensation payments.

(f) Self-assessments are conducted by institutions and communicated to supervisors to check compliance with the compensation regulation.

(g) Supervisors conduct off-site and dedicated on-site reviews to check banks' practices and compliance with the compensation regulation.

(h) Discuss compensation issues of institutions between home and host supervisors (eg within supervisory colleges).

Additional guidance

71. To support implementation of Standard 19, the Basel Committee has set up a network of supervisors to discuss issues and share experience in the interpretation and

implementation of the FSB Principles and Standards on compensation. This network provides a forum for real-time exchange of questions and answers among supervisors, including questions raised by firms in their respective jurisdictions;

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.

> **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.

Supervisory objectives

72. Supervisors may want to ensure that appropriate conditions for market discipline to operate are in place, by answering in particular the following question:

- Are firms disclosing clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders?

In jurisdictions where supervisors do not have authority to require some (or any) of the appropriate disclosures, supervisors should recommend to the appropriate regulators that they require such disclosure.

Additional supervisory guidance

73. The following additional guidance represents criteria against which compliance with Principle 9 and Standard 15 could be assessed:

(a) In order to provide market participants with accurate and comprehensive information regarding the risk profile of individual institutions, banks may be required to disclose additional information not explicitly listed in the FSB Implementation Standard 15 if necessary to meet this objective.

(b) Supervisors may give additional guidance by releasing requirements on the structure and presentation of compensation disclosures. It would be beneficial if national supervisors could agree on a common international structure for this.

(c) For reasons of confidentiality, banks should be able to limit the detail of disclosure to the public of information relating to the amounts of severance payments awarded during the financial year.

Supervisory review

74. Supervisors may:

(a) Review public disclosure on compensation made by firms, on the basis of the internal information they might have collected or required.

(b) Define periodic (or ad hoc) supervisory reporting on compensation in order to monitor development of compensation practices within firms.

Annex

Example of an approach to reviewing performance measures and credit, market and liquidity risk adjustments

This example may be particularly helpful in the case of supervisory reviews of compensation in trading, structuring, and investment-banking business units and other units where market, credit and liquidity risk measures are well-developed and reliable, and where significant discretion is exercised with respect to recognition of revenues.

Supervisors could expand the scope of routine on-site examinations of business lines within banks to include documentation of the performance measurement system used by the firm for the business. Every control validation exam could include a review and documentation of the performance assessment process for the unit under examination. Some specific areas of focus are listed below.

(a) Adjustments for credit and market risk

Supervisors should specifically investigate adjustments, if any, to the performance measurement process for risk taken and capital employed in the generation of revenues. Such adjustments may be quantitative or judgmental. Quantitative practices can take the form of computing returns on risk capital - where the numerator of the ratio is the performance income of the business and the denominator the economic risk capital employed by the business. An alternative process is to transfer price risk capital at an estimated cost of capital for the firm and include it as a direct charge in a risk-adjusted performance income statement. In both cases, the effect of the adjustment is critically dependent on the performance income and risk capital balance attributed to the business. As a result, the methodologies of both of these processes (performance income and economic risk capital) require examination.

(b) Adjustments for liquidity

Supervisors should investigate adjustments, if any, for the liquidity risk assumed in the conduct of business. Such adjustments might take the form of transfer pricing mechanisms in which the cost of funds provided from the firm's Treasury unit is adjusted for the transactional market liquidity of the position funded under normal or, importantly, stress conditions. Liquidity surcharges based upon the characteristics of positions in stress conditions may critically rely upon the contingent liquidity plan for the firm – in which case supervisors should assess the adequacy of the contingent liquidity plan of the firm. Supervisors should note whether there is a control function with oversight responsibility for liquidity risk management. Typically the Treasury function manages the liquidity (and capital) position of the firm. Oversight of the liquidity management practices of Treasury may reside with the independent risk management control function.

(c) Incorporation of controls

Supervisors should review qualitative factors, if any, that are incorporated in the performance assessment process. For business units, supervisors should note if the control practices of the business are evaluated in performance assessment. Such practices would include (but not be limited to):

- Compliance with limits;
- Provision of adequate information to assess business unit risk;
- Identification and escalation of material risks to control groups and management;
- Valuation practices and the resolution of disputes between valuation control groups and the business;
- Participation in new product or business approval processes;
- Satisfactory audits.

(d) Departures from financial reporting standards

Supervisors should be attentive to any departures from financial reporting/accounting standards in the computation of performance income or other elements of performance measurement (apart from the transfer pricing adjustments listed above). Such departures should be evaluated for whether they provide incentives for taking or ignoring material risks to the firm.

(e) Quality of revenues

Supervisors should be attentive to the quality of revenues in regards to the likelihood and timing of receipt of the underlying cash. In order of declining quality, revenues might be categorised as: (a) realised, (b) unrealised - but able to realise at discretion due to high liquidity or locked in via hedging; and (c) unrealised with no certainty of receipt via capacity to buy/sell or ability to hedge (net open risk). Supervisors should specifically identify performance schemes that include material balances of income of the lowest of the three qualities - as these effectively monetise hypothetical revenues projected to occur in the future but whose occurrence remains uncertain.

The expansion of fair value accounting to include virtually any element of the balance sheet irrespective of the existence of a market for that element has significantly increased the inclusion of the lowest quality level of revenues in performance income statements. No longer is the recognition of revenue linked closely to the receipt of cash. As a result there can be wide disparity between the recognition of revenue in accounting and both the timing and likelihood of receiving the associated cash. *Level 1 through 3 accounting classifications might be used to prioritise revenues to investigate* - in which case specific supervisory focus should be given to revenues originating from Level 3 positions.

(f) Differential payouts

Supervisors should be attentive to the existence of different classes of performance income with different bonus accrual rates. Different bonus accrual rates provide direct and strong incentives to shift the recognition of performance income to the higher accrual class. This is especially prevalent in Level 3 assets in which the capacity to obtain external validation of pricing is nil and wide discretion is left to individual traders and bankers.

An example is the revenue booked at deal inception on exotics and hybrid structures. Such revenue is usually regarded as ‘risk free’ client income and may be granted higher incentive compensation accrual rates (eg 35%) than the ‘risky’ activity of hedging and managing the residual book of business (eg 15%). As client income is defined to be the difference between the price paid by the client and a value produced by a model at which a deal is booked at inception, there are strong incentives to minimise the wholesale (model) value using heroic assumptions on hedging capacity, liquidity and parameter inputs. The failure of these assumptions only becomes apparent later - in many cases after the compensation year has passed.

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