

# **BANK REMUNERATION RULES**

## *A case study of post-GFC regulation reform*

**PRESENTED BY: JUSTIN DOUGLAS, FINANCIAL SYSTEM DIVISION**

**THE TREASURY**

**31 MAY 2010**

**15<sup>th</sup> MELBOURNE MONEY AND FINANCE CONFERENCE**

JUSTIN DOUGLAS, TANZILA FATEMA and PHILLIP HAWKINS

---

### **ABSTRACT**

*Since the severity of the Global Financial Crisis (GFC) became clear in late 2008, governments around the world have been working to strengthen and improve regulation of global financial markets. As a result, a broad agenda of reform to financial sector regulation and supervisory practice is underway. There have also been substantial changes to international institutional arrangements to support the advancement of this ambitious agenda of reform. For example, G20 processes have provided the political momentum to ensure that reforms are both comprehensive and timely, so that the lessons of the GFC are not forgotten before reforms are implemented across all parts of the financial sector where weaknesses have been revealed.*

*One aspect of the reform agenda is remuneration and compensation practices within the financial sector. This reflects that compensation schemes in some financial institutions encouraged the excessive risk-taking that amplified the impact of the GFC. Since reforms to the rules governing compensation have been one of the first areas to be implemented under the new international institutional framework, it provides a useful case-study to illustrate how the new international arrangements operate. The experience with compensation also highlights some of the questions for governments, regulators and industry that will likely arise in other parts of the reform agenda. These include assessing the importance of international consistency to prevent regulatory arbitrage, finding the optimal balance between regulation and supervision, the scope of prudential regulation and extent to which the effectiveness of reforms can be predicted based upon how they are implemented.*

---

## **CONTEXT – RESPONDING TO THE GLOBAL FINANCIAL CRISIS (GFC)**

The GFC differed from other crises over recent decades in terms of both its size and the range of countries affected. In terms of magnitude:

- governments were forced to provide capital injections to many of the world's largest banks on an unprecedented scale;
- wholesale funding guarantees were introduced in at least 19 countries;
- 29 out of 33 advanced economies experience recession during 2008-09;
- advanced economy GDP fell by 4.3% over the year to June 2009;
- 60 million people lost their job as a result of the global recession;
- whereas other crises were concentrated in particular regions or groups of countries, and were devastating in those particular economies, the GFC disrupted financial markets and financial flows around the world so that, at times, even the most credit-worthy borrowers had difficulty raising funds.

The international nature of the problems exposed by the GFC and the disruption that it caused to global financial flows meant that it quickly became clear that policy responses to mitigate the impending downturn and to prevent a re-occurrence of the same problems needed to be internationally coordinated. Multiple efforts to achieve this coordination came together in November 2008, with the first meeting of G20 Leaders in Washington. Since then, G20 processes have served to coordinate and motivate reform efforts that were spread across many different regulatory bodies and organisations which had largely developed in an ad hoc or evolutionary manner in response to previous concerns.

The G20's initial focus in responding to the financial crisis was on stabilising financial markets and mitigating impacts on the economy. This included coordinating monetary and fiscal stimulus, supporting liquidity, assistance for developing and emerging economies to access finance in difficult market conditions and ensuring the International Monetary Fund, the World Bank and

other multilateral development banks had the resources to meet the demands being placed upon them.

In addition to these measures, the G20 also moved quickly to identify the root causes of the crisis and coordinate development responses aimed at preventing and/or mitigating future crises.

The communiqué from the November 2008 *G20 Summit on Financial Markets and the World Economy* identified a range of factors that contributed to the GFC. These included:

- pursuit of yield without adequate regard to risk;
- weak underwriting standards;
- unsound risk management practices;
- increasingly complex and opaque financial products;
- excessive leverage; and
- failure by policy-makers, regulators and supervisors in some countries to appreciate the risks building up in their financial markets or keep pace with financial innovation.

One of the most obvious unsound risk management practices identified was employee compensation practices that either encouraged or were insensitive to excessive risk-taking. To understand the process by which the new compensation rules were developed, it is also important to understand the other changes to the international institutional architecture that were put into place as a result of the GFC. The two most relevant of these was the creation of the Financial Stability Board (FSB) and the establishment of the FSB peer review process.

The FSB was established by broadening the membership and mandate of the Financial Stability Forum (FSF). The FSF itself was created in response to the financial crises of the late 1990s and was created in 1999 by the G7<sup>1</sup> to enhance cooperation among national and international supervisory bodies and international financial institutions to promote stability in the international financial system. Consistent with the shift from the G7 to the G20 as the premier forum for international economic cooperation, there was a recognition that membership of the FSF needed to

---

<sup>1</sup> Australia was one of the few non-G7 countries to be invited to be a founding member of the FSF.

be expanded to better reflect changes in the world economy and developments in international financial markets. Thus in April 2009, the FSF was expanded to include representatives from all G20 countries; it was given a more general mandate of promoting financial stability, and re-established as the FSB with a stronger institutional basis and enhanced capacity.

The peer review process was developed to support the FSB in its mission of promoting financial stability and involves countries agreeing to undergo periodic peer reviews focused on the implementation and effectiveness of international financial standards and policies. The aim of peer reviews is fourfold:

- *Exchange information* on regulatory, supervisory and other financial sector policies, and receive feedback from peers about the effective implementation of these policies.
- *Evaluate the adherence of FSB member jurisdictions* to their commitment to (a) pursue the maintenance of financial stability, (b) maintain the openness and transparency of the financial sector, and (c) implement international financial standards.
- *Foster a race to the top* with regard to the implementation of effective regulatory, supervisory and other financial sector policies.
- *Assess the effectiveness of international financial standards*, and of policies agreed within the FSB, in realising their intended results.

To achieve these goals, the FSB has agreed to perform both thematic and country based reviews. The primary goal of *thematic reviews* is to review implementation of international financial standards and policies to ensure consistency in cross-country implementation and the effectiveness of the standard or policy in achieving the intended results. In contrast, *country reviews* aim to complement existing assessment processes through systematic and timely follow up to relevant recommendations arising from FSAPs and ROSCs<sup>2</sup>.

## **COMPENSATION REGULATION**

---

<sup>2</sup> FSAP refers to the joint IMF-World Bank Financial Sector Assessment Program and ROSC refers to the World Bank's Reports on the Observance of Standards and Codes

Reforms to the regulation of compensation should be seen as part of a much broader set of reforms developed in response to the GFC. The breadth of this broader reform framework can be seen from the fact that the progress report on economic and financial action prepared for the G20 St Andrews Summit in November 2009 includes 93 different action items, some of which comprise multiple sub-items. These items cover topics as diverse as macroeconomic and fiscal strategies, strengthening the roles of the IMF and the World Bank, improving the international consistency of financial regulation, accounting standards, prudential standards, corporate governance, hedge funds and providing assistance to poorer nations affected by the crisis. Compensation reforms are just one important part of this broader reform agenda.

The need for reforms to compensation regulation was identified early on and has also been one of the first areas where regulatory reform has been developed, implemented and assessed. This means it provides a useful case study, both from the perspective of improving the mechanisms by which regulatory standards are set as part of the new international institutional framework and to assist with understanding the steps and processes that will be followed in areas where reform of financial regulation is taking place.

### **Development of the principles and standards**

One of the reasons that compensation has been one of the areas where regulation reform has been developed and implemented ahead of other areas is that problems with employee compensation models were identified as an issue early on in the GFC. In April 2008, the Financial Stability Forum (FSF) recommended to the G7 that ‘Regulators and supervisors should work with market participants to mitigate the risks arising from remuneration policies.’<sup>3</sup> This reflected concern that many of the firms around the world that were incurring very large losses were also those that were paying large bonuses. One high profile example of this (among many) was US bank

---

<sup>3</sup> FSF 2008, [http://www.financialstabilityboard.org/publications/r\\_0804.pdf](http://www.financialstabilityboard.org/publications/r_0804.pdf)

Merrill Lynch & Co, which paid out US\$3.7 billion in bonuses in 2008, despite losing US\$19.2 billion between July 2007 and July 2008<sup>4</sup>.

The April 2008 FSF report referred to above identified three key weaknesses in financial institutions' compensation practices:

- inadequate governance, with boards of directors treating compensation as unrelated to risk management;
- misalignment between remuneration and risk, with bonuses often based on sales volumes or short-term profits, without regard for longer-term risks that created for their firms
- competitive pressure to attract high quality staff and a first mover disadvantage are a disincentive for firms that may wish to more effectively manage the interactions between risk and remuneration.

Diagram 1 shows a timeline with the major stages in the development, implementation and assessment of the rules governing financial sector compensation.

To address these, nine *Principles for Sound Compensation Practices*<sup>5</sup> were developed by the FSF<sup>6</sup>. They fall into three main groups, those relating to:

- governance of compensation and remuneration arrangements by boards and senior management;
- alignment of incentives; and
- supervisory oversight, disclosure and stakeholder engagement.

Endorsement of the Principles by the G20 in April 2009 and a commitment to implement them across all G20 member jurisdictions gave these reforms additional impetus. The G20 also asked the

---

<sup>4</sup> [http://www.nytimes.com/2008/07/18/business/18merrill.html?\\_r=1&scp=23&sq=merrill%20lynch&st=cse](http://www.nytimes.com/2008/07/18/business/18merrill.html?_r=1&scp=23&sq=merrill%20lynch&st=cse)

<sup>5</sup> FSF 2009, [http://www.financialstabilityboard.org/publications/r\\_0904b.pdf](http://www.financialstabilityboard.org/publications/r_0904b.pdf).

<sup>6</sup> The FSF sub-group that developed these principles included Charles Littrell, Executive General Manager from APRA.

Basel Committee on Banking Supervision<sup>7</sup> (BCBS) to incorporate the FSF Principles into their risk management guidance. To support this, the FSB developed ‘Implementation Standards’<sup>8</sup> designed to strengthen adherence to the Principles and address first mover concerns by ensuring rigorous and consistent application of the principles internationally. Without this consistency, jurisdictions and firms may have been reluctant to implement the Principles for fear of losing human capital to countries or firms that had not implemented the Principles as rigorously. This issue of ensuring a level-playing field was also a key driver of the thematic review process.

### **FSB Peer Review and International Consistency**

In their September 2009 Pittsburgh Summit Communiqué<sup>9</sup>, G20 Leaders tasked the FSB to monitor the implementation of the FSB Principles and Standards and propose additional measures as required by March 2010. As a result, compensation was chosen as the topic for the FSB’s first thematic review, which commenced in January 2010 and reported in March 2010<sup>10</sup>. The team that conducted the review included members from six G20 countries (including Australia), the BCBS, OECD and the FSB Secretariat.

Since the peer review needed to assess whether countries were compliant with the Principles and Standards, one of the questions faced by the review team was how to deal with different implementation approaches, since different countries had approached implementation in different ways. This reflected that existing approaches to regulation differed between countries due to differences in business practices, history, culture and other factors. However, international consistency is important to prevent opportunities for regulatory arbitrage that would allow financial institutions to relocate parts of their businesses to jurisdictions where regulation is weakest, to

---

<sup>7</sup> The BCBS is a group of central bank governors and the heads of other prudential supervisors, which has become the international standard setting body for bank supervision.

<sup>8</sup> Financial Stability Forum, [http://www.financialstabilityboard.org/publications/r\\_090925c.pdf](http://www.financialstabilityboard.org/publications/r_090925c.pdf)

<sup>9</sup> G20 2009, [http://www.g20.org/Documents/pittsburgh\\_summit\\_leaders\\_statement\\_250909.pdf](http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf)

<sup>10</sup> FSB 2010 x. *Thematic Review on Compensation – Peer Review Report*  
[http://www.financialstabilityboard.org/publications/r\\_100330a.pdf](http://www.financialstabilityboard.org/publications/r_100330a.pdf)

minimise incentives for jurisdictions to use weak regulation as an incentive to attract financial firms and to minimise compliance costs for firms operating internationally.

Recognising the different contexts across countries, it seemed reasonable to the review team that countries could adopt different implementation approaches while still achieving consistency in outcomes. However, since the Standards had only been finalised in late 2009, an additional complication was that implementation was either very recent or still underway. Therefore, it was only possible to do a preliminary assessment of the steps that had been taken or that were underway to determine whether sufficient consistency in terms of effectiveness is likely.

### ***Regulation v supervision***

One area where the review team found that differences in implementation approach were most stark relates to the choice between enforceable regulation and supervisory oversight to give effect to the Principles and Standards. Regulation has the benefit of being clearer and potentially more certain than supervision since it requires codification. However, it cannot respond as flexibly as supervision to changing circumstances or innovations that, while technically compliant with the regulations, circumvent the regulatory intent. In contrast, a supervisory approach provides the supervisor with greater discretion in using general powers to interpret guidelines and principles. The main weakness of a supervisory approach is that it can appear subjective or arbitrary from the perspective of the entities being supervised and its effectiveness depends on how the supervisor uses its discretion. That said, the effectiveness of regulation is also sensitive to how strictly it is enforced.

Table 1 shows the review team's assessment of which approach (regulation or supervision) each country is using to implement each of the FSB's Principles and Standards. It shows that, in general, although European countries tend to give greater emphasis to regulation, Canada and the Asian G20 members have put more emphasis on supervision. Australia has a mix of the two approaches. Recognising the difficulties in predicting effectiveness, the peer review recommended

a follow-up review in the second quarter of 2011 to assess on the ground effectiveness of the different approaches and how firms are complying with them.

### ***Disclosure***

A risk to efforts to foster a race-to-the-top in relation to good compensation practices is that a firm's compensation decisions will be influenced by misinformation or misunderstanding of what competitor institutions are offering, or suggestions that other jurisdictions are being lenient in their regulatory enforcement or supervisory oversight. The review team considered that this risk could be minimised through better disclosure arrangements. Accordingly, the peer review recommended that the BCBS, in consultation with the FSB, consider including disclosure arrangements for compensation into Pillar 3 (which deals with market discipline, including disclosure) of Basel II.

### ***Coverage***

Another practical issue is what institutions need to be covered. The FSB Principles state that they 'are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms'<sup>11</sup>. However, different countries have very different financial sectors, and many have multiple regulators dealing with different types of institutions. Further, the nature of an institution can change over time. Therefore, what constitutes a significant firm cannot be easily defined in an internationally consistent manner. Some countries set size thresholds, while others apply the rules across the board (e.g. Australia).

While most countries are applying the Principles and Standards to insurance companies as well as banks, the review identified differences of approach in the treatment of significant non-bank institutions such as asset managers, hedge funds, insurers, pension funds etc. These institutions are often outside the scope of prudential regulation unless part of a larger banking group. Two reasons for not exempting these institutions are that they often compete for the same talent pools and therefore their compensation practices can influence those adopted by prudentially regulated

---

<sup>11</sup> Financial Stability Forum, *FSF Principles for Sound Compensation Practices*, 2 April 2009, p.1.

entities. In addition, these institutions have the capacity to create or concentrate systemic risks to the financial system. Accordingly, the review team recommended further work by individual countries to ensure that all 'significant' financial institutions follow sound compensation practices.

### **Risk alignment**

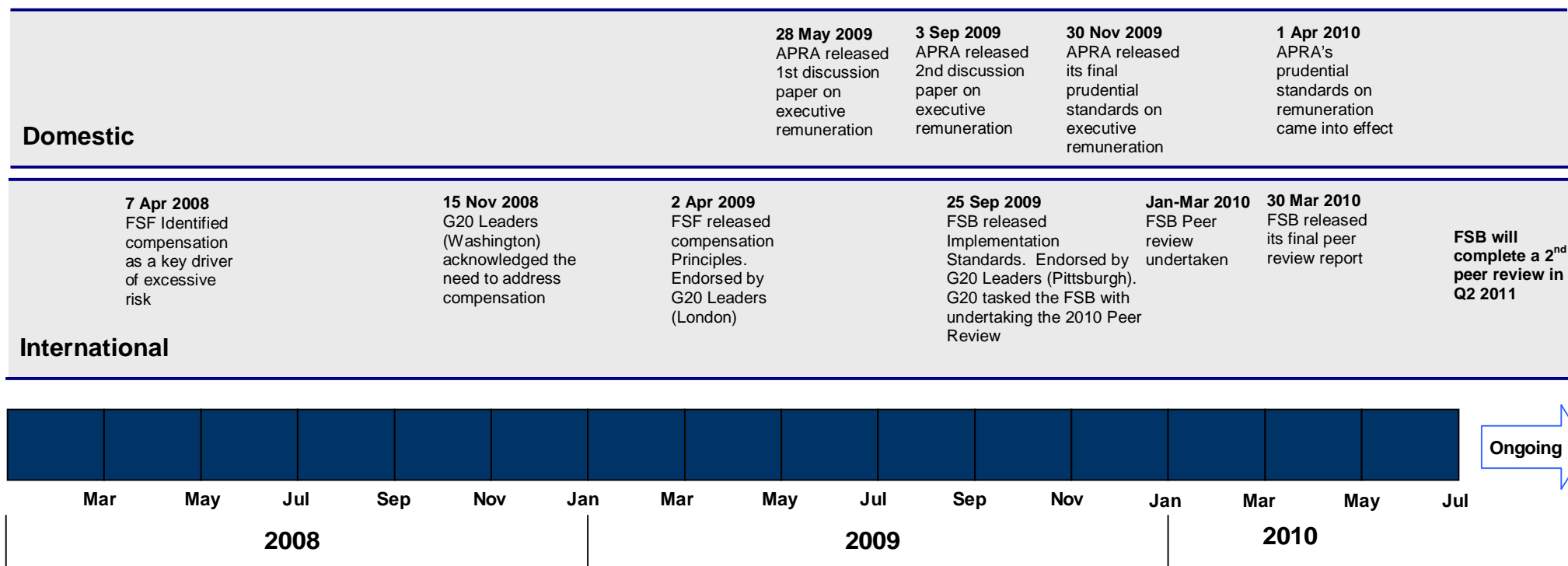
The issue of risk alignment relates to ensuring that that compensation practices do not create an incentive for employees to expose their institutions to excessive risks. A clear case of this would be remuneration based solely on sales of new loans, without regard for the quality of those loans. Four of the nine FSB Principles deal with risk alignment. Feedback from institutions indicated that they remain concerned about the degree of consistency in relation to this criterion, especially in relation to requirements for how compensation should be adjusted for risk and requirements for the mix of fixed and variable remuneration. It is possible that differences in approach between countries reflect that on the one hand, having a high fixed component should not create incentives to take excessive risks, while on the other, a high variable component can be made risk sensitive. Challenges remain in finding the optimal balance between adjusting compensation when it is received for ex-ante risk taking and adjusting for risks that cannot be easily measured up front through the use of equity based compensation, deferrals and claw-back arrangements. In light of these issues, the peer review has recommended that the Basel Committee develop a consultation paper by the end of 2010.

### **CONCLUSION**

There are still many different areas where new regulatory arrangements incorporating lessons from the GFC are being progressed. Some of these will be relatively minor in their impact on Australian financial institutions, while others have the potential to drive significant changes. Accordingly, it is important that institutions, academia and others with an interest understand how these new arrangements are being developed and the ongoing review processes that are being put in place. The issue of compensation provides an

opportunity to understand how the various processes are operating so that all stakeholders have an opportunity to contribute constructively; and ensure that the new arrangements are suitable for Australia and are effective in strengthening the global financial system so that the risk of future financial crises is mitigated.

**Diagram 1: Timeline for the development, implementation and review of the new standards for financial sector compensation regulation**



**Table 1: FSB THEMATIC REVIEW ON COMPENSATION – PEER REVIEW REPORT**

**Status of national implementation**

The table below provides a preliminary snapshot of implementation initiatives in FSB member jurisdictions. The table does not provide an assessment of the degree of compliance with the particular Principle or Standard, rather an indication of whether regulatory or supervisory initiatives are underway to implement a Principle or Standard (or elements thereof); 20 initiatives are at the preparatory stage (i.e., regulation or supervisory guidance being drafted or under consultation); under consideration; or not currently underway. The table was developed by the FSB Secretariat based on the responses to the template provided by members, and national entries have been checked for accuracy by the relevant authorities.

Principal or Standard #	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
<i>Effective governance of compensation</i>																								
<b>P1</b>	IP	R	IP	S	S	R	R	S	R	IP	R	S	S	IP	R	S	R	R	IP	S	R	IP	R	R
<b>P2</b>	IP	R	IP	S	S	R	R	S	R	IP	R	S	S	IP	R	S	R	S	IP	S	R	IP	R	S
S1	IP	R	IP	S	S	R	R	S	UC	IP	R	S	S	IP	R	S	R	R	IP	S	R	IP	R	R
<b>P3</b>	IP	R	IP	S	S	R	R	S	UC	IP	R	S	S	IP	S	R	R	R	IP	S	R	IP	R	S
S2	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	S	S	R	R	IP	S	R	IP	R	S
<i>Effective alignment of compensation with prudent risk taking</i>																								
<b>P4</b>	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	R	IP	S	R	IP	R	S
S3	IP	R	IP	S	S	R	IP	S	UC	UC	R	S	S	IP	S	UC	R	R	IP	S	R	IP	S	R
S4	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	S	UC	R	S	IP	S	R	IP	R	S
<b>P5</b>	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
S5	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
P6	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
S6	IP	S	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
S7	IP	S	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
P7	IP	S	IP	S	IP	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	S	S

Principal or Standard #	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
S8	IP	S	IP	S	IP	R	R	S	UC	UC	S	S	S	IP	IP	UC	R	S	IP	S	R	IP	UC	S
S9	IP	S	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	UC	R	S	IP	S	R	IP	R	S
S11	IP	S	IP	S	S	R	R	S	UC	UC	S	S	S	IP	R	UC	R	S	IP	S	R	IP	S	S
S12	IP	S	IP	S	S	Ri	R	S	UC	UC	R	S	S	IP	IP	UC	R	S	IP	S	R	IP	S	S
S14	IP	S	NA	S	S	R	R	S	UC	UC	R	S	S	IP	IP	UC	S	IP	IP	S	UC	IP	NA	UC
<b>Effective supervisory oversight and engagement by shareholders</b>																								
<b>P8</b>	IP	S	IP	S	S	R	S	S	UC	S	S	S	S	IP	S	S	S	S	IP	S	R	IP	S	S
S10	IP	NA	IP	UC	S	R	R	R	UC	R	R	R	S	IP	Rii	R	R	R	NA	UC	R	R	R	R
S13	IP	S	IP	S	S	R	R	S	UC	UC	R	S	S	IP	S	S	S	S	IP	S	S	IP	S	S
S16	IP	S	IP	S	S	R	S	S	UC	S	S	S	S	IP	S	S	S	S	IP	S	S	IP	S	S
S17	IP	R	IP	S	S	R	R	S	UC	UC	S	S	S	IP	R	S	S	S	IP	S	R	IP	S	S
S18	IP	S	IP	S	S	R	R	S	UC	UC	S	S	S	IP	S	S	R	S	IP	S	R	IP	R	S
<b>P9</b>	IP	R	IP	S	S	R	R	S	UC	R	R	R	S	IP	R	R	R	S	IP	S	R	IP	R	R
S15	IP	R	IP	S	S	R	R	S	UC	UC	R	S	S	IP	R	R	R	IP	IP	S	R	IP	IP	R

*Legend:* R – regulatory approach (including applicable laws, regulations, and a mix of both regulation and supervisory oversight); S – supervisory approach (including supervisory guidance and/or oversight); IP – initiatives under preparation; UC – initiatives under consideration; NA – not addressed or not relevant. (S19 not included.)

*Acronyms:* AR – Argentina; AU – Australia; BR – Brazil; Ca – Canada; CN – China; FR – France; DE – Germany; HK – Hong Kong; IN – India; ID – Indonesia; IT – Italy; JP – Japan; KR – Korea; MX – Mexico; NL – Netherlands; RU – Russia; SA – Saudi Arabia; SG – Singapore; ZA – South Africa; ES – Spain; CH – Switzerland; TR – Turkey; UK – United Kingdom; US – United States.

## **FSB Principles**

### Principles relating to governance

1. The firm's board of directors must actively oversee the compensation system's design and operation.
2. The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.
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.

### Principles relating to alignment

4. Compensation must be adjusted for all types of risk.
5. Compensation outcomes must be symmetric with risk outcomes.
6. Compensation payout schedules must be sensitive to the time horizon of risks.
7. The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

### Principles relating to supervisory oversight, disclosure and stakeholder engagement

8. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
9. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.