INSTITUTE OF INTERNATIONAL FINANCE

COMPENSATION IN FINANCIAL SERVICES

Industry Progress and the Agenda for Change

Institute of International Finance

March 2009

Compensation in Financial Services

Industry Progress and the Agenda for Change

An Institute of International Finance Report

In collaboration with

OLIVER WYMAN

On behalf of the Board of Directors of the Institute of International Finance (IIF) and the IIF's Committee on Market Best Practices, we are pleased to present Compensation in Financial Services: Industry Progress and the Agenda for Change.

In its final report of July 2008, the IIF Committee on Market Best Practices set out seven Principles of Conduct on incentive compensation ('compensation principles'), reflecting widespread concern that misaligned employee incentives were one of the factors underlying the current financial crisis, particularly for senior management and for wholesale banking (corporate and institutional banking, sales and trading). Since then, many financial services firms have taken, and many continue to take, important steps to align compensation practices more closely with sound risk management.

In making the transition to improved compensation practices, the financial services industry faces challenges on a number of levels. This report intends to help the industry overcome these challenges by presenting a thorough picture of current compensation practices, with a particular focus on senior management and on wholesale banking (corporate and institutional banking, sales and trading). It includes recent changes made by firms in light of the crisis and establishes the 'direction of change'- key improvements in development and under consideration. The findings of the report are based on the results of an in-depth survey of a tailored sample of IIF member institutions conducted by management consultancy Oliver Wyman. The Institute is grateful for the participation of so many member firms in both the survey and subsequent interviews.

The IIF recognises that there can be no one-size-fits-all approach to financial services compensation - the precise approach each firm takes to changing compensation will of course depend on the firm's current practices, unique business model and other strategic considerations, as well as different legal and regulatory conditions. However, the IIF believes that the series of recommendations based on leading practices which are set out in this report are worthy of consideration by the financial services industry in the development of prudent compensation models.

The Institute welcomes the publication of guiding principles by regulatory authorities which are broadly consistent with key conclusions and recommendations presented in this report. The IIF has coordinated its work on compensation with the Financial Stability Forum, and we hope that this report will inform and support the ongoing dialogue between the industry and members of the regulatory community on matters relating to compensation.

Contents

Executive summary 1

1. What's At Stake? 5

2. Industry Self-Assessment 7
   2.1. Alignment to the Institute of International Finance compensation principles 7
   2.2. Plans to increase alignment to Institute of International Finance principles in 2009/2010 8

3. Survey Results on Compensation Practices and Industry Progress 10
   3.1. The compensation setting process: current practices 10
   3.2. Industry change dynamics and challenges 14
      3.2.1. Alignment of performance measurement with risk appetite and strategy 14
         3.2.1.1. Completeness and accuracy of performance measurement 14
         3.2.1.2. Compensation aligned to firm strategy and shareholder interests 18
      3.2.2. Alignment of compensation payouts to risk time horizon 23
      3.2.3. Effective governance and oversight 28

4. Compensation: The Agenda for Change 30
   4.1. Recommendations based on leading market practices and survey views 30
   4.2. Overcoming obstacles to change 31
      4.2.1. Technical challenges 31
      4.2.2. Organisational will, change management and governance 34
      4.2.3. Environmental factors 35
   4.3. Concluding remarks and industry next steps 39

Survey methodology 40

Acknowledgements 40

List of Figures

Figure 1 Industry self-assessed alignment to Institute of International Finance principles 2
Figure 2 Checklist based on leading market practices 4
Figure 3 Industry self-assessed alignment to Institute of International Finance principles 7
Figure 4 Changes to compensation approach planned for 2009/2010 8
Figure 5 The compensation setting process 10
Figure 6 Approaches to bonus pool generation 11
Figure 7 Main areas for industry change 14
Figure 8 Balance of financial / non-financial factors in individual incentive compensation.... 15
Figure 9 Performance metrics used in bonus pool generation and allocation processes 15
Figure 10 Current and planned risk adjustments in the compensation process 16
Figure 11 Current and planned productivity adjustments for bonus pool allocation 17
Figure 12 Impact of weak firm performance upon business unit bonus pools 19
Figure 13 Use of non-financial metrics at different levels of the compensation process 20
Figure 14 Payout formulas for individual compensation incentives 21
Figure 15 Risk management compensation summary 22
Figure 16 Approaches to aligning compensation payouts to risk time horizon 23
Figure 17 Performance measurement for deals with multi-year payback timeframes 24
Figure 18 Deferral rates and delivery mechanisms 25
Figure 19 Areas of deferred compensation slated for change in 2009 26
Figure 20 Compensation “currency” choices 26
Figure 21 Typical wholesale banking compensation governance structure 28
Figure 22 Disclosure of compensation information to stakeholders 29
Figure 23 Checklist based on leading market practices 30
Figure 24 Barriers to change in compensation 31
Figure 25 Possible risk measurement approaches by business 33
Figure 26 Improving compensation governance 35
Figure 27 Industry intention to improve compensation processes 36
Figure 28 Industry view on impact of possible regulatory actions on compensation reform 38

Executive Summary

Background

As the financial crisis has intensified in recent months, compensation has been one of the many aspects of financial services to come under increased scrutiny. The case has been made that excessive risk-taking in the boom years, especially in corporate and institutional or wholesale banking, was driven by the potential for excessively large rewards coupled with the limited downside of moving to a new employer in the case of failure. The tone of debate has understandably grown increasingly hostile - the cycle has now turned, shareholder value has collapsed and many wholesale banks have received taxpayer-funded financial support; however many in the financial services industry secure substantial bonuses.

Unsurprisingly, and perhaps justifiably, the focus of recent debate has been on high levels of compensation. While a number of senior financial services executives have declined bonuses in 2008, there remain clear examples of where the industry has overpaid, both recently and earlier in the cycle. The structure and governance of compensation have received far less attention, and it is the Institute of International Finance's view that these are more important in driving the desired level of prudence in the behaviour of front-line employees, managers and executives. Lasting change to structures and governance will be key to helping prevent a repeat of the current market crisis, and will drive the rightsizing of compensation. As a result, this report aims to answer three fundamental questions:

- **What are the structural weaknesses (and the strengths on which to build) in current industry compensation models?**
- **What changes are needed to ensure that future compensation structures support the agenda of shareholder value creation and sound risk-reward management?**
- **To what extent has the industry already started to implement these changes and what are the challenges in moving from today's status to full implementation?**

This report explores these questions by presenting a thorough picture of current industry compensation approaches. It highlights industry-wide challenges, identifies existing leading practices, reviews in-flight changes made by firms in light of the current crisis up to March 2009, and then proposes next steps. The report's intention is to provide a fact base which will help the industry to overcome the fears that first movers on compensation reform will lose talent.

The report is based on the results of a survey of compensation practices and a series of interactions with IIF member institutions between December 2008 and March 2009. 70 IIF member firms with significant wholesale banking businesses[1] were invited to participate in the survey. Responses were received from 37 banks, representing a total of 57% of wholesale banking activity.[2] The survey and subsequent interactions were designed to assess current and intended future industry alignment to the Institute of International Finance's Principles of Conduct for financial services compensation: principles that are intended to guide firms in the re-alignment of compensation incentives with shareholder interests and the realisation of risk-adjusted returns. The IIF was supported by Oliver Wyman in designing, executing and analysing the survey.

Sections one and two of the report introduce the compensation debate and present the industry's self-assessment against the IIF's compensation principles. Section three examines industry compensation practices, delving deeper into key topics that the industry identifies as major areas for change. Section four discusses ways to overcome a number of obstacles that firms expect to face when changing their compensation schemes.

[1] Including corporate and institutional banking, capital markets sales and trading, investment banking
[2] Based on 2007 wholesale banking (corporate and institutional banking, sales and trading) revenues before write-downs

Summary of findings

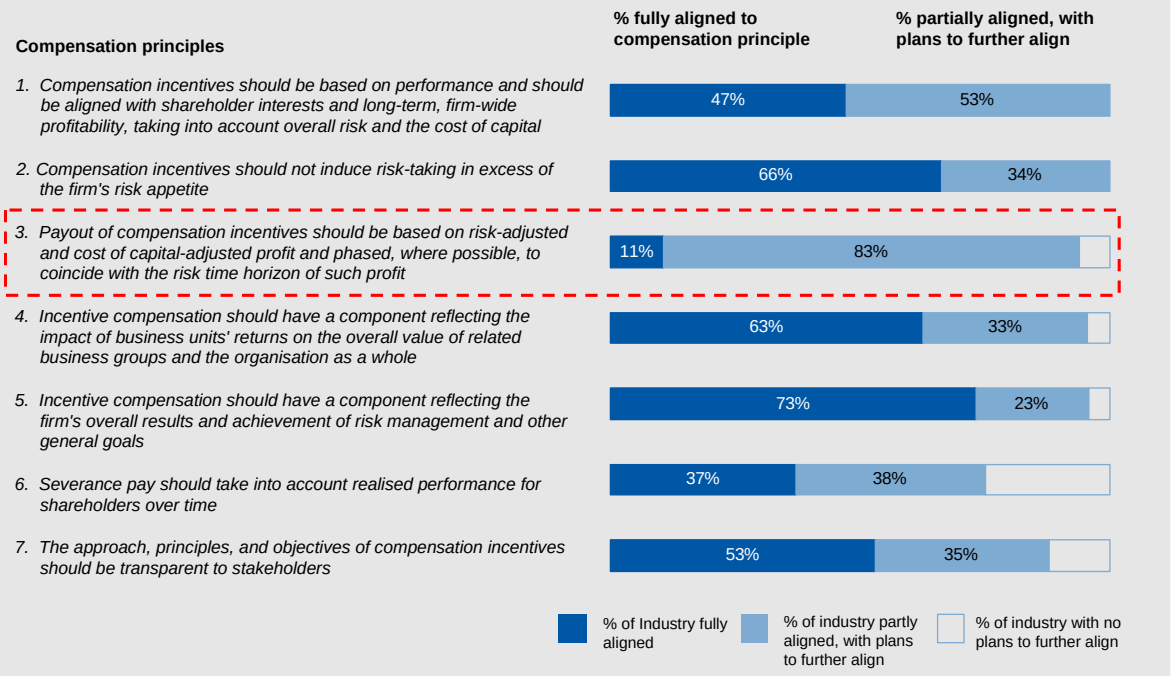
This report presents a detailed discussion of financial services, and specifically wholesale banking, compensation practices supported by a large body of survey data and industry interviews. The three main findings of the report can be summarised as follows:

1. Financial Services firms are responding to the compensation challenge; significant shortcomings exist which the industry is working to resolve

- ***Respondents agree that compensation structures were one of the factors underlying the current crisis***
  98% of survey respondents believe that compensation structures were a factor underlying the crisis. To improve the functioning of financial markets, practitioners highlight that compensation needs to be addressed in concert with other issues, especially risk management.

- ***Respondents are working towards convergence with the Institute of International Finance principles: current alignment varies by principle, some critical gaps need to be addressed***
  Respondents have a high degree of alignment to a number of the IIF's principles; however, there have been critical gaps in the area of risk-adjusted performance measurement and compensation phasing to coincide with the risk time horizon of profit. Only 11% of respondents stated that they were fully aligned to Principle 3: risk adjustment and time horizon alignment, although the vast majority of institutions (83%) already have plans to close the gap. Indeed, 60% of respondents expect to be fully aligned to all seven principles once their plans are implemented.

Figure 1 Industry self-assessed alignment to Institute of International Finance principles



Shows responses weighted by 2007 wholesale banking revenues. Partial alignment to a principle indicates that the firm may align to certain aspects of the principle but not others, or alternatively that compensation policy is aligned at certain levels (or in particular business areas) but not others.
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

- ***Leading industry compensation practices, from which others can learn, are readily identifiable***
  A number of firms have already developed systematic approaches towards reflecting risk in performance measurement, handling deferred compensation mechanisms and governing the overall compensation process. In response to the crisis more firms have implemented innovative solutions, thereby diminishing the risk that first-movers to new compensation schemes will lose talent. Whilst a small sample, anecdotal evidence suggests that firms with a holistic approach to risk management which included compensation (firms who therefore consider themselves well aligned to the compensation principles above) have weathered the financial crisis better than other firms.

2. Closing these gaps requires the resolution of multiple performance measurement issues – significant time and effort needed

- ***Completeness and accuracy of financial performance measurement will need to be improved, with adjustments to reflect risk***
  Respondents identified the improvement of performance measures used in the bonus generation and allocation process as a key area for review in 2009. The incorporation of risk in the compensation process is a significant challenge which both industry and regulators are working to address. 50% of survey respondents currently incorporate adjustments for risk into the compensation process. 67% have plans to increase use of risk adjustment in 2009/2010. Respondents note that improving performance measures (and in particular adopting or increasing use of risk-adjustment) requires resolution of significant technical challenges. Even leading methods in quantitative risk measurement and adjusted compensation formulas are subject to weaknesses inherent in statistical approaches and can thus only be part of the solution for sound risk management and compensation systems.

- ***Firms will need to ensure that compensation is aligned to firm strategy and encourages appropriate employee behaviours***
  Incentive compensation schemes based solely on financial performance measures cannot fully capture shareholder interests, and as such, firms should pay strategically to shape employee behaviour. This can be done through use of non-financial performance measures, qualitative adjustments to compensation, correct structuring of payout functions and the tying of severance pay to performance – practices which some survey respondents already employ. As these practices play an increasing role, new approaches and further calibration will be required.

- ***Increasing alignment of compensation payouts with risk time horizon***
  95% of respondents have plans to increase the alignment of compensation delivery with risk time horizon in an effort to discourage maximisation of short-term production at the expense of long-term risk management. This is particularly key in businesses where risk-adjusted performance is hard to measure accurately, either because the time horizon of transactions is long or the products are illiquid. The implementation of deferred compensation schemes that achieve this is non-trivial.

3. Effective implementation will require new governance structures and strong leadership

- ***Organisational will and strong leadership are needed to ensure internal acceptance of changes to compensation policy***
  The current point in the cycle unquestionably represents the most opportune time to implement change, although survey respondents still believe that retaining competitiveness versus peers will be a challenge. In order to implement change, senior management, including the CEO, CFO and CRO, need to be fully involved in the change process and closely engaged with Human Resources on compensation. Boards should demand transparency around performance metrics and employee incentives to accurately appraise compensation schemes. We encourage supervisors and regulators to support an industry push towards compensation structures and governance that avoid any undue build-up of risk at financial institutions.

- ***More effective oversight of the compensation system; improved checks and balances***
  Discussions with industry participants indicated that improving the governance process through which compensation is debated and validated, and striking the correct balance between fact-based metrics and more discretionary aspects, will be critical to shaping new compensation practices.

- ***At a time of significant industry and individual stress, significant mobilization is required***
  Dedicated resources, senior management time and influence, and strong links between management, finance, risk and human resources teams will be necessary to implement the changes required.

Figure 2 Checklist based on leading market practices

There is no 'one-size-fits-all' approach to compensation – approaches must match a firm's goals and unique agenda, and can also provide significant competitive advantage. Banks with different starting points will also have varying priorities regarding the improvement of metrics or governance. However, the following steps – based on survey inputs and interviews with market participants – can be taken to assess current compensation structures with the aim of stimulating strategic thinking and aiding discussion on possible system redesign.

I. Align performance metrics with the firm's risk appetite and strategy

A. ***Ensure completeness and accuracy of financial performance measurement***

- Incorporate adjustments for risk/capital usage based on the risk measures most appropriate to the business in question – regulatory capital, economic capital (reflecting VaR, Stressed VaR or other metrics)
- Make use of performance assessment adjustments to measure true productivity (adjustments for indirect costs, 'value of seat'/'franchise value', value of infrastructure, etc.)

B. Encourage appropriate employee behaviours through alignment of compensation to strategy

- Adjust the allocation of bonus pools to reflect firm strategy (for instance higher payout ratios in growth businesses)
- Shape employee behaviour through tools such as payout functions; increase compensation system transparency to enforce desirable behaviours
- Increase weighting of non-financial input and output criteria in the compensation process

II. Align compensation payouts to the risk time horizon of the business

- Measure performance over a multi-year period where appropriate
- Defer compensation delivery in businesses that have a multi-year risk time horizon
- Pay compensation in units with value that is linked to the individual's future performance (i.e. company stock may not always be the best currency) thus focusing deferrals on alignment with performance development over time rather than on retention
- Introduce forward-looking long-term incentive plans for executives and key strategic roles, based on performance achievements beyond total shareholder return metrics

III. Enforce effective governance and oversight

- Have board-level remuneration committees oversee the compensation process with access to 'compensation dashboards' of key performance and non-performance information to support the challenge of decisions
- Have boards ensure that senior risk management executives are involved in the compensation process as part of a broader strengthening of the Chief Risk Officer's mandate
- Have senior business management involve itself further in the compensation process and ensure that a system of checks and balances is in place
- Establish clear rules of engagement on areas traditionally negotiated between division heads/management committee – for example for handling business cross-subsidies or to cover the event of narrowly-caused losses

Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Each of the main findings and recommendations presented above is discussed in detail in the following report. Leading practices, as well as implementation challenges, are identified alongside strategic considerations for overcoming obstacles to change.

1. What's At Stake?

Industry compensation practices have come under increased scrutiny

Over the past eighteen months, the financial services industry has been transformed by the global financial market turbulence triggered by the US subprime crisis. The second half of 2008 and early 2009 witnessed large-scale government bailouts of financial institutions around the world. Many leading firms have been purchased for fractions of their 2007 market capitalization or transformed their legal status from investment banks into bank holding companies, gained a significant new shareholder in the form of government, or disappeared altogether. In the context of the ongoing market crisis, one of the many aspects of financial services to come under scrutiny from shareholders, regulators and governments is compensation.

Concern is threefold – compensation schemes encourage excessive risk-taking, bonuses do not reflect shareholder value, overall levels are too high

Increased scrutiny of compensation practices is founded on three major concerns. The primary concern is that the structure of financial services remuneration schemes contributed to the financial market crisis by incentivising bankers, and in particular traders, to take short-term decisions and excessive risk. This issue was raised by the UK's Financial Services Authority in its letter to chief executives in October 2008, expressing the view that "in many cases the remuneration structures of firms may have been inconsistent with sound risk management".[3] In particular, the dynamics of the securitisation and structured products businesses generated incentives that in some cases undermined sound risk management and long-term profitability. Performance measurement was generally linked to short-term revenue or profit generation, without sufficient consideration of the risk profile or time horizon of the transaction entered.

Second, there is concern that industry bonus payouts do not accurately reflect shareholder value. In particular, in 2007 and 2008, years of either heavily reduced profits or outright losses for the industry, substantial sums were paid out in bonuses and severance packages, raising questions regarding the elasticity of compensation levels in years of weak performance. Public sector interest in the issue has increased from autumn 2008 to date, after a number of governments injected, on one or more occasions, public funds into the financial sector to rebuild depleted capital. The US economic stimulus package passed in the House of Representatives in February 2009 included caps on cash bonus payments to top employees at institutions that had received significant government aid, on the grounds that it was inappropriate for emergency government funding to be spent on large year-end bonuses. For the same reason, many financial executives forwent bonuses in 2008.

Third, much of the media attention on the topic has questioned why absolute bonus levels in the industry are so high. Compensation costs at the top eleven wholesale banks grew by a total of 74% between 2004 and 2007 (versus headcount growth of 42%), before falling back down to 2004 levels in 2008.[4] The Institute of International Finance takes the view that it is lasting change to compensation structures and governance that will be the key to helping to prevent a repeat of the current market crisis, as well as driving the right sizing of compensation. Nevertheless, the industry's review of compensation should take account of concerns regarding compensation levels, in particular the mismatch between compensation for front office producers and that of middle and back office oversight functions, such as risk management.

[3] FSA letter on remuneration policies, accessed at http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf, October 13, 2008
[4] Oliver Wyman analysis, based on publicly available compensation data for the largest eleven wholesale banks, by 2007 revenues

The Institute of International Finance launched an industry survey to benchmark compensation practices against its Principles of Conduct

In response to rising concerns about industry compensation practices, the Institute of International Finance Committee on Market Best Practices addressed the issue of compensation in its final report (July 2008), presenting seven basic Principles of Conduct for the design of sound incentive compensation practices by firms. These principles read as follows:

- Compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital.
- Compensation incentives should not induce risk-taking in excess of the firm's risk appetite.
- Payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit.
- Incentive compensation should have a component reflecting the impact of business units' returns on the overall value of related business groups and the organization as a whole.
- Incentive compensation should have a component reflecting the firm's overall results and achievement of risk management and other general goals.
- Severance pay should take into account realized performance for shareholders over time.
- The approach, principles, and objectives of compensation incentives should be transparent to stakeholders.

Following the report's publication, the Institute of International Finance's Board of Directors approved the formation of a Steering Committee on Implementation which launched a survey of compensation practices among Institute of International Finance member institutions in late 2008. 70 Institute of International Finance member firms with significant wholesale banking businesses were invited to participate in the survey. Responses were received from 37 banks with major wholesale banking operations and asset managers, representing a total of 57% of industry activity.[5] The results were supplemented with feedback from leading players, garnered through a series of interviews.

The aim of the survey and the following report is to present an accurate picture of current compensation practices, including recent changes made by firms in light of the crisis, and to provide direction for firms planning to modify these practices. Section two of the report presents the industry's self-assessment against the Institute of International Finance's Principles of Conduct and the areas identified for change. Section three examines industry compensation practices, delving deeper into topics that the industry identifies as major areas for change. Finally, section four discusses ways around a number of obstacles firms expect to face in changing their compensation schemes.

[5] Estimate based on 2007 wholesale banking (corporate and institutional banking, sales and trading) revenues before write-downs.

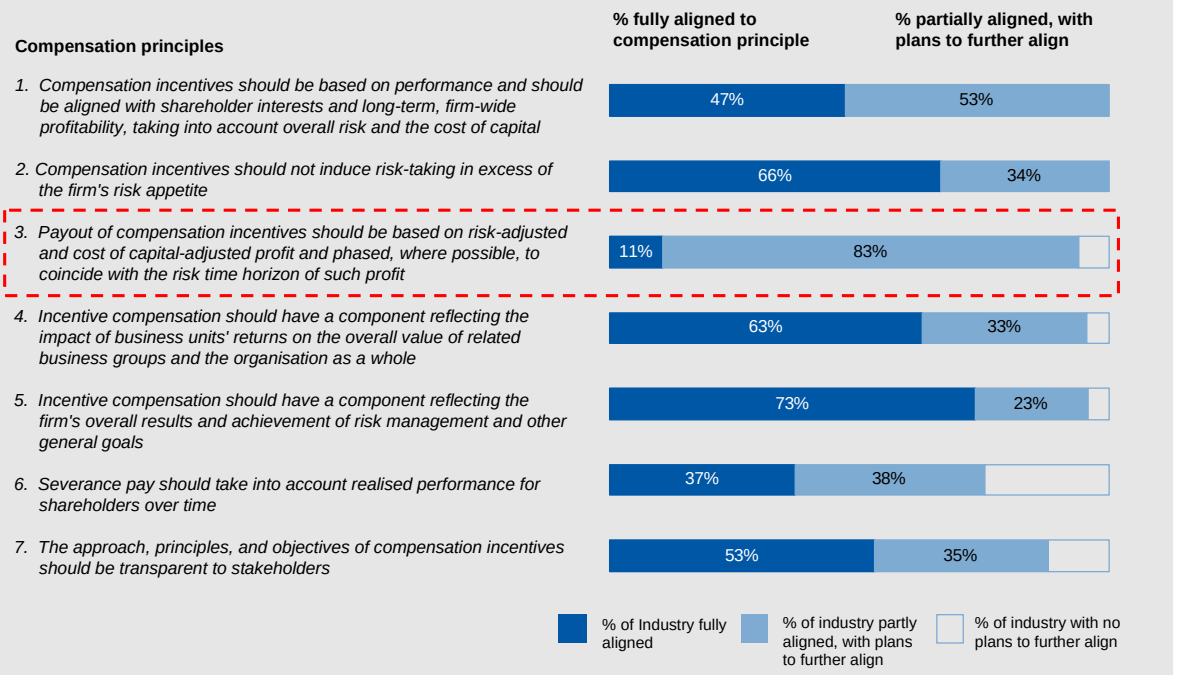
2. Industry Self-Assessment

Survey participants acknowledge that compensation practices were one of the factors underlying the current market crisis. Practitioners highlight the fact that compensation reform cannot be addressed in isolation, but should be considered as part of a broader industry effort to improve the effective functioning of financial markets that also includes key issues such as strengthening of risk management.

2.1. Alignment to the Institute of International Finance compensation principles

In its 2008 Report, the Institute of International Finance Committee on Market Best Practices set out seven Principles of Conduct for banking compensation. These principles are intended to guide firms in the re-alignment of compensation incentives with shareholder interests and the realisation of risk-adjusted returns. They apply primarily to senior management of financial institutions as well as wholesale banking and sales and trading. Principles and degree of current industry alignment are presented in Figure 3.

Figure 3 Industry self-assessed alignment to Institute of International Finance principles



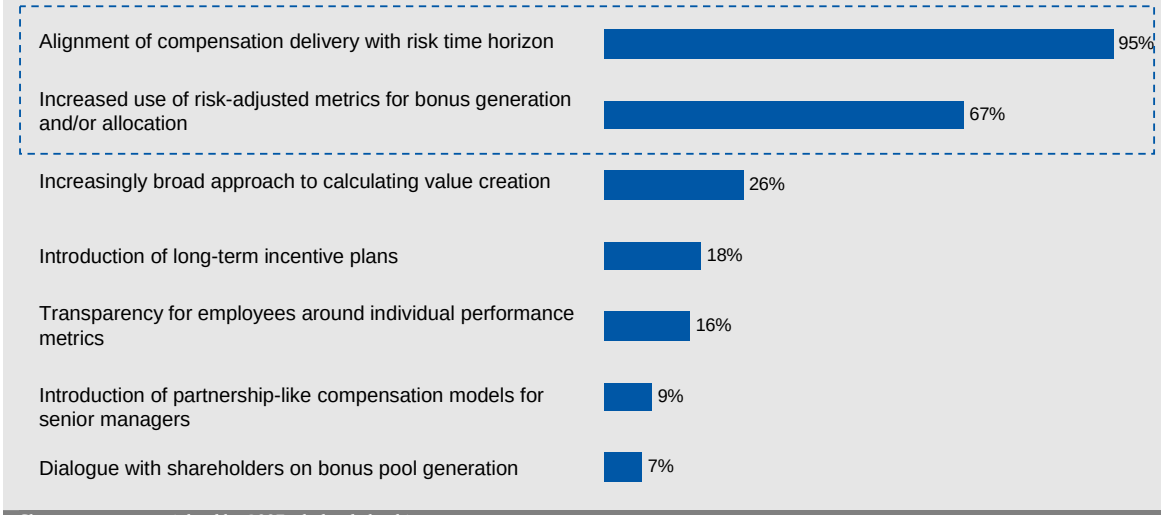
Shows responses weighted by 2007 wholesale banking revenues. Partial alignment to a principle indicates that the firm may align to certain aspects of the principle but not others, or alternatively that compensation policy is aligned at certain levels (or in particular business areas) but not others.
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Respondents' have a high degree of alignment to a number of the Institute of International Finance's principles, however there have been critical gaps in some areas. Survey participants identify the most challenging area for improvement in compensation practices as Principle 3: *risk adjustment and time horizon alignment*. Only 11% of respondents stated that they were fully aligned to this principle, although the vast majority of institutions (83%) already have plans to close the gap. Indeed, 60% of respondents expect to be fully aligned to all seven principles once their plans are implemented. Whilst a small sample, anecdotal evidence suggests that firms with a holistic approach to risk management which included compensation (firms who therefore consider themselves well aligned to the compensation principles above) have weathered the financial crisis better than other firms.

2.2. Plans to increase alignment to Institute of International Finance principles in 2009/2010

Compensation practices are currently under review at all firms surveyed. Consistent with the low level of perceived alignment to Principle 3, respondents cite the alignment of compensation delivery with risk time horizon and increased use of risk-adjusted metrics as the key areas for change in 2009/2010.

Figure 4 Changes to compensation approach planned for 2009/2010



Shows responses weighted by 2007 wholesale banking revenues
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Increased adoption of risk-adjusted metrics and greater alignment of compensation delivery with risk time horizon present a major challenge. Whilst around three quarters of firms surveyed have deferred compensation schemes that attempt to align compensation delivery with risk time horizon, very few of these use anything other than stock in order to achieve this. Risk adjustment of performance measures is currently used by only half of the firms surveyed (in either the bonus pool generation or allocation processes). Slightly more than half of firms surveyed (52%) take adherence to risk management policies into account when determining bonuses for front office staff.

Barriers to changing compensation practices are significant, and respondents most commonly cite the following as critical:

- **Technical challenges**
  The complexities of accurate risk measurement and limited availability of the necessary data in certain business areas are perceived as major constraints on the potential use of risk-adjusted performance measures for compensation purposes. An increase in the complexity of compensation schemes may create the undesired effect that these are perceived as a pure "black box," and hence do not provide an incentive effect on employee behaviour

- **Organisational will, change management and governance**
  In order for progress to be made, there must be internal will for change, especially amongst the senior executive and board levels. To ensure the change created is in the best interest of the firm, governance measures must be put into place to provide oversight of the process and increase transparency

- **Environmental factors**
  Competitiveness versus peers is the most significant barrier to change for the industry. A number of firms feel that modification of the compensation structure will create a first mover disadvantage, though there is much evidence to allay this fear. There does not seem to be broad support for regulation amongst the industry; nevertheless, there is a clear need for intelligent collective action

The following section takes a close look at the state of the industry, examining the compensation setting process and key challenges that lie within.

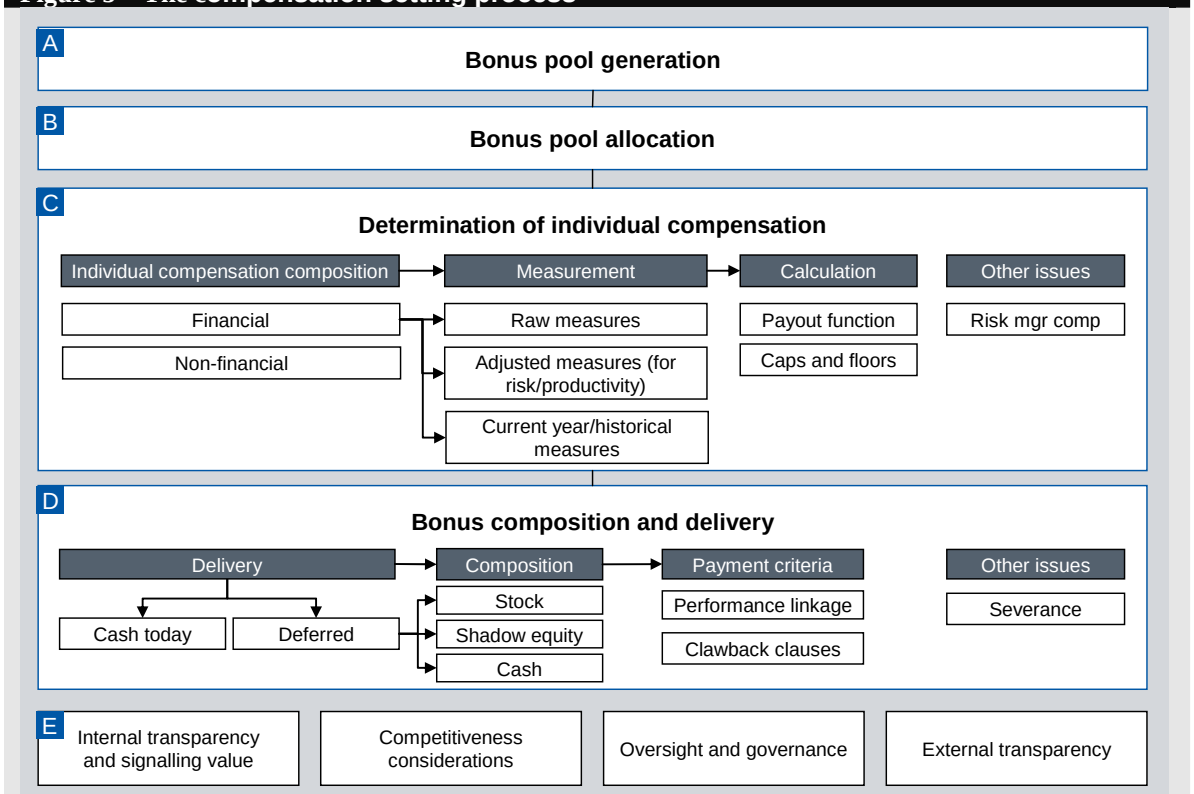
3. Survey Results on Compensation Practices and Industry Progress

The aim of this section is to provide a factual account of current compensation practices, focusing on senior management and wholesale banking. It includes recent changes made in light of the market crisis as well as the industry's future direction. A brief overview of the steps in the compensation setting process is followed by a more in-depth discussion of those issues most relevant to the industry's change agenda.

3.1. The compensation setting process: current practices

The annual compensation setting process at major wholesale banks is a complex and highly iterative affair, typically involving at least three rounds of formal review and the involvement of many different functions. Stripped down to its bare essentials, a linear front office compensation setting process can be mapped out as in Figure 5.

Figure 5 The compensation setting process



Source: Oliver Wyman.

A. Bonus pool generation

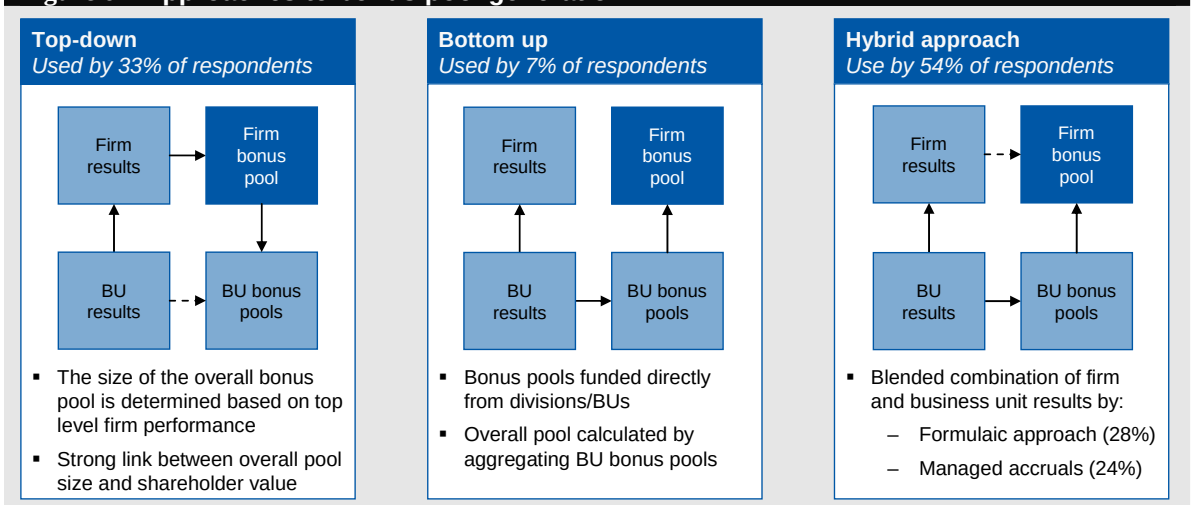
Wholesale banks generally take one of two approaches to generating the overall bonus pool:

- **Top down** approaches in which the bonus pool is determined based primarily on top-level firm results
- **Bottom up** approaches whereby individual business unit bonus pools are calculated and then aggregated to arrive at the firm level bonus pool

In practice, the majority of institutions use a hybrid approach to account for both firm and business unit performance in the sizing of the overall pool. This can be done through the following approaches:

- **Formulaic approaches** with a predetermined weighting attributed to firm-level and business unit-level results
- **Managed accrual approaches** where bonus pools proposed at the business unit level are calibrated to reflect overall firm performance

Figure 6 Approaches to bonus pool generation



Remaining respondents to question (7%) informally calculate bonus pools
Source: Oliver Wyman, Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

The choice of financial performance measures used in the bonus pool generation and allocation processes can have a significant impact upon compensation ratios across businesses, as well as upon employee incentives. Section 3.2.1 presents a close look at financial performance metrics and adjustments used in the bonus pool generation and allocation process.

B. Bonus pool allocation

Once the firm has determined the overall bonus pool, the pool is then allocated between the divisions and business units, with a number of adjustments made, including:

- **Cross-subsidisation adjustments** whereby bonus pools of high margin businesses are used to subsidise bonuses of other areas. These may be used in particular where dependencies exist between businesses, for instance a flow sales desk's bonus pool may be subsidised by a higher margin structured products business

- **Reserving adjustments** whereby a percentage of the bonus pool is held in reserve in good years in order to subsidise bonus payments in years of weak performance

Roughly 50% of firms surveyed use cross-subsidisation mechanisms, typically at the divisional and business unit levels (only 14% use cross-subsidisation at the individual level). Reserving practices are less common, currently used by 15% of survey respondents. Reserving practices may be viewed as problematic, as risk-taker downside is protected in difficult years, effectively leading to a floor on bonus payments and breaking down the pay for performance relationship. There is a great deal of debate surrounding the question of whether firms should smooth compensation volatility in order to protect employees from economic cycle factors beyond their control.

It should be noted that management discretion typically plays an important role in both the bonus pool generation and allocation processes. For 20% of survey respondents, allocation of the bonus pool to divisions and business units is a purely discretionary, rather than formulaic, process. Those banks that use financial performance metrics to guide bonus pool sizing typically also incorporate a discretionary element to take account of market conditions, strategic considerations and other business judgements.

C. Determination of individual compensation

Bonus payments for front office employees are generally calculated based on an individual's performance over the past year. Use of historical performance measures to determine compensation is rare and used by only 8% of wholesale banking respondents (although they are used by 27% of asset manager respondents). A number of performance assessment adjustments for "value of seat," technology and franchise value are also made prior to calculating individual bonuses.

- **Financial versus non-financial performance balance:** Individual bonuses are determined primarily by financial performance, which on average determines 77% of the bonus amount. The remaining 23% is determined by non-financial factors, frequently measured through 360-degree reviews and scorecards
- **Compensation payout functions:** 31% of firms surveyed employ a formal compensation payout function to determine individual bonuses. This function is then adjusted to account for non-financial performance factors. At the remaining 69% of firms, individual bonus calculation follows a less formulaic approach

In over half of firms surveyed the exact relationship between a front office employee's financial results and his or her bonus payout is subject to a great degree of discretion. Whilst bonus calculation may initially follow a formulaic approach, a large discretionary component is determined through negotiation among business heads. This topic is explored further in Section 3.2.1.

It has historically been commonplace for wholesale banking institutions to offer bonus guarantees for certain new hires, which typically cover the value of deferred compensation forfeited by the employee by switching companies. According to survey respondents, bonus guarantees accounted on average for 10% of total wholesale banking bonus pools in 2006 and 2007, rising to 14% in 2008 (as firms cut non-guaranteed bonuses). Several respondents argue that buyouts and bonus guarantees (often based on limited performance data) by definition undermine sound incentive schemes. Many participants are taking steps to reduce the number and size of bonus guarantees in the future.

D. Bonus composition and delivery

Once an individual's bonus award has been determined a portion is paid out in cash, and the remainder is deferred for payment in future years. Deferred compensation schemes are used by 76% of survey respondents.

- **Deferral rates** vary significantly by institution, total compensation and bonus levels. Average deferral rates start at 9% for an employee with a $100,000 bonus, capping out at an average deferral rate of 45% for $3,500,000 or higher
- **Delivery mechanism** for the deferred component of the bonus payment is most commonly company stock (used by approximately 65% of respondents), normally vesting over a period of 2-3 years

A majority of firms surveyed note that the relationship between a front office employee's performance and his or her bonus is subject to a significant degree of discretion. Issues associated with bonus composition and delivery are discussed in Section 3.2.2.

E. Transparency, governance and competitiveness

The compensation setting process is not an isolated event and to produce the most desirable outcome several broader topics must be considered, including transparency, governance and competitiveness. Transparency and governance are critical mechanisms necessary to balance trade-offs and manage conflicting demands throughout the process. Competitiveness is a constant concern in the industry and frequently plays a sizeable role in many decision-making processes. Section 4 examines these issues in depth.

3.2. Industry change dynamics and challenges

Survey respondents indicated that they intend to better align compensation structures with ideal practices by pursuing three main areas for change. Each of these comes with independent challenges which merit attention from the industry.

Figure 7 Main areas for industry change

1. **The alignment of performance metrics with risk appetite and strategy**
   A. *Completeness and accuracy of performance measurement*
   Determination of incentive compensation at wholesale banks relies heavily upon financial performance measures that are used as the basis for bonus pool generation and allocation. These measures should accurately measure employee productivity and incorporate risk taken in order to generate profit
   B. *Compensation aligned to firm strategy and shareholder interests*
   Beyond financial metrics, firms should pay strategically to shape employee behaviour in recognition of the fact that financial measures alone cannot fully capture shareholder interests. This can be achieved through qualitative adjustments, proper structuring of payout functions and the avoidance of large severance payouts, where not merited by performance
2. **The alignment of compensation payouts to the risk time horizon of the business**
   Many wholesale banking business areas are characterised by transactions with multi-year payback timeframes. Given that not all risks can be accurately modelled, the time horizon of compensation payouts should reflect the risk time horizon of the business
3. **Effective governance and oversight**
   The compensation process should be wrapped in an effective governance structure which provides the necessary checks and balances and manages tradeoffs

Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

The following chapter examines each of these areas for change in turn.

3.2.1. Alignment of performance measurement with risk appetite and strategy

3.2.1.1. Completeness and accuracy of performance measurement

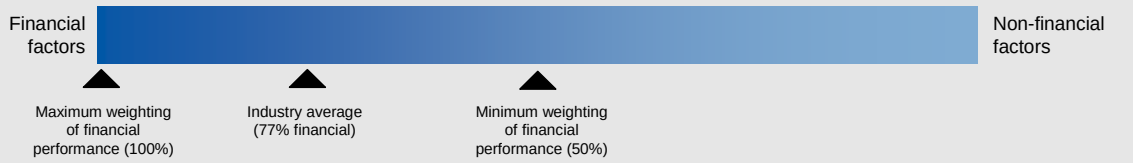
Optimising financial performance measurement is a priority for survey participants, as assessment of financial results lies at the heart of wholesale banking incentive compensation schemes. Some banks take a strictly formulaic approach, paying out a predetermined percentage of profits, for example, at the firm, business unit and individual level. Others introduce qualitative adjustments to shape payouts and employee behaviours. Nonetheless, financial metrics remain integral to performance evaluation. Firms surveyed are currently taking steps to improve performance measurement, particularly through adjustments for capital usage (and hence risk), but also in some cases through measurement of franchise value and support value.

Financial performance measures underpin incentive compensation schemes

The determination of incentive compensation in the wholesale banking industry is driven by financial results.

- The overall wholesale banking bonus pool is either generated based on firm-level financials (in the case of 33% of respondents), or by simultaneously considering business unit and firm results (used by 54% of respondents)
- The bonus pool is typically allocated to divisions and business units using a managed accruals approach in which a formula based on financial results is used to determine the initial bonus pool allocation, which is subsequently adjusted for a range of non-financial factors
- Survey respondents indicated that on average financial results determine 77% of a front office employee's bonus.

Figure 8 Balance of financial / non-financial factors in individual incentive compensation



Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

The completeness and accuracy of the financial metrics used for the calculation of bonus pools, therefore, have a significant impact on employee incentives. Indeed, much of the recent criticism of industry compensation practices has focused on the use of revenues or profits to calculate bonus payouts, without adequately accounting for the risk taken to generate profits.

A wide range of financial metrics and adjustments are used within the industry as the basis for determining the overall bonus pool and allocating it to divisions, as shown in Figure 9. Many institutions use more than one financial performance measure at each stage of the process (in addition to further performance assessment adjustments).

Figure 9 Performance metrics used in bonus pool generation and allocation processes

Metric/adjustment	Bonus pool generation	Bonus pool allocation
Risk-adjusted measures		
Profits after capital charges	28%	28%
Profits after tax and capital charges	4%	4%
Revenues after capital charges	8%	8%
Non risk-adjusted measures		
Gross or net revenues	37%	36%
Pre-tax profit	48%	36%
Other measure	36%	8%
Based on management discretion only	18%	20%
Measures used in allocation process		
Financial performance vs. targets		48%
Revenue growth		28%
Financial performance vs. peers		20%
Historical performance		12%

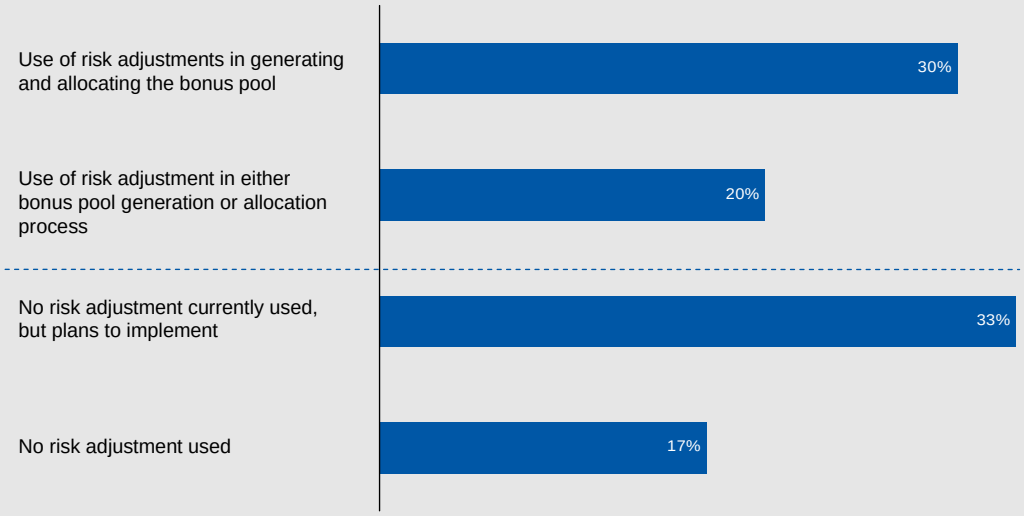
Shows % of respondents choosing each metric, Respondents may use more than one metric at each stage; includes both primary and secondary metrics
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Asset management survey respondents use a similar range of metrics to determine the size of the bonus pool: the most commonly used are profits before tax (used as primary metric by 40% of respondents) and revenues (13%).

Survey respondents are taking steps to incorporate adjustments for risk into bonus pool calculations

Half of the firms surveyed do not yet incorporate a form of risk adjustment into the bonus pool generation or allocations processes (Figure 10). At the level of the overall bonus pool generation and allocation, risk is typically incorporated through a financial metric such as economic profit that accounts for capital usage and expected losses. In the allocation process, risk may be taken into account either through the use of risk-adjusted financial metrics or, if a non risk-adjusted financial metric is used, through subsequent adjustments to reflect the relative capital intensity of each business unit. Payout ratios based on unadjusted metrics are typically highest for origination and advisory business, and lowest for proprietary trading, structured products and exotics.

Figure 10 Current and planned risk adjustments in the compensation process



Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Most firms that do not currently adjust for risk in either the bonus pool generation or allocation processes have plans to introduce risk-adjustments. Furthermore, half of the firms that already incorporate some form of risk adjustment have plans to increase their use of risk-adjusted performance metrics, as the industry experiments with this relatively new approach to compensating employees.

Implementation challenges vary by business area, depending on the difficulty of accurate risk measurement

The challenge facing the industry is how, in practice, to incorporate an accurate measure of risk into the compensation setting process. In relatively simple business areas, there are imperfect yet accepted risk metrics that capture economic capital usage. In more complex business areas, the problem of capturing risk is amplified by product intricacies and deal time horizons. Given the uncertainty surrounding accurate risk assessment, the industry may be inclined to shift towards more conservative compensation practices and increased use of deferral. It should nevertheless be stressed that the move forward, albeit with imperfect measures, represents a positive step for the industry. This topic is discussed in detail in Section 4.

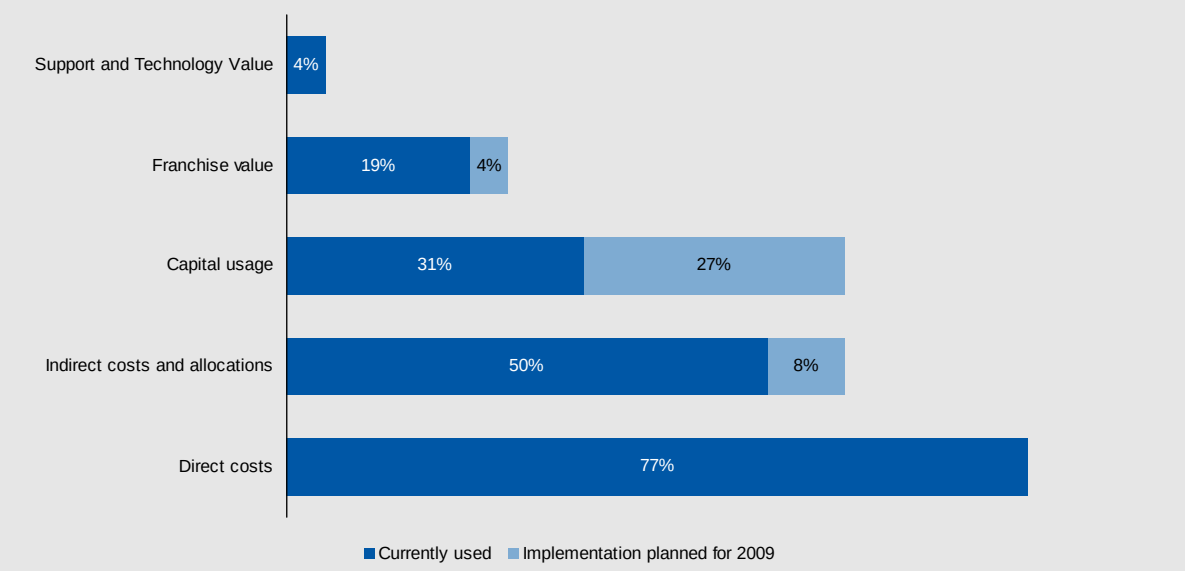
Case study: European wholesale bank introducing risk-adjusted metrics[6]

- Implemented incentive adjustment for 2008 in parts of wholesale banking business and asset management, based on economic profit, accounting for:
  - Capital usage
  - Expected losses
- Plan to roll out implementation to the rest of the wholesale bank including markets business in 2009

The current rethinking of compensation represents an opportunity for the industry to develop additional adjustments and non-financial performance indicators

Adjustments for capital usage in the bonus pool allocation process are increasingly common in the industry and have received much attention in the wake of the market crisis. However, only a minority of firms make further productivity adjustments. These adjustments are particularly important if business unit payout ratios are based on industry benchmarks. The capacity of each producer to generate business is influenced by the "franchise" or brand value of the business. Other adjustments that should be considered are "captive" flows from group subsidiaries or other divisions, leverage from support functions and technological infrastructure.

Figure 11 Current and planned productivity adjustments for bonus pool allocation



Shows % of respondents choosing each option, multiple responses possible
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

[6] Case studies are provided to illustrate industry direction of travel, and are based on available survey and interview data. By their nature, most of the cases presented are works in progress, with tangible results not yet realised.

Case study: Global wholesale bank adjusting allocations for franchise value

- Business unit payout ratios based on capital usage-adjusted compensation/revenue benchmarks
- Institutional franchise value of each business unit estimated based on league table positions/surveys
- Payout ratios adjusted downwards for business units with strong franchise, upwards for business units with weak franchise

Summary survey evidence: financial performance measurement

- **67%** of respondents stated that they had plans to increase the use of risk-adjusted metrics for bonus generation and/or allocation in 2009/2010
- Approximately **50%** of respondents currently use some form of risk adjustment in either the bonus generation or allocation processes (or both)
  - **37%** base the calculation of the overall bonus pool on a risk-adjusted financial metric (such as economic profit)
  - **33%** allocate the bonus pool to divisions/business units based on a risk-adjusted financial metric; a further **10%** do not use a risk-adjusted metric but subsequently adjust bonus pools to reflect relative capital usage
- Use of other performance assessment adjustments is not common: only **19%** of survey respondents make adjustments for franchise value, and **4%** account for support/technology value

3.2.1.2. Compensation aligned to firm strategy and shareholder interests

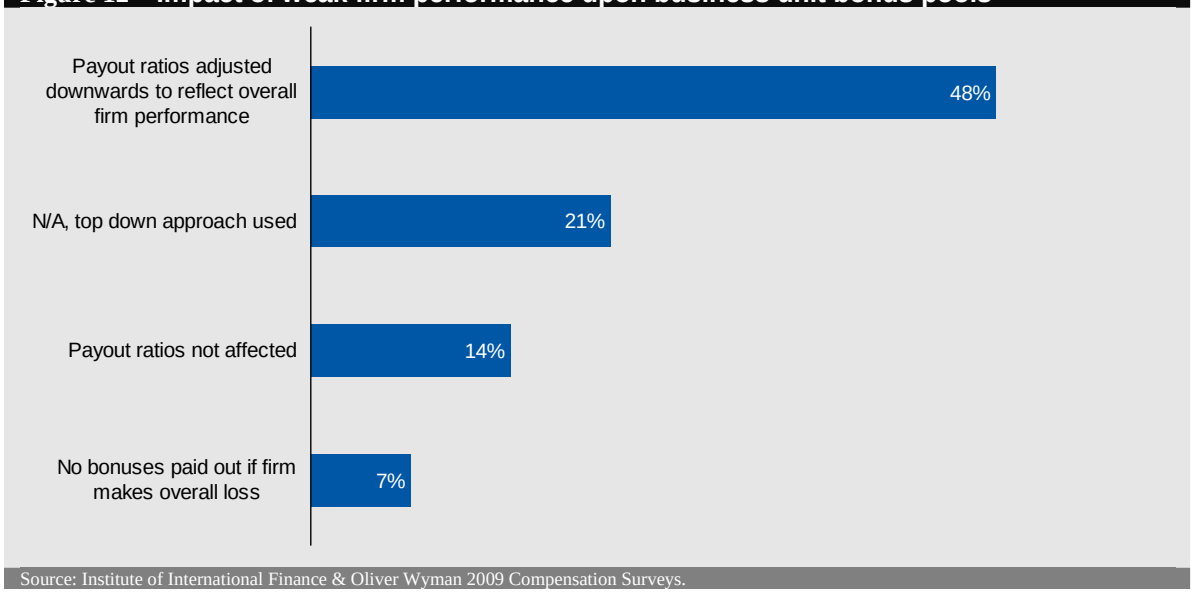
Even use of the most refined financial metrics, adjusted to reflect employee productivity through measurement of capital usage and franchise value, cannot guarantee that compensation will provide incentives to support the long-term interests of shareholders. Wholesale banks make use of additional levers at the business unit and individual level to shape employee incentives, both to control employees' risk appetite and to bring the compensation scheme in line with the firm's broader strategies and shareholder value. These levers include:

- Impact of overall firm performance on business unit bonus pools
- Allocation adjustments to reflect firm strategy
- Incorporation of non-financial performance criteria
- Payout functions to shape employee behaviour
- Incorporation of employee performance into severance pay calculations

Impact of overall firm performance on business unit bonus pools

Banks face a netting issue in years such as 2008 when overall firm and industry performance are weak, yet some business units and employees still perform strongly. In years such as these, business unit bonus pools determined using a bottom up approach may be adjusted downwards, to account for weak top level firm performance. However, even when the firm makes an overall loss, banks may choose to continue to pay bonuses in certain business areas in order to protect the franchise (and arguably long-term shareholder value).

Figure 12 Impact of weak firm performance upon business unit bonus pools



Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Indeed in determining bonuses firms must carefully manage the trade off between encouraging and rewarding high quality input and paying for output. Rewarding for input is in the shareholders' best interests. However rewarding input may weaken the direct link between compensation costs and overall firm performance.

Allocation adjustments to reflect firm strategy

Financial services compensation systems should tie closely to firm strategy. 64% of firms surveyed adjust business unit bonus pools in order to nurture businesses identified as strategically important. This adjustment is done by increasing payout ratios, effectively subsidising compensation levels to attract and retain talented employees. One European bank notes that the level of development of the business is the central consideration when determining bonus payouts, although this approach is the exception rather than the rule.

Equally important from a management perspective is identification of those business areas that are not strategically important. In order to manage costs the firm may choose not to match top market payout rates in these businesses.

Case study: Global wholesale bank reinforcing firm strategy through allocation

- Funding of overall bonus pool based on economic profit
- Allocation is determined by a compensation committee, with the explicit aim of fostering inter-business unit cooperation
  - Economic profit used as a guide
  - Discretionary adjustments for cross referral, team work and firm strategy

Incorporation of non-financial performance criteria

The wholesale banking industry has a bias towards rewarding tangible (i.e. financial) output. A number of firms balance their compensation schemes through the inclusion of non-financial performance criteria. This effectively represents a shift from reward based purely on output to reward based on both output and input: the approach can be used to limit the dependence of bonus levels on externalities beyond the individual's control (e.g. market environment) and reward actions taken to strengthen the franchise with long-term shareholder interests in mind.

Figure 13 Use of non-financial metrics at different levels of the compensation process

Bonus pool level	Typical non-financial performance measures used
Firm	▪ Achievement of strategic targets (e.g. share of wallet) ▪ Overall strength of the franchise (and implications for coming year financial performance)
Division/ business unit	▪ New clients won ▪ Share of wallet ▪ Level of cooperation with other divisions/business units (where not captured through formal revenue-sharing agreements) ▪ Customer satisfaction (ability to understand and meet the customer's needs, cross-selling skills, ability to share relationships)
Individual	▪ Customer satisfaction ▪ Development potential (self-development initiative, willingness to change, creativity, leadership motivation skills) ▪ Adherence to risk management policies ▪ Compliance with legal, regulatory and ethical standards

Source: Oliver Wyman.

Non-financial performance criteria typically include new clients won, client satisfaction and cooperation with other business units (where not wholly captured by internal revenue sharing agreements). Notably, only 24% of institutions use balanced scorecards to aggregate financial and non-financial performance measures. Scorecards serve to add accountability to qualitative measures that can otherwise be too opaque and subjective to incentivise behaviours effectively.

Case study: Asian wholesale bank using balanced scorecard approach

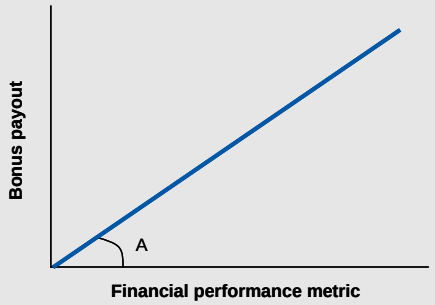
- Performance measurement for individuals is based on a balanced scorecard, incorporating
  - Financial results, including risk assessment (50% weighting)
  - Non-financial performance (50% weighting)
- Specific financial and non-financial goals and targets are set for each individual

Shaping employee behaviour through the payout function

31% of firms surveyed use a formal "payout function" to determine how employees are paid for their financial performance. This function can be used as a tool to shape employee behaviour (e.g. with regard to risk-taking) independent of the precise financial metric used; however as with many formulaic approaches, may provide opportunities to "game the system", hence the debate on whether they should be used. Although payout functions are typically based on financial performance, the curve may be "flexed" to account for non-financial criteria.

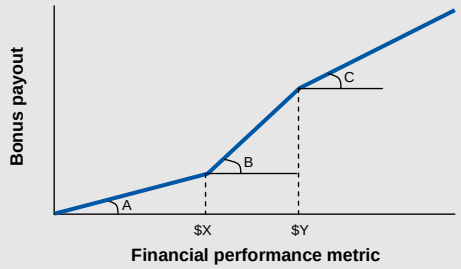
Figure 14 Payout formulas for individual compensation incentives

Single rate payout ratio
Used by 14% of respondents to question



- Simple function payout ratio: Transparent linkage between pay and performance

"S-curve" payout ratio
Used by 17% of respondents to question



- Lower payout ratio before $X to account for market conditions/franchise value
- Lower rates after $Y reduces the chance of "extraordinary" payouts, disincentivises excessive risk-taking

Source: Oliver Wyman, Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

A linear "single rate" payout function (see Figure 14), which compensates employees *x* cents for every dollar generated for the firm (revenue, profit or their risk-adjusted forms, depending on the metric used) creates a transparent link between performance and pay. However, the function itself does not shape employees' risk appetite (although they will be typically working within defined risk limits). Conversely, an "S-curve" function sets a payout ratio of *x*% above a predetermined hurdle rate, but reduces the payout ratio above a certain threshold. This effectively discourages risk-taking above the threshold without the need for absolute caps that would constrain the firm's ability to attract top performers. The curve can then be "flexed" (i.e. plus or minus a percentage) to account for the non-financial performance factors discussed above.

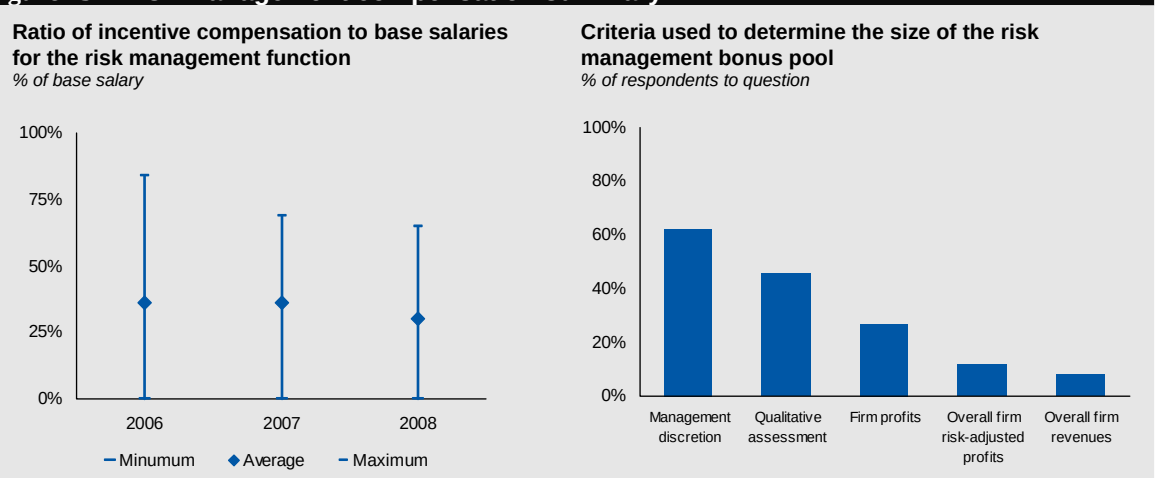
The shape of the payout function also influences how skewed the payout of bonuses will be towards top performers and firms can use this to differentiate their compensation schemes. If the firm's strategic focus was on retention of its very top employees, a low payout ratio could be used up until a predetermined hurdle rate, after which payout would increase rapidly then taper off.

Using risk management compensation to provide incentives for effective oversight of risk-taking employees

The incentives provided by compensation should not be considered in isolation. Even when front office incentive compensation schemes are fully adjusted to incorporate risk, it is possible that an employee's risk appetite will exceed that of the firm. Effective risk limiting and oversight from a risk management function that is distanced from profit generation is critical. In this regard, the incentives created for risk management staff by their compensation structures are highly relevant to the discussion.

The first issue is the disparity in compensation levels between front office producers and risk management staff, which may act as a constraint on the recruitment of top talent into the risk management function. The current rethinking of wholesale banking compensation structures should incorporate a review of the pay differential between the oversight function and producers (although more likely through higher base salaries and long-term compensation opportunities for the former, as opposed to high variable bonuses).

Figure 15 Risk management compensation summary



Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Second, incentive compensation for risk management staff needs to balance the need to control risk with revenue generation. The size of the risk management bonus pool and performance assessment of individual risk management staff are commonly based on qualitative measures and management discretion, rather than on quantitative measures such as budget adherence or loss rates. Where quantitative measures for risk management staff are used, they typically include budget adherence (30% of survey respondents), risk-adjusted profits of the supported business (19%), or losses (11%). One survey participant suggested that the incentive component of the support function's compensation should be lowered, given the potential conflicts of interest and financial dependence of employees on discretionary bonuses.

Summary survey evidence: compensation aligned to strategy

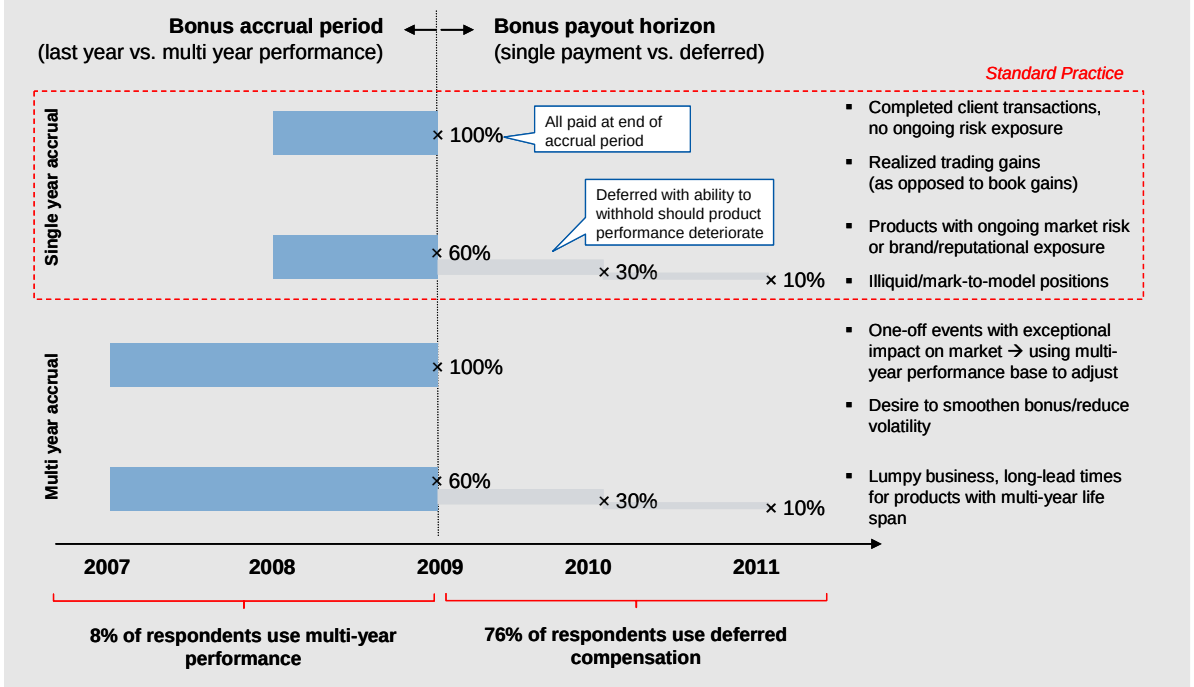
- **64%** of firms surveyed adjust business unit bonus pools to reflect firm strategy
- On average, **23%** of an employee's performance assessment is attributable to qualitative measures, although this varies significantly by institution
- **31%** of respondents use a formal payout function based on financial results, which can be adjusted to shape employee behaviours
- Average ratio of incentive compensation to base salaries for risk management is **30%**
  - **62%** of respondents determine the size of the risk management bonus pool on an informally calculated/negotiated process
  - **67%** informally calculate/negotiate bonus awards for risk management staff; of those that use a formal calculation approach, qualitative measures account for roughly **60%** of performance assessment

3.2.2. Alignment of compensation payouts to risk time horizon

The preceding section has shown how survey participants are increasing the adoption of risk-adjusted financial metrics in the compensation process and making further adjustments to align employee incentives to shareholder interests. The residual challenge will be to further develop mechanisms to align compensation payouts to the risk time horizon. There are three approaches to addressing this issue:

- Measurement of performance over a multi-year period
- Deferral of compensation delivery
- Payment of compensation in a unit whose value is linked to future performance

Figure 16 Approaches to aligning compensation payouts to risk time horizon



Source: Oliver Wyman, Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

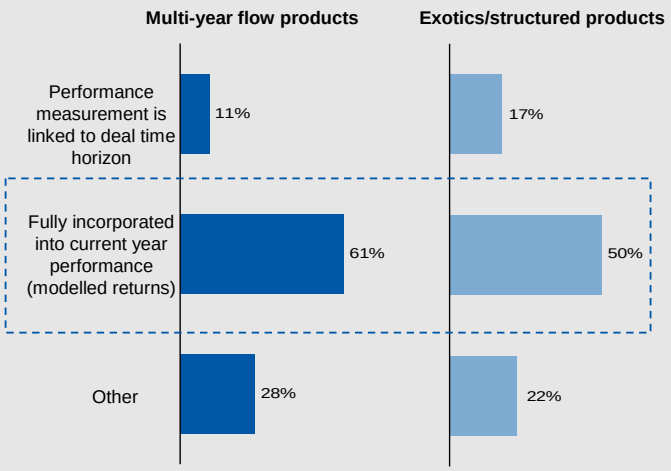
The majority of firms surveyed base incentive compensation on current year performance

Alignment of compensation incentives to risk time horizon can be increased by using a historical performance measure, such as a multi-year average. Only 8% of firms surveyed currently use historical performance measures. Notably, rewarding consistent multi-year performance is more widespread in the asset management business, with 27% of asset managers using an historical measure to compensate portfolio managers.

The drawback of historical performance measurement is that retention becomes counter-cyclical: employees will stay on at the start of a downturn to gather the reward for performance in previous years, but then have incentives to move firms after one or more years of weak economic performance. This effect can be mitigated if historical performance measurement is used in conjunction with balanced input/output performance measures, creating a longer-term strategic focus for risk-taking employees.

Establishing longer-term employee incentives through the use of historical performance is viable in product areas where deals have multi-year payback timeframes, for instance multi-year flow products and exotics/structured products. In these areas, performance measurement is currently incorporated based primarily on modelled returns; however, historical performance measures may provide incentives that are better aligned to shareholder value.

Figure 17 Performance measurement for deals with multi-year payback timeframes



Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Case study: global wholesale bank using historical performance measurement

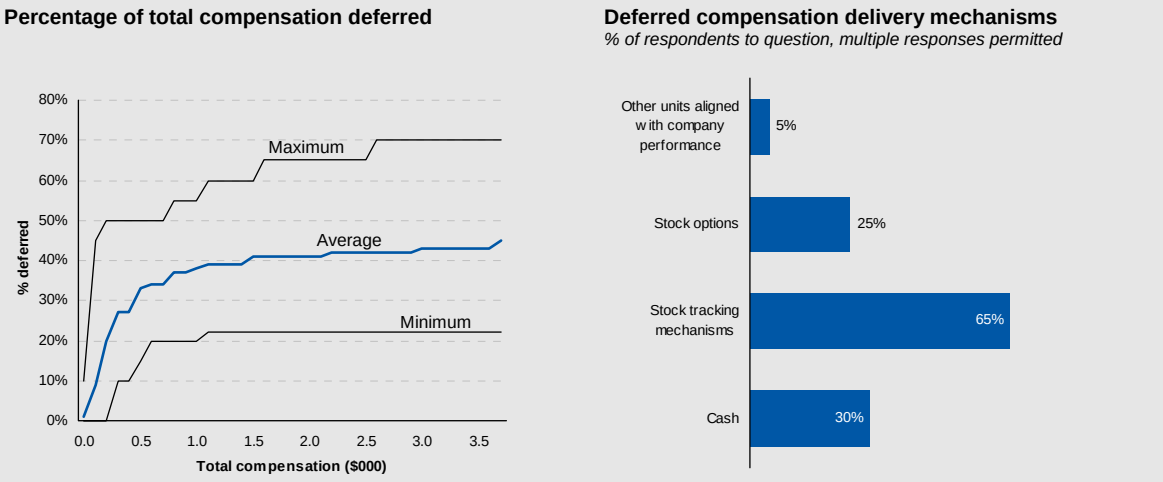
- Performance in the proprietary trading business based on multi-year performance measurement
- Deferred compensation is put at risk based on the performance over multi-year time horizon

Survey respondents are moving towards greater use of deferred compensation to reward longer-term performance and exploring "look-back" adjustments

Deferring payment of bonuses represents an alternative means of building longer-term risk considerations into employees' incentives, particularly if the timing of payout is linked to the time horizon of transactions entered by the individual or team.

Deferred compensation is already prevalent throughout the industry, used by 76% of firms surveyed. Deferral rates and thresholds vary significantly between institutions (Figure 18). The maximum deferral rate ranges from 22% to 70%, depending on the firm, with global wholesale banks typically deferring a greater portion of compensation than regional players.

Figure 18 Deferral rates and delivery mechanisms



Note: at some firms more than one delivery mechanism is used
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Deferral generally serves the dual purpose of providing incentives for employees to remain at the firm (as well as increasing competitor talent acquisition costs) and better aligning employee incentives with shareholder value creation. Historically, delivery of deferred compensation has been contingent solely on continued tenure at the firm. Payment of such service-based deferred compensation is typically in company stock (or other stock-tracking mechanism) or stock options, providing a link to ongoing company performance (but not directly to individual or business unit performance). Notably, asset managers surveyed use stock-based pay to a lesser degree: more common delivery mechanisms for deferred compensation are cash (30% of respondents) and investments in the funds managed by the employee or firm (30%).

The industry has begun to take steps to strengthen the link between delivery of deferred compensation and the continued performance of the individual. Over 40% of the firms surveyed include performance-based criteria in their deferred compensation schemes, although in a majority of cases this takes simply the form of a penalty for gross misconduct or large-scale unexpected losses. A number of firms have developed more sophisticated approaches that incorporate a final payout multiplier that adjusts compensation up or down based on current year or historical performance.

The financial crisis has raised questions over the incentive value of stock-based pay – the industry is exploring alternative approaches

The recent market turmoil has called into question the efficacy of using stock-based compensation to align employee interests to the long-term interests of the firm. Bear Stearns and Lehman Brothers, the two wholesale banks hardest hit in 2008 by the financial crisis, both extensively used stock-based pay to compensate executives and key risk takers. There are two key problems with stock-based compensation:

- Except for the highest level executives, an individual employee's ability to influence the company stock price through strong performance is limited, weakening the incentive value of stock-based pay
- Employees may discount the value of stock-based compensation, particularly if it is accompanied by long vesting periods

Deferred compensation has come to light as one of the key areas in which wholesale banks plan to change their compensation schemes. Survey results show a majority planning to change deferred compensation,

with deferred compensation delivery types and percentage of compensation deferred the greatest areas for change.

Figure 19 Areas of deferred compensation slated for change in 2009

Deferred compensation aspect	% of respondents planning to change
Delivery types (i.e. long-term incentive plan, mandatory deferral of year-end compensation)	
Percentage of year-end bonus deferred	
Delivery forms (i.e. cash, stock options, etc.)	
Length of maximum vesting period	

0% of survey respondents 100% of survey respondents

Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

A number of viable alternatives to the payment of deferred compensation in stock exist, although they require to overcome practical and legal challenges (Figure 20). The first is a cash balance, or bonus/malus, approach, in which part of the bonus awarded each year is held at risk and may be added to or subtracted from in the subsequent or current year, depending on performance. The second option is shadow equity, the value of which is linked to business unit performance,. These phantom stock units would vest over a predetermined period of time and would then be paid out in cash. This approach has the advantage of tying employee wealth to a unit whose value his performance will affect, without necessitating the determination of payout criteria required under a bonus/malus system. In order to reduce the exposure to market fluctuations that the quasi-partnership approach would imply, the value of the phantom stock unit could reflect performance versus peer benchmarks in addition to (or instead of) absolute performance.

A balance needs to be struck between aligning compensation payouts in any given year to shareholder value, rewarding employees for strong performance (rather than market conditions) and laying the foundations for future returns to shareholders.

Figure 20 Compensation "currency" choices

Approach	Efficacy	Mechanism and concerns
Mandatory stock-based deferred compensation		▪ Heavily discounted by employees ▪ Weak linkage between individual action and individual payout (only way for most individuals to move stock price is through excessive risk-taking) ▪ Staff buyout by competitors
Cash balance (bonus/malus) systems		▪ Part of annual bonus at risk and may be subtracted from in the subsequent or current year – effectively introduces downside ▪ Payment in cash reduces discount rate applied by employees ▪ Complexity of implementation below the executive level
Phantom stock systems		▪ Unit whose value is linked to team / business unit performance (i.e. similar to stock-based pay, but value of unit is more closely linked to employee performance) ▪ Introduces significant exposure to externalities, potentially high compensation volatility
Employees compensated with assets originated		▪ Ties individual compensation to risks originated, encourages cooperation and communication across businesses ▪ Assets used to compensate employees may not be those originated by them

Ineffective Highly effective

Source: Oliver Wyman.

Introduction of forward-looking long-term incentive plans

Aside from the increasingly sophisticated use of deferral mechanisms for year-end bonus payments, several major wholesale banks are also seeking to link senior executive wealth to company performance through long-term incentive plans. Such plans are intended to align senior employee interests to shareholder value, but also include a measure of business unit or individual performance. Delivery mechanisms used for long-term incentive plans include performance shares, performance units paid in cash rather than shares, or stock options with a performance hurdle (based on financial results or shareholder returns). Long term incentive plans (at executive level and below) are used by 55% of survey respondents.

Incorporation of employee performance into severance pay calculations

In order to maintain the pay-for-performance relationship, it is important that severance pay take into account realised performance for shareholders over time. This particular aspect of wholesale banking compensation has recently attracted much scrutiny due to high profile payouts to senior executives of struggling institutions.

In practice, the legal environment restricts the ability of firms to determine severance paid to employees leaving either due to poor performance or redundancy: approximately half of the global wholesale banks surveyed cite this as the primary factor for determining severance pay. At the majority of participating firms, less than 20% of employment contracts for front office staff (VP level and above) constrain the firm to pay severance greater than that mandated by law. Typically the legal minimum is determined by formula and by the loss that the employee suffers, but is not tied to the individual's performance (except in the case of fundamental breach of duty).

Where substantial severance awards are made above the legal minimum, severance pay should be reviewed by the internal compensation committee or at board level to ensure that it is an accurate reflection of the performance of the individual over a period of time and also takes into account the underlying reason for dismissal.

Summary survey evidence: alignment of compensation payouts to risk time horizon

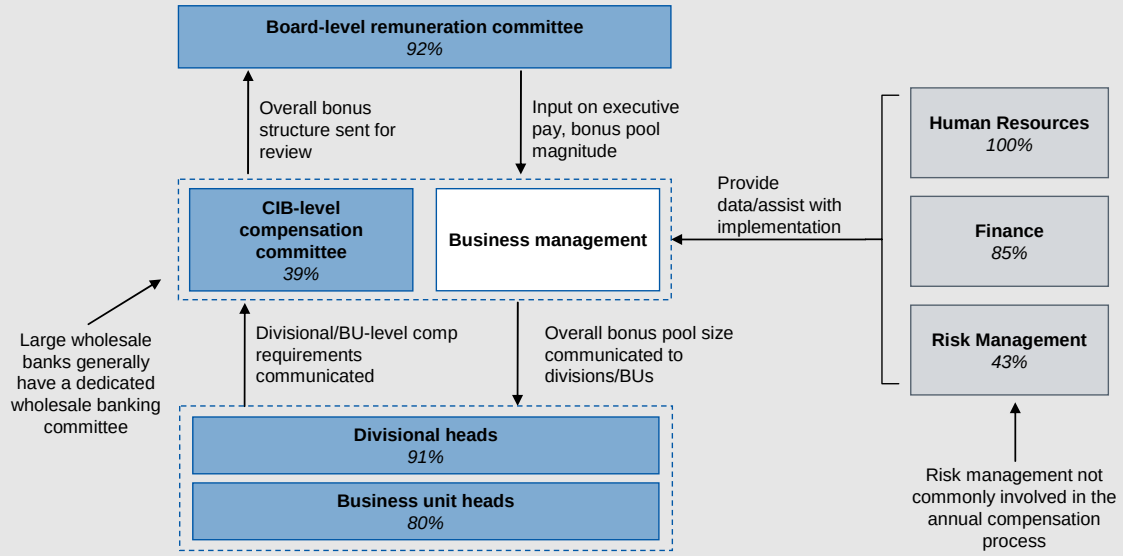
- Only **8%** of banks surveyed use historical measurements of performance (e.g. based on multi-year weighted averages)
- **17%** of firms surveyed link performance measurement of multi-year structured product/exotics deals to the time horizon of the deal (**50%** incorporate into current year performance, based on modelled returns)
- **76%** of respondents use deferred compensation
  - Deferred compensation in 2008 accounts on average for **20%** of the total bonus pool (up from 17% in 2007)
  - The average maximum deferral rate applied by respondents is **45%** of pay
- **40%** of those using deferred compensation employ performance-based delivery criteria (although this may simply take the form of penalties for gross misconduct or material restatement of financials)
- Severance pay accounted on average for only **3%** of total compensation expenses in 2006 and 2007; this rose to **10%** in 2008
  - **83%** of firms surveyed indicated that less than 20% of their employee contracts mandate a severance payment above the legal minimum

3.2.3. Effective governance and oversight

There is no single "best practice" approach to incentive compensation. The compensation setting process involves trade-offs and the balancing of occasionally conflicting demands. As such, it is necessary to have a sound governance structure that includes relevant stakeholders and provides the appropriate checks and balances. Further discussion of how to strengthen governance and oversight follows in Section 4.2.

Figure 21 Typical wholesale banking compensation governance structure

% of respondents to question citing business area as involved in the annual compensation process



Responses weighted by 2007 wholesale banking revenues
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Board level remuneration committees, CIB level remuneration committees and business management are all heavily involved in the annual compensation process.

- The vast majority of wholesale banks surveyed have a **board-level remuneration committee** that is involved in both periodic reviews of compensation policy and in aspects of the annual compensation process, such as approval of the size of the overall bonus pool. Approximately 39% of respondents (on a revenue weighted basis), involve the board-level remuneration committee in establishing compensation formulas.
- **CEOs and senior management** are generally involved in the annual compensation setting process as well as in periodic reviews of compensation policy, which take place annually or more frequently at a majority of institutions. At global banks, senior management involvement typically takes the form of a dedicated internal wholesale banking compensation committee[7]
- **Support functions** are generally involved in the implementation of the process (providing data or communicating decisions to employees). Risk management is involved in the annual compensation process at 43% of institutions, however involvement in determining performance metrics used for compensation is limited to 15% of cases.

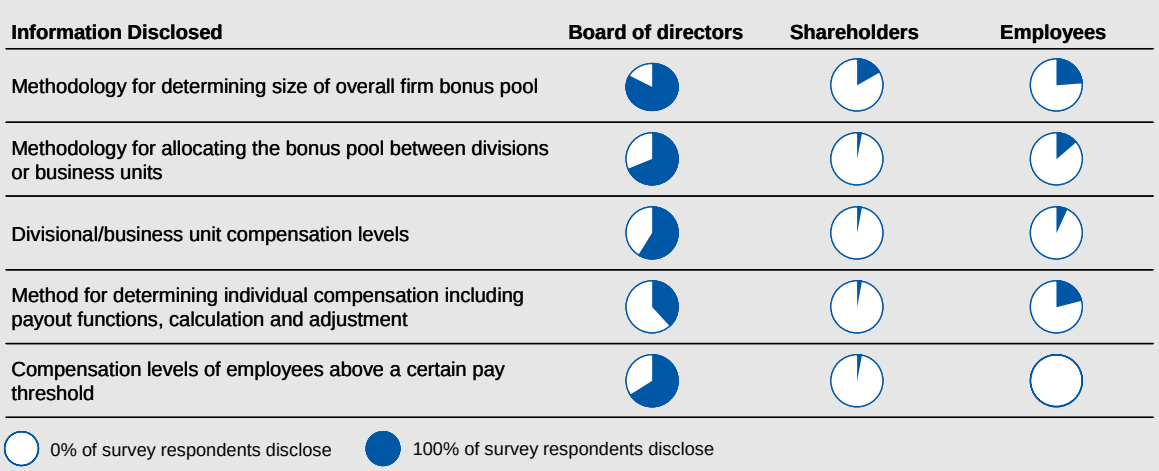
The question for governance going forward is how it can be improved in order to provide better oversight of the compensation system. Transparency of the compensation process is a key area for change. The

[7] Global banks defined as banks with global reach across business lines and wholesale banking revenues exceeding $3.5BN.

incentive value of new compensation schemes will be limited if employees have limited awareness of how they are being measured and compensated.

At present, most financial services firms have a relatively opaque compensation system. At around a quarter of firms surveyed, individual compensation methodology is disclosed to employees. Transparency for ordinary shareholders on the compensation process is limited, although 16% of survey respondents indicated that they were currently reviewing opportunities for dialogue with shareholders on bonus pool generation.

Figure 22 Disclosure of compensation information to stakeholders



Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

4. Compensation: The Agenda for Change

4.1. Recommendations based on leading market practices and survey views

There is no 'one-size-fits-all' approach to compensation – approaches must match a firm's goals and unique agenda, and can also provide significant competitive advantage. Financial services firms with different starting points will have varying priorities regarding the improvement of metrics or governance. Additionally different legal and accounting environments will require tailored solutions. However, the following steps – based on survey inputs and interviews with market participants – can be taken to assess current compensation structures with the aim of stimulating strategic thinking and aiding discussion on possible system redesign.

Figure 23 Checklist based on leading market practices

I. Align performance metrics with the firm's risk appetite and strategy

A. ***Ensure completeness and accuracy of financial performance measurement***

- Incorporate adjustments for risk/capital usage based on the risk measures most appropriate to the business in question – regulatory capital, economic capital (reflecting VaR, Stressed VaR or other metrics)
- Make use of performance assessment adjustments to measure true productivity (adjustments for indirect costs, 'value of seat'/'franchise value', value of infrastructure, etc.)

B. Encourage appropriate employee behaviours through alignment of compensation to strategy

- Adjust the allocation of bonus pools to reflect firm strategy (for instance higher payout ratios in growth businesses)
- Shape employee behaviour through tools such as payout functions; increase compensation system transparency to enforce desirable behaviours
- Increase weighting of non-financial input and output criteria in the compensation process

II. Align compensation payouts to the risk time horizon of the business

- Measure performance over a multi-year period where appropriate
- Defer compensation delivery in businesses that have a multi-year risk time horizon
- Pay compensation in units with value that is linked to the individual's future performance (i.e. company stock may not always be the best currency) thus focusing deferrals on alignment with performance development over time rather than on retention
- Introduce forward-looking long-term incentive plans for executives and key strategic roles, based on performance achievements beyond total shareholder return metrics

III. Enforce effective governance and oversight

- Have board-level remuneration committees oversee the compensation process with access to 'compensation dashboards' of key performance and non-performance information to support the challenge of decisions
- Have boards ensure that senior risk management executives are involved in the compensation process as part of a broader strengthening of the Chief Risk Officer's mandate
- Have senior business management involve itself further in the compensation process and ensure that a system of checks and balances is in place
- Establish clear rules of engagement on areas traditionally negotiated between division heads/management committee – for example for handling business cross-subsidies or to cover the event of narrowly-caused losses

Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

4.2. Overcoming obstacles to change

Industry participants ranked a number of obstacles that they expect to face in changing their compensation schemes. These can broadly be grouped into three categories: technical, organisational and environmental challenges.

Figure 24 Barriers to change in compensation

		Degree of challenge perceived by the industry
Technical challenges	Availability of data for appropriate metrics	
	Complexity of implementation of new compensation plans	
	Lack of trust in complex metrics	
Organisational challenges	Resistance to change among business heads	
Environmental challenges	Retaining competitiveness vs. peers	

Insignificant challenge Stumbling block

Average ranking of main challenges to compensation reform. Results are weighted by 2007 wholesale banking revenue
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Understanding the nature of these challenges will be essential to determining the shape of the compensation solution for each industry player. The following pages discuss each challenge category in further detail and propose ways for the industry to supersede these.

4.2.1. Technical challenges

Implementation of the change agenda outlined above raises a series of technical implementation challenges. In particular, there are concerns regarding the practicalities of adopting risk-adjusted performance metrics and implementing performance-linked deferred compensation schemes:

- ***Concerns over the relevance and validity of risk measures***

At a general level there are concerns within the industry regarding the relevance of current risk measures, and whether it would be useful to incorporate these into performance measurement. More specifically, the recent market crisis has drawn attention to weaknesses of the assumptions underlying the hitherto widely accepted VaR framework: the implicit normal probability distribution does not accurately capture the 'fat tail' of some risk types, the metric underestimates risk in cases where recent historical measurement period was benign. Finally, VaR works on the assumption that trading positions can be rapidly liquidated: VaR for arbitrage businesses is typically very low, but events in the current market crisis showed that calculations overlooked significant liquidity and operational risks.

- ***Availability of data for the necessary metrics at a granular level***

In order to shape employee behaviours, it is not sufficient to base only the calculation of the overall wholesale banking bonus pool on risk-adjusted metrics: the incentive value of the measure increases with the level of granularity, and risk-adjustment should be used in the allocation process and, ideally, in the determination of individual compensation. However, this raises a number of practical challenges:

- The organisation of business units/desks changes over time, making year-on-year comparisons problematic
- The data for risk-adjusted metrics is often incomplete or not accepted at the business unit or individual levels
- Concerns regarding the validity of risk metrics such as VaR are amplified at such granular levels

- ***Variation in risk measurement challenges across business areas***

For origination, advisory and flow trading businesses, data is typically available to measure economic capital usage (including market, credit and operating risk). However, in businesses with lower liquidity or longer transaction time horizons (e.g. structured products), accurate risk assessment is more complex. For example, firms which have origination businesses that are now in run-offs face the challenge of determining compensation for portfolio managers, with no comparable industry benchmarks due to the illiquidity of the portfolios. Furthermore, in particularly complex business areas, there is potential for conflict of interest if the only people with a strong understanding of the risks involved are those directly involved.

- ***Practicalities of linking compensation payouts to the risk time horizon of the business***

Deferred payouts directly linked to ongoing employee or business unit performance (e.g. through a payout multiplier) will require strong internal financial systems and data capture, particularly if implemented below the executive level. The introduction of new compensation "currencies" – for example, units whose value is linked to business unit performance – requires a valuation methodology that does not overly penalise (or reward employees) for externalities such as market movements. On the flipside, the market measures organisations on an annual basis - the optics of long term deferred compensation may not always work well with this. If deferred compensation triggered a substantial payout after 5 years of solid performance, but payout was made in the last year as the cycle turned, this could lead to substantial outcry.

Resolution of these challenges will be neither trivial nor immediate. Firms should consider the following in their redesign of compensation systems.

Managing the trade-off between completeness and practicality of risk-adjusted performance measures

The ideal balance between the completeness (and thus complexity) and practicality of performance measures will vary depending on each firm's particular business mix and current compensation practices. For example:

- A bank with substantial long-term origination, arbitrage and exotics options businesses, which may have already developed sophisticated risk measurement approaches will likely need to adopt a fairly complex approach towards risk-adjustment in the compensation process.
- A commercial bank with some wholesale banking functions and not engaged to a significant degree in highly complex businesses may be able to implement relatively simple risk-adjusted performance metrics based on VaR at various levels within the organisation.

It should be stressed that even the use of "imperfect" risk-adjusted metrics in bonus pool generation and allocation can act as a valuable tool for shaping employee behaviour. Moreover, the risk measurement approach need not be consistent across different business areas: it will likely be more effective to tailor the approach to the particularities of the business, provided that they result in a distributable compensation pool that is adjusted to reflect risk (Figure 25, below).

Combining risk-adjusted metrics with non-financial assessment and deferral of compensation to strengthen risk control

Even leading methods in quantitative risk measurement and adjusted formulas are subject to weaknesses inherent in statistical approaches and can thus only ever be part of the solution for sound risk management and risk-adjusted compensation. Financial metrics should be supplemented with non-financial assessment to shape employee behaviours and discourage excessive risk-taking:

- Number and severity of infractions of risk policy guidelines
- Number of cases where the time horizon of a desk's transactions exceeded the deferral time horizon for the business (to monitor for any "gaming" of the system)
- Audit scores
- Qualitative input from relevant risk management function

The calibration of non-financial assessment will require significant effort and a degree of experimentation: it is important to understand where to set thresholds for punitive measures, and what the impact of those thresholds will be at the desk level (accounting for differing levels of risk volatility between products). Firms need to balance the need to ensure that employees are not undermining the risk measurement system with a sufficient degree of flexibility.

In business areas where reliable risk metrics are not available – particularly those businesses characterised by multi-year transactions – the deferral of compensation payouts is an important tool to control excessive risk-taking (Figure 25).

Figure 25 Possible risk measurement approaches by business

Business type	Complexity of measuring risk	Potential benefits of deferral	Possible risk metrics / approaches
Origination and advisory			▪ Risk-adjusted return on capital (RAROC) above predetermined hurdle rate – specific focus on run-off businesses; incentives for portfolio managers
Brokerage and short-term flow			▪ VaR ▪ Tail contribution metrics (Tail VaR) ▪ Stress tests (Stressed VaR)
Multi-year flow			
Exotics and structured products			▪ Compensation payout linked to time horizon of transactions – further investigation if the transaction time horizon of a particular desk repeatedly exceeds deferral time horizon
Securitisation			
Private equity			▪ Compensation wholly linked to performance of investments

Low complexity / low benefits High complexity / high benefits

Source: Oliver Wyman.

Strengthening compensation system incentives through signalling

Changes to compensation calculation and performance assessment will need to be communicated to employees in order to guide changes in behaviour. Whilst there is a danger that an overly transparent compensation system may generate opportunities for employees to game the system, a non-transparent system will struggle to provide incentives. Specific examples of where signalling is particularly important include:

- Traders that are being compensated based on risk-adjusted performance, with payout determined by a specific function (linear/S-curve)
- Sales staff, if performance is assessed on more than sales credits, e.g. share of wallet improvement, actions taken to support trading/ syndication functions
- Where incentives to reward cooperation between business units, e.g. ECM/DCM cooperation

As such, it is important that compensation changes are accompanied by:

- A strategy for Human Resources to communicate the direction of change to front office employees
- Clear explanation of proposed changes to deferral thresholds, vehicles and criteria
- Signalling around how risk will be incorporated into performance assessment (even if details of particular metrics used are not given), i.e. evaluations should not be a pure "black box"

4.2.2. Organisational will, change management and governance

Changes to compensation policy require internal organisational acceptance in order to be feasible and effective. The industry acknowledges the need for change and plans to modify compensation over the next two years; at the firm level, impetus will need to come from CEOs, senior management and the board. A number of compensation principles issued by industry and regulator groups over the past few months include provisions for strengthening compensation governance and oversight.

Whilst executives have great incentive to steer the firm in the right direction, it is necessary to take account of the fact that they may have significant personal wealth at stake when making business decisions. CEOs and senior management should drive the development and internal acceptance of new schemes, particularly among business heads. Additional impetus and support may be required from the board of directors, representing the long-term interest of the shareholders.

Broadening the role of key participants in the compensation process

The roles of the key participants in the compensation process should broaden to allow greater consideration of the incentives provided by the system, and its capture of risk. Considered as a whole, the governance structure should provide an effective system of checks and balances.

Figure 26 Improving compensation governance

	Status quo	Broader involvement
Management (Divisional and Business Unit)	▪ Negotiation of business unit bonus pools, 'going to bat' for the business ▪ Performance discussions and communication of results	▪ Involve in debate and acceptance of new performance measurement approaches (financial and non-financial) ▪ Involve in top down debate on portions of compensation system that remain discretionary
CEO / CFO	▪ Sign off on compensation numbers and approach ▪ CFO has ultimate responsibility for financial performance measurement	▪ Ultimate responsibility for incentives provided by compensation system ▪ CFO and group strategy collaboration with HR to redesign and manage compensation schemes ▪ CFO engagement in performance measurement challenges, including consideration of historical performance of division, business unit
CRO / Risk function	▪ Low involvement in compensation process	▪ Policy responsibility for risk costs in the compensation system ▪ Monitor risk incentives provided by compensation
Human Resources	▪ Compensation system management and redesign ▪ Running annual compensation process ▪ Communicating results	▪ Create clear rules of engagement on major sources of dispute - for example business cross-subsidisation or to cover the event of narrowly-caused losses ▪ Establish 'compensation dashboard' to support decisions ▪ Implement changes to compensation ▪ Support business buy-in to comp approach ▪ Provide transparency on compensation system
Board level remuneration committee	▪ Approving overall bonus pool ▪ Reviewing bonuses over a certain threshold	▪ Agree new compensation systems, examining evidence on incentives provided ▪ Consideration of adequacy of financial and non-financial performance metrics ▪ Certify risk assessment of incentive plans has been effectively performed ▪ Understanding / approval of compensation models

Source: Oliver Wyman.

Board-level oversight of the compensation process will in many cases need to be strengthened. Although 92% of institutions surveyed have a board-level remuneration committee that is involved in annual compensation setting, the depth of participation varies significantly. It is critical that such committees not only oversee the overall bonus pool sizing and pay for top individuals, but also demand transparency around performance metrics and employee incentives.

Below the board level, it is important that there are sufficient opportunities for debate and/or review by relevant stakeholders. At many firms, compensation setting is currently a hierarchical process with significant discretionary aspects, which limits the opportunities for checks and balances. In order to improve the governance structure, firms should take one of two broad approaches:

- "Horizontal" or committee-based governance structure, incorporating the CFO, CRO and Head of HR and creating a forum for internal debate on compensation issues and ensuring that key stakeholders are involved in discretionary decisions
- "Vertical" or hierarchical governance structure, with decisions driven by financial or quantitative non-financial metrics which can be reviewed by the Finance and Risk functions

4.2.3. Environmental factors

Both survey participants and industry interviews highlighted environmental factors, particularly competitive pressures, as a significant obstacle to changing compensation practices. There is concern that by implementing bonus/malus systems, clawback provisions and other innovative compensation practices, firms may face problems over the next growth cycle or even in current circumstances as competitors poach top performers.

Environmental factors affecting the industry's ability to change compensation structures are at their most favourable in 2009, but additional elements could prove useful to foster change.

The "first mover disadvantage" has been minimised by the market context

Concerns over first mover disadvantage should be allayed by the current market context and clear indications that the industry as a whole is moving forward on compensation:

- Competitiveness in the labour market has been dampened (although not altogether neutralised) by the market downturn
- Much of the industry has already expressed explicit interest in implementing changes
- Firms face financial and reputational risks by remaining static on the issue, along with external pressure from governments, regulators and the general public

Survey data provides evidence that industry compensation structures will change in 2009.

Figure 27 Industry intention to improve compensation processes

Compensation Principles	% of respondents fully aligned or with plans to increase alignment
1. *Compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital*	
2. *Compensation incentives should not induce risk-taking in excess of the firm's risk appetite*	
3. *Payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phase, where possible, to coincide with the risk time horizon of such profit*	
4. *Incentive compensation should have a component reflecting the impact of business units' returns on the overall value of related business groups and the organisation as a whole*	
5. *Incentive compensation should have a component reflecting the firm's overall results and achievement of risk management and other general goals*	
6. *Severance pay should take into account realised performance for shareholders over time*	
7. *The approach, principles, and objectives of compensation incentives should be transparent to stakeholders*	

0% of industry 100% of industry

Shows responses weighted by 2007 wholesale banking revenues
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

Potential need for collective action: industry forums can support compensation change

Competitor actions have traditionally played a large role in determining compensation in financial services, as is evident in a number of situations:

- The use of compensation benchmarking against competitors is widespread, and may have led to a ratcheting up of compensation over the years
- Competitive actions, such as the industry willingness to provide sign-on bonuses and guarantees to "buy out" deferred compensation, invalidate the incentives provided by the compensation system

Some have argued that this has resulted in a typical winner's curse, where the banks which made the biggest compensation overestimation for specific areas have set the market price and through sign-on or guaranteed bonuses have neutralized compensation scheme incentives. A broad-based industry shift may be needed in certain areas to get around these issues, and industry forums in which to share best practices

and develop innovative approaches can support this. Practically, this means implementing a high level of industry discipline around control of guaranteed bonuses. The idea would not be to limit competition, which would be both inappropriate and ineffective, but to avoid some of the systemic biases of uninformed competition.

The Institute of International Finance Compensation in Financial Services report and survey can represent a first step in this direction. These forums could support the industry's adoption of improved compensation practices, for example, the establishment of more informed compensation benchmarks, which would allow firms to compare compensation-to-economic profit or other risk-adjusted ratios, rather than simply compensation-to-revenues.

The question of supervisory support

Recent controversy over the issue of compensation has raised the question of whether regulatory intervention in some areas of compensation might be helpful, with voices raised in favour of capping incentive compensation.

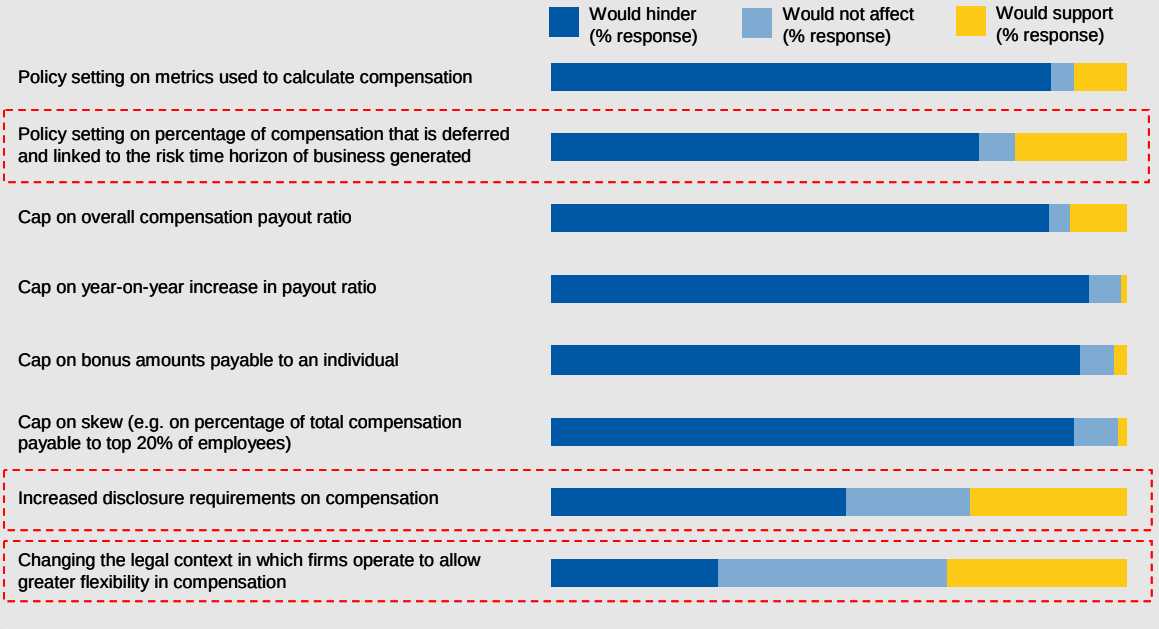
It should be stressed that a well-functioning bonus system is in the interests of financial institutions' shareholders, management and clients. Used properly, bonuses can allow financial services companies far greater flexibility in cost structure, in what is a highly cyclical business. Bonuses allow the pay-for-performance relationship that has been critical to the growth of the business, and value creation over the past two decades. A well designed scheme retains employees who are key in contributing to value creation. Survey respondents therefore do not support direct regulatory caps on bonus levels or payout ratios.

Given that compensation policy is a key area of competitive differentiation within the industry, there is concern about the potential for regulatory action to erode some of the positive aspects of certain compensation practices, particularly if there is a lack of uniformity across countries or regions.

Despite these concerns, some firms felt that supervisory support could be useful in three areas:

- Changing legal constraints to allow for greater flexibility in compensation (i.e. making sure that employment laws in various jurisdictions do not prevent the implementation of new compensation practices)
- Policy setting on the percentage of compensation that is deferred
- Increased disclosure requirements on compensation

Figure 28 Industry view on impact of possible regulatory actions on compensation reform



Shows responses weighted by 2007 wholesale banking revenues
Source: Institute of International Finance & Oliver Wyman 2009 Compensation Surveys.

4.3. Concluding remarks and industry next steps

This report has presented a thorough view of current financial services compensation practices, focusing on senior management and wholesale banking, and including recent changes made by firms in light of the crisis and the intended 'direction of change' to come. It offers a clear picture:

- Compensation practices have varying degrees of alignment to the IIF's compensation principles – practices are sophisticated in some areas, but critical gaps exist with respect to the alignment of compensation payouts with risk
- 50% of respondents currently incorporate risk adjustments into the compensation process; 67% plan to increase use of risk-adjusted performance metrics; 95% plan to change their compensation approaches to align compensation delivery with risk, amongst other changes
- In making the transition to improved compensation practices, the industry faces challenges on a number of levels; technical, environmental and organisational
- There is some support for intelligent collective action and supervisory support in select areas; the emerging regulatory principles may help the industry overcome some of the first mover disadvantages

Whilst recognising that there can be no one-size-fits-all approach to financial services compensation - the precise approach each firm takes to changing compensation will of course depend on the firm's current practices, unique business model and other strategic considerations - the IIF believes that the series of recommendations based on industry leading practices set out in the report are worthy of consideration by the financial services industry as a guide to individual firms' efforts for achieving full alignment with sound principles of compensation.

Industry compensation practices are changing rapidly, but lasting change will require significant time and effort. The challenge for the industry over the coming year will be to mobilise resources in order to design and implement compensation schemes with stronger linkages to shareholder value and risk once and for all. Simplicity and speed of implementation will be important. Communication with both shareholders and markets about progress with respect to compensation principles is key. Finally, banks must retain the lessons learned, maintaining sound compensation practices throughout the cycle, and continuing momentum on changes to compensation even when good times return.

Survey methodology

The Institute of International Finance and Oliver Wyman Compensation Survey was conducted between December 2008 and March 2009. The survey consisted of two parts:

- Executive Survey on Compensation Policy
- Survey on Compensation Setting

70 Institute of International Finance member firms with significant wholesale banking businesses were invited to participate in the compensation surveys. Responses were received from 37 banks with major wholesale banking operations and asset managers, representing a total of 57% of industry activity.[8] This included six of the top ten global wholesale banks.

Revenue weighted response rate by region was as follows:

- Asia-Pacific: 88%
- Europe: 75%
- North America: 46%
- Other regions: 44%

Survey results were supplemented with feedback from a series of interviews with leading players.

On average 83% of questions were answered in the Executive Survey on Compensation Policy, and 74% in the Survey on Compensation Setting. Questions most commonly skipped were open text fields and data questions

Acknowledgements

The Institute of International Finance would like to thank the member institutions that participated in the compensation surveys that underpin this report. The Institute of International Finance would also like to thank the following contributors for their support in the preparation of this report:

Institute of International Finance

- George T. Abed

Oliver Wyman

- Nick Studer
- Bruno de Saint Florent
- Catherine Brown
- Adam Kemmis Betty
- Andrew Shelton

Report Advisory Panel

- Michael Aldred
- Anne Marion-Bouchacourt
- Sylvia Chrominska
- Margot Dargan
- Philipp Haerle
- John Terry

[8] Estimate based on 2007 wholesale banking (corporate and institutional banking, sales and trading) revenues before write-downs.

Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations

Financial Services Industry Response to the Market Turmoil of 2007-2008

July 2008

Principles of Conduct on Compensation

Principle I: Compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital.

Principle II: Compensation incentives should not induce risk-taking in excess of the firm's risk appetite.

Principle III: Payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit.

Principle IV: Incentive compensation should have a component reflecting the impact of business units' returns on the overall value of related business groups and the organization as a whole.

Principle V: Incentive compensation should have a component reflecting the firm's overall results and achievement of risk management and other general goals.

Principle VI: Severance pay should take into account realized performance for shareholders over time.

Principle VII: The approach, principles, and objectives of compensation incentives should be transparent to stakeholders.

INSTITUTE OF INTERNATIONAL FINANCE
BOARD OF DIRECTORS
March 2009

Chairman
Josef Ackermann*
Chairman of the Management Board and
the Group Executive Committee
Deutsche Bank AG

First Vice Chairman
William R. Rhodes*
Senior Vice Chairman, Citi
Chairman, President & CEO, Citibank
.

Vice Chairman
Roberto E. Setubal*
President & CEO of Itaú Unibanco Banco
Multiplo S/A and
President & CEO of Banco Itaú S/A

Vice Chairman
Francisco González*
Chairman and Chief Executive
Officer
BBVA

Treasurer
Marcus Wallenberg*
Chairman of the Board
SEB

Hassan El Sayed Abdalla
Vice Chairman and Managing Director
Arab African International Bank

Daniel Bouton*
Chairman of the Board
Société Générale

Amy Brinkley
Global Risk Executive
Bank of America Corporation

Yannis S. Costopoulos*
Chairman of the Board of Directors
Alpha Bank A.E.

Ibrahim S. Dabdoub
Group Chief Executive Officer
National Bank of Kuwait, S.A.K.

Charles H. Dallara (ex officio)*
Managing Director
Institute of International
Finance

Robert E. Diamond, Jr.
President, Barclays plc and
CEO, Investment Banking and
Investment Management

Roger Ferguson
President and Chief Executive Officer
TIAA-CREF

Stephen K. Green*
Group Chairman
HSBC Holdings plc

K. Vaman Kamath
Managing Director and
Chief Executive Officer
ICICI Bank Ltd.

Kang Chung Won
President and Chief Executive Officer
Kookmin Bank

Walter B. Kielholz
Chairman of the Board of Directors
Credit Suisse Group

Nobuo Kuroyanagi*
President & CEO, Mitsubishi UFJ Financial
Group, Inc. & Chairman, The Bank of
Tokyo-Mitsubishi UFJ, Ltd.

Gustavo A. Marturet
President
Mercantil Servicios Financieros

Klaus-Peter Müller **
Chairman of the Supervisory Board
Commerzbank AG

Ergun Özen
President & Chief Executive Officer
Garanti Bankasi A.S.

Corrado Passera
Managing Director and
Chief Executive Officer
Intesa Sanpaolo

Baudouin Prot
Chief Executive Officer
BNP Paribas Group

Yasuhiro Sato
Deputy President
Mizuho Corporate Bank, Ltd.

James J. Schiro
Chief Executive Officer
Zurich Financial Services

Andreas Treichl
Chairman of the Management Board &
Chief Executive Officer
Erste Bank Holding

Rick Waugh**
President and Chief Executive Officer
Scotiabank

William T. Winters
Co-Chief Executive Officer
JPMorgan Chase Investment Bank

Xiao Gang
Chairman
Bank of China

Secretary of the Board
Michael Bradfield, Esq.

*Member of the Administrative and Nominations Committee
**Co-Chair of the Steering Committee on Implementation

Institute of International Finance
1333 H Street, NW, Suite 800 East, Washington, DC 20005-4770
Tel: 202-857-3600 Fax: 202-775-1430
www.iif.com