

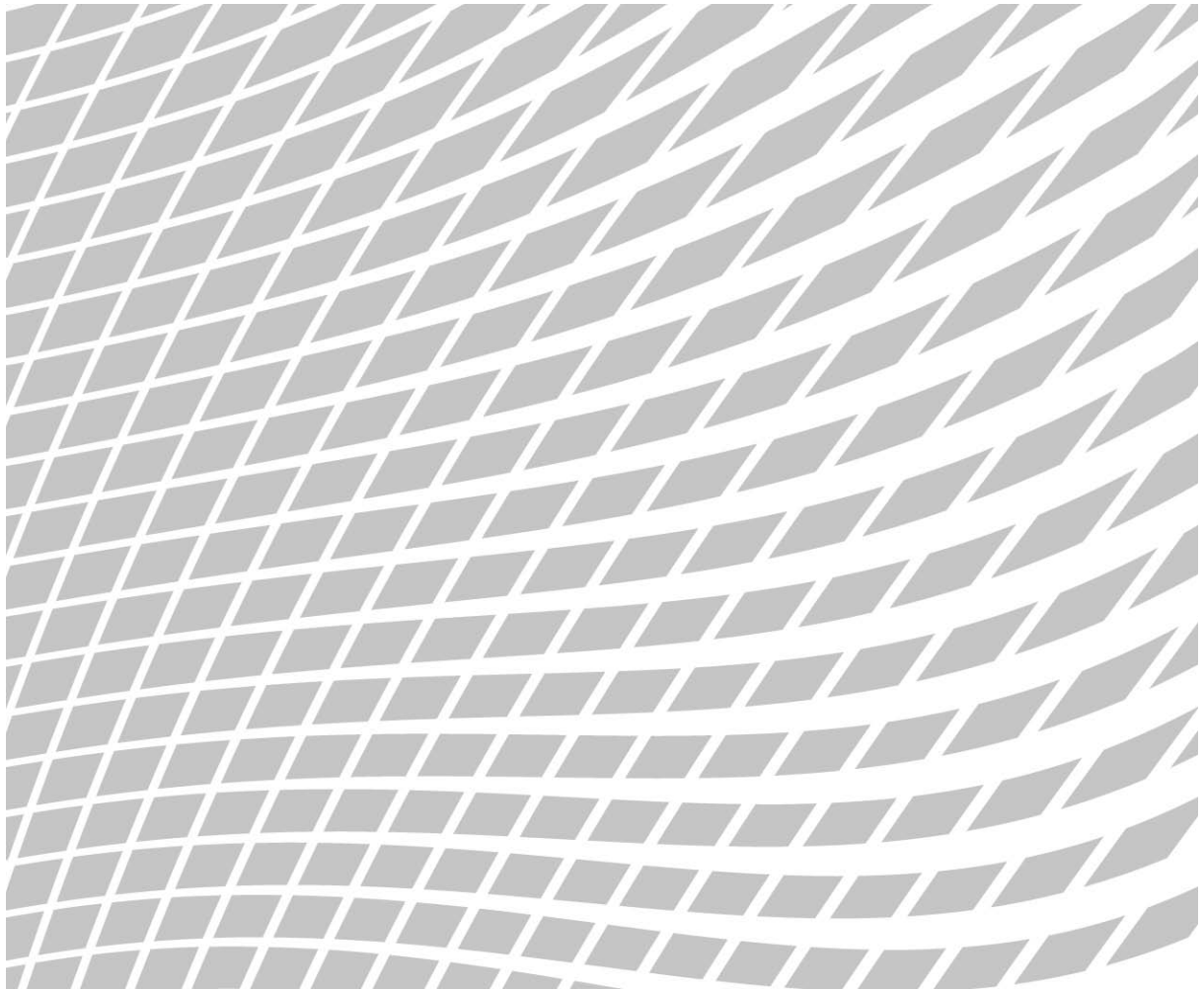
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# Remuneration Schemes Circular

## Key Points

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**FINMA is publishing a Circular on remuneration schemes which will enter into force on 1 January 2010. In drawing up the Circular, account has been taken of the results of the consultation and of international developments, in particular the latest standards issued by the Financial Stability Board. The Circular will have a direct impact on the remuneration schemes of the financial institutions concerned. The aim is to help ensure that remuneration schemes do not create incentives to take inappropriate risks and thereby potentially damage the stability of financial institutions. Firms will have to structure their variable remuneration (bonuses) on a sustainable and long-term basis in line with their economic performance, taking into account all costs related to all risks entered into. Furthermore, boards of directors will have greater responsibility. They will be responsible for the remuneration policy of the entire financial institution and will have to publish a remuneration report.**

Inappropriate risks and false incentives can threaten the business and profitability of a financial institution and thus its stability. Remuneration schemes can create false incentives and lead to inappropriate risks being taken. Experience in recent years has shown that remuneration schemes have considerable importance for risk management at financial institutions. In line with international bodies such as the Financial Stability Board and financial market supervisory authorities abroad, FINMA is subjecting the remuneration policy of financial institutions to supervisory regulation based on the organisational provisions of financial market legislation. However, the proposed rules are just one element of financial market regulation and supervision. Regulation of remuneration schemes cannot be expected to prevent future financial crises by itself. Remuneration schemes should be structured so as to enhance employees' risk awareness. This not only includes financial risks, such as credit defaults, losses from trading positions or liquidity problems, but also operational risks, including legal and compliance risks, which can severely damage a financial institution and must therefore be included in the overall risk picture. Large risks must entail lower variable remuneration than small risks with the same financial result, and this should apply at the level of the institution as a whole, a department or an individual employee. This provides all employees at a financial institution with an incentive to act in a risk-aware manner.

### **Results of the consultation process**

Between 3 June and 14 August 2009, FINMA conducted a consultation with regard to its draft Circular on minimum standards for the remuneration schemes of financial institutions. The consultation elicited a large response. The reaction to the draft varied greatly. FINMA-supervised firms are sceptical or opposed to the extension of financial market regulation into the area of remuneration. In concrete terms they reported having difficulty in particular with various specific rules contained in the Circular. It was argued that some provisions contained in the FINMA regulation would be at odds with existing employment and tax law or, in view of their worldwide scope, could not be implemented in all markets. A further criticism was that some of the draft rules were too procedural and would unnecessarily restrict the flexibility of firms and incur considerable cost. In addition, smaller firms in particular regard the scope of application as defined by the minimum threshold values as too broad.

## **International coordination**

Independently of developments in Switzerland, the issue has also been discussed at an international level. Various regulatory initiatives have been undertaken. The most important result of these international initiatives is the Implementation Standards drawn up by the Financial Stability Board (FSB). On many points these go beyond the Principles published by the same body in May and are more specific. Among other bodies, the Basel Committee on Banking Supervision has also attended to the issue. National supervisory authorities are required to integrate the FSB rules into domestic law within a few months and to monitor adherence.

The FINMA rules meet the FSB requirements and those of the Basel Committee. Applying international standards is of great importance in terms of preventing regulatory arbitrage and ensuring domestic market participants are not put at a competitive disadvantage. In a few points FINMA's remuneration rules go beyond international consensus, but they also allow firms greater freedom in designing appropriate ways of implementing the rules. The Circular is binding not only on systemically important banks but also on other large banks and large insurance providers. All other firms are to regard the principles of the Circular as guidelines for best practice when designing their remuneration schemes. Other aspects too, such as the use of deferred remuneration and the structuring thereof, are given a broader scope by FINMA. However, FINMA has also adjusted some of the provisions contained in the consultation draft, without diluting the core content of the draft and the goals pursued. At the end of the day, the advantages of a coordinated international approach are to be regarded as more important than the potential benefits of much more far-reaching rules specifically for the Swiss market, the effectiveness of which would in any case be questionable without the backing of international consensus.

## **Adjusted scope of application**

FINMA has decided to adjust the Circular's scope of application. Whilst the Circular is still intended to be used by all banks, securities traders, insurance providers and persons and firms authorised under the Collective Investment Schemes Act, only large banks and insurance providers are subject to mandatory implementation. The scope of application is determined by threshold values based on equity capital requirements for banks and solvency margin requirements for insurance providers. These key figures reflect both the size of an institution and the risk it has entered into and are already used as part of prudential supervision. Implementation of the Circular is mandatory for firms required to have at least CHF 2 billion in equity capital or as solvency. By increasing the threshold values as against the consultation draft, FINMA also wishes to prevent a disproportionate cost being imposed on small and medium-sized firms.

Irrespective of the Circular's scope of application, FINMA wishes to integrate the issue of remuneration more closely into its risk-based supervisory processes. The Circular is to be regarded as best practice for all firms supervised by FINMA, and thus as a guideline for the design of remuneration schemes. FINMA will therefore at least observe the remuneration practices of those financial institutions that do not fall within the scope of the Circular. It also has the option of imposing implementation of the Circular on individual firms where there is reason to do so, even if these fall below the threshold values.

FINMA would make use of this option if, for example, it learnt of shortcomings or inappropriate remuneration practices at such firms.

In taking this approach, FINMA aims to strike a suitable balance between cost and benefit. However, it will observe the effects of this aspect of the regulations, and reserves the right to adjust the scope of application if necessary. This would be appropriate if, in particular, the scope of application envisaged were to lead to market distortions and were to cast doubt on the effectiveness of regulation as a whole.

### **Variable remuneration as a share in success**

A total ban or severe restrictions on variable remuneration, as called for by some, are not regarded by FINMA as a useful approach; furthermore, FINMA would hardly have the powers to stipulate such. Variable remuneration creates an incentive for employees to pursue the goals and interests of the institution by enabling them to share in its success. It also allows financial institutions a greater degree of cost flexibility. Provided the interests of the company's owners are taken into account and there is no inducement to assume inappropriate risks, variable remuneration can therefore undoubtedly be of benefit to all stakeholders of an institution. However, FINMA expects remuneration schemes to place an emphasis on sustainable business. It wishes to treat variable remuneration as the employees' stake in the success of the company, by requiring that all variable remuneration paid out must actually have been earned by the company over the long term. Accordingly, payment of variable remuneration is scarcely appropriate if a company is not successful in its business activities over a given period.

FINMA has based its approach here on the economic performance of an institution. All the company's costs of capital are to be taken into account, including, therefore, the risk costs for providers of capital or shareholders. A company only creates genuine added value if a surplus remains after deduction of all risk-related capital costs. The larger an institution's risk, the smaller this surplus. This concept does not limit the amount of variable remuneration. However, it prevents high variable remuneration being awarded merely as a result of entering into large risks and generating short-term, unsustainable earnings. Firms are required to consider the long-term development and sustainability of their economic performance when determining variable remuneration. The aim in this is to prevent disproportionately inflated variable remuneration being granted during boom phases; however, it also enables companies to provide a degree of variable remuneration during brief downturns in business. The more sustainable a company's positive performance, the more employees can benefit from variable remuneration.

### **Incorporation into capital and liquidity planning**

Remuneration represents an important cost factor for financial institutions. Remuneration payments have a considerable influence on an institution's capital base. Remuneration also needs to be considered in terms of liquidity. FINMA is therefore stipulating that remuneration be fully incorporated into an institution's capital and liquidity planning. If an institution falls short of its capital targets, priority is to be given to building up the necessary capital or solvency buffer, and a conservative remuneration policy must be pursued, particularly in regard to variable remuneration. In this way, remuneration costs will be prevented from further weakening an institution and its stability.

### **Long-term allocation criteria**

FINMA requires that the allocation of variable remuneration be based on sustainable criteria which are open to scrutiny. This is to prevent employees focusing on targets that have little to do with the sustainable success of the institution or that do not take into account the risks entered into. In addition, persons in the higher levels of the hierarchy in particular, i.e. those with significant responsibility for risk or with relatively high total remuneration, are to receive part of their remuneration with deferred effect and thus in a way which is linked to risk. This applies in particular to firms where, because of their risk profile, it can be assumed that the success of their business activities can only be definitively determined in the medium or long term. Many financial institutions already use deferred remuneration. Remuneration in the form of blocked shares or options is an example of this. Employees holding blocked shares can dispose of the remuneration only after the holding period has expired. By deferring payment, remuneration can be subjected to a risk and tied to future developments even after it has been granted. Deferred remuneration must be subject to fluctuations in value during the holding period so as to enhance risk awareness and the incentive for sustainable business. Employees thus benefit from their institution performing well, for example if the institution's share price rises. They are also impacted by the risk of negative performance, for example if the share price falls or risks arise, such as credit defaults or losses from trading positions. It is important to strike a suitable balance between the institution's success, risks and the value of the deferred remuneration, in addition to ensuring that employees are appropriately impacted by the company's performance, whether negative or positive. Where any variable remuneration is granted in the event of negative business performance, this should be predominantly in deferred form wherever possible. In this way, the institution can grant variable remuneration whilst making its value dependent on business success. FINMA also welcomes "clawback" and "malus" provisions which allow for the complete or partial loss of variable remuneration already granted if negative events occur. Clawbacks have the advantage that they can be linked to specific risks within an employee's area of responsibility.

### **Increased transparency**

From a legal perspective, FINMA is not authorised to restrict the remuneration paid to employees. Indeed, this would not be a sensible option. Given the large differences within the Swiss financial sector, it would be almost impossible to determine a single appropriate arrangement for all areas. This would be even more difficult for firms with international operations. FINMA will continue to leave it to

the market to find the best level of remuneration. However, it is also aware that market mechanisms have not functioned adequately in recent years and that this is a reason for the huge increase in remuneration in this period. FINMA therefore wishes to strengthen market discipline by means of transparency and reporting obligations.

Financial institutions will be required to disclose their remuneration policy to the market and their owners in a remuneration report. Third parties, such as shareholders and analysts, should be able to assess the structure of the remuneration scheme, allowing them to compare the variable remuneration with the performance of the company. The proposed transparency rules go beyond the previous requirements under Swiss law. Whereas the current company and stock market disclosure legislation only requires disclosure of the remuneration received by senior management, FINMA is stipulating summary disclosure of the remuneration structure for all employees. This reflects the fact that in the financial sector a large part of variable remuneration is granted to persons below senior management level. However, FINMA does not intend to insist that individuals' names be disclosed with the remuneration received.

#### **Employment and tax legislation: a balancing act**

In regulating remuneration schemes, FINMA has to perform a balancing act to ensure that regulation is both appropriate and effective. The concept of performance and success-related variable remuneration came from the English-speaking business world. In the financial sector in particular, the relationship between fixed salaries and bonuses has shifted to favouring the latter, meaning that nowadays variable remuneration often makes up a significant part of employees' total remuneration. However, Swiss employment law has not kept pace with this trend. The lack of clear statutory regulations on bonuses may be one reason why, in the past, Swiss courts have judged claims from employees for variable remuneration to be a component of salary to which they are entitled. The judicial interpretation of applicable legal provisions makes it more difficult to defer variable remuneration with conditions attached, or to reduce it on the basis of business performance for example. Legislators need to remove the legal uncertainty in Swiss employment law and adjust it in line with current practices. There is a similar problem with regard to tax legislation. The deferred remuneration being promoted by FINMA and which is already widely used across the sector must in some cases be taxed before employees can have access it.

FINMA recognises that firms may well be confronted with some challenges in terms of legal requirements when implementing the Circular. However, irrespective of this, many firms already apply just those remuneration practices which FINMA is now stipulating. FINMA is therefore assuming that implementation of the Circular in conformity with legal requirements is possible, particularly since firms will have room to make their own specific adjustments in implementation. Thus, FINMA does not regard it as necessary to postpone issuing the Circular until the legislation has been revised. It is also to be hoped that the courts will take account of FINMA's remuneration regulations in making their decisions.

### **Next steps**

FINMA expects the financial institutions concerned to adhere to the rules set out in the Circular from 2011. FINMA is thereby giving the firms time to undertake what may be complex adjustments to their remuneration schemes. However, as part of its supervisory procedures FINMA is already being careful to ensure that firms subject to the Circular do not return to remuneration practices which have proved to be unacceptable in the light of recent experience. It is doing this in accord with foreign supervisory authorities and as part of the international consensus.

FINMA will observe the effects of its Circular and of foreign initiatives in this new regulatory field. It will also continue in dialogue with the firms it supervises and with other supervisory authorities as well as on the relevant international bodies. FINMA will make use of the knowledge gained to develop the Circular further as necessary.