COMPENSATION REFORM: EMBEDDING GLOBAL STANDARDS

OCTOBER 2013

INSTITUTE OF INTERNATIONAL FINANCE

OLIVER WYMAN

FOREWORD

On behalf of the Board of Directors of the Institute of International Finance (IIF) and the IIF's Committee on Governance and Industry Practices, we are pleased to present Compensation Reform: Embedding Global Standards.

Financial services firms have supported the work of the Financial Stability Board (FSB) to improve compensation practices following the financial crisis. Great efforts have been made to meet the requirements of the FSB's 2009 Implementation Standards, with the ensuing progress documented in the IIF's previous reports on compensation in 2009, 2010 and 2011.

This year's survey again uses the FSB Principles and Implementation Standards as a point of reference and seeks to gauge the full extent of the progress since 2009 when they were issued. The survey focuses on elements in the FSB Standards where work was still on-going at the time of the last survey in 2011. The results show that the FSB Standards have now been largely embedded into the business practices of the global wholesale banking industry.

In addition to reporting on the industry's efforts to improve compensation practices, the report considers the potential impact of relevant legislative and regulatory interventions beyond the FSB Standards – notably, Capital Requirements Directive IV (CRD IV) in Europe – and the extent to which these interventions are inconsistent with the objectives set out in the FSB Principles. Finally, we look ahead and outline some of the implications of compensation reform for the industry and regulators.

The Institute is grateful to the member firms which participated in the survey and for the individual supplementary interviews that form the backbone of this report. Special thanks go to the IIF Advisory Panel on Compensation for reviewing drafts and for providing valuable feedback.

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CONTENTS

1. CONTEXT FOR THE REPORT

This report presents the results of the 2013 Institute of International Finance (IIF) and Oliver Wyman joint survey on compensation practices in wholesale banking. This is the fourth survey since the financial crisis and was conducted throughout June and July 2013. This report assesses the impact of the implementation of the Financial Stability Board's compensation standards, and takes a wider look at the implications for the industry, regulators and public policymakers.

The survey group covers 26 of the world's leading financial institutions. This group accounts for approximately 60% of the global wholesale banking revenues (compared to approximately 70% in the previous survey). Respondents include both standalone wholesale banks and wholesale divisions of larger banking groups, with the following geographic distribution[1]:

- Europe: 17
- North America: 6
- Other: 3

As in previous years, responses to the survey are weighted according to total wholesale banking revenues. Unless otherwise stated all statistics quoted refer to the weighted shares of respondents. Due to the change in the survey population this year, where comparisons with previous results are used we have recalibrated the peer-sets to include only those firms that participated in both surveys. For these comparisons we have used simple averages from both sets of survey results.

Due to the broader scope and forward looking nature of the report, interviews with member firms were a crucial part of its preparation. In comparison with previous years, a greater emphasis was placed on qualitative insights gained from discussions with Board and C-Suite level management and Human Resources professionals.

[1] Geographic split based on the locations of respondent institutions' headquarters

2. EXECUTIVE SUMMARY

Over the two years since the Institute's last survey the industry has continued to implement the FSB Standards and this work is now essentially complete. Significant changes have been made to pay-out structures so that they better reflect the risks taken to generate revenue. Only a few banks reported plans for further small changes to their compensation practices in response to changes in the market environment or in their own business models.

Survey respondents and interviewees generally believe that compensation practices have been reformed in five main respects:

- Improved alignment of compensation with risk-adjusted performance and the overall performance of the firm
- Tightening the governance of compensation through board committees and supporting processes
- Increasing the use of deferrals, vesting and clawback/malus arrangements[2]
- Limiting the use of guaranteed bonuses
- Enhancing public disclosure of compensation

The FSB Implementation Standards have brought about industry convergence and thus limited first-mover disadvantages. While the largest banks report that this reform accelerated or expanded existing plans to improve compensation practices, the more significant effect has been to set out minimum standards. This has helped to level the playing field across jurisdictions. However, subsequent actions by regulators and supervisors, particularly in relation to CRD IV, have gone some way to undoing this.

A degree of geographic variation was also apparent, with European institutions reporting a greater impact of the reform than the US Banks, although this must be looked at in the context of diverse starting points and different approaches by US and European regulators.

WORK COMPLETED SINCE THE LAST REPORT

1. Measuring performance

Our last report highlighted that the development and application of risk metrics required more time and experience. Since then, banks have continued to improve the data quality and granularity at which they can calculate risk-adjusted performance metrics. The more sophisticated institutions are now able to cascade these through the organisation down to the desk level, and use risk-adjusted performance along with individual performance indicators to assess compensation awards.

2. Deferrals, malus and clawback

A noticeable early impact of the FSB Standards was to increase the proportion of variable compensation that is deferred. This increased level has been maintained and almost all deferred compensation (96%) is now paid subject to some form of possible negative adjustment in the form of bonus malus. Institutions report continued work in two areas to increase the influence of bonus-malus on employees' risk taking:

- **Increasing awareness of the application of bonus malus provisions:** increasing transparency of the use of bonus malus within the organisation as a way to ensure the triggers have a meaningful impact on behaviour throughout the firm
- **Finding the appropriate balance between collective and individual malus triggers**: Ensuring that employees have sufficient influence on the bonus malus triggers by using both individual and team level triggers, as well as a link to overall firm performance.

[2] For the purposes of this report 'Bonus malus' is defined as reduction of unvested compensation, 'Clawback' is defined as a reclaim of compensation that has already been paid out

3. Conduct, culture and compensation

The last two years have seen conduct rise to the top of the agenda of senior managers, regulators and legislators. Banks report that major strides have been made in their efforts to communicate the standards of conduct they expect of their employees and that these are now generally well understood.

Business culture is perceived to be the main driver in ensuring that these expectations are met and compensation plays a critical supporting role in this. Many respondents noted that it is also essential that the compensation framework is designed to reinforce this desired culture and employee behaviour and does not inadvertently encourage behaviours that run contrary to it. Further, they noted that compensation can be used as a mechanism to reinforce the desired behaviours by ensuring that failure to demonstrate the desired cultural values and conduct results in reduced compensation.

Many participants reported that the basic work on the compensation mechanisms to achieve the desired objectives is now complete. However, there was also a consensus amongst respondents and interviewees that such change will take a few compensation cycles to be embedded and have its full impact as employees see the rules enforced, and that this will vary across jurisdictions due to different regulatory approaches.

POLICY AND REGULATION BEYOND THE FSB

Divergent legislation and related regulation, notably between the EU and other key jurisdictions, has hampered the uniform application of the FSB Standards and led to inconsistencies across key markets. Many respondents and interviewees were troubled by policy makers' actions that went beyond the FSB Standards and left them with the feeling that the goalposts for compensation reform have been moved. Respondents from all countries are particularly worried about the direction taken in the EU, where a cap on the ratio of variable to fixed remuneration has been legislated for those defined as Material Risk Takers.

In going beyond the FSB principles, this regulation serves to create an uneven playing field and raises two major issues for the industry:

- For EU headquartered firms, their employees in non-EU locations are subject to different restrictions to the employees of their non-EU competitors (due to the home regulator of the group)
- For non-EU headquartered firms with operations in the EU, internal inconsistencies are created due to different employees being subject to different regimes (in respect of amounts deferred, vehicle for delivery, retention periods etc.), based on their national locations

The bonus cap is also expected to drive a shift towards fixed compensation with consequences that are inconsistent with the FSB's Principles for Sound Compensation Practices. The unintended consequences of the EU policy in this regard are:

- Banks' cost-base flexibility will be reduced, reducing their ability to vary pay-out levels with financial results and, thus, limits an institution's ability to increase its capital with retained earnings
- The higher proportion of fixed pay will make it harder to align pay-outs with risk-adjusted performance and prudent risk-taking
- The shift from variable compensation into fixed in effect acts as a guarantee of greater pay-outs – something the FSB Implementation Standards sought to eliminate
- Deferred pay will be reduced as a proportion of total compensation, reducing the impact of measures that link compensation to conduct

IMPLICATIONS FOR THE INDUSTRY

Results of the survey and interviews show that work on the FSB Implementation Standards is largely complete. However, respondents indicated that some work still needs to be done to embed the progress to date into the culture of their firm and to realise the full benefits of the Compensation reforms. Some of this work may include:

- Ensuring that compensation payouts have sufficient flexibility and are consistent with maintaining a sound capital base
- Completing the on-going work in the area of bonus malus, in particular to resolve issues related to taxation and labour laws, most likely in collaboration with regulators and policy makers
- Refining the application of malus triggers to ensure greater individual accountability
- Embedding the changes into the institutional culture at the various levels of the organization, ensuring employees understand the expected behaviours and how these feed into compensation outcomes

IMPLICATIONS FOR SUPERVISORS

Some in the industry fear that some policymakers will pursue further legislative interventions, driven by a perception that the industry has not yet changed. The results of this survey indicate that the industry has in fact made fundamental changes in policies and practices in line with the FSB Standards and in ways that foster institutional resilience and financial stability. As noted, the remaining challenge for the financial firms is to embed these changes in ways that have the desired effects on the business culture and the risk-taking behaviour of employees. This will not be helped by further changes in legislation or regulation. A period of stability is required to allow compensation frameworks to be "bedded down" and employees to understand them and experience them at work.

Where public policymakers and supervisors deem further regulation is required, they should ensure that sufficient consultation takes place, on both policy development and implementing rules, and that any potential unintended consequences are identified and addressed beforehand. Policymakers should also ensure that any future intervention in compensation is consistent with the FSB principles, with prudent risk-taking and with maintaining a sound capital base.

Two other steps would support industry progress:

- Work to remove barriers within the labour and taxation laws to enable the industry to implement compensation adjustments in line with current regulation, in particular, the ability to implement necessary bonus malus/clawback provisions
- Through the FSB implementation monitoring process, promote consistent implementation of agreed FSB standards across jurisdictions

3. FSB IMPLEMENTATION STANDARDS

3.1. SUMMARY OF IMPLEMENTATION

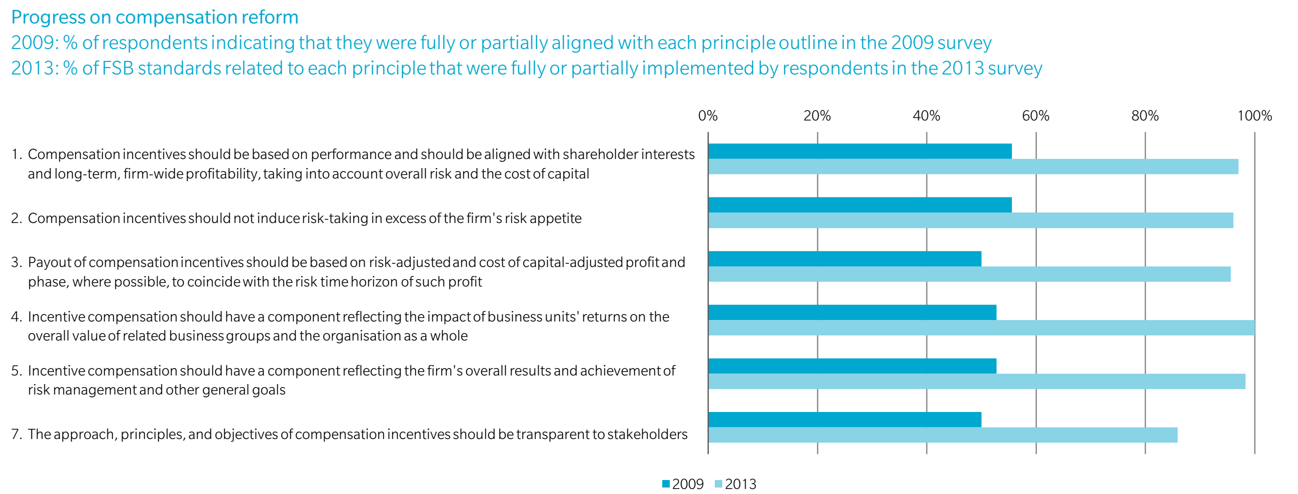
The Financial Stability Board published its Principles for Sound Compensation Practices in April 2009, with the objective of setting baseline compensation principles for the industry. A set of Implementation Standards followed in September that year, designed to provide the industry and regulators with further guidance on specific areas where change needs to happen. These then formed the basis for extensive national-level guidelines on compensation.

The Institute's previous studies in 2009, 2010 and 2011 tracked the progress of the industry in meeting the FSB Implementation Standards. Work in this area has been on going. The 2011 report showed that banks had achieved notable progress in implementing the FSB Standards by aligning compensation with risk-adjusted performance, strengthening remuneration governance, severely limiting guaranteed bonuses and increasing the use of deferrals. It was also found that further work was needed on disclosure and on refining risk metrics and methodologies. Over the two years since this last IIF survey, the industry has continued to make progress and implementation is now largely complete.

- Pay-out structures have been further improved, with all respondents increasing deferred compensation and subjecting stock-based instruments to an appropriate vesting policy to help guard against excessive risk taking
- Risk alignment has been strengthened, with 92% of respondents using risk adjustments that reflect the cost and quantity of capital (compared with 75% in 2011 and less than half in 2009), and Remuneration Committees now working closely with the Risk Committee at 88% of respondents (2011: 75%)
- Information on aggregate remuneration and the decision-making process is widely disclosed, by 91% and 75% of respondents respectively

When the FSB Standards were designed, practically no bank was already applying the full set of standards. The results of this year's survey show that the vast majority of banks have now implemented all of the FSB Standards relevant to them. Across all categories, an average of 83% of respondents have implemented all of the FSB's Standards (2011: 77%)[3], with a further 11% implementing them in part or in modified form.

EXHIBIT 1: OVERVIEW OF PROGRESS SINCE 2009[4]



[3] Full results were 82% (2013), 73% (2011)

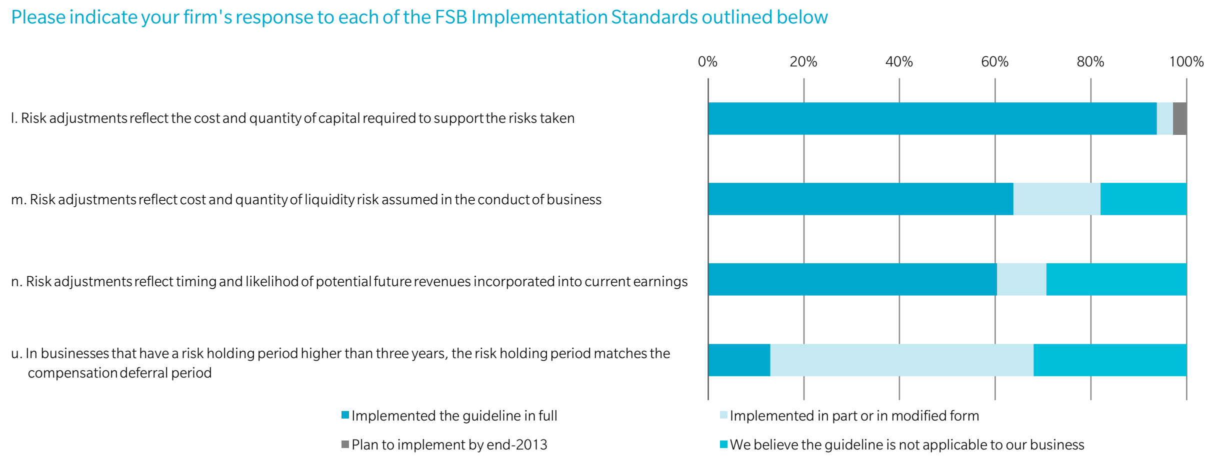
[4] This is not a direct comparison as the 2009 IIF/Oliver Wyman compensation survey was carried out prior to the release of the FSB Implementation Standards in September of that year. We have therefore mapped the FSB principles to the questions asked in the 2009 survey to allow this comparison across time periods to allow for comparison across the two time periods. The data presented in Exhibit 1 is based on a constant sample so the figures presented here do vary slightly from those released in the 2009 report.

Implementation has progressed well on all dimensions. The only apparent exception is a slight reduction between 2011 and 2013 in the proportion of respondents reporting that they have fully implemented the guidelines relating to disclosure. This is because, on disclosure, national regulations have differed from the FSB Standards in some subtle ways. The reduction in respondents reporting "implementation in full" reflects these subtle differences in new national regulations rather than a material retreat from compliance with FSB Standards. This result may also reflect the extensive changes now being made to broader disclosure standards, which require substantial adjustments by banks.

Previous reports have noted banks' difficulties with the availability of risk data, and this year's survey again highlights data as a challenge. While 94% of respondents use risk adjustments that reflect the capital required, only 62% make them also reflect the liquidity risk assumed, with a further 20% implementing the guideline in part or in modified form.

Matching deferral lengths to risk holding periods can also pose serious practical problems, as our survey shows (this guideline has been fully implemented by only 12% of respondents). Some wholesale banking products, such as spot FX and short-term futures, pose no problems here due to short risk-holding periods. However, there are difficulties involved with other products, such as loans and long-term derivatives, which often have tenures greater than ten years. The problem has been recognised in the compensation guidelines developed by national regulators and its adoption has ceased to be a major part of the compensation reform efforts.

EXHIBIT 2: SELECTED INDIVIDUAL IMPLEMENTATION STANDARDS



This year's survey shows the industry has now broadly completed the process of implementing the FSB Implementation Standards. A few of the standards have been found not to be relevant to some businesses and therefore may not have been universally applied, the remainder have now been implemented partially or fully by more than 95% of respondents, with few further actions planned. This provides us with an opportunity to review the impact of compensation reform and assess how successful this has been in delivering the intended results

3.2. IMPACT OF THE IMPLEMENTATION STANDARDS

The results of this year's survey and supporting interviews indicate that respondents believe that the industry's own reforms and FSB Implementation Standards have been effective in bringing about change in several areas:

- Reform of compensation structures: this has been one of the greatest impacts, with 83% of respondents indicating that the Standards have been successful or very successful in increasing the usage of deferrals, vesting and clawback/malus arrangements
- Limiting guaranteed bonuses: again an overwhelming majority of respondents recognise the effect of the standards on eliminating multi-year bonuses and restricting guarantees (86% of respondents)
- Enhancing public disclosure (80% of respondents)
- Some institutions also highlighted a significant impact on business culture, with improved governance and the use of risk-adjusted metrics for overall bonus pool calculation helping to build a culture of prudent risk management and increased focus on risk-taking in the front office

The Standards have proved important in driving industry convergence. Leading banks report that the FSB Implementation Standards systematised or expanded their existing efforts. However, the more significant effect has been to push up minimum standards and set a more level playing field. Smaller institutions[5] were more likely than larger institutions to observe that the Standards had been effective in linking compensation to firms' financial condition and future prospects (81% vs. 54%), and ensuring independent and effective oversight (69% vs. 61).The largest institutions reported less change here because such links were already in place prior to the Standards.

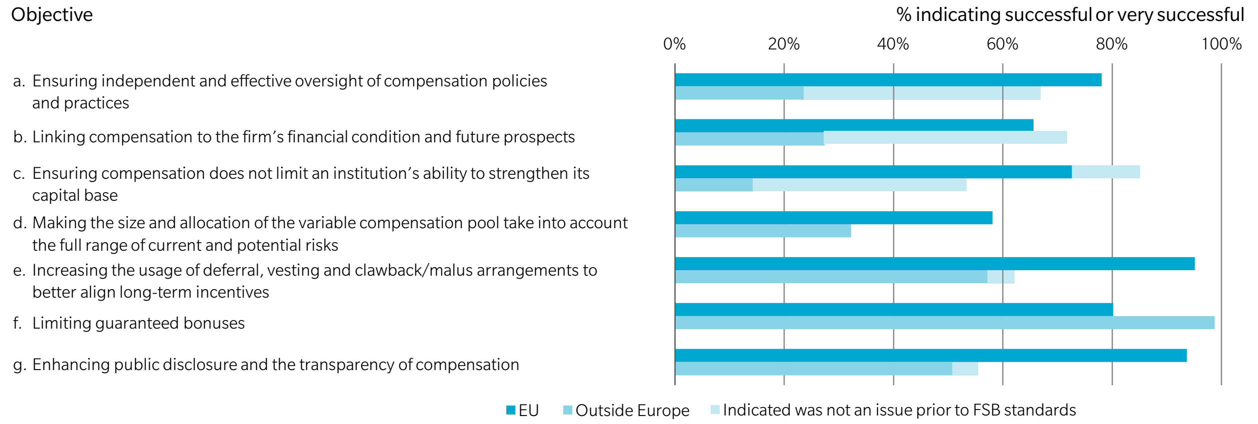
Several of our interviewees believe there are geographic discrepancies in implementation and in the efficacy of the FSB Implementation Standards. These are rooted in the different philosophies of both banks and regional and national regulators. This was also reflected in the survey results:

- Disclosure practices differ: European banks are more likely to submit an independent compensation review to the public regulators (62% European respondents vs. 8% outside Europe) and to disclose aggregate quantitative information on compensation for senior executives and Material Risk Takers to the public (87% European respondents vs. 47% outside Europe)
- Pay-out structures also diverge: European banks are more likely to defer 40-60% of variable compensation (100% European respondents vs. 52% outside Europe) to pay at least 50% of variable compensation in non-cash instruments (98% European respondents vs. 45% outside Europe) and to match risk holding periods to compensation deferral periods (69% European respondents vs. 57% outside Europe)

These discrepancies were reflected in banks' views on how successful the FSB Standards have been in accomplishing their objectives. Responses from European firms differ substantially from those of others on this question, as shown in Exhibit 3. Those outside Europe were more likely to observe that some areas required no change as a result of the publication of the Standards and, overall, European banks consistently observed greater change as a result of the FSB Implementation Standards.

EXHIBIT 3: IMPACT OF THE FSB STANDARDS

From your firm's perspective, how successful have the FSB standards been in accomplishing each of the objectives below



[5] Survey banks with annual wholesale revenues <$5BN

4. COMPLETED WORK SINCE THE LAST SURVEY

While industry adherence to the FSB Implementation Standards progressed as outlined above, work continues at some institutions in several areas where further detail or refinement of core standards is needed. In this section we assess the progress made and work that is in train in three areas of the remuneration framework:

- *Refining performance metrics*, including the cascade of risk-adjusted performance metrics down the organisational structure
- *Deferrals, and bonus malus,* further progress on establishing administrative and financial tools to make at-risk deferrals credible and effective
- *Conduct, culture and compensation,* continuing efforts to embed desired behavioural norms into all levels of the firm's organization and to ensure that compensation can and should play a role in supporting good conduct

4.1. MEASURING PERFORMANCE

Two objectives of the FSB Implementation Standards were to "better align compensation structure with risk" and to "link the total variable compensation pool to the overall performance of the firm". This required a move to risk-adjusted financial metrics.

The first-stage reform was to link the overall size of the bonus pool to risk-adjusted financial metrics. Banks responded quickly and total wholesale profit after risk charges is now calculated by all of our respondents and used in front office compensation by 96%.

Cascading more granular performance metrics through the compensation framework has strengthened the link between risk-adjusted performance and reward. When the FSB Standards were published in 2009, few banks could calculate risk-adjusted metrics at the desk, product and even major division level (23% of respondents in 2011 could not calculate risk-adjusted profit for major divisions).

The industry has made substantial progress in the last two years:

- 95% of respondents calculate risk-adjusted profits at the major division level (2011: 77%)[6]
- The majority of banks cascade these metrics down to the product level. 68% calculate risk-adjusted profit and 91% now set targets and track financial performance against them (2011: 59% and 82%) at this level[7]
- Banks have also made major progress in the calculation of desk-level metrics, with 41% now calculating risk-adjusted profit at this level (2011: 27%)[8]

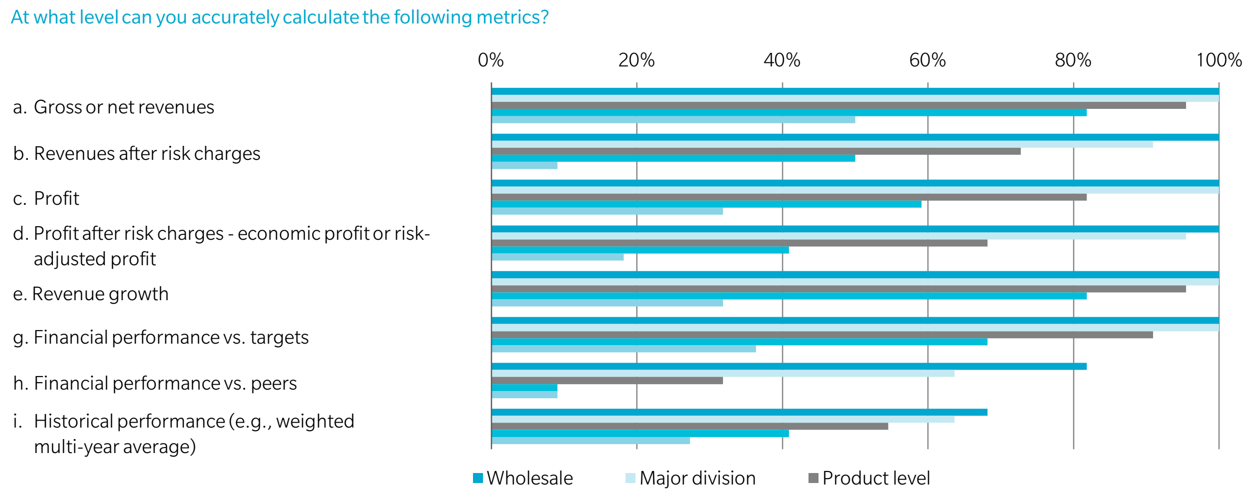
The practical impossibility of accounting for diversification and netting benefits in risk figures, and of allocating costs to individuals or small operating units, makes it difficult in many cases to cascade risk-adjusted return measures "all the way down". Most respondents and interviewees felt that the focus should not therefore be on pushing every bank to use individual risk-adjusted profit as the primary performance metric. Rather, each institution should reach a level of granularity appropriate to its size and lines of business.

[6] Like-for-like comparison using the same peer-set. Full 2013 survey result also 96%.

[7] Full 2013 results 64% and 95% respectively.

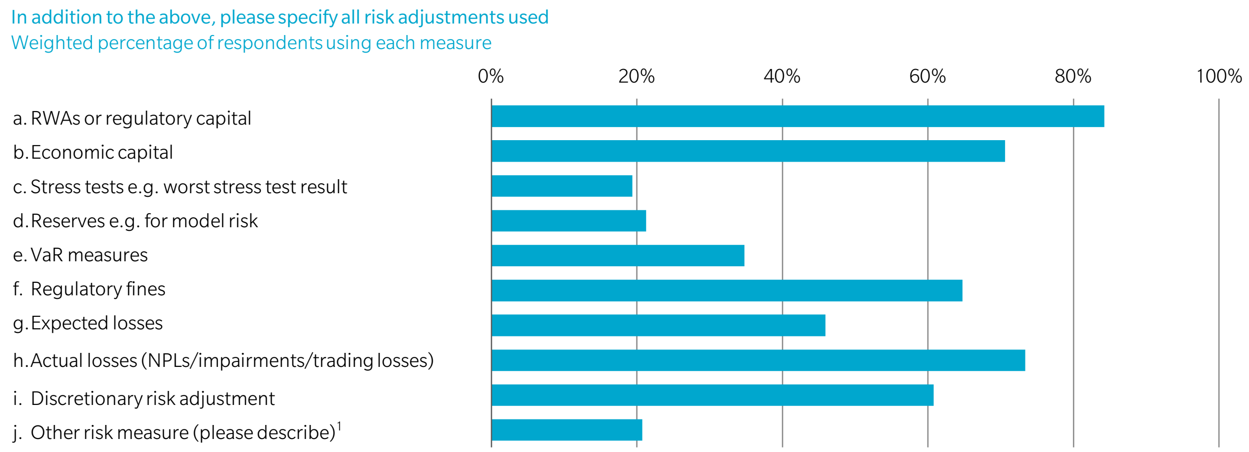
[8] Full 2013 result 39%.

EXHIBIT 4: AVAILABILITY OF GRANULAR RISK METRICS



The risk adjustments used for performance metrics reflect those used in a firm's financial reporting. The most commonly used adjustments are Risk Weighted Assets (RWAs)/regulatory capital (83%), potential losses as measured by NPLs impairments or trading losses, (83%) and regulatory fines (70%). The majority of banks also apply discretionary risk adjustments to provide flexibility and enable any risks not reflected in the metrics noted above to be adequately reflected in the assessment of performance (53%).

EXHIBIT 5: USE OF RISK ADJUSTMENTS



1. Other risk measures included bespoke risk measures, risk behaviour assessments and performance against scorecards

4.2. DEFERRALS AND BONUS MALUS

Deferrals and malus have helped bring consideration of future earnings into the compensation process; and the proportion of compensation to which malus adjustments can be applied has also increased. However, as noted above, recent European legislation may undermine this trend.

The FSB Standards' strong immediate impact on deferrals has been maintained; 90% of respondents reported full implementation of the FSB Implementation Standard which states that at least 60% of compensation for the most senior management should be deferred.

The survey results show that the increase in deferrals as a percentage of the bonus pool since 2009 has been maintained and that 91% of respondents had an average vesting period of three years or more.

Deferrals only affect behaviour when it is perceived by employees to genuinely place compensation at risk. We have synthesized interview responses concerning this issue into three requirements:

1. Unvested compensation must be subject to (malus and clawback) adjustments[9]
2. The bank must set transparent triggers for adjustments
3. Employees must believe adjustments will be applied according to the rules. In other words, the threat must be credible

MAKING COMPENSATION SUBJECT TO EX-POST ADJUSTMENTS

An increase in deferred compensation was achieved quickly following the publication of the FSB Implementation Standards. The move to make deferred compensation subject to ex-post adjustments was also swiftly completed and has now been almost universally applied by banks; 96% of deferred compensation covered by the survey was subject to bonus malus or clawback. While this implementation level represents significant progress against the FSB Implementation Standards, it presents an incomplete picture of their effectiveness as discussed below.

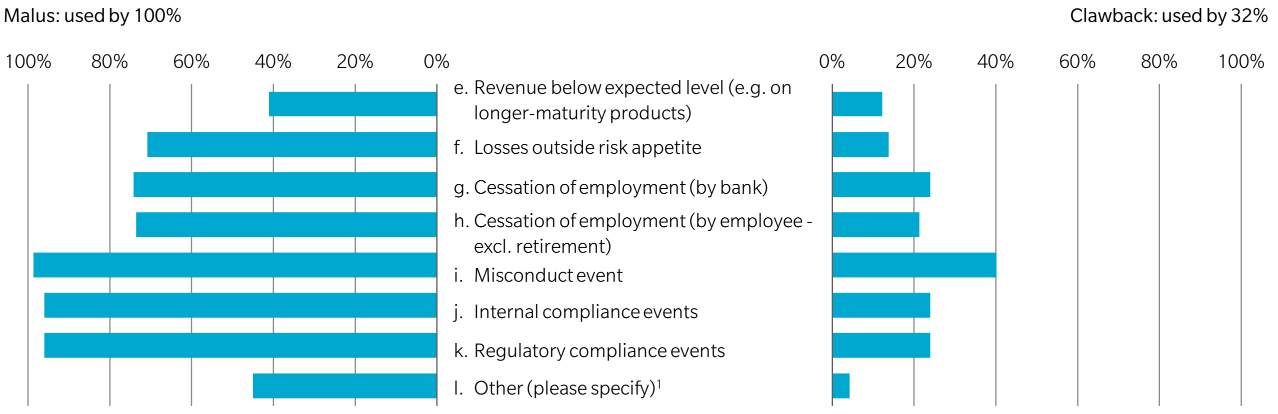
DEFINING TRIGGERS FOR EX-POST ADJUSTMENTS

Deferred compensation can be reduced based on either collective or individual events. In the right circumstances collective criteria provide a healthy dose of shared responsibility and encourage scrutiny from co-workers. But this can sometimes be too remote from the individual to influence risk taking behaviour. Individual triggers are therefore also important. These are now explicitly defined at most institutions. Losses outside of those reasonably anticipated were an explicit trigger for malus at 70% of respondents, while misconduct events are explicit triggers for 99% of respondents (showing progress from 83% in our 2011 report[10]).

Interviewees emphasised that the size of the adjustments permitted is also important; some noted that there must be sufficient downside to outweigh the potential upside that could arise as a result of misconduct.

EXHIBIT 6: INDIVIDUAL MALUS AND CLAWBACK CONDITIONS

Do you carry out any ex-post performance adjustments via (i) malus adjustment of unvested compensation and (ii) clawback of vested compensation?
Weighted percentage of respondents using each measure



1. Other responses included management discretion, values demonstrated and reputational harm

[9] Remuneration subject to clawback can to an extent also play this role. However, the clawback of vested compensation is generally subject to more stringent criteria and is legally problematic in a number of jurisdictions.

[10] Weighted share of respondents indicating that deferred compensation was dependent on employee not committing harmful acts.

USING EX-POST ADJUSTMENTS AND ESTABLISHING A CREDIBLE THREAT

The next requirement for effective deferred compensation is the credibility of the threat. To be credible, employees must see these measures being applied in practice.

Interviewees and survey respondents indicated that while malus adjustments can be made on both collective and individual triggers, the majority of actual malus adjustments are made based on collective criteria, such as significant losses for the bank or large regulatory fines. However, some banks are beginning to increase their use of individual-level malus clauses too.

Enforcing malus adjustments can be problematic when employees have moved on to different roles or left the organisation. Proponents of long deferrals typically argue that they are needed to facilitate financial penalties for losses that materialise long after decisions are taken, but an increase in the deferral period is useful only if it can be enforced.

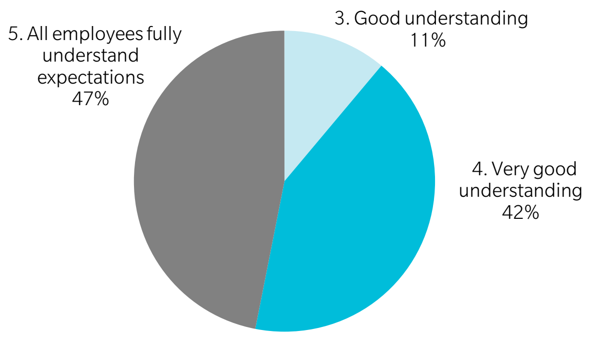
4.3. CONDUCT, CULTURE AND COMPENSATION

Conduct is now at the top of senior management's and regulators' agendas. Losses, fines, and reputational damage due to malfeasance, in both retail and wholesale banking, have highlighted the need to manage standards of conduct across the organisation, in part by using compensation to influence behaviour and punish misconduct.

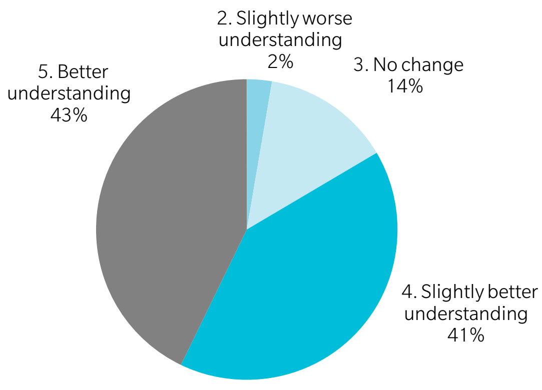
Accordingly, this year's survey was expanded to examine in more detail the work done to align compensation with desired conduct. The first step is to communicate conduct and behavioural expectations to employees. The survey shows that respondents believe themselves to be relatively successful in this and that a considerable improvement has been made in the past 18 months.

EXHIBIT 7: EMPLOYEE UNDERSTANDING OF CONDUCT EXPECTATIONS

Overall, how well do you believe your employees currently understand the standards of conduct expected of them? (1–5 scale)



Has the employee understanding of conduct changed over the last 18 months? (1–5 scale)



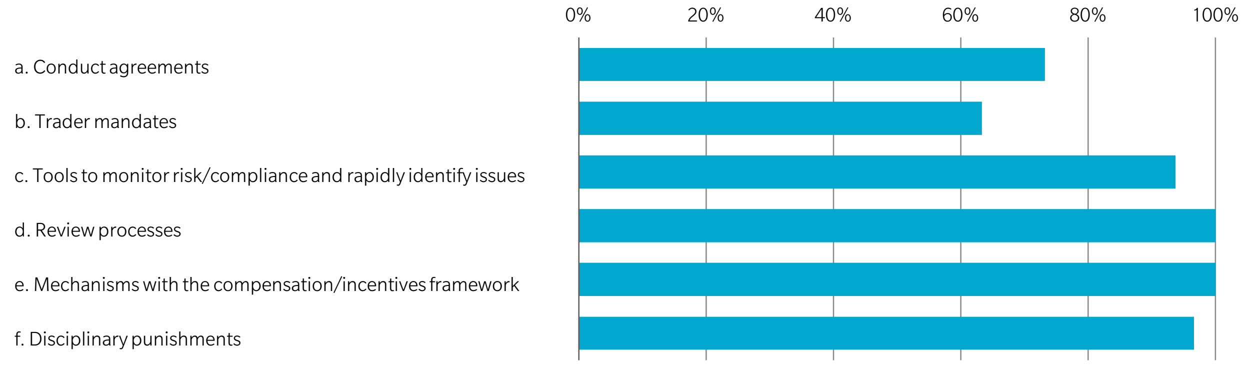
The survey and interviews revealed that once standards have been communicated, efforts must move to ensuring that they are monitored and enforced. Policies and compliance are considered less important than culture, which is seen as the most important lever to influence behaviour by 38% of survey respondents. The need for cultural change at many institutions was widely recognised following the crisis and has been publically announced as a central focus for reform. A number of large global banks have launched major initiatives in this area.

It is well recognised that on its own, compensation is a limited lever for bringing about cultural change. However, most interviewees felt that the performance management framework needs to support and reinforce the desired culture of the firm, with the metrics used for assessment and compensation properly aligned with the business's target outcomes. While compensation alone will not create the desired business culture, badly designed compensation can quickly undermine cultural change or even create a bad culture.

At the same time, there is a role for compensation as a mechanism to influence behaviour by impacting the financial outcomes of those who do not demonstrate the desired cultural values and conduct behaviours. Our survey results show that review processes within the compensation framework are the most common ways of monitoring and enforcing compliance with conduct expectations, with both used by all respondents.

EXHIBIT 8: MONITORING AND ADHERENCE TO CONDUCT EXPECTATIONS

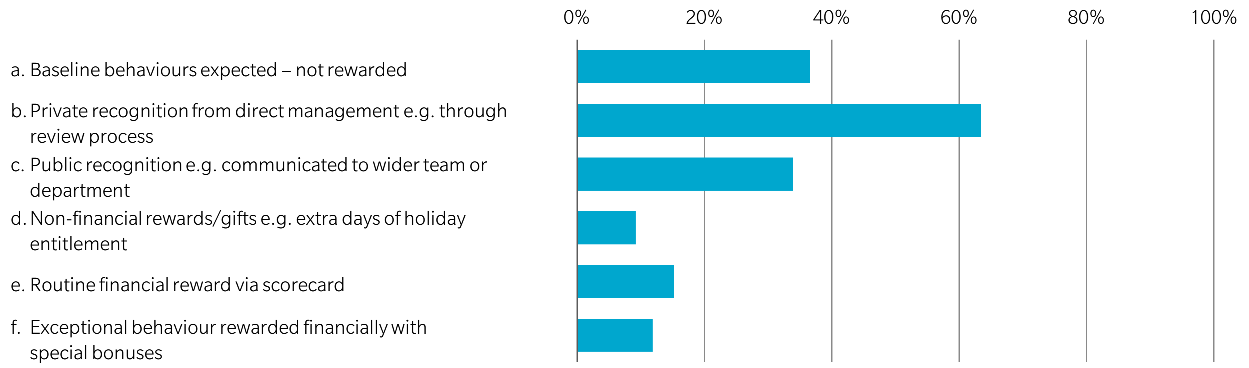
What mechanisms do you have in place to monitor and enforce compliance with conduct expectations?



Besides malus adjustments, bonus 'knock-outs', scorecard-based bonus adjustments and salary freezes commonly complete a suite of financial penalties for misconduct. When combined with explicitly defined trigger events for conduct investigations (used by more than 80% of respondents), these tools create a transparent framework for using compensation to influence conduct.

EXHIBIT 9: REWARDING GOOD CONDUCT

How is good conduct in front-office employees rewarded?



Which of the following non-financial factors are taken into account when setting individual bonuses?

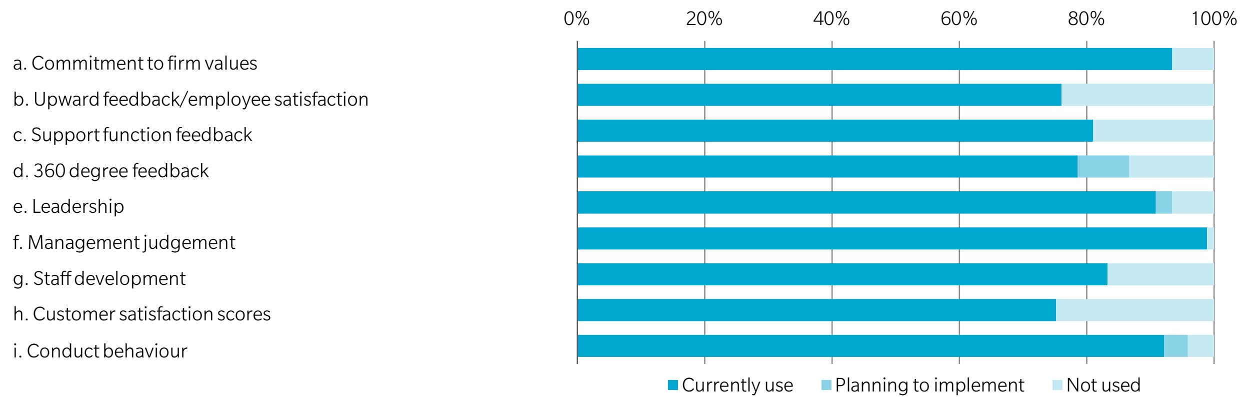
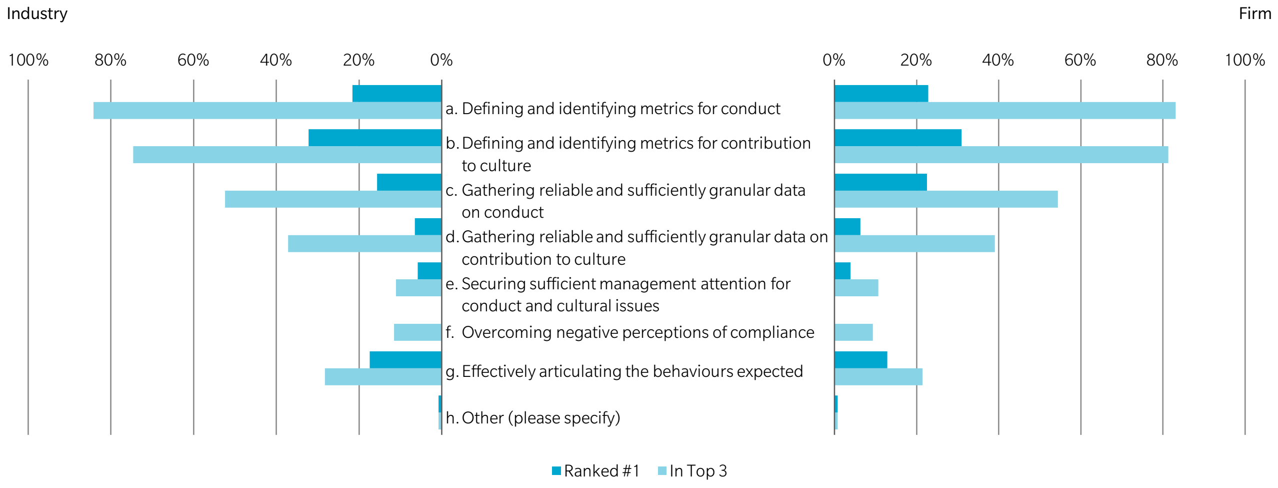


EXHIBIT 10: CHALLENGES LINKING COMPENSATION TO CONDUCT AND RISK CULTURE

What do you see as the main challenges in linking compensation to conduct and risk culture?
Respondents ranked the top five by importance and effectiveness



5. REGULATORY DEVELOPMENTS BEYOND THE FSB STANDARDS

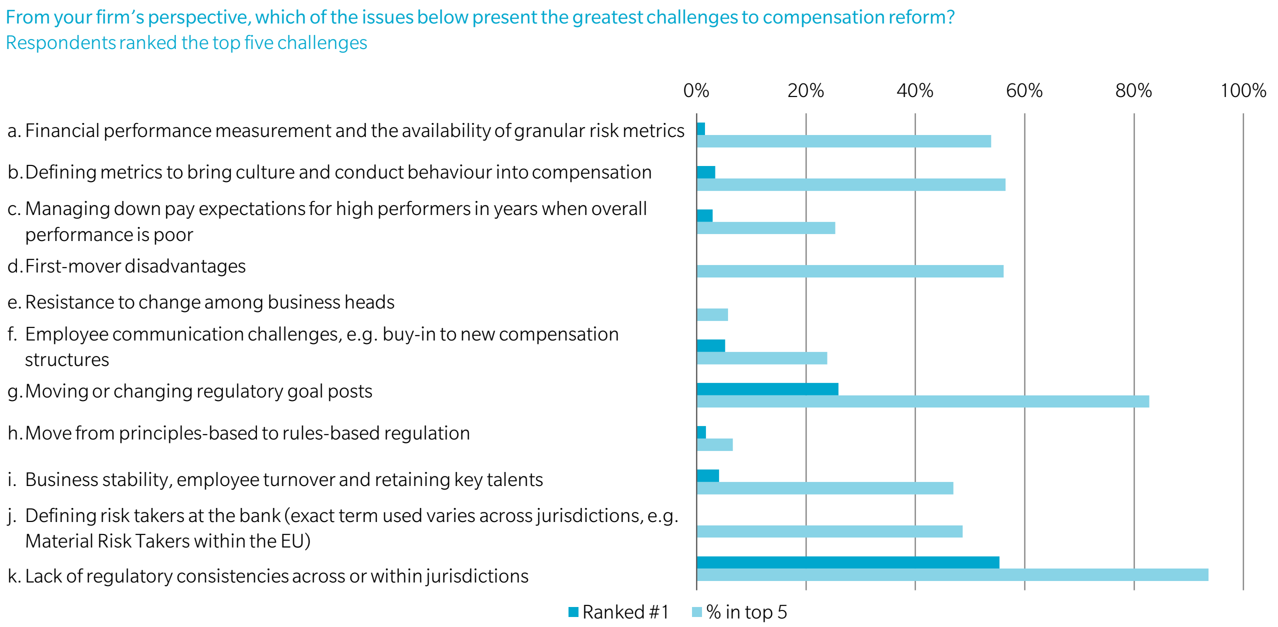
In Europe this year, a bonus cap has been legislated under the Capital Requirements Directive IV (CRD IV). The bonus granted to an individual deemed a Material Risk Taker cannot be greater than their fixed salary (or double their fixed salary, if specific shareholder approval is granted for this extension). Further details of the CRD IV requirements are outlined below.

EXHIBIT 11: OVERVIEW OF CRD IV REQUIREMENTS

"Bonus Cap"	• Variable pay to be capped at 100% of fixed pay, increased to up to 200% of fixed pay with shareholder approval • Shareholder approval levels required to increase the cap: – 65% support with a quorum of 50% of shareholders – 75% support without a quorum
Deferrals and pay structure	• At least 40% of variable remuneration must be deferred for not less than three to five years (rises to 60% for senior management) • At least 50% of any variable remuneration must consist of shares or share equivalents • Vesting should be subject to the financial performance of the institution, with "malus" and clawback clauses applied to up to 100% of variable compensation • Long-term deferred instruments of up to 25% of variable pay can be discounted when calculating the variable-to-fixed pay ratio, provided they are deferred for at least five years
Timing	• The implementation date for CRD IV is January 2014 • However, firms need only apply the requirements on variable compensation (including the bonus cap) for services provided or performance from the year 2014 onwards • Indeed, the Council's press release clarifies that "the first bonuses to be affected will be those paid in 2015 in respect of performance in 2014"

This new requirement has made many of our survey respondents feel subject to inconsistent rules, citing this issue as the greatest challenge to further reform.

EXHIBIT 12: REMAINING CHALLENGES IN COMPENSATION REFORM



Current form of the CRD IV rules on compensation go beyond efforts to ensure the capital adequacy of EU supervised entities. This is clear from their extraterritorial reach; while other rules in CRD IV apply only to EU-supervised entities (namely resident entities and their branches), the bonus cap goes applies to non-EU subsidiaries whose capital adequacy is overseen by their host regulators.

By going beyond the FSB principles and by applying such broad territorial reach, CRD IV-based regulations create an uneven playing field, causing two major problems for the industry:

- For EU headquartered firms: their employees in non-EU locations are subject to different restrictions to the employees of their non-EU competitors
- For non-EU headquartered firms with operations in the EU, internal inconsistencies are created due to different employees being subject to different regimes (in respect of amounts deferred, vehicle for delivery, retention periods etc.) based on their national locations

Interviewees expressed concern that this rule undermines the FSB Implementation Standards goal of making compensation vary with risk-taking. Sixty five per cent of respondents believed that a shift to a greater percentage of fixed pay would form part of their response to the directive. This has several unintended consequences:

- The higher proportion of fixed pay will make it harder to align pay-outs with risk-adjusted performance and with prudent risk-taking
- The flexibility of banks' cost-base will be reduced, thus eroding their ability to vary pay-out levels with financial results their ability to increase capital by retaining earnings
- The shift from variable to fixed compensation effectively acts as a guarantee of a greater level of pay-out – something the FSB Implementation Standards sought to eliminate
- Deferred pay will become a smaller part of total compensation, reducing the impact of at-risk deferrals and measures to link compensation to conduct

6. LOOKING AHEAD

6.1. IMPLICATIONS FOR THE INDUSTRY

The Implementation of FSB Standards is largely complete. However, as indicated earlier, respondents expressed the view that further refinements will be needed to achieve an optimal compensation structure as may be appropriate for the business model of the firm. We highlight here four:

- Ensuring that compensation payouts include an adequate degree of flexibility in the allocation of the firm's revenues as may be needed for maintaining a sound capital base
- Completing and refining the on-going work described above, particularly in the area of bonus malus to help resolve issues related to taxation and labour laws, most likely in collaboration with regulators and policy makers
- Refining the application of malus triggers to ensure greater individual accountability
- Embedding compensation changes into the institutional culture and ensuring employees understand the expected behaviours and how these feed into compensation outcomes

6.2. IMPLICATIONS FOR SUPERVISORS AND PUBLIC POLICY

Some in the industry fear that policymakers will pursue further legislative interventions, driven by a perception that the industry has not yet changed. The results of this survey indicate that the industry has in fact made fundamental changes in policies and practices in line with the FSB Standards. As noted, the remaining challenge for the financial firms is to embed these changes in ways that have the desired effects on their culture and the risk-taking behaviour of employees. This will not be helped by further changes in legislation or regulation. A period of stability is required to allow compensation frameworks to be "bedded down" and employees to understand them and experience them at work.

Where public policymakers and supervisors deem further regulation is required, they should ensure that sufficient consultation takes place, on both policy development and implementing rules, and that any unintended consequences are identified and addressed beforehand. Policymakers should also ensure that any future intervention in compensation is consistent with the FSB principles, with prudent risk-taking and with maintaining a sound capital base

Regulators are called upon to take two further steps to assist industry progress:

- Work to reconcile the labour and taxation laws with the need to effect compensation adjustments demanded by current regulation, in particular, the ability to implement necessary bonus malus/clawback provisions. Only 32% of respondents to this survey were able to claw back vested compensation in case of misconduct, with the rest legally unable to enforce this measure
- Through the FSB implementation monitoring process, promote consistent implementation of agreed FSB standards across jurisdictions

Working with the FSB as indicated above would offer several benefits, including:

- Preventing incentive schemes from slipping through the cracks and incentivising behaviour that raises risks to the financial system
- Reducing the extent to which firms implementing FSB standards place themselves at a competitive disadvantage
- Reducing the risk of geographic arbitrage and business relocation

Above all, international consistency in applying the FSB standards serves as important enablers of reform.

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ACKNOWLEDGEMENTS

This Report is a synthesis of the ideas of many people. The project team would like to thank all contributors including participating firms in the Working Group Advisory Panel and Oliver Wyman, for contributing their time, energy and insights so generously.