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FINANCIAL SERVICES REGULATIONS

Regulatory Reforms: Governance and Supervision of Remuneration

A look at evolving regulatory reforms around remuneration practices, and the business and technology implications for global financial services institutions

People matter, results count.

Contents

1 Highlights

Regulators, academics, and executives across the world have been devoting increased time and resources to analyzing the events and triggers that led to the global financial crisis. Globally, regulators have been designing new guidelines and proposing controls that will help in preventing such crises in the future.

One key area of focus has been on the remuneration practices of financial services institutions. Even with the turmoil in global financial markets at its peak, executives at big financial services institutions continued to receive hefty bonuses. This led to public outrage against many of the existing remuneration practices of financial services institutions. Regulators also questioned the way in which compensation packages for executives were designed, as huge payouts to executives were made even when the firm suffered overall losses at a group level.

In 2009, the Financial Stability Board[1] issued a set of guidelines to better align remuneration practices with a firm's long-term profitability goals. These guidelines aim to improve the governance and supervision of executive remuneration and increase the trust of all stakeholders. Regulators across the world have built on the guidelines laid out by the Financial Stability Board to further enhance supervision of institutions that come under their direct authority. While much has been spoken and written about the effectiveness of these new regulatory reforms, they are likely to have multiple implications for financial services institutions.

Though the underlying principles of remuneration-related regulations, as laid out by the Financial Stability Board, remain the same for different types of financial services institutions (such as banks, hedge funds, asset managers, and private equity firms), the implications for each type of institution vary in terms of the change in remuneration structures, operational costs, and terms of deferral payments for variable pay.

Although the new reforms present multiple challenges for financial services institutions, they also provide an opportunity for financial services institutions to develop business-led and technology-enabled solutions for compliance with the new regulations. Key investment areas include ensuring efficient storage and retrieval of compensation-related data, enhancing the report generation process, and creating systems that help ensure compliance with the new regulations.

Regulatory reforms around governance and supervision of remuneration practices will continue to evolve, but financial services institutions have an opportunity to design strategies and solutions now to deal with the future implications.

[1] The Financial Stability Board, established in April 2009, brings together national authorities responsible for financial stability in significant international financial centres and international financial institutions.

2 Introduction

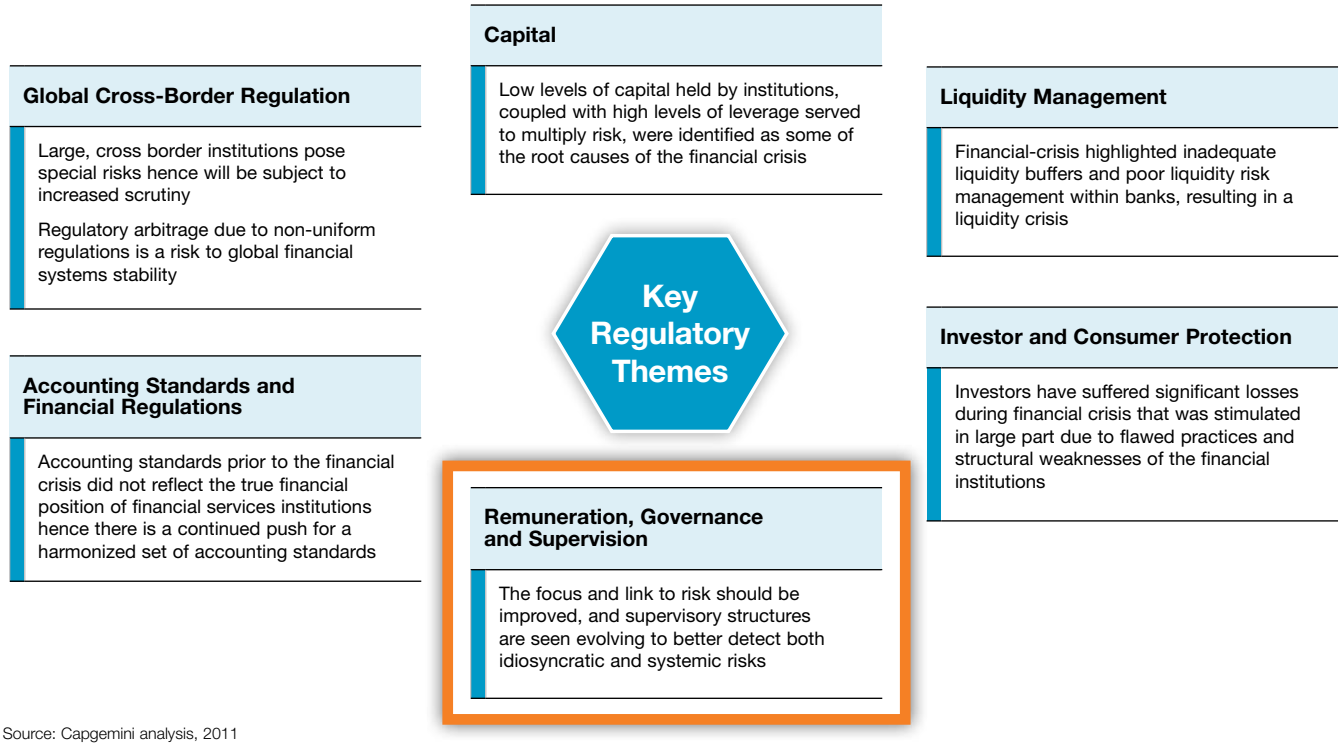
The financial crisis exposed weaknesses in the global financial system. Chief among them was the web of interconnections across global financial institutions and investments, which resulted in a cascading effect that gained strength and toxicity. Key weaknesses revealed by the financial crisis include:

- Lack of transparency
- Noncompliance of accounting practices
- Inadequate risk measurement and management process
- Misaligned compensation and incentive policies
- Lack of sufficient governance and supervision

Throughout 2008 and 2009, regulators around the world acted quickly to take measures to increase the strength of the overall financial system. Though these regulatory reforms are still evolving, regulators have attempted to fill the gaps that emerged during the crisis (especially regarding risk assessment and measurement), strengthen the capital base, adopt global standards for minimum liquidity, and enhance accounting standards to reduce systemic risks.

As regulations are expected to evolve to create a risk-aware financial system, the momentum for change is converging around six key regulatory themes.

Exhibit 1: Key Themes Driving Regulatory Reforms and Structural Changes across Global Financial Services Institutions



Source: Capgemini analysis, 2011

This paper reviews and summarizes the regulatory reforms emerging around Governance and Supervision of Remuneration.

3 Current and Evolving Regulatory Reforms around Governance and Supervision of Remuneration

3.1. The Need for Reforming Remuneration Practices

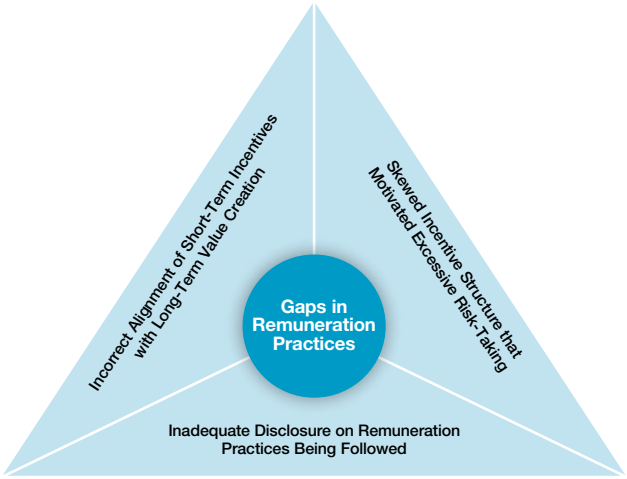
The recent financial crisis had far-reaching consequences for global markets and negatively affected financial services institutions, investors, the public, and even governments. A faulty remuneration structure that motivated aggressive risk-taking by employees is believed to have been one of the key reasons behind the global financial crisis. Huge public outrage over perceived excessive bonuses led to an increased public and regulatory focus on existing remuneration practices being followed by financial services institutions. The three key gaps identified by regulators are described below.

A faulty remuneration structure that motivated aggressive risk-taking by employees is believed to have been one of the key reasons behind the global financial crisis of 2008 and 2009.

Skewed Incentive Structure that Motivated Excessive Risk-Taking

The incentive structure for executives provided them with a huge upside in remuneration for making a profitable bet, without any corresponding downside in case of a loss. Such a dynamic resulted in an uneven pay structure that acted as a beneficial call option[2] for executives, while increasing the overall risk exposure of the firm.

Exhibit 2: Key Gaps around Remuneration Practices Followed by Global Financial Services Institutions



Source: Capgemini analysis, 2011

Incorrect Alignment of Short-Term Incentives with Long-Term Value Creation

Many executives were offered incentives based upon their short-term performance, even though the long-term implications of their actions were still not clear. This created a mismatch in the alignment of risk and related rewards.

In cases where cash bonuses represented a larger part of the overall compensation mix, executives were immediately rewarded for their short-term performance, even though the real outcome of their actions would have been clear only at a later date.

[2] A call option holder benefits from any upside in value of the underlying asset while at the same time he is also protected from any downside in value of the same

Financial regulatory boards across the globe have agreed to implement guidelines that regulate remuneration practices at large financial institutions.

Inadequate Disclosure on Remuneration Practices Being Followed
The remuneration disclosure norms followed by financial services institutions were often inadequate to present a complete picture to their shareholders. For example, in the case of mergers and acquisitions, the incentive structure for employees with vested interests in such activities was not made clear to shareholders and regulatory authorities.

In many instances, outside advisors were hired to determine remuneration packages for senior level executives. However, the independent nature of such advisors remained questionable.

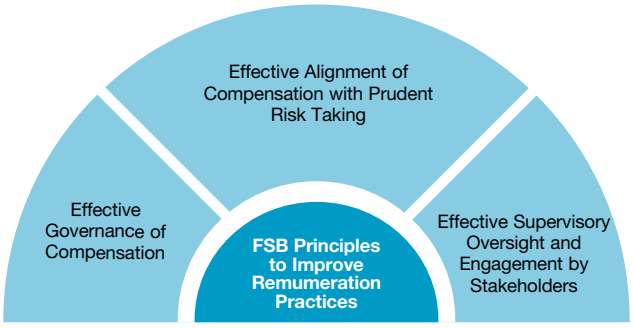
3.2. Remuneration Principles Set Out by the Financial Stability Board

In 2009, the Financial Stability Board issued a set of principles to help better govern and supervise compensation[3] practices at financial services institutions. Regulatory boards across North America, Europe, and other major markets have been creating new regulations to ensure that institutions in these regions adhere to the new guidelines set out by the Financial Stability Board. Some of the key principles[4] are described below and in Exhibit 3:

Effective Governance of Compensation
According to the guidelines laid out by the Financial Stability Board, a separate committee comprised of board members should oversee compensation practices for financial services institutions. The committee should be independent in nature and should have expertise in risk management and compensation. The independence of compensation committee members would be defined by the listing standards of the stock exchanges, and all listed companies would need to comply. The remuneration system they design should include internal controls that are regularly reviewed for consistency with stated intentions.

The independent nature and composition of the compensation committee will make sure that firms do not grant very generous golden parachute[5] agreements to their employees. The committee can also design remuneration packages that do not encourage excessive risk taking by executives.

Exhibit 3: Remuneration Principles Set by the Financial Stability Board



Source: Capgemini analysis, 2011. FSF Principles for Sound Compensation Practices, April 2009

[3] Throughout this document, the words remuneration and compensation have been used interchangeably
[4] FSF Principles for Sound Compensation Practices, April 2009
[5] A golden parachute is an agreement between a company and an employee that specifies benefits that the employee will receive upon termination of his employment

Effective Alignment of Compensation with Prudent Risk Taking
Compensation plans for employees should take into consideration all of the types of risks that employees take on behalf of the firm. The system should be able to differentiate between two employees who generate the same level of profits but take different amounts of risk, and then decide their compensations accordingly. Also, the payment schedule of incentive plans should align with the duration of risk to which the firm is exposed.

These measures will motivate executives to engage in activities that create long-term value for the enterprise as well as themselves.

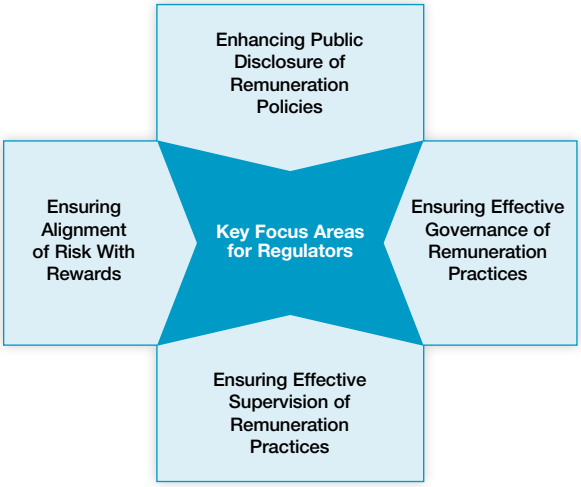
Effective Supervisory Oversight and Engagement by Stakeholders
Compensation practices should be continuously monitored to ensure their adherence to stated principles, and any discrepancies should be rectified immediately. Supervisors should also be responsible for communicating these practices to regulatory authorities, employees, and shareholders.

Increased disclosure norms would put more control in the hands of regulators and shareholders as they would then be able to express opinions on the compensation practices being followed. This would also help persuade the board of directors to continuously improve upon these practices.

3.3. Evolving Regulatory Guidelines across Regions

Following the crisis of 2008 and 2009, regulatory authorities across most markets issued guidelines to regulate compensation practices for financial services institutions. These guidelines were meant to be adhered to at the local level over and above the ones set by the Financial Stability Board. While many guidelines have already been published in their final form, work is still underway to formalize a few others. Authorities have also proposed different sets of guidelines by firm type. Remuneration practice guidelines are also differentiated by the role and nature of work carried out by employees such as financial advisors, relationship managers, CEOs, and executives. Though different, most of these guidelines fall under four broad categories. Each category targets better management of the firm's overall risk and an increase in shareholders' trust in these practices.

Exhibit 4: Key Focus Areas for Regulators



Source: Capgemini analysis, 2011

Enhancing Public Disclosure of Remuneration Policies
Many policymakers believe that current disclosure norms for compensation plans are not sufficient, and that more information should be shared with stakeholders. Financial services institutions across many regions are now required to disclose information on the compensation structure of high-income earning employees, golden parachute arrangements, comparison of historical executive compensation with firm performance, and other such details.

In the U.S., the Securities Exchange Commission (SEC) now has the authority to clarify disclosure norms related to compensation practices. For example, the SEC can now request and receive a chart that compares executive remuneration to the stock performance over a five-year period. The body has now also made it mandatory for financial services institutions to disclose, in their annual proxy statement, the median annual compensation of all executives excluding the CEO, and to compare this figure with the CEO's compensation. Also, financial services institutions are required to provide additional disclosures regarding golden parachute compensation arrangements with executive officers.

In Europe, the European Banking Authority (EBA) now requires large financial institutions to provide the remuneration-specific data of all employees on an annual basis. The EBA has also asked for a separate report from EU Banks that provides information on the compensation structure of employees with salaries greater than €1 million.

In the UK, the Retail Distribution Review published by the Financial Services Authority has laid-out guidelines (to be implemented by 2013) that require independent financial advisors to explicitly state the fees they charge their customers. This aims to bring greater levels of transparency by preventing advisors from charging high commission-based fees, and reducing the mis-selling of financial products.

In China, the regulatory authority requires commercial banks to disclose criteria used for aligning compensation with performance measurement and risk adjustment, deferral compensation, and claw-back arrangements. Banks also need to disclose information on compensation paid to the board of directors, senior executives, and members of the compensation committee.

Ensuring Effective Governance of Remuneration Practices
Regulators globally are asking financial services institutions to establish supervisory committees that would be responsible for designing the firms overall compensation structure. Also, shareholders are now empowered to express their opinions on a firm's compensation policies and raise their concerns to the board of directors.

For example, in the U.S., one of the SEC's new rules requires institutions to enable shareholders to cast their advisory 'say-on-pay' votes (non-binding) at least once every three years beginning with the first annual shareholders' meeting taking place on or after Jan. 21, 2011. Financial services institutions are also required to hold a frequency vote at least once every six years in order to allow shareholders to decide

how often they would like to be presented with the 'say-on-pay' vote. In the UK, shareholders are already familiar with the concept of 'say-on-pay' votes, while in Europe regulators are considering implementing a similar rule for other markets.

Ensuring Effective Supervision of Remuneration Practices
New guidelines and proposals from regulators require financial services institutions to establish remuneration committees that have direct involvement from the board of directors to ensure compliance with newly established regulations.

For example, in the U.S., the SEC requires that members of the compensation committee be independent in nature (per the established definition by the SEC), and the committee is required to select compensation consultants and advisors only after ensuring that they meet the independence criteria as set by the regulatory body[6]. In Europe, the EBA requires that the remuneration policy should not be controlled by the CEO or other executive directors. The guidelines also discourage any incentive-based remuneration packages for members of the remuneration committee.

Ensuring Alignment of Risk with Rewards
Regulators across the globe are implementing guidelines that help align incentive plans with long-term performance outcomes. In many markets, regulators now require at least a fixed percentage of performance-linked remunerations to be paid under deferral arrangements over a fixed number of years.

In the U.S., financial services institutions are now required to claw back any profit-linked reward policy if they have to restate profits downwards at a later time period.

In Europe, the EBA requires golden parachute arrangements to be related to performance achieved over a period of time and designed in a way that does not reward failure.

In the UK, depending upon the size of bonuses, the Financial Services Authority has published guidelines that require a certain proportion of the bonus to be deferred for a minimum period of three years. Also in the UK and Europe, the Alternative Investment Fund Managers Directive states that alternative investment firms will have to defer 40% to 60% of variable pay for employees over a period of three to five years (coming into effect in 2013). Future regulatory reforms are also expected to target the way private equity firms treat carried interest[7] to incentivize their employees.

[6] Some of the criteria that the compensation committee should check when assessing the "independent" nature of a consultant are: 1) all types of services these consultants provide to the organization; 2) the amount of revenue received from the company as a percentage of total revenue of the consultant; 3) the policies and procedures of the consultant; 4) any kind of business or personal relationship between the consultant and members of the compensation committee; 5) the amount—if any—of stock the compensation consultant owns in the company.

[7] Carried interest is share of the profits paid by private equity firms to their employees which acts as an incentive for the employees to maximize fund performance.

4 Business Implications for Financial Services Institutions

4.1. The Impact of Evolving Regulatory Reforms on Financial Services Institutions

The emerging regulations will require financial services institutions to take a renewed look at their compensation practices. There will be increased consideration of these practices when assessing risk exposure and board-level involvement will be required to ensure compliance with newly established regulatory guidelines. Also, increasing public anger against exorbitant executive bonuses requires immediate action from top management to better align incentive structures with firm performance.

Some industry analysts feel that regulators should focus on the structure of incentives and that the level of compensation should not be regulated.

While financial services institutions have little choice other than implementing the guidelines set by regulatory authorities, some industry analysts are sceptical about the impact of new regulations. These analysts note that remuneration-related regulations were also present before the financial crisis, but they did not prove to be very effective. Others have been advocating that regulations should be focused on the structure of incentives and that level of compensation should not be regulated.

Differences in remuneration-related regulations across regions are expected to create an uneven playing field for financial services institutions. For example, regions with very stringent regulations on executive compensation may see their talent pool leaving for markets with more lenient regulations.

Another key area of impact of the new regulations would be on firms' cost structures. To remain competitive in attracting talent, financial services institutions may need to increase the base salaries of their employees to compensate them for the expected reduction in future bonus payouts. This would increase the level of fixed cost expenses for financial services institutions over several years, at a point in time where future top-line growth drivers are uncertain. Instead of just paying low bonuses to offset a bad year, firms will now be saddled with high fixed costs due to higher salaries and rolled-over bonuses for several years. While in the past, such firms would cut variable costs through a reduction in the employee bonus pool (but retain the employees themselves), they may in the future be faced with cutting headcount to reduce fixed costs.

For alternative investment managers, the payment made to their employees is highly market-sensitive information, with disclosure potentially putting the firm at a competitive disadvantage. Also, asset managers will now need to link remuneration and incentives of their employees to their long-term performance and risk exposure, a practice currently being followed by the private equity industry.

As a result of these ongoing debates and discussions, regulations around governance and supervision of remuneration practices are expected to evolve further in the near future.

4.2. Next Steps for Financial Services Institutions as Regulations Evolve around Remuneration Practices

In light of the growing regulations around remuneration practices and the increasing role they play in terms of total risk exposure of a firm, financial institutions now need to better align incentive plans with their long-term profitability. The following key areas will need to be addressed:

Create a Compensation Framework to Comply with Evolving Regulations

- Compensation framework and design has attracted increased attention from regulators, with many financial services institutions now required to have board-level involvement to design better practices. Regulatory bodies are asking for more information on these practices than ever before. It is important for financial services institutions to put in place a robust framework that meets the expectations of all stakeholders and helps align the incentive structure with company performance.
- While stock options are normally an important part of the consolidated remuneration package, the pros and cons of their usage should be carefully studied and performance measurement terms should be defined in a clear and detailed manner.
- For financial services institutions having hedge fund or private equity operations as part of their business, the compensation frameworks should be able to accommodate differences in regulation for each of these businesses.
- Remuneration committee members need to re-check assumptions behind all key performance indicators and consider whether or not they are still relevant in the post crisis world. New key performance indicators should be introduced that help better align risk taken by employees to their incentive structure.

Change Compensation Structure while Retaining Existing Staff

A significant component of success for financial services institutions is their ability to attract the best available talent in the market. Firms now need to consider ways in which they can alter their compensation structures so as to meet regulatory guidelines while maintaining their ability to retain existing staff and attract new talent. An important factor in this is that competitors from a different region may have less stringent regulatory compliance for compensation.

Evaluate the Impact of Increased Fixed Expenses
Since the introduction of remuneration-related reforms, many financial services institutions have taken measures to increase basic salaries while deferring bonuses. The deferred pay-outs that will now be distributed over three- to five-year periods will tend to increase the fixed cost for the institution. Financial services institutions will now have to evaluate the long-term impact of this on their overall cost structure.

Design Internal Controls That Provide Necessary Information for Better Supervision and Governance
Financial services institutions should establish internal control mechanisms that help supervisory committees to efficiently monitor compensation practices. All compensation-related information should be readily available to these committees and any discrepancies found by them should be immediately resolved. Also, supervisory committees should be free from any direct involvement of the CEO or any other party with vested interests.

Devise Plan to Increase Communication and Information Sharing with Shareholders
Along with adhering to the new regulatory guidelines, financial services institutions should also proactively increase communication with their shareholders to explain the rationale behind the new compensation practices being followed. The increasing public discontent around executive pay and bonuses needs to be alleviated to ensure reduced conflicts between shareholders and the management. Also, it can be beneficial to create internal guidelines that clearly explain how shareholder opinions on remuneration-related matters would be considered and acted upon by the firm. Any new key performance indicators should be effectively communicated to shareholders, explaining how they are an appropriate benchmark for the evolving reforms. Such actions will help increase shareholder trust in the firm and in its newly designed compensation policies.

5 The Path Forward: Imperatives for Financial Services Institutions

Technology will play a key role in helping financial services institutions comply with the new regulatory reforms. Historically, the introduction of new regulations has required faster access to more data and information. Hence, financial services institutions will have to generate more and increasingly complex reports to ensure compliance with both internal controls and the ones set by the regulatory authorities. Additional reporting will also be required for internal key stakeholders, providing them the necessary information to make informed decisions.

The following are the key areas around which additional technology investments may have to be made by financial services institutions.

Agile Solutions to Design and Maintain Compensation-Related Information
Even today, many large financial services institutions use legacy systems to maintain a database of their employees' remuneration-related details. While these systems can adequately store employee information, they are of very little help in ensuring compliance with evolving regulations. Data retrieval from such systems can prove to be a tedious and time consuming activity.

Financial services institutions have to focus on creating tools and systems that assist in designing compensation packages for employees, while also ensuring compliance with various regulatory requirements. It is necessary that these systems have a high degree of built-in agility, as compensation structures vary across multiple employee factors and can change periodically. Rule-based systems are considered to be appropriate in scenarios where a number of criteria, which are expected to vary continuously, need to be satisfied.

Sound Performance Measurement System
Much of the blame placed on remuneration practices revolves around the traditional focus on short-term rewards for actions having long-term implications. Financial services institutions may have to put in place new performance measurement systems that can take into consideration the risk tenure of an employee's actions and distribute incentive benefits accordingly. The system should also have the capability to divide the total risk tenure into smaller time periods and then break the total incentive amount and allocate a part of it to each time period, depending upon the risk remaining at the end of each period. This will help to design risk-adjusted compensation packages that are in line with the regulators and shareholders expectations.

Enhanced Management Information Systems (MIS) for Additional Report Generation Requirements
As part of the new regulatory reforms, financial services institutions will need to establish supervisory committees that will be responsible for the firm's overall compliance with the new and existing regulations. Any discrepancies found by these committees are expected to be rectified immediately. Hence, these committees will need quick access to real-time information for effectively monitoring remuneration practices at firms.

Additional reporting requirements are expected to require financial services institutions to focus on upgrading their existing MIS tools and systems. Reports are now required to give details on the changing risk profile of an employee action and also the firms overall risk exposure at any given point. Gaining access to relevant reports will be absolutely necessary for the supervisory committees to perform their tasks.

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