
THE MONETARY AUTHORITY OF SINGAPORE

Issue date: 9 December 2010

GUIDELINES ON CORPORATE GOVERNANCE FOR BANKS, FINANCIAL HOLDING COMPANIES AND DIRECT INSURERS WHICH ARE INCORPORATED IN SINGAPORE

1 The Guidelines on Corporate Governance (“The Guidelines”) are relevant to all banks, financial holding companies and direct insurers, which are incorporated in Singapore (“Financial Institutions”). They provide guidance on best practices that a bank, financial holding company or direct insurer should strive to achieve in relation to its corporate governance.

2 The Guidelines should be read in conjunction with the provisions of the Banking Act (Cap. 19) or the Insurance Act (Cap. 142) as the case may be, the relevant Corporate Governance Regulations issued pursuant to either of the Acts as well as written directions, codes and other guidelines that the Monetary Authority of Singapore (“the Authority”) may issue from time to time.

3 The Guidelines at Annex 1 comprise the Code of Corporate Governance 2005¹ (“Code”) for companies listed on the Singapore Exchange and supplementary principles and guidelines added by the Authority (in italics) to take into account the unique characteristics of the business of banking and insurance, given the diverse and complex risks undertaken by these Financial Institutions and their responsibilities to depositors and policyholders.

4 The Authority expects every Financial Institution to observe the Guidelines at Annex 1 to the fullest extent possible. Financial Institutions listed on the Singapore Exchange should disclose their corporate governance practices and explain deviations from the Guidelines in their annual reports. Those

¹ The Code was first issued by the Corporate Governance Committee on 21 March 2001 and revised by the Council on Corporate Disclosure and Governance on 14 July 2005. The Code came under the purview of the MAS and SGX with effect from 1 September 2007. It can be found at http://www.mas.gov.sg/fin_development/corporate_governance/code_of_corporate_governance.html

Financial Institutions that are not listed on the Singapore Exchange should disclose the same on their websites. For ease of reference, the specific principles and guidelines in the Code for disclosure are set out in Annex 2.

Rationale for a Corporate Governance Framework for Financial Institutions

5 In an increasingly complex business environment influenced by globalisation and other rapid changes in the financial scene, good corporate governance is crucial to ensure that the business of a Financial Institution is managed in a safe and sound manner. Weak governance can undermine public confidence in a Financial Institution as well as the financial system and markets in which it operates.

6 In Singapore, directors of a company are required to promote the success of the company in the interests of its shareholders as a group. Corporate governance for Financial Institutions is arguably of greater importance than for other companies given their crucial financial intermediation roles in an economy and the need to safeguard depositors' and policyholders' funds.

Risk-based Supervision and Corporate Governance

7 The Authority recognises that the Board plays a critical role in the successful operation of a Financial Institution. The Board is chiefly responsible for setting corporate strategy, reviewing managerial performance and maximising returns for shareholders at an acceptable level of risk, while preventing conflicts of interest and balancing competing demands on the Financial Institution. Therefore, the effectiveness of the Board of a Financial Institution is a basic tenet of MAS' risk-based supervisory approach. While the Board may delegate to the management the responsibility for formulating sound and prudent policies and practices, it remains accountable and cannot abrogate its overall responsibility for the Financial Institution. This does not mean however that the Board should assume the role of the management. The management is accountable to the Board for the day-to-day conduct of the business and affairs of the Financial Institution.

Cancellation of Guidelines

8 These Guidelines take immediate effect. The Guidelines on Corporate Governance for banks, financial holding companies and direct insurers which are incorporated in Singapore, issued on 8 September 2005, are cancelled.

BOARD MATTERS

THE BOARD'S CONDUCT OF AFFAIRS

Principle:

1 Every company should be headed by an effective Board to lead and control the company. The Board is collectively responsible for the success of the company. The Board works with Management to achieve this and the Management remains accountable to the Board.

Guidelines:

1.1 The Board's role is to:

- (a) provide entrepreneurial leadership, set strategic aims and ensure that the necessary financial and human resources are in place for the company to meet its objectives;
- (b) establish a framework of prudent and effective controls which enables risk to be assessed and managed;
- (c) review management performance; and
- (d) set the company's values and standards and ensure that obligations to shareholders and others are understood and met.

1.2 All directors must objectively take decisions in the interests of the company.

1.3 If authority to make decisions on certain board matters is delegated by the Board to any Board Committee, such delegation should be disclosed.

1.4 The Board should meet regularly and as warranted by particular circumstances, as deemed appropriate by the board members. Companies are encouraged to amend their Articles of Association to provide for telephonic and videoconference meetings. The number of board and board committee meetings

held in the year, as well as the attendance of every board member at these meetings, should be disclosed in the company's annual report.

1.5 Companies should adopt internal guidelines setting forth matters that require board approval, and specify in their corporate governance disclosures the type of material transactions that require board approval under such guidelines.

1.6 Every director should receive appropriate training (including his or her duties as a director and how to discharge those duties) when he is first appointed to the Board. This should include an orientation program to ensure that incoming directors are familiar with the company's business and governance practices. It is equally important that directors should receive further relevant training, particularly on relevant new laws, regulations and changing commercial risks, from time to time.

1.7 Upon appointment of each director, companies should provide a formal letter to the director, setting out the director's duties and obligations.

Commentary:

1.8 The company is encouraged to provide training for first-time directors in areas such as accounting, legal and industry-specific knowledge.

Additional Guidelines of the Authority

1.9 The Board should discuss and approve the organisational structure of the Financial Institution. This would include ensuring that adequate corporate governance frameworks and systems are in place across the Financial Institution. In the case of a Group, the Board of the ultimate holding company should refrain from setting up complex structures given the inherent risks of such structures. In the case of a Board of a subsidiary, it is responsible for the corporate governance of the subsidiary and it should ensure that any reliance placed on group-level corporate governance practices are in accordance with the local regulatory requirements.

1.10 The Board should also be responsible for the appointment and removal of senior management of the Financial Institution. The Board should set out clearly the role, responsibilities, accountability and reporting relationships of senior management, and have these properly documented. The delegation of authority from the Board to the senior management should be formal and clear.

1.11 As corporate values set by the Board are aimed at promoting and maintaining a high level of professional conduct of the business, these values should emphasise, among others, integrity, honesty and proper conduct at all times, both with respect to internal dealings and external transactions, including situations where there are potential conflicts of interest. Such values should discourage excessive risk taking activities, promote open discussions and encourage issues to be raised upwards within the organisation where appropriate. The Board should oversee the establishment of policies to strengthen the values of the Financial Institution.

1.12 The Board should ensure that senior management formulates policies and processes to promote fair practices and high standards of business conduct by staff. Such policies should address any misrepresentation, in particular, making of false and misleading statements and misconduct by the staff. In particular, for an insurer, such policies should also apply to its distribution channels and its claims adjudication.

1.13 There should be clear complaint handling procedures in place to ensure that all complaints are dealt with professionally, fairly, promptly and diligently. These complaint handling procedures should be clearly communicated to customers.

1.14 The Board should maintain records of all its meetings, in particular records of discussions on key deliberations and decisions taken.

1.15 In addition to the types of training referred to in Guideline 1.6, the Board should develop a continuous professional development programme for all directors to ensure that they are equipped with the appropriate skills and knowledge to perform their roles on the Board and Board Committees effectively. Such programmes may include providing the directors with a detailed overview and risk profile of the Financial Institution's significant or new business lines and an update on regulatory developments in jurisdictions which the Financial Institution has a presence in. The Board may develop separate programmes for executive directors and non-executive directors.

1.16 The Financial Institution should disclose the type of continuous professional development programme established for its directors and how the programme incorporates the types of skills which the NC assesses that the Board and the respective Board Committees should have in order to perform their roles effectively.

BOARD COMPOSITION AND GUIDANCE

Principle:

2 There should be a strong and independent element on the Board, which is able to exercise objective judgement on corporate affairs independently, in particular, from Management. No individual or small group of individuals should be allowed to dominate the Board's decision making.

Guidelines:

2.1 There should be a strong and independent element on the Board, with independent directors making up at least one-third of the Board. An "independent" director is one who has no relationship with the company, its related companies² or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgement with a view to the best interests of the company. Examples of such relationships, which would deem a director not to be independent, include:

- (a) a director being employed by the company or any of its related companies for the current or any of the past three financial years;
- (b) a director who has an immediate family member³ who is, or has been in any of the past three financial years, employed by the company or any of its related companies as a senior executive officer whose remuneration is determined by the remuneration committee;
- (c) a director, or an immediate family member, accepting any compensation from the company or any of its subsidiaries other than compensation for board service for the current or immediate past financial year; or
- (d) a director, or an immediate family member, being a substantial shareholder of or a partner in (with 5% or more stake), or an executive officer of, or a director of any for-profit business organisation to which the company or any of its subsidiaries made, or from which the company or any of its subsidiaries received, significant payments in the current or immediate past financial year. As a guide, payments⁴ aggregated over

² A related company in relation to a company includes its subsidiary, fellow subsidiary, or parent company.

³ As defined in the Listing Manual of the Singapore Exchange to mean the spouse, child, adopted child, step-child, brother, sister and parent.

⁴ Payments for transactions involving standard services with published rates or routine and retail transactions and relationships (for instance credit card or bank or brokerage or mortgage or insurance accounts or transactions) will not be taken into account, unless special or favourable treatment is accorded.

any financial year in excess of S\$200,000 should generally be deemed significant.

2.2 The relationships set out above are not intended to be exhaustive, and are examples of situations which would deem a director to be not independent. If the company wishes, in spite of the existence of one or more of these relationships, to consider the director as independent, it should disclose in full the nature of the director's relationship and bear responsibility for explaining why he should be considered independent.

2.3 The Board should examine its size and, with a view to determining the impact of the number upon effectiveness, decide on what it considers an appropriate size for the Board, which facilitates effective decision making. The Board should take into account the scope and nature of the operations of the company.

2.4 The Board should comprise directors who as a group provide core competencies such as accounting or finance, business or management experience, industry knowledge, strategic planning experience and customer-based experience or knowledge.

2.5 Non-executive directors should:

- (a) constructively challenge and help develop proposals on strategy; and
- (b) review the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

Commentary:

2.6 To facilitate a more effective check on management, non-executive directors are encouraged to meet regularly without management present.

Additional Guidelines of the Authority

2.7 The length of service on the Board should also be taken into consideration when assessing a directors' independence on the Board. Long-serving directors, in particular those who have served under the same Chairman or CEO, may have certain entrenched interests that impair their ability to act independently.

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

Principle:

3 There should be a clear division of responsibilities at the top of the company – the working of the Board and the executive responsibility of the company’s business – which will ensure a balance of power and authority, such that no one individual represents a considerable concentration of power.

Guidelines:

3.1 The Chairman and chief executive officer (“CEO”) should in principle be separate persons, to ensure an appropriate balance of power, increased accountability and greater capacity of the Board for independent decision making. The division of responsibilities between the Chairman and CEO should be clearly established, set out in writing and agreed by the Board. In addition, companies should disclose the relationship between the Chairman and CEO where they are related to each other (i.e. be of the same immediate family, as defined in footnote 3).

3.2 The Chairman should:

- (a) lead the Board to ensure its effectiveness on all aspects of its role and set its agenda;
- (b) ensure that the directors receive accurate, timely and clear information;
- (c) ensure effective communication with shareholders;
- (d) encourage constructive relations between the Board and Management;
- (e) facilitate the effective contribution of non-executive directors in particular;
- (f) encourage constructive relations between executive directors and non-executive directors; and
- (g) promote high standards of corporate governance.

The responsibilities set out above provide guidance and should not be taken as a comprehensive list of all the duties and responsibilities of a Chairman.

Commentary:

3.3 Companies may appoint an independent non-executive director to be the lead independent director where the Chairman and the CEO is the same person, where the Chairman and the CEO are related by close family ties, or where the Chairman and the CEO are both part of the executive management team. The lead independent director (if appointed) should be available to shareholders where they have concerns which contact through the normal channels of the Chairman, CEO or Finance Director has failed to resolve or for which such contact is inappropriate.

Additional Guidelines of the Authority

3.4 *In deciding whether there is a need to appoint a lead independent director to the Board, the Financial Institution should also consider if the Chairman has any other relationship with the Financial Institution, such as the relationships referred to in Guideline 2.1, or the independence (or lack thereof) of the Chairman from any of the substantial shareholders of the Financial Institution.*

3.5 *Where a lead independent director is appointed, the roles and responsibilities of the Chairman and the lead independent director should be clearly defined.*

3.6 *If appointed, the lead independent director should provide some form of independent leadership on the Board, and act as a sounding board for the Chairman. The lead independent director should, amongst others, lead the independent directors during Board meetings to raise relevant queries and ensure that there is a check and balance between the Board and senior management. The lead independent director should also meet regularly with the other independent directors to assess the performance of the Chairman and senior management.*

BOARD MEMBERSHIP

Principle:

4 There should be a formal and transparent process for the appointment of new directors to the Board.

Guidelines:

4.1 Companies should establish a Nominating Committee (“NC”) to make recommendations to the Board on all board appointments. The NC should comprise at least three directors, a majority of whom, including the Chairman, should be independent. In addition, the NC Chairman should be a director who is not, or who is not directly associated with⁵, a substantial shareholder (with interest of 5% or more in the voting shares of the company). Its membership should be disclosed in the annual report. The NC should have written terms of reference that describe the responsibilities of its members.

4.2 The NC should be charged with the responsibility of re-nomination having regard to the director’s contribution and performance (e.g. attendance, preparedness, participation and candour) including, if applicable, as an independent director. All directors should be required to submit themselves for re-nomination and re-election at regular intervals and at least every three years.

4.3 The NC is charged with the responsibility of determining annually if a director is independent, bearing in mind the circumstances set forth in Guideline 2.1 and any other salient factors. If the NC determines that a director who has one or more of the relationships mentioned therein can be considered independent, the company should make such disclosure as stated in Guideline 2.2. Conversely, the NC has the discretion to determine that a director is non-independent even if he does not fall under the circumstances set forth in Guideline 2.1.

4.4 When a director has multiple board representations, he or she must ensure that sufficient time and attention is given to the affairs of each company. The NC should decide if a director is able to and has been adequately carrying out his/her duties as director of the company. Internal guidelines should be adopted

⁵ A director will be considered “directly associated” to a substantial shareholder when the director is accustomed or under an obligation, whether formal or informal, to act in accordance with the directions, instructions or wishes of the substantial shareholder.

that address the competing time commitments that are faced when directors serve on multiple boards.

4.5 A description of the process for the selection and appointment of new directors to the Board should be disclosed. This should include disclosure on the search and nomination process.

4.6 Key information regarding directors, such as academic and professional qualifications, shareholding in the company and its subsidiaries, board committees served on (as a member or Chairman), date of first appointment as a director, date of last re-election as a director, directorships or chairmanships both present and those held over the preceding three years in other listed companies and other major appointments, should be disclosed in the annual report. In addition, the company's annual disclosure on corporate governance should indicate which directors are executive, non-executive or considered by the NC to be independent. The names of the directors submitted for election or re-election should also be accompanied by such details and information to enable shareholders to make informed decisions.

Additional Guidelines of the Authority

4.7 *In reviewing nominations, the NC should satisfy itself that each nominee is a fit and proper person, and is qualified for the office taking into account the nominee's track record, age, experience, capabilities, skills and such other relevant factors as may be determined by the NC. In addition, the NC should review, on an annual basis, that each existing director remains qualified for the office based on these criteria.*

4.8 *The NC should maintain records of all its meetings, in particular records of discussions on key deliberations and decisions taken.*

4.9 *The Board should carry out succession planning for itself and the CEO to ensure continuity of leadership.*

4.10 *When setting the internal guidelines referred to in Guideline 4.4, the NC should include guidance on the number of Board memberships that each director may hold taking into consideration the competing time commitment faced when directors serve on multiple Boards. In assessing the time commitment of a director, the NC should consider not only the size of the companies, but also factors such as the complexity of the companies' operations and risk management systems and controls. Other relevant factors that should be considered include whether the companies fall within the same group,*

whether the other directorships are on Boards of listed companies, the frequency of Board meetings held, as well as the director's job commitments.

4.11 The NC should be charged with the responsibility of developing a framework to identify the skills that the Board collectively needs in order to discharge the Board's responsibilities effectively, taking into account the complexity of the Financial Institution's existing risk profile, business operations and future business strategy.

4.12 The NC should assess, at least on an annual basis, if the Board and the respective Board Committees lack any skills to perform their roles effectively and identify steps to improve the effectiveness of the Board and the respective Board Committees.

4.13 The NC should review the nominations, and reasons for resignations, of key appointment holders such as directors, chief executive officer, deputy chief executive officer, chief financial officer, chief risk officer and relevant senior management staff.

4.14 The NC should include in its annual assessment a check as to whether there is any deviation from the internal guidelines referred to in Guidelines 4.4 and 4.10 and disclose such deviation (and the explanation for the deviation) in the Financial Institution's annual report.

BOARD PERFORMANCE

Principle:

5 There should be a formal assessment of the effectiveness of the Board as a whole and the contribution by each director to the effectiveness of the Board.

Guidelines:

5.1 Every Board should implement a process to be carried out by the NC for assessing the effectiveness of the Board as a whole and for assessing the contribution by each individual director to the effectiveness of the Board. This assessment process should be disclosed in the annual report.

5.2 The NC should decide how the Board's performance may be evaluated and propose objective performance criteria. Such performance criteria, which allow for comparison with industry peers, should be approved by the Board and address how the Board has enhanced long term shareholders' value. These performance criteria should not be changed from year to year, and where circumstances deem it necessary for any of the criteria to be changed, the onus should be on the Board to justify this decision.

5.3 In addition to any relevant performance criteria which the Board may propose, the performance evaluation should also consider the company's share price performance over a five-year period vis-à-vis the Singapore Straits Times Index and a benchmark index of its industry peers.

5.4 Individual evaluation should aim to assess whether each director continues to contribute effectively and demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The Chairman should act on the results of the performance evaluation, and where appropriate, propose new members be appointed to the Board or seek the resignation of directors, in consultation with the NC.

Commentary:

5.5 Other performance criteria that may be used include return on assets ("ROA"), return on equity ("ROE"), return on investment ("ROI") and economic value added ("EVA") over a longer-term period.

Additional Guidelines of the Authority

5.6 *The performance criteria proposed by the NC should include other qualitative measures such as setting of strategic directions and achievement of strategic objectives, quality of risk management and adequacy of internal controls. Performance criteria should reflect the responsibility of the Board to safeguard the interests of the depositors and policyholders. If necessary, Financial Institutions should consider engaging qualified external persons to facilitate such Board evaluations.*

5.7 *When the NC is deliberating upon the performance of a particular member of the NC, that member should recuse himself/herself from the discussions to avoid conflict of interests.*

ACCESS TO INFORMATION

Principle:

6 In order to fulfil their responsibilities, Board members should be provided with complete, adequate and timely information prior to board meetings and on an on-going basis.

Guidelines:

6.1 Management has an obligation to supply the Board with complete, adequate information in a timely manner. Relying purely on what is volunteered by Management is unlikely to be enough in all circumstances and further enquiries may be required if the particular director is to fulfil his or her duties properly. Hence, the Board should have separate and independent access to the company's senior management.

6.2 Information provided should include background or explanatory information relating to matters to be brought before the Board, copies of disclosure documents, budgets, forecasts and monthly internal financial statements. In respect of budgets, any material variance between the projections and actual results should also be disclosed and explained.

6.3 Directors should have separate and independent access to the company secretary. The role of the company secretary should be clearly defined and should include responsibility for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Under the direction of the Chairman, the company secretary's responsibilities include ensuring good information flows within the Board and its committees and between senior management and non-executive directors, as well as facilitating orientation and assisting with professional development as required. The company secretary should attend all board meetings.

6.4 The appointment and the removal of the company secretary should be a matter for the Board as a whole.

6.5 The Board should have a procedure for directors, either individually or as a group, in the furtherance of their duties, to take independent professional advice, if necessary, at the company's expense.

Additional Guidelines of the Authority

6.6 Management should provide the Board with information on all potentially material risks facing the business (e.g., credit, market, liquidity, legal and operational risks).

6.7 Members of Board Committees should also have unfettered access to information in the Financial Institution for the purposes of carrying out the responsibilities of the Board Committee concerned.

REMUNERATION MATTERS

PROCEDURES FOR DEVELOPING REMUNERATION POLICIES

Principle:

7 There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his own remuneration.

Guidelines:

7.1 The Board should set up a Remuneration Committee (“RC”) comprising entirely of non-executive directors, the majority of whom, including the Chairman, should be independent. This is to minimise the risk of any potential conflict of interest.

7.2 The RC will recommend to the Board a framework of remuneration, and the specific remuneration packages for each director and the CEO (or executive of equivalent rank) if the CEO is not a director. The RC’s recommendations should be submitted for endorsement by the entire Board. The RC should cover all aspects of remuneration, including but not limited to director’s fees, salaries, allowances, bonuses, options, and benefits in kind. The RC will also review the remuneration of senior management.

Commentary:

7.3 If necessary, the RC should seek expert advice inside and/or outside the company on remuneration of all directors.

Additional Guidelines of the Authority

7.4 *The Board should seek to ensure that the remuneration policies are in line with the strategic objectives and corporate values of the Financial Institution, and do not give rise to conflicts between the objectives of the Financial Institution and the interests of individual directors and key executives.*

7.5 *The RC should maintain records of all its meetings, in particular records of discussions on key deliberations and decisions taken.*

7.6 In addition to the remuneration matters specified in Principles 7 to 9 of these Guidelines, the RC should ensure that the Financial Institution adopts the Principles for Sound Compensation Practices and Implementation Standards issued by Financial Stability Board. For ease of reference, the specific principles and standards issued by the Financial Stability Board are attached at Annex 3.

LEVEL AND MIX OF REMUNERATION

Principle:

8 The level of remuneration should be appropriate to attract, retain and motivate the directors needed to run the company successfully but companies should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

Guidelines:

8.1 The performance-related elements of remuneration should be designed to align interests of executive directors with those of shareholders and link rewards to corporate and individual performance. There should be appropriate and meaningful measures for the purpose of assessing executive directors' performance.

8.2 The remuneration of non-executive directors should be appropriate to the level of contribution, taking into account factors such as effort and time spent, and responsibilities of the directors. Non-executive directors should not be over-compensated to the extent that their independence may be compromised.

8.3 In the case of service contracts, there should be a fixed appointment period for all executive directors. In any case, service contracts should not be excessively long or with onerous removal clauses. The RC should review what compensation commitments the directors' contracts of service, if any, would entail in the event of early termination. The RC should aim to be fair and avoid rewarding poor performance.

8.4 Long-term incentive schemes are generally encouraged. The RC should review whether directors should be eligible for benefits under long-term incentive schemes. The costs and benefits of long-term incentive schemes should be carefully evaluated. In normal circumstances, offers of shares or granting of options or other forms of deferred remuneration should vest over a period of time. The use of vesting schedules, whereby only a portion of the benefits can be exercised each year, is also strongly encouraged. Directors should be encouraged to hold their shares beyond the vesting period, subject to the need to finance any costs of acquisition and associated tax liability.

Commentaries:

8.5 In setting remuneration packages, the company should be aware of pay and employment conditions within the industry and in comparable companies. But they should use such comparison with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvements in performance.

8.6 Notice periods in service contracts should be set at a period of six months or less. If it is necessary to offer longer notice periods to new directors recruited from outside, such periods should reduce to six months or less after the initial notice period.

No Additional Guidelines from the Authority

DISCLOSURE ON REMUNERATION

Principle:

9 Each company should provide clear disclosure of its remuneration policy, level and mix of remuneration, and the procedure for setting remuneration, in the company's annual report. It should provide disclosure in relation to its remuneration policies to enable investors to understand the link between remuneration paid to directors and key executives, and performance.

Guidelines:

9.1 The company should report to the shareholders each year on the remuneration of directors and at least the top 5 key executives (who are not also directors) of the company. This annual remuneration report should form part of, or be annexed to the company's annual report of its directors. It should be the main vehicle through which the company reports to shareholders on remuneration matters. The members of the RC should be listed in the report.

9.2 The report should set out the names of directors and at least the top 5 key executives (who are not also directors) earning remuneration which falls within bands of S\$250,000. There will be a breakdown (in percentage terms) of each director's remuneration earned through base/fixed salary, variable or performance-related income/bonuses, benefits in kind, and stock options granted and other long-term incentives. Companies are however encouraged, as best practice, to fully disclose the remuneration of each individual director.

9.3 For transparency, the report should disclose the same details of remuneration of employees who are immediate family members⁶ of a director or the CEO, and whose remuneration exceeds S\$150,000 during the year. This can be done on a no-name basis with clear indication of which director or the CEO the employee is related to.

9.4 The report should also contain details of employee share schemes to enable their shareholders to assess the benefits and potential cost to the companies. The important terms of the share schemes, including the potential size of grants, methodology of valuing stock options, exercise price of options that were granted as well as outstanding, whether the exercise price was at the market or otherwise on the date of grant, market price on the date of exercise,

⁶ As defined in the Listing Manual of the Singapore Exchange to mean the spouse, child, adopted child, step-child, brother, sister and parent.

the vesting schedule, and the justifications for the terms adopted, should be disclosed.

No Additional Guidelines from the Authority

ACCOUNTABILITY AND AUDIT

ACCOUNTABILITY

Principle:

10 The Board should present a balanced and understandable assessment of the company's performance, position and prospects.

Guidelines:

10.1 The Board's responsibility to provide a balanced and understandable assessment of the company's performance, position and prospects extends to interim and other price sensitive public reports, and reports to regulators (if required).

10.2 The Management should provide all members of the Board with management accounts which present a balanced and understandable assessment of the company's performance, position and prospects on a monthly basis.

No Additional Guidelines from the Authority

AUDIT COMMITTEE

Principle:

11 The Board should establish an Audit Committee (“AC”) with written terms of reference which clearly set out its authority and duties.

Guidelines:

11.1 The AC should comprise at least three directors, all non-executive, the majority of whom, including the Chairman, should be independent.

11.2 The Board should ensure that the members of the AC are appropriately qualified to discharge their responsibilities. At least two members should have accounting or related financial management expertise or experience, as the Board interprets such qualification in its business judgement.

11.3 The AC should have explicit authority to investigate any matter within its terms of reference, full access to and co-operation by Management and full discretion to invite any director or executive officer to attend its meetings, and reasonable resources to enable it to discharge its functions properly.

11.4 The duties of the AC should include:

- (a) reviewing the scope and results of the audit and its cost effectiveness, and the independence and objectivity of the external auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the AC should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money;
- (b) reviewing the significant financial reporting issues and judgements so as to ensure the integrity of the financial statements of the company and any formal announcements relating to the company’s financial performance;
- (c) reviewing the adequacy of the company’s internal controls, as set out in Guideline 12.1;
- (d) reviewing the effectiveness of the company’s internal audit function; and
- (e) making recommendations to the Board on the appointment, re-appointment and removal of the external auditor and approving the remuneration and terms of engagement of the external auditor.

11.5 The AC should meet with the external auditors, and with the internal auditors, without the presence of the company's Management, at least annually.

11.6 The AC should review the independence of the external auditors annually.

11.7 The AC should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The AC's objective should be to ensure that arrangements are in place for the independent investigation of such matters and for appropriate follow up action.

11.8 The Board should disclose the names of the members of the AC and details of the Committee's activities in the company's annual report.

Additional Guidelines of the Authority

11.9 The AC should be responsible for reviewing the accounting policies and practices of the Financial Institution.

11.10 The AC should maintain records of all its meetings, in particular records of discussions on key deliberations and decisions taken.

INTERNAL CONTROLS

Principle:

12 The Board should ensure that the Management maintains a sound system of internal controls to safeguard the shareholders' investments and the company's assets.

Guidelines:

12.1 The AC should review the adequacy of the company's internal financial controls, operational and compliance controls, and risk management policies and systems established by the Management (collectively "internal controls"). The AC should ensure that a review of the effectiveness of the company's internal controls is conducted at least annually. Such review can be carried out by the internal and/or public accountants, provided that where the public accountant is also the external auditor of the company, the AC should satisfy itself that the independence of the public accountant is not compromised by any other material relationship with the company.

12.2 The Board should comment on the adequacy of the internal controls, including financial, operational and compliance controls, and risk management systems in the company's annual report.

No Additional Guidelines from the Authority

INTERNAL AUDIT

Principle:

13 The company should establish an internal audit function that is independent of the activities it audits.

Guidelines:

13.1 The Internal Auditor's primary line of reporting should be to the Chairman of the AC although the Internal Auditor would also report administratively to the CEO.

13.2 The Internal Auditor should meet or exceed the standards set by nationally or internationally recognised professional bodies including the Standards for the Professional Practice of Internal Auditing set by The Institute of Internal Auditors.

13.3 The AC should ensure that the internal audit function is adequately resourced and has appropriate standing within the company. For the avoidance of doubt, the internal audit function can either be in-house, outsourced to a reputable accounting/auditing firm, or performed by a major shareholder, holding company, parent company or controlling enterprise with an internal audit staff.

13.4 The AC should, at least annually, ensure the adequacy of the internal audit function.

Additional Guidelines of the Authority

13.5 The scope of the Internal Auditor's responsibility should be clear and appropriate for the risks which the Financial Institution is or could be exposed to, including those risks arising from proposed new lines of business or products.

13.6 The Internal Auditor's responsibilities should include the following:

- (a) evaluating the reliability, adequacy and effectiveness of the internal controls and risk management processes of the Financial Institution.*
- (b) reviewing the internal controls of the Financial Institution to ensure prompt and accurate recording of transactions and proper safeguarding of assets.*

(c) *reviewing whether the Financial Institution complies with laws and regulations and adheres to established policies, and whether Management is taking the appropriate steps to address control deficiencies.*

13.7 The Internal Auditor should have unfettered access to the AC, the Board, and the senior management where necessary, as well as the right to seek information and explanations.

13.8 The AC should ensure that there are processes in place for ensuring that recommendations raised in internal audit reports are dealt with in a timely manner. Outstanding exceptions or recommendations should be closely monitored.

13.9 The AC should approve the appointment, remuneration, resignation or dismissal of the head of internal audit. The Board should also disclose the resignation or dismissal of the head of internal audit in its annual report.

COMMUNICATION WITH SHAREHOLDERS

Principle:

14 Companies should engage in regular, effective and fair communication with shareholders.

Guidelines:

14.1 Companies should regularly convey pertinent information, gather views or inputs, and address shareholders' concerns. In disclosing information, companies should be as descriptive, detailed and forthcoming as possible, and avoid boilerplate disclosures.

14.2 Companies should disclose information on a timely basis. Where there is inadvertent disclosure made to a selected group, companies should make the same disclosure publicly to all others as soon as practicable. This could be through the use of modern technology such as Internet websites.

No Additional Guidelines from the Authority

Principle:

15 Companies should encourage greater shareholder participation at AGMs, and allow shareholders the opportunity to communicate their views on various matters affecting the company.

Guidelines:

15.1 Shareholders should have the opportunity to participate effectively and to vote in AGMs. They should be allowed to vote in person or in absentia. In this regard, companies are encouraged to make the appropriate provisions in their Articles of Association to allow for absentia voting methods such as by mail, email, fax, etc, if the shareholders so consent.

15.2 There should be separate resolutions at general meetings on each substantially separate issue. Companies should avoid "bundling" resolutions unless the resolutions are interdependent and linked so as to form one significant proposal. Where resolutions are "bundled", companies should explain the reasons and material implications.

15.3 The chairpersons of the Audit, Nomination and Remuneration committees should be present and available to address questions at general meetings. The external auditors should also be present to address shareholders' queries about the conduct of audit and the preparation and content of the auditors' report.

Commentaries:

15.4 Companies are encouraged to amend their Articles of Association to avoid imposing a limit on the number of proxies for nominee companies so that shareholders who hold shares through nominees can attend AGMs as proxies.

15.5 Companies are encouraged to prepare minutes or notes of general meetings, which include substantial comments or queries from shareholders and responses from the Board and management, and to make these minutes or notes available to shareholders upon their requests.

No Additional Guidelines from the Authority

ADDITIONAL PRINCIPLES AND GUIDELINES OF THE AUTHORITY

EXECUTIVE COMMITTEE

Principle:

16 *The Board may establish an Executive Committee to assist in the discharge of its duties.*

Guidelines:

16.1 *A Financial Institution may have an Executive Committee (EXCO) of the Board, to deliberate on matters requiring Board review that arise between full Board meetings. With regard to the representation of independent directors, the composition of the EXCO should mirror that recommended for the Board in these Guidelines.*

16.2 *The Board should ensure that the role of the EXCO is clear. An EXCO should have written terms of reference that describe the responsibilities of its members. It should not have the authority to exercise all of the powers of the Board. The role of the EXCO is to carry out Board functions and not to take on the functions of senior management. In carrying out its duties, the EXCO should not lose its capacity, as part of the Board, to exercise oversight over senior management and objectively evaluate the performance of senior management.*

16.3 *The EXCO should maintain records of all its meetings, in particular records of discussions on key deliberations and decisions taken.*

16.4 *A Financial Institution should disclose in the annual report the names of the members of the EXCO and details of the activities of the EXCO.*

RISK MANAGEMENT

Principle:

17 *The Board should ensure that the Financial Institution has a robust risk management system to identify, measure, monitor, control and report its risks.*

Guidelines:

17.1 *An effective Board should have a sound understanding of the nature of the business activities of the Financial Institution and their associated risks. It should ensure that Management has established an adequate risk management system to identify, measure, monitor, control and report those risks. The risk management system should be supported by a system of sound internal controls. If necessary, the Board should seek advice from within the Financial Institution or externally to enable it to discharge its functions properly.*

17.2 *For the purposes of managing the risks of the Financial Institution, the responsibilities of the Board include, but are not limited to:*

- (a) *overseeing the establishment and operation of an independent risk management system for identifying, measuring, monitoring, controlling and reporting risks on an enterprise-wide basis. In this respect, the limitations and constraints of the risk management system should be clearly identified and incorporated when reporting and managing the risks of the Financial Institution. Risks relating to the Financial Institution's remuneration and incentive structure should also be included in the risk assessment process.*
- (b) *ensuring the adequacy of risk management practices for material risks, such as credit, market, liquidity, legal, compliance, fraud, regulatory and operational risks, on a regular basis.*
- (c) *reviewing the current risk profile, risk tolerance level and risk strategy of the Financial Institution.*
- (d) *ensuring that the risk management function has adequate resources and is staffed by an appropriate number of experienced and qualified employees who are sufficiently independent to perform their duties objectively. The risk management function should have appropriate reporting lines, independent of business lines.*

- (e) *maintaining records of all its meetings, in particular records of discussions on key deliberations and decisions taken.*

17.3 Depending on the scale, nature and complexity of its business, the Board may appoint a chief risk officer (“CRO”) to oversee the risk management function. The CRO should have a direct reporting line to the Board and have the right to seek information and explanations from senior management. The Board should approve the appointment, remuneration, resignation or dismissal of the CRO. The role of the CRO should be distinct from other executive functions and business line responsibilities, and there generally should be no “double hatting”. The resignation or dismissal of the CRO should be disclosed publicly. These guidelines should apply to any officer who fulfils the role of a CRO regardless of the title assigned to the role.

17.4 The CRO should manage the risk management systems and put in place processes to identify, measure, monitor, control and report risks. The CRO is further responsible for facilitating senior management’s understanding of the various types of risks and the corresponding inter-relationships as well as engaging senior management to develop risk controls and risk mitigation procedures for the operations functions.

17.5 The Board may establish a dedicated Board Risk Management Committee (“RMC”) to assist the Board in the discharge of its responsibilities in relation to risk management specified in Guideline 17.2. The RMC should comprise at least 3 directors of whom a majority are non-executive. The Board should ensure that the members of the RMC are appropriately qualified to discharge their responsibilities. At least 2 members should have the relevant technical financial sophistication in risk disciplines or business experience, as the Board interprets such qualification in its judgment. Where a RMC has been established by the Board, the Board may delegate to the RMC the authority to appoint a CRO and in such a case, the reference to “the Board” in Guideline 17.3 shall include a reference to “the RMC”.

17.6 A Financial Institution should disclose in its annual report:

- (a) *the composition of the Board Risk Management Committee as stated in Guideline 17.5, and details of the Committee’s activities; and*
- (b) *comments by the Board and, where established, the RMC as stated in Guideline 17.5, on the adequacy of the risk management processes of the Financial Institution.*

RELATED PARTY TRANSACTIONS

Principle:

18 The Board should ensure that related party transactions⁷ with the Financial Institution are undertaken on an arm's length basis.

Guidelines:

18.1 The Financial Institution should establish policies and procedures on related party transactions, which include the definitions of relatedness, limits applied, terms of transactions, and the authorities and procedures for approving, monitoring, and, where necessary, writing off of these transactions. Material transactions should be disclosed in the annual reports of the Financial Institution.

18.2 The Board should ensure that established control processes are not overridden to accommodate the Financial Institution's related parties⁸ and individuals. The AC should review all material related party transactions and keep the Board informed of such transactions.

18.3 Related party transactions should be monitored with particular care, and appropriate steps taken to control or mitigate the risks of related party lending. The terms and conditions of such credits should not be more favourable than credit granted to non-related obligors under similar circumstances.

⁷ "Related party transaction" means a transfer of resources or obligations between related parties, regardless of whether a price is charged. Related party transactions include transactions with related parties and director and director-related entities

⁸"Related party", in relation to a Financial Institution, means any of its associates or subsidiaries, its holding company or any subsidiary of its holding company.

DISCLOSURE OF CORPORATE GOVERNANCE ARRANGEMENTS

The Singapore Exchange Listing Rules require listed companies to describe in the annual reports their corporate governance practices with specific reference to the principles of the Code, as well as disclose and explain any deviation from any guideline of the Code. Companies are also encouraged to make a positive confirmation at the start of the corporate governance section of the annual report that they have adhered to the principles and guidelines of the Code, or specify each area of non-compliance. Many of these guidelines are recommendations for companies to disclose their corporate governance arrangements. For ease of reference, the specific principles and guidelines in the Code for disclosure are set out below:

- | | |
|--|----------------|
| <ul style="list-style-type: none"> • Delegation of authority, by the Board to any Board Committee, to make decisions on certain board matters | Guideline 1.3 |
| <ul style="list-style-type: none"> • The number of board and board committee meetings held in the year, as well as the attendance of every board member at these meetings | Guideline 1.4 |
| <ul style="list-style-type: none"> • The type of material transactions that require board approval under internal guidelines | Guideline 1.5 |
| <ul style="list-style-type: none"> • <i>The type of continuous professional development programme established for directors and how the programme incorporates the types of skills which the NC assesses that the Board and the respective Board Committees should have in order to perform their roles effectively</i> | Guideline 1.16 |
| <ul style="list-style-type: none"> • Where the company considers a director to be independent in spite of the existence of a relationship as stated in the Code that would otherwise deem him as non-independent, the nature of the director's relationship and the reason for considering him as independent should be disclosed | Guideline 2.2 |

<ul style="list-style-type: none"> Relationship between the Chairman and CEO where they are related to each other⁹ 	Guideline 3.1
<ul style="list-style-type: none"> Composition of nominating committee 	Guideline 4.1
<ul style="list-style-type: none"> Process for the selection and appointment of new directors to the board 	Guideline 4.5
<ul style="list-style-type: none"> Key information regarding directors, including whether they are considered independent by the nominating committee 	Guideline 4.6
<ul style="list-style-type: none"> <i>Deviation and explanation for the deviation from the internal guidelines on time commitment referred to in Guidelines 4.4 and 4.10</i> 	Guideline 4.14
<ul style="list-style-type: none"> Process for assessing the effectiveness of the Board as a whole and the contribution of each individual director to the effectiveness of the Board 	Guideline 5.1
<ul style="list-style-type: none"> Clear disclosure of its remuneration policy, level and mix of remuneration, procedure for setting remuneration and link between remuneration paid to directors and key executives, and performance 	Principle 9
<ul style="list-style-type: none"> Composition of remuneration committee 	Guideline 9.1
<ul style="list-style-type: none"> Names and remuneration of each director. The disclosure of remuneration should be in bands of S\$250,000. There will be a breakdown (in percentage terms) of each director's remuneration earned through base/fixed salary, variable or performance-related income/bonuses, benefits in kind, and stock options granted and other long-term incentives. 	Guideline 9.2
<ul style="list-style-type: none"> Names and remuneration of at least the top 5 key executives (who are not also directors). The disclosure should be in bands of S\$250,000 and include a breakdown of remuneration. 	Guideline 9.2

⁹ As defined in the Listing Manual of the Singapore Exchange to mean the spouse, child, adopted child, step-child, brother, sister and parent.

<ul style="list-style-type: none"> • Remuneration of employees who are immediate family members of a director or the CEO, and whose remuneration exceeds S\$150,000 during the year. The disclosure should be made in bands of \$250,000 and include a breakdown of remuneration. 	Guideline 9.3
<ul style="list-style-type: none"> • Details of employee share schemes 	Guideline 9.4
<ul style="list-style-type: none"> • Composition of audit committee and details of the committee's activities 	Guideline 11.8
<ul style="list-style-type: none"> • Adequacy of internal controls, including financial, operational and compliance controls, and risk management systems 	Guideline 12.2
<ul style="list-style-type: none"> • <i>Resignation or dismissal of the head of internal audit</i> 	<i>Guideline 13.9</i>
<ul style="list-style-type: none"> • <i>Composition of executive committee, and details of the committee's activities</i> 	<i>Guideline 16.4</i>
<ul style="list-style-type: none"> • <i>Resignation or dismissal of the CRO</i> 	<i>Guideline 17.3</i>
<ul style="list-style-type: none"> • <i>Composition of Risk Management Committee and details of the committee's activities</i> 	<i>Guideline 17.6</i>
<ul style="list-style-type: none"> • <i>Board's comments, made in consultation with the Risk Management Committee where established, on the adequacy of the risk management processes of the Financial Institution</i> 	<i>Guideline 17.6</i>
<ul style="list-style-type: none"> • <i>Material related party transactions</i> 	<i>Guideline 18.1</i>

- (I) FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES**
- (II) FSB PRINCIPLES FOR SOUND COMPENSATION PRACTICES
- IMPLEMENTATION STANDARDS**

(I) FSF Principles for Sound Compensation Practices

2 April 2009

FSF Principles for Sound Compensation Practices

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Introduction¹

Compensation practices at large financial institutions are one factor among many that contributed to the financial crisis that began in 2007. High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms. These perverse incentives amplified the excessive risk-taking that severely threatened the global financial system and left firms with fewer resources to absorb losses as risks materialised. The lack of attention to risk also contributed to the large, in some cases extreme absolute level of compensation in the industry.

These deficiencies call for official action to ensure that compensation practices in the financial industry are sound. While national authorities may continue to consider short-term measures to constrain compensation at institutions that receive government assistance, it is essential that steps also be taken immediately to make compensation systems as a whole sound going forward.

To date, most governing bodies (henceforth “board of directors”) of financial firms have viewed compensation systems as being largely unrelated to risk management and risk governance. This must change. While voluntary action is desirable, it is unlikely to effectively and durably deliver change given competitive pressures and first-mover disadvantage. The global supervisory and regulatory infrastructure is an appropriate vehicle for making sound compensation practices widespread.

The FSF Principles for Sound Compensation Practices are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms. They will be implemented by firms and will be reinforced through supervisory examination and intervention at the national level. Authorities, working through the FSF, will ensure coordination and consistency of approaches across jurisdictions.

The Principles are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. They are *not* intended to prescribe particular designs or levels of individual compensation. One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm. However, any compensation system must work in concert with other management tools in pursuit of prudent risk taking.

¹ In April 2008, the Financial Stability Forum (FSF) recommended that “regulators and supervisors work with market participants to mitigate the risks arising from remuneration policies.” The FSF formed a Compensation Workstream Group in late 2008 with a mandate to draft sound practice principles for large financial institutions.

I. Principles

The FSF Principles for Sound Compensation Practices aim to ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation. The benefits of sound compensation practices will be achieved only if there is determined and coordinated action by national regulators, facilitated if necessary by suitable legislative powers and supported by national governments.

1. Effective governance of compensation

The board of directors of major financial firms should exercise good stewardship of their firms' compensation practices and ensure that compensation works in harmony with other practices to implement balanced risk postures. The Principles need to become ingrained over time into the culture of the entire organisation.

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.
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.
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.

2. Effective alignment of compensation with prudent risk taking

An employee's compensation should take account of the risks that the employee takes on behalf of the firm. Compensation should take into consideration prospective risks and risk outcomes that are already realised.

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.

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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.
6. **Compensation payout schedules must be sensitive to the time horizon of risks.** Profits and losses of different activities of a financial firm are realized over different periods of time. Variable compensation payments should be deferred accordingly. Payments should not be finalized over short periods where risks are realized over long periods. Management should question payouts for income that cannot be realized or whose likelihood of realisation remains uncertain at the time of payout.
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.

3. Effective supervisory oversight and engagement by stakeholders

Firms should demonstrate to the satisfaction of their regulators and other stakeholders that their compensation policies are sound. As with other aspects of risk management and governance, supervisors should take rigorous action when deficiencies are discovered.

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.
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.

II. Commentary on the principles

This section sets out why changes in compensation policies are needed and why the issues are important for supervisory authorities. It discusses the Principles in more detail and further sets out further comment on the Principles.

Change is necessary

During the course of its work, the Workstream Group reviewed relevant reports and analyses by other bodies and experts, engaged in discussions with experts from the financial industry, the public sector and academia, and investigated industry practice by conducting a global survey of practice at major financial firms. It also reviewed the results of surveys commissioned by others.²

Multiple surveys find that over 80 percent of market participants believe that compensation practices played a role in promoting the accumulation of risks that led to the current crisis. Experts agree. Few if any observers and respondents believe that compensation was the sole cause of the crisis, nor do they believe that changes limited to compensation practice will be enough to limit the chance of future systemic crises. However, absent such changes, other reforms are likely to be less effective.

Market participants are pessimistic about the effectiveness of change unless it is industry-wide and global. Major financial institutions compete for talent in a global labour market. Some firms have already moved to change their practices and may temporarily feel safe in doing so because of the impact of the crisis on the labour market. However, in the longer run, such firms will be forced to conform to broad industry practice by labour market pressures. Moreover, firms have many competing priorities. Changing compensation practice will be challenging, time-consuming, and will involve material costs. Therefore, in the absence of sustained external pressure, firms may fail to carry through on originally good intentions. Although some market participants are wary of regulatory pressure, many believe that a widespread change in practice can be achieved only with the help of supervisory and regulatory agencies, which should coordinate at the global level.

Compensation is an incentive system, not simply a market wage

Major financial institutions are too large to be managed solely by the direct knowledge and action of senior executives. Consequently, systems, such as accounting systems, budgets, position limits, capital allocations, risk management and control systems and, importantly, compensation systems are designed to encourage employees to accomplish the goals set by senior management and the firm's governing bodies. Systems inform senior management and the firm's governing bodies ("board of directors") of the position and activities of the organisation. They help management set employee incentives in order to steer the organisation in pursuit of profit and other goals while staying within the risk appetite set by

² See, for instance, the FSF report on *Enhancing Market and Institutional Resilience* (April 2008), the IIF report on *Principles of Conduct and Best Practice Recommendations* (July 2008), the G30 report on *Financial Reform. A Framework for Financial Stability* (January 2009) and various initiatives at the national level.

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the board of directors. Labour market pressures influence compensation systems, but the systems also influence how the market for financial talent operates.

Too little attention to links between compensation and risk

As a practical matter, most financial institutions have viewed compensation systems as being unrelated to risk management and risk governance. Compensation systems have been designed to incentivise employees to work hard in pursuit of profit and to attract and retain talented employees. Risk management systems have been designed to inform senior management about risk postures and to be an element of risk controls.

In principle, if risk management and control systems were strong and highly effective, the risk-taking incentives provided by compensation systems would not matter because risk would stay within the firm's appetite. In practice, all risk management and control systems have limitations and, as the current crisis has shown, they can fail to properly control risks. The incentives provided by compensation can be extremely powerful. Without attention to the risk implications of the compensation system, risk management and control systems can be overwhelmed, evaded, or captured by risk-takers.

Until recently, financial supervisory and regulatory authorities also have not focused on the implications for risk of compensation systems. Front-line supervisory personnel have long understood that compensation based solely on revenue or volume can lead to unbalanced risk postures. However, supervisory strategy has focused on risk control systems. A few decades ago this was a workable approach for most financial institutions. Most risk was in the traditional loan book and most firms were able to control front-line incentives towards excessive risk by having strong and separate credit underwriting and monitoring departments. In recent years, however, risk has become more multidimensional and complex and the array of means of taking risk has grown large. A simple one-dimensional balance between front-line and risk management personnel is no longer sufficient. Greater balance within the compensation system itself will reduce the burden on risk management systems and increase the likelihood that they are effective.

Such balance is not inconsistent with pursuit of profit and need not require a change in the firm's strategy or goals. Indeed, the current crisis has revealed that many firms took actions that were inconsistent with their own goals and internally determined risk appetite.³ Priority must be given to the link between risk and compensation.

³ In principle, there is a danger that compensation systems could become too inflexible or oversensitive to risk. In practice, a swing towards excessive risk-sensitivity is unlikely. Boards of directors are well aware of the need for effective incentives, and senior supervisory and regulatory agencies around the world are well aware of the need for the financial industry to remain dynamic and profitable. Thus, implementation of the Principles is unlikely to lead to compensation systems that are imbalanced in the sense of placing too much weight on risk.

Principles 1–3: Effective governance of compensation

Rationale

Effective governance is a necessary precondition for compensation systems to be sound, though other practices are required as well. Financial firms that adopt a view that the compensation system interacts materially with other aspects of risk governance are likely to comply with the other principles as well. In contrast, firms that are not attentive to the governance of compensation may in reaction to supervisory pressure adopt policies and procedures that appear to be in compliance, but substance is likely to be lacking.

To date, most boards of directors have viewed compensation systems as being largely unrelated to risk management and risk governance. Compensation committees of boards have been attentive to the compensation of the most senior executives. Decisions about the compensation of all other employees have been delegated to the firm’s senior management. Often, formal responsibility for design and operation of the firm’s compensation system has been the duty of human resources departments. However, such departments tend to have little real power. Variable compensation (“bonus”) has been substantially influenced by the results of negotiations between senior management and the heads of business units and by the levels of compensation offered by competitors. Risk typically was not among the primary influences on the outcomes of such negotiations.

More about the governance principles

The firm’s board of directors should be responsible for the compensation system’s design and operation. Boards must pay serious, sustained attention to the design *and* to the operation of compensation practices for the whole firm, not just the most senior executives.⁴ Complete delegation of compensation system operation to senior executives is risky because they are subject to many pressures, especially during economic booms. Without sustained board attention, the operation of well-designed compensation systems may change in ways that are inconsistent with the spirit of the system design.

To achieve effective governance of compensation systems, substantial expertise on the part of the most-involved board members will be required. Such individuals must be independent, non-executive directors. Because sensitivity of compensation to risk will be essential, the most-involved board members will find themselves mediating disputes about details of risk measurement. They must have enough risk-measurement expertise to grasp the essence of the problems. They must also have enough sense of the history of risk realizations to mediate disputes about how compensation should change during periods of high losses.⁵

Activities that are conceptually similar to those already used for accounting and risk management systems are likely to be helpful in supporting good governance of compensation

⁴ Non-executive directors hold particular responsibility for ensuring that executive incentive compensation arrangements are sound. For financial institutions with dual boards, the Supervisory Board must take responsibility for all compensation arrangements, not just senior executive compensation arrangements.

⁵ Boards may wish to obtain independent audits of the adequacy of risk management systems and controls as well as of compensation system operation. However, such audits are not a substitute for the presence of some board members who themselves have expertise.

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systems. At lower levels of the organization, ***the compensation system should be monitored and reviewed to ensure that it operates as intended.*** A good design is not sufficient – the system must also function well. It cannot do so without controls, just as an accounting system is unreliable without controls.

Each firm should conduct regular reviews that identify material deviations of compensation outcomes from the intent of its compensation system. Such reviews should detect not only departures from rules, but also unreasonable or undesirable outcomes that flow from unavoidable system weaknesses, such as imprecise risk measures. It is important that such reviews touch all levels of the organisation. Large numbers of lower-level employees with inappropriate incentives can take actions that are individually insignificant but that, taken together, can harm the firm.

Staff engaged in financial and risk control should be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm. Moreover, compensation of back-office and risk-control employees should not be influenced by personnel in front-line business areas. Such employees must play a continuing role in the operation of the compensation system. For example, risk measures and risk judgments play a key role in risk-adjustment of compensation, as does the long-term accuracy of measures of profit-and-loss. Back-office and risk control employees play a key role in ensuring the integrity of such measures. If their own compensation is importantly affected by short-term measures, their independence will be compromised. If their compensation is too low, the quality of such employees may be insufficient to their tasks and their authority may be undermined.

As a practical matter, the compensation system often includes its own accounting system for profit-and-loss (so called “management P&L”), with rules for the treatment of revenue and expense that differ across business units and that depart from accounting standards for financial statements. Performance goals and hurdles are often set in terms of this parallel accounting system’s measures. Because the measures influence compensation, three aspects of the quality of the measures deserve particular attention from governing bodies to ensure that compensation is not distorted: The inclusion of all costs, the quality and independence of valuations, and avoiding giving current-year credit for expected future-year revenue. For some activities, such as spot foreign exchange trading involving no end-of-day positions, risks are intraday and marginal daily cash profit is directly measurable using independently obtained market prices. However, overhead costs are hard to allocate, especially the value of the firm’s creditworthiness and use of liquidity resources. It may also be the case that a business strategy generating measurable daily results possesses embedded risks that only emerge every few years, under unusual stress conditions. For many other activities, profit is difficult to measure and firms rely upon a mark-to-model process for valuation. Exotic products and positions are an example. Some of these impose a long tail of risk on the firm in the form of model assumptions which cannot be validated and whose failure only becomes apparent in future years. Market prices may not exist and employees managing the business may influence the models that provide mark-to-model valuations. Moreover, the expected future revenues of model valued products are sometimes present-valued irrespective of the likelihood of receipt and considered as profit for the current year when employee performance is evaluated. The result is strong incentives to transact these products in order to

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maximize current year compensation while the residual risks are borne by shareholders in future years.

Measures produced for financial statements have their own drawbacks, and senior management must be able to engineer features of the performance measurement accounting system to encourage some kinds of activity and discourage others. Thus, bespoke performance measurement systems should not be eliminated. But governing bodies must ensure that controls and adjustments are such that compensation is appropriately related to economic profit and risk.

Principles 4-7: Effective alignment of compensation with prudent risk taking

Rationale

Two complementary approaches exist for aligning compensation with risk-taking incentives. One, the focus of Principle 4, adjusts for risk that the employee or business unit imposes on the firm but that is not yet realized. Imagine two employees whose activity generates the same short-run profit for the firm. One is a trader who ends each day with no positions and thus who exposes the firm to losses only during the trading day. Another is an originator of long-term, on-balance-sheet assets that provide substantial fees at origination but that expose the firm to substantial risk of loss over the life of the asset. Many compensation systems would tend to reward the two employees similarly, other things being equal, because there would be no “risk charge” applied to the short-term profits generated by the second employee.

Though the need for risk adjustment may seem obvious, material risk-adjustment of variable compensation grants was not widespread in the industry through 2008.⁶

The focus of the second approach and of Principles 5, 6 and 7 are practices that make compensation appropriately sensitive to risk outcomes. Such sensitivity also is not yet widespread. These Principles complement the risk adjustment approach because available risk measures, both quantitative and judgmental, have limitations. Sole reliance on them is likely to leave loopholes that would encourage taking poorly measured risk. If compensation is sensitive to outcomes, exploiting the loopholes becomes less attractive. However, bad outcomes of some risk positions are infrequent but large, so a purely outcome-based system would encourage the taking of tail risks, especially by employees with a relatively short expected remaining tenure of employment.

⁶ At least in some jurisdictions, major banks moved towards risk-adjustment of compensation in the mid-1990s. The reasons why such efforts were abandoned are not entirely clear, but one commonly cited reason is the limitations of risk measures. In large complex organizations, implementation of risk adjusted compensation is likely to involve some use of quantitative risk measures, but such measures are often not comparable across products and business units and are known to have other weaknesses. Each business unit criticizes not only the risk measures applied to its activities but also those applied in other units, making it difficult to achieve consensus about how to move forward with implementation of risk measures in compensation systems. Putting a good face on such internal debates, perhaps the perfect became the enemy of the good.

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A compensation system that employs both approaches is more robust but still imperfect if it is purely mechanical. For example, many tail risks are hard to measure, so both risk adjustment and outcome-based approaches may fail to fully align compensation with the risk. Governing bodies must use intuition and common sense in looking for compensation outcomes that are not sensitive enough to risk. Boards and executive management should also be sensitive to the danger signal inherent in businesses where it is very difficult to develop appropriately risk-aligned compensation. If the firm cannot assess the employee's performance in a business, the firm is probably unable to fully assess this business's risks, and may wish to limit its exposure to the business.

More about the risk alignment principles

Perhaps the greatest barriers to progress towards the principle that *compensation must be adjusted for risk* are:

- Determining and implementing the proper mix of executive judgment and quantitative risk measures. Though quantitative risk measures have limitations, this does not imply that quantitative measures should not be used nor that risk cannot be judged.⁷ Well-governed firms make risk decisions at multiple levels and budget risk-taking across business units. Quantitative risk measures provide support for such decisions but substantial amounts of judgment are used as well. Just as judgment is required in managing the firm's risk posture, significant amounts of judgment will be an element of any system for risk-adjusting compensation. Perhaps because risk adjustment has been uncommon, the nature of best practice in combining judgment and quantitative measures in risk-adjusting compensation has not yet become clear.
- The difficulty of incorporating types of risk for which measurement is at early stages, such as liquidity or reputation risk. This difficulty is not a reason to ignore such risks.
- The difficulty of safeguarding the fairness of risk adjustments.
- The danger that quantitative measures will be distorted by self-interested employees trying to unduly influence the measurement process.

One of the greatest challenges to achieving sound compensation practice, for both financial firms and supervisors, is that the particulars of the way towards risk-adjusted compensation are not always clear, and yet the details of how compensation is earned are essential to sound practice. Over the medium term, the industry must experiment. Two visions of possible ways forward emerged from discussions with experts and market participants.

One vision is of a system that relies almost entirely upon judgment: Although the overall firm-wide amount of the bonus pool in a given year might be driven largely by firm-wide profit, senior executives would allocate the pool to business units or even individual employees quite far down in the organisational structure. In doing so, the executives might make themselves aware of quantitative measures of risk, but decisions would not be driven by such measures in any mechanical or reproducible way. The strength of the approach is that

⁷ For example, even for a single type of risk, such as credit risk, several types of measures that cannot be mechanically aggregated may be needed to assess the risk of a position. And for some important risks, such as those associated with liquidity or reputation, existing quantitative measures are crude at best.

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it cannot be gamed by influencing quantitative measures and the risk adjustments are likely to be fairly good if the overall risk management system of the firm is good. The weaknesses of the approach are that it places a large operational burden on senior executives and that it lacks objectivity and transparency and is therefore difficult to audit. There is also the likelihood that a considerable proportion of internal management and senior staff time will be devoted to securing good outcomes for individuals and teams via internal political processes.

A second approach would make somewhat heavier use of quantitative measures in allocating the firm-wide variable pay pool to business units. For example, economic capital allocations might be used, with judgmental adjustments for known weaknesses of the allocations. Managers of the business units would then use substantial judgment in risk-adjusting the variable pay of individuals, producing written descriptions of their rationale. A strength of this approach is that it is more transparent and auditable and it uses the knowledge of mid-level managers. Weaknesses include the possibility that business units will try to influence economic capital measures to their own advantage and that, over time, the firm will underweight risks that the economic capital system captures poorly.

The two visions are only examples. Firms are likely to differ in the approaches they use and ways forward will emerge that are not yet apparent. The fact that the ways forward are not yet well understood is not a rationale for inaction.

Any robust compensation system is likely to take advantage of the signals arising from the firm's risk management infrastructure. Poor business unit results for internal audit, compliance, or risk management, for example, should reduce payments to the staff and managers of that business unit.

Risk adjustment of variable pay for the most senior executives presents a special challenge. They are responsible for the entire firm's risk posture and performance. However, quantitative risk measures of firm-wide risk are especially difficult to produce and to deconstruct into the contribution of each member of the executive team. Thus, the compensation committee of the board of directors, which should determine the compensation of senior executives, must use judgment in adjusting for risk. They should pay particular attention to the quality of operation of the firm's risk management and risk-adjusted compensation systems, as well as other determinants of risk.

Three principles focus on making compensation sensitive to risk outcomes: ***compensation outcomes must be symmetric with risk outcomes; compensation payout schedules must be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.*** They are motivated by the fact that, as a practical matter, the industry's efforts to achieve such sensitivity have not been effective in containing risk-taking incentives.

Theoretical treatments of how to motivate employees to act in the interests of the firm's shareholders emphasise various forms of stock-based compensation. Many financial firms paid a significant portion of total compensation in stock or similar instruments, with the stock-based portion typically greater the higher the level of the employee. Vesting and other restrictions required employees to hold some newly granted stock for significant periods of time. Although stock ownership exposed employees to losses in event of poor firm performance, many market participants and experts believe that this was not sufficient to offset risk-taking incentives. Three reasons are commonly cited. First, performance targets

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and other features of compensation systems encourage employees to focus on “getting the stock.” Downside risk that might be realized later is not as relevant to an employee who receives only a small grant of stock. Second, below the level of the executive suite, most employees view the performance of the firm as a whole as being almost independent of their own actions. Actions by other employees or business units are seen as determining the firm’s fate. Similarly, stock performance might be driven by various exogenous factors. Thus, employees heavily discount the value of the stock and act to bring the cash component of bonus up. Third, many market participants view equity prices as being over-sensitive to short-term performance of the firm on both the upside and the downside and view shareholders as having a focus on short-term results. Psychologically, this pushed employees toward a focus on short-term performance.

Thus, when implementing the principle that *the mix of cash, equity and other forms of compensation should be consistent with risk alignment*, it is not obvious that more equity and less cash always increases the employee’s incentive to align risk with the firm’s appetite. The mix is likely to differ across employees and to involve a smaller cash component the more senior the employee. Some evidence implies that traditionally structured options, which are out-of-the-money when granted, are inferior to ordinary equity because the asymmetric payoff properties of options offer incentives to take too much risk.⁸ However, options that are in-the-money when granted might have different properties in that they would be similar to ordinary equity in terms of upside payout but, like a clawback, would reduce compensation in event of poor firm performance. The goal should be a mix of cash, ordinary equity, and appropriately structured options that generates a closer match between executive incentives and the long term stewardship of the firm than in the past.

Variable compensation for senior executives is probably more risk-aligned when a relatively small fraction is paid in cash and most is deferred. Compensation for more junior and transactionally oriented staff should also rely upon appropriate deferral, but a larger share could prudently be paid in cash once the relevant validation period is cleared.

Recent practice has not been consistent with the principle that *compensation outcomes must be symmetric with risk outcomes* because the bonus component of compensation has been much more variable upward in response to good performance than downward in response to poor performance, especially poor firm-wide performance. In years of losses by the firm as a whole, most employees’ bonuses at most firms have continued at a significant portion of boom-year levels. In other words, the size of firms’ bonus pools showed much more inertia than did economic performance. Firms justified this mainly by arguments that employees need incentives to work effectively even in bad years, that many employees and business units perform well even in bad years for the firm, and that employees will move to another firm if bonuses fall far below recent levels. Individual employees and business units receive small or no bonus only if their performance is poor relative to competitors or if their line of business generates very large losses.

⁸ See for instance Chen, Steiner and Whyte (2006), *Does stock option-based executive compensation induce risk-taking? An analysis of the banking industry*, Journal of Banking and Finance 30; Sanders and Hambrick (2007), *Swinging for the fences: the effects of CEO stock options on company risk taking and performance*, Academy of Management Journal 50; and Jensen and Murphy (2004), *Remuneration: where we’ve been, how we got to here, what are the problems, and how to fix them*, ECGI working paper.

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It might appear that such practice simply implies part of the bonus is more like a fixed salary, so that the variable component of compensation is smaller than it appears, perhaps reducing incentives to take risk. However, the effect on incentives is more perverse. Because weak relative performance may be punished, and taking more risk, especially tail risk, is a way to boost short-run performance, the asymmetry of bonus practice encourages taking of excessive risk.⁹ It also reduces the incentive to draw attention to excessive risk taking by others, since the sensitivity of the employee's compensation to losses caused by others is reduced. Moreover, during booms, bonus amounts ratchet up each year as a result of both benign conditions and increased risk-taking, unlike fixed salaries.

The obvious ways forward are to make bonus grants much more sensitive to poor performance of the firm or business unit, or to make grants a smaller portion of total compensation. Such changes might have a price in terms of specific business unit incentives to work hard or employee retention, so the size of such changes is not clear, but some change is required.¹⁰

Recent practice has also been inconsistent with the principle that *compensation payout schedules must be sensitive to the time horizon of risks*. In addition to making *new* bonus grants sensitive to risk outcomes, which is the focus of the symmetry principle, grants from any given year should typically be sensitive to risk outcomes over a multi-year horizon. Otherwise employees will have an incentive to expose the firm to risks that are unlikely to be realized for some time, especially in cases where risk adjustments are known to the employee to be inadequate.

One way to align time horizons is to place a portion, and in some cases up to the entirety, of any given year's bonus grant, both cash and equity, into the equivalent of an escrow account. All or part of the grant is reversed if the firm as a whole performs poorly or if the exposures the employee caused the firm to assume in the year for which the bonus was granted perform poorly (a "clawback"). Departure of the employee from the firm should not trigger early payout (hence, for example, many past "golden parachute" arrangements did not conform to this principle).

Commonly used vesting provisions for stock grants do not achieve the same result because the employee forfeits unvested stock only upon leaving the firm. Thus, long-term risks imposed on the firm by employee actions are reflected in compensation only through declines in the value of stock or by dismissing the employee.

Design features of systems that make payouts sensitive to the time horizon of risk include the relative weight given to firm and employee performance, the time horizon of payout, and the rate of clawback per unit of poor performance. Both the horizon and the rate are likely to

⁹ Risk adjustment may reduce the perversity of the incentives, but only if the tail risks the employee or business unit takes are measured well.

¹⁰ Maintaining bonus payments from current revenue is not necessarily the only way to provide incentives. One possibility would be to grant bonuses in the form of claims on future-year bonus pools, with the claims exposed to clawbacks as described below. In the event a firm with losses recovers and its franchise proves valuable, such claims would eventually convert into wealth for the employee. This is only an example – there may be other ways to achieve similar ends.

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differ for firm and employee performance and to differ across employees because different employees expose the firm to risks of different duration.

Unlike bonus grants, considerations of legal enforceability may require that clawback systems be driven by observable and verifiable measures of risk outcomes. Moreover, such provisions have not been common practice and in some jurisdictions may be legally difficult to implement. An exception is violations of policy by the employee, such as violations of risk management or control policies, fraud, or other malfeasance. Such employee actions are grounds for dismissal-for-cause in most jurisdictions and thus should be a basis for clawbacks.

“Golden handshake” payments that reimburse unvested compensation foregone at the employee’s predecessor firm are a difficult problem. If employees are routinely compensated by a new employer for accumulated unvested bonuses, or for vested bonuses still subject to clawback, in a manner that removes the employee’s exposure to risks imposed on the old employer, the incentive effects of the Principles will be reduced.¹¹ Similarly, multi-year guaranteed bonuses are not in line with the principle.

Similarly, “golden parachute” arrangements that generate large payouts to terminated staff that are not sensitive to performance or risk are prudentially unsound. Such arrangements create a “heads I win, tails I still win” approach to risk, which encourages more risk taking than would likely be preferred by the firm’s shareholders or creditors.

Principles 8–9: Effective supervisory oversight and engagement by stakeholders

Rationale

As noted previously, supervisory oversight is not only required for collective action to occur, but is likely to be required in the long run to offset countervailing pressures. Such oversight will be ineffective if it becomes routine or inattentive.

Similarly, governance is more likely to be effective if the firm’s stakeholders, particularly shareholders, are engaged with compensation. In order for them to be engaged, they must be informed. They can only be informed if the firm discloses relevant information. Giving shareholders an explicit voice may also be helpful.¹²

Some countries require disclosure of the level of compensation paid to top executives. However, disclosure of remuneration policies and structures, particularly as they affect other levels of an organization, has generally been poor. In the future, all the stakeholders of financial firms, including supervisors, shareholders, and (where firms are systematically

¹¹ One possible approach might involve giving the new employee deferred compensation in the form of deferred shares in the new firm, on terms similar to those that would have applied at the old firm. Such a practice would have to be widely adopted to be effective. Or sign on bonuses might only cover vested bonuses at the previous employer that are not at risk.

¹² For example, each year shareholders might vote on a nonbinding resolution to approve compensation. In cases where the resolution is not approved, the firm would be expected to consult, make material changes, and provide explanations why proposed compensation is aligned with shareholders’ interests.

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important) governments, will expect to receive more information about compensation policies and to increase their engagement with them.

More about the supervisory oversight and stakeholder engagement principles

Supervisory review of compensation practices should be rigorous and sustained and deficiencies should be addressed promptly with supervisory action. Supervisory assessments of a firm's compensation policies against sound practice should be included in the supervisor's overall assessment of a firm's soundness. Any shortcomings in compensation arrangements should be brought to the attention of the firm's management and board. Often such communications have more impact if delivered by very senior supervisors.

When a supervisor discovers any practice which appears to be contributing to material weakness in a firm's soundness, direct intervention may be necessary to remedy the situation. Particularly when the totality of a firm's compensation practices are less than sound, supervisors should first exercise suasion on the affected firm, and in the absence of necessary improvement should consider escalation to firmer intervention, which may include increased capital requirements.

National supervisory authorities must move cooperatively towards implementation of the Principles. Two avenues of cooperation are likely to be necessary. First, all would benefit from a better understanding of the range of current practice and from work that reveals ways toward improvement. Such understanding can only be achieved by reviews and other work that cuts across borders. Second, regulations and supervisory practices must be such that their impact is consistent across nations. Achieving this is not mechanical because legal constraints, supervisory infrastructure, and other aspects differ across nations. Thus, supervisors must work together to develop guidance and procedures to achieve common impact, not only in the early, developmental stage, but also in the long run, and consistent with other supervisory matters.

Supervisors should be alert for regulatory arbitrage activity within as well as across borders. For example, a shift of exposures or activity to a unit using risk measures or compensation practices that are less well-suited than those in the former unit should trigger supervisory attention.

Apart from supervisors, other stakeholders such as shareholders, counterparties, depositors, auditors and analysts also have an interest in the firm's compensation policy in order to independently assess the firm's continued financial health and stability.

Hence, *firms should disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.* The shape of sound disclosure is likely to change over time and to remain fluid for some years because practice is likely to evolve. Nonetheless, the necessary information should cover all the elements of the Principles and extend well beyond the details of the compensation of a handful of senior executives. Among the relevant information is the general design philosophy of the system and the manner of its implementation, a sufficiently detailed description of the manner of risk adjustment and of how compensation is related to actual performance over time, information about compensation outcomes for employees at different levels or in different units sufficient to allow stakeholders to evaluate whether the system operates as designed, and summaries of results of internal and external audits.

Members of the FSF Compensation Workstream

This report has been developed by a sub-group of the FSF. Its members are listed below.

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(II) FSB Principles for Sound Compensation Practices

Implementation Standards

25 September 2009

FSB Principles for Sound Compensation Practices

Implementation Standards

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

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

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

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

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

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

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

Governance

1. Significant financial institutions should have a board remuneration committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation on behalf of the board of directors. The remuneration committee should:
 - be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives created for managing risk, capital and liquidity. In addition, it should carefully evaluate practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain. In so doing, it should demonstrate that its decisions are consistent with an assessment of the firm's financial condition and future prospects;
 - to that end, work closely with the firm's risk committee in the evaluation of the incentives created by the compensation system;
 - ensure that the firm's compensation policy is in compliance with the FSB Principles and standards as well as complementary guidance by the Basel Committee, IAIS and IOSCO, and the respective rules by national supervisory authorities; and
 - ensure that an annual compensation review, if appropriate externally commissioned, is conducted independently of management and submitted to the relevant national supervisory authorities or disclosed publicly. Such a review should assess compliance with the FSB Principles and standards or applicable standards promulgated by national supervisors.
2. For employees in the risk and compliance function:
 - remuneration should be determined independently of other business areas and be adequate to attract qualified and experienced staff;
 - performance measures should be based principally on the achievement of the objectives of their functions.

Compensation and capital

3. Significant financial institutions should ensure that total variable compensation does not limit their ability to strengthen their capital base. The extent to which capital needs to be built up should be a function of a firm's current capital position. National supervisors should limit variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.

Pay structure and risk alignment

4. For significant financial institutions, the size of the variable compensation pool and its allocation within the firm should take into account the full range of current and potential risks, and in particular:
 - the cost and quantity of capital required to support the risks taken;
 - the cost and quantity of the liquidity risk assumed in the conduct of business; and
 - consistency with the timing and likelihood of potential future revenues incorporated into current earnings.
5. Subdued or negative financial performance of the firm should generally lead to a considerable contraction of the firm's total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.
6. For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm:
 - a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance;
 - a substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years; and
 - these proportions should increase significantly along with the level of seniority and/or responsibility. For the most senior management and the most highly paid employees, the percentage of variable compensation that is deferred should be substantially higher, for instance above 60 percent.
7. The deferral period described above should not be less than three years, provided that the period is correctly aligned with the nature of the business, its risks and the activities of the employee in question. Compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis.
8. A substantial proportion, such as more than 50 percent, of variable compensation should be awarded in shares or share-linked instruments (or, where appropriate, other non-cash instruments), as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk. Awards in shares or share-linked instruments should be subject to an appropriate share retention policy.
9. The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually. In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line.

10. In the event of exceptional government intervention to stabilise or rescue the firm:
 - supervisors should have the ability to restructure compensation in a manner aligned with sound risk management and long-term growth; and
 - compensation structures of the most highly compensated employees should be subject to independent review and approval.
11. Guaranteed bonuses are not consistent with sound risk management or the pay-for-performance principle and should not be a part of prospective compensation plans. Exceptional minimum bonuses should only occur in the context of hiring new staff and be limited to the first year.
12. Existing contractual payments related to a termination of employment should be re-examined, and kept in place only if there is a clear basis for concluding that they are aligned with long-term value creation and prudent risk-taking; prospectively, any such payments should be related to performance achieved over time and designed in a way that does not reward failure.
13. Significant financial institutions should take the steps necessary to ensure immediate, prospective compliance with the FSB compensation standards and relevant supervisory measures.
14. Significant financial institutions should demand from their employees that they commit themselves not to use personal hedging strategies or compensation- and liability-related insurance to undermine the risk alignment effects embedded in their compensation arrangements. To this end, firms should, where necessary, establish appropriate compliance arrangements.

Disclosure

15. An annual report on compensation should be disclosed to the public on a timely basis. In addition to any national requirements, it should include the following information:
 - the decision-making process used to determine the firm-wide compensation policy, including the composition and the mandate of the remuneration committee;
 - the most important design characteristics of the compensation system, including criteria used for performance measurement and risk adjustment, the linkage between pay and performance, deferral policy and vesting criteria, and the parameters used for allocating cash versus other forms of compensation;
 - aggregate quantitative information on compensation, broken down by senior executive officers and by employees whose actions have a material impact on the risk exposure of the firm, indicating:
 - amounts of remuneration for the financial year, split into fixed and variable compensation, and number of beneficiaries;

- amounts and form of variable compensation, split into cash, shares and share-linked instruments and other;
- amounts of outstanding deferred compensation, split into vested and unvested;
- the amounts of deferred compensation awarded during the financial year, paid out and reduced through performance adjustments;
- new sign-on and severance payments made during the financial year, and number of beneficiaries of such payments; and
- the amounts of severance payments awarded during the financial year, number of beneficiaries, and highest such award to a single person.

Supervisory oversight

16. Supervisors should ensure the effective implementation of the FSB Principles and standards in their respective jurisdiction.
17. In particular, they should require significant financial institutions to demonstrate that the incentives provided by compensation systems take into appropriate consideration risk, capital, liquidity and the likelihood and timeliness of earnings.
18. Failure by the firm to implement sound compensation policies and practices that are in line with these standards should result in prompt remedial action and, if necessary, appropriate corrective measures to offset any additional risk that may result from non-compliance or partial compliance, such as provided for under national supervisory frameworks or Pillar 2 of the Basel II capital framework.
19. Supervisors need to coordinate internationally to ensure that these standards are implemented consistently across jurisdictions.