Reward Bulletin

G20 announcement on reforming compensation practices

Financial services compensation

28 September 2009

The G20 communiqué following its Pittsburgh meeting contains new provisions on compensation reform. At the same time the Financial Stability Board (FSB) issued Implementation Standards for Sound Compensation Practices.

The new announcement largely reinforce and clarify existing principles, but leave open the key question, which is how quickly, and in what form, implementation will happen on the ground, particularly in the US.

The G20 communiqué will be published in due course at www.g20.org

The FSB's Implementation Standards can be found at http://www.financialstabilityboard.org/publications/r_090925c.pdf

Introduction

The G20 restates the commonly held view that "excessive compensation in the financial sector has both reflected and encouraged excessive risk taking. Reforming compensation policies and practices is an essential part of our effort to increase financial stability."

The communiqué then "fully endorses" the Implementation Standards of the FSB.

G20 communiqué: compensation references

We fully endorse the implementation standards of the FSB aimed at aligning compensation with long-term value creation, not excessive risk-taking, including by:

(i) avoiding multi-year guaranteed bonuses;

(ii) requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate clawback and to be vested in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk;

(iii) ensuring that compensation for senior executives and other employees having a material impact on the firm's risk exposure align with performance and risk;

(iv) making firms' compensation policies and structures transparent through disclosure requirements;

(v) limiting variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base; and

(vi) ensuring that compensation committees overseeing compensation policies are able to act independently.

Supervisors should have the responsibility to review firms' compensation policies and structures with institutional and systemic risk in mind and, if necessary to offset additional risks, apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices. Supervisors should have the ability to modify compensation structures in the case of firms that fail or require extraordinary public intervention. We call on firms to implement these sound compensation practices immediately. We task the FSB to monitor the implementation of FSB standards and propose additional measures as required by March 2010.

So what's really new?

In practice there is little in the G20 communiqué itself that goes beyond the April principles issued by the Financial Stability Board. However, it is significant that a number of those principles have been brought directly into the communiqué language, indicating genuine shared commitment across territories.

Principle (v) is new. It reflects a desire for more directive limits on total compensation, as desired by some of the member countries, but leaves open significant questions about how the appropriate limiting ratio would be established.

By contrast the FSB's Implementation Standards themselves contain some significant new developments compared with the April Principles for Sound Compensation Practices. The Implementation Standards "focus on those areas in which especially rapid progress is needed".

FSB Implementation Standards: key points

Governance

- Largely a reassertion of the existing FSB principles.
- The Remuneration Committee is required to ensure that an annual compensation review, if appropriate externally commissioned, is conducted independently of management to assess compliance with relevant regulatory standards, and submitted to the relevant national supervisory authorities or disclosed publicly.
- Remuneration for employees in the risk and compliance function should be determined independently of other business areas and be based on the objectives of their function.

Compensation and capital

- Total variable compensation should not limit a firm's ability to strengthen their capital base. The extent to which capital needs to be built up should be a function of the 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

- Risk-alignment provisions largely a reassertion of the existing FSB principles.
- The importance of deferral is reaffirmed, and guidance is given on appropriate levels of deferral for senior executives and other employees with a material impact on the risk exposure of the firm:
  - substantial proportion "such as" 40% to 60% (or higher for the most senior or highly paid employees) of variable compensation payable over a period of years, on the basis of individual, business-unit, and firm-wide measures that adequately measure performance;
  - deferral period should not be less than three years and should vest no faster than on a pro-rata basis;
  - a substantial proportion "such as" more than 50% of variable compensation should be awarded in shares (or other appropriate non-cash instruments) creating incentives aligned with long-term value creation and time-horizons of risk, combined with an appropriate share retention policy;
  - remaining portion can be paid as cash compensation vesting gradually, with unvested portions subject to forfeiture in case of realised performance of firm and business line.

FSB Implementation Standards: key points (continued)

Pay structure and risk alignment (continued)

- Supervisors to be able to restructure compensation generally and approve compensation structures of most highly compensated employees in the event of exceptional government intervention to stabilise or rescue the firm.

- Guaranteed bonuses should not be used other than when hiring new staff and should be minimal, exceptional and limited to one year.

- Contractual provisions on termination of employment should be re-examined to ensure consistency with long-term value creation and prudent risk-taking.

- Significant financial institutions should ensure immediate, prospective compliance with the FSB compensation standards and relevant supervisory measures.

- Significant financial institutions should require employees to commit not to use personal hedging strategies to offset risk-alignment effects in their compensation arrangements, and should establish appropriate compliance arrangements.

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- An annual report should be issued to the public including description of:
  - governance arrangements; and
  - key design characteristics of the compensation system.

- In addition, aggregate quantitative information broken down by senior executive officers and employees having a material impact on risk profile of the firm, giving information on:
  - number of employees, total compensation, split between fixed and variable;
  - amounts and form of variable compensation, split between cash, shares, and other instruments;
  - amounts of outstanding deferred compensation split into vested and unvested;
  - the amounts of deferred compensation awarded during the year, paid out, and reduced through performance adjustments;
  - new sign-on and severance payments made during the financial year, and the number of beneficiaries;
  - the amounts of severance payments awarded, number of beneficiaries, and the highest such award to a single person.

Supervisory oversight

- Supervisors to ensure effective implementation of FSB Principles in their jurisdiction.

- Non-compliance by firms should result in prompt remedial action and, if necessary, appropriate corrective measures to offset additional risk.

Comment

The FSB's Implementation Standards are significant, because they represent the consensus, at a working level, among regulators internationally.

At a principles level they add little to the FSB's Principles for Sound Compensation Practices (or, say, the UK Financial Services Authority's Code of Practice on Remuneration). However, the Standards do provide some helpful clarifications as to the regulators' thinking on issues such as what constitutes an appropriate level and term of deferral, and attitudes to guaranteed bonuses.

The deferral guidance is not far out of line with where the market has already been moving to and is, for example, less stringent than the requirements of the Walker Review in the UK:

Deferral requirements for most senior executives	FSB Implementation Standards	Walker Review
Proportion of total variable compensation paid in deferred form	60%+	80%+
Proportion in long-term incentive scheme	50%+	50%+
Period of deferral	Phased vesting over at least three years	Phased vesting of cash bonus over at least three years LTI vests half each over three and five years

On the disclosure question, the Implementation Standards indicate the type of information that regulators may well require firms to provide to demonstrate compliance – as indeed has already happened in the UK with the FSA's Remuneration Policy Statement questionnaire. However, it is difficult to see how regulators will have a locus in requiring public disclosure of such information, which is likely to be resisted by financial institutions. Increased public disclosure requirements are likely to be implemented by local legislation or governance standards (for example via the Combined Code in the UK).

The good news is that, rather than being distracted by eye-catching new initiatives, governments and regulators have, on the whole, focused on reinforcing commitment to existing principles and rules. This helps to provide certainty as to the direction of travel of regulatory developments. In certain cases (e.g. deferral) helpful clarification has been provided.

However, implementation of new regulatory rules happens locally in individual territories. What regulators agree in working groups is potentially very different from what politics will allow nationally. As the FSB states: "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 key outstanding question remains: outside of the UK, Australia, Netherlands, and Switzerland, how quickly will implementation happen and in what form? It feels like global consistency has moved a step closer, but it remains tantalizingly uncertain. Without the guarantee of a level playing field, firms operating in a highly competitive international market will be reluctant to move too fast.

The G20 communiqué and the FSB's Implementation Standards helpfully maintain the momentum of compensation reform in the financial services sector. But change will only really happen when the US regulators show their hand.

Contacts

We have extensive experience in helping clients in all of these areas referred to in this briefing. If you would like assistance in planning or executing your thinking then please contact your usual PricewaterhouseCoopers adviser or alternatively one of the people listed below:

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