



FINANSINSPEKTIONEN

Bonuses: Are companies following the rules?

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Summary

Finansinspektionen (FI) received an assignment from the Government to report on the implementation of the EU Recommendation on remuneration in the financial services sector, the measures taken to ensure compliance with the new rules and how affected companies have adapted to the recommendations.

FI limited the survey to 41 credit institutions investment firms and fund management companies and studied how these companies adapted to Finansinspektionen's regulations and general guidelines (FFFS 2009:6) regarding remuneration policy in credit institutions, investment firms and fund management companies (the remuneration regulations).

The results show that only about half of the surveyed companies have sufficiently adapted to the remuneration regulations. FI will conduct a separate follow-up investigation of the companies demonstrating material deficiencies in their compliance with the remuneration rules, and the underlying provisions on risk management, as part of its supervision process. FI will conduct more thorough reviews of more than half of the companies that were included in the survey since there is reason to believe that they are in violation of the requirement to possess sound risk management practices. These reviews can lead to an intervention by FI.

Based on the areas that were the focus of the survey, FI identified the following deficiencies in compliance with the remuneration regulations:

Incorrect interpretation of the term "variable remuneration".

Incorrect or too narrow interpretation of the term "risk-taker", resulting in incorrect application of the rules regarding deferred variable remuneration (bonuses).

Insufficient risk analysis as a basis for the remuneration policy.

In addition, some companies have not followed the general guidelines on the disclosure of more detailed information about remuneration.

In summary it can be said that a number of companies included in the survey do not perceive variable remuneration to be a risk in their operations. In some cases the companies' actions are probably due to an insufficient understanding of the rules. In others, the deficiencies are so remarkable that they leave FI with the impression that the company consciously decided to circumvent the rules.

As of 1 March 2011, new stricter rules governing the remuneration structures at credit institutions, investment firms and fund management companies with authorisation to conduct discretionary portfolio management go into effect. The current remuneration regulations allow companies considerable flexibility, which means that it is up to the companies to apply the rules responsibly and appropriately. However, the survey shows that many companies have not fulfilled their responsibilities and, as a result, the new remuneration rules contain stricter limitations on both interpretation and application. As previously, however, it is still the companies themselves that will identify, measure, govern and control all of their risks, including risks associated primarily with variable remuneration.

Background

IMPLEMENTATION OF THE EU RECOMMENDATION ON REMUNERATION POLICY

The regulations and general guidelines (FFFS 2009:6) regarding remuneration policies in credit institutions, investment firms and fund management companies (the remuneration regulations) that were decided by FI have been in effect since 1 January 2010. FI also decided on general guidelines (FFFS 2009:7) regarding remuneration policies in insurance undertakings, exchanges, clearing organisations and institutions for the issuance of electronic money (the general guidelines regarding remuneration policy). The remuneration regulations and the general guidelines regarding remuneration policy are based on EU Recommendation K(2009) 3159 with respect to remuneration policy in the financial services sector. The purpose of the EU Recommendation was to introduce new, stricter principles for salaries and other remuneration and to support sustainable remuneration structures and social responsibility in all companies.

Work on a regulatory framework has since then continued within the EU. On 11 October 2010 the Council adopted the so-called CRD 3 Directive. This directive emphasizes that the basic provisions on risk management also include the risks associated with variable remuneration, which means that a risk assessment of their remuneration structures shall be included in the companies' processes for internal capital adequacy assessment practices (ICAAP). Based on this directive, FI has decided on new rules for the remuneration structures in credit institutions, investment firms and fund management companies with authorisation to conduct discretionary portfolio management that enters into force on 1 March 2011.

THE REMUNERATION REGULATIONS

The remuneration regulations contain both regulations and general guidelines. In contrast to regulations, general guidelines are not binding but rather comprise general recommendations for how a regulation should be applied. Companies can use alternative solutions provided that they can demonstrate that the requirements in the underlying regulation have been fulfilled. Both the regulations and the general guidelines in the remuneration regulations are pursuant to the provisions governing companies' risk management laid down by laws regulating the operations of different types of companies¹. In conjunction with its decision to adopt the regulations, FI published a decision memorandum outlining the considerations made by the authority when preparing the remuneration regulations. FI also published questions and answers about the regulation of remuneration structures in the finance sector based on the questions FI received from companies once the rules entered into force.

The companies covered by the remuneration regulations are required to identify, control and manage the risks inherent in their operations. The remuneration regulations aim to improve how financial companies'

¹ See Chapter 6, section 2, first paragraph of the Banking and Financing Business Act (2004:297), Chapter 8, section 4, first paragraph of the Securities Market Act (2007:528) and Chapter 2, section 17 and Chapter 5, section 2 of the Investment Funds Act (2004:46).

manage the risks in their remuneration structures. It is important that the risks in the financial sector's remuneration structures be managed efficiently and, therefore, principles are needed to ensure that companies possess sound remuneration policies. The remuneration regulations state that the remuneration policy shall be adopted by the board of directors. The policy shall be based on an analysis of the risks associated with the policy and describe the remuneration structure and how the application and follow-up are conducted.

The rules place considerable weight on a long-term perspective in the design of the companies' remuneration policies. Remuneration should not counteract the companies' long-term interests. When measuring the performance that serves as a basis for variable remuneration, remuneration for a specific period should not jeopardize a company's ability to report positive results over an entire business cycle. For an employee whose actions can have a material impact on the risk exposure of the firm, at least 60 per cent of the variable remuneration should be deferred for at least three years. In addition, the remuneration policy should be designed such that the company can decide to completely or partly nullify deferred remuneration amounts. This applies to situations where, after the fact, it is shown that the performance criteria were not fulfilled or that the company's position has significantly deteriorated. An independent control function shall review as a minimum once a year the compliance of the company's remuneration with the remuneration policy. In addition, companies shall disclose information about remuneration by providing relevant, clear and comprehensible information. The information shall be provided in such a manner as to prevent revealing the financial conditions of private individuals.

Pursuant to the proportionality principle, application of the regulations shall take into account the firm's size and the nature, scope and complexity of its activities. The purpose of this principle is to ensure that the rules are appropriate for all types of companies. Smaller companies with uncomplicated activities are subsequently not expected to apply the provisions in the same way as large companies or companies with complex operations. However, the principle of proportionality does not mean that a company can completely refrain from applying any or several of the provisions.

Are companies following the rules?

REPORT TO THE GOVERNMENT

This report serves as FI's reporting as set out in the letter of appropriation. FI has been tasked by the Government to "demonstrate how the European Commission Recommendation on remuneration policy in the financial services sector of 29 April 2009 has been implemented". According to the assignment the basis for the report shall be an account of how Finansinspektionen, through regulations and/or general guidelines, regulated the issue of how financial companies manage their remuneration structures. The report shall also state the measures taken to ensure that the new regulations are followed and how the affected companies have adapted to the recommendations.²

In principle, the new regulation of remuneration systems affects all companies under FI's supervision. The remuneration regulations apply to approximately 150 credit institutions, 140 investment firms and 80 fund management companies, and in total around 400 insurance undertakings, exchanges and clearing organisations are covered by the general guidelines regarding remuneration policy.

During the autumn, FI also mapped the variable remuneration paid by insurance companies and was able to determine that the insurance industry's variable remuneration structures were limited in scope compared to other companies in the financial sector.

FI opted to limit the participants of the survey to credit institutions, investment firms and fund management companies since these are the companies in which variable remuneration is more common and therefore would provide more information. As a result, the companies covered by the general guidelines regarding remuneration policy are not included in the survey or in this report.

One of the purposes of the survey is to determine FI's future supervisory focus. FI has also implemented a number of measures to ensure that companies comply with the new regulations. For example, FI published FAQs on its website, compiled information from companies that as of 31 August 2010 had outstanding remuneration commitments that did not comply with the remuneration regulations and in general strove to raise the awareness of companies about the significance of remuneration risks.

THE SURVEY

FI took a sample of the companies covered by the remuneration regulations that represented the largest or most complex companies in each category. In total, 41 companies are included in the survey. The sample consists of the 4 major banks and their (4) fund management companies, 9 savings banks, 13 investment banks and larger investment firms, 5 other banks and credit institutions and 6 other fund management companies.

Because the regulations were only in force for barely one year before the survey was conducted, FI chose to limit the survey to the most basic measures that the companies should have taken to adapt to the framework

² See the Letter of Appropriation for the 2011 Budget Year for Finansinspektionen, II 13 2010-12-22 Fi2010/4920, Fi2010/5063, Fi2010/5322, etc.

and the risks for variable remuneration, for example if the companies' remuneration policies were based on a sufficient analysis of the risks associated with remuneration, if all forms of variable remuneration were taken into consideration when applying the regulations and which employees the companies had defined as risk-takers and whose variable remuneration would be partly deferred. The term "risk-taker" in this report is used synonymously with the term "employee whose actions can have a material impact on the risk exposure of the firm" as set out in Chapter 1, section 3 of the remuneration regulations. The survey also looked more closely at the extent to which the companies disclosed information about remuneration. FI has decided that the survey will not focus on the companies' methods for assessing performance, adjustments to deferred remuneration amounts and issues related to the control and review of the companies' remuneration policies and structures. A review of how the companies apply the rules in respect of these areas may be conducted when data spanning a longer period of time is available in order to make a more accurate and fair assessment.

SURVEY RESULTS

FI's survey shows that less than half of the companies evaluated in the survey sufficiently comply with the requirements and recommendations set out in the remuneration regulations.

The deficiencies in the application of the remuneration regulations identified by FI in the non-compliant companies, which constitute more than half of the companies participating in the survey, refer primarily to four areas.

1. INCORRECT INTERPRETATION OF THE TERM "VARIABLE REMUNERATION"

A company's remuneration policy shall take into account all forms of remuneration. Due to the fact that risks requiring special management primarily arise with respect to variable remuneration, FI has issued special provisions on how to adjust variable remuneration for risk. Accordingly, it is crucial that all forms of variable remuneration be taken into account when applying the regulations. The regulations only allow for the possibility to exclude "commission-based salary not linked to future risk assumptions that may alter the firm's profit and loss statement or balance sheet".

Despite this, companies are taking the position that they are not paying variable remuneration since the remuneration is based on the previous year's finalised results. Because the results have already been confirmed, the risk level of the company should not be affected. Some companies also believe that bonuses distributed equally among all employees do not constitute variable remuneration. Since these companies do not believe they are paying variable remuneration, they do not believe that they need to apply the most important provisions of the regulatory framework.

In addition to this type of variable remuneration, which in everyday terminology is usually called a bonus, there are a number of different remuneration programs directed at employees. It is the terms and conditions of these programs, regardless of how they are designed, that decide if the program should be considered variable remuneration.

Since all forms of variable remuneration shall be taken into account

when applying the regulations, the company is required to conduct an analysis of the remuneration programs it offers its employees. The survey shows that several companies have not conducted any analysis of their remuneration programs, which means it is possible they are paying variable remuneration without applying the provisions regarding risk adjustment of variable remuneration.

2. INCORRECT OR TOO NARROW INTERPRETATION OF THE TERM "RISK-TAKER"

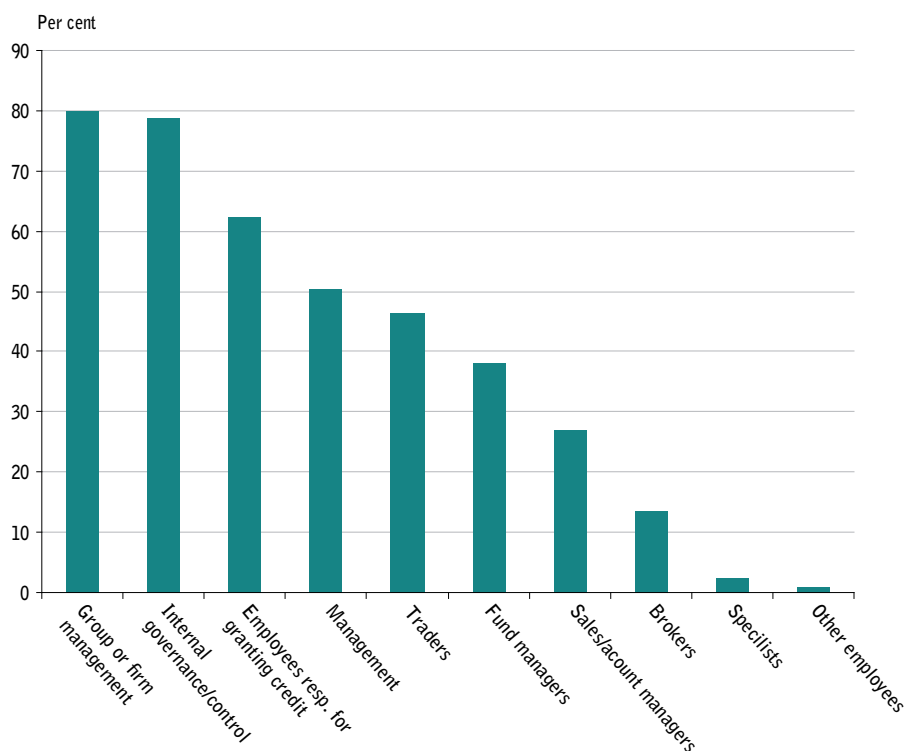
In order to achieve an appropriate and effective risk management, it is of particular importance for employees whose actions can have an impact on the risk exposure of the firm (risk-takers) to defer a portion of their variable remuneration. Deferred remuneration is a prerequisite for being able to maintain a risk profile that is manageable in the long run. It is therefore fundamental that companies identify which employees are risk-takers in order to accurately apply – and achieve the purpose of – the rules. Pursuant to the remuneration regulations, the remuneration policy shall specify a company's definition of risk-taker.

A risk-taker is an employee who can exercise not insignificant influence on the company's risk profile. The regulations state that senior executives, strategic management positions, traders on the capital market, employees responsible for granting credit and employees responsible for internal governance and control are normally considered risk-takers. There is no separation between employees who can have a direct impact on the risk profile and those whose impact is more indirect. This means that employees involved in strategic decision-making can, for example, impact the company's risk profile indirectly, while employees who take positions on behalf of the company introduce risk in a more direct manner.

The survey shows that there is considerable variation in how companies define risk-taker. Some variation is expected since the size and type of activities of each company are different. However, FI is under the impression that the surveyed companies in general defined too few of their employees as risk-takers in relation to the scope of the business and the size of the variable remuneration. This does not necessarily mean that companies do not comply with the regulations, but it can be a sign that the definition of risk-taker is too narrow, which in turn can raise questions about whether some companies are remiss in their approach to the risks associated with variable remuneration.

The survey shows that in total one-fifth of all employees belonging to Group and senior management are not considered to be risk-takers (see diagram 1). Given that these employees either themselves have a mandate to make strategic or operational decisions that can directly or indirectly impact the firm's risk profile or are involved in contexts in which these types of decisions are made, the question can be raised if the assessments behind the definitions are accurate.

Diagram 1. Share of risk-takers per personnel category



the highest variable remuneration in relation to fixed salary and take the largest risks on behalf of the company. Traders take trading risks, i.e. positions on the capital market on behalf of the company. Because traders normally have such a high share of variable remuneration, this can contribute to excessive risk-taking. It is therefore particularly important that traders be categorised as risk-takers and that companies apply the regulations regarding deferred payment of variable remuneration to them.

The survey also shows that variable remuneration paid to traders is often based on performance over a short period of time (one year). This tendency, combined with the fact that this type of remuneration is seldom subject to deferred payment, can in turn counteract the companies' long-term interests.

Some companies in the survey have excluded traders subject to limits, i.e. traders who may only take positions on behalf of the company up to a certain limit, from the risk-taker group. Whether or not an employee has a limit is not the deciding factor for whether he or she is considered a risk-taker, but it is a sign that the employee should be considered a risk-taker.

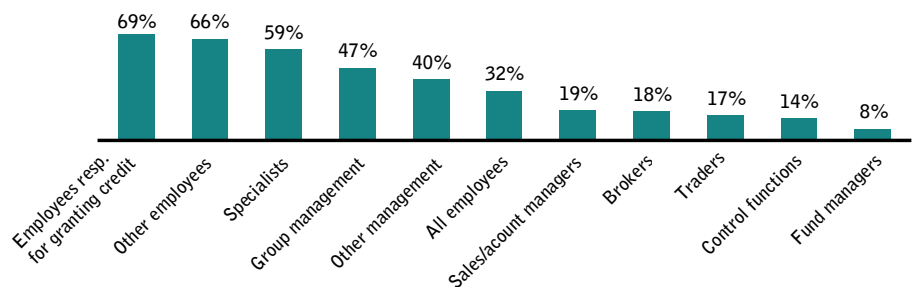
The presence of limits does not mean that there are no risks. Insufficient management of trading risks was a deciding factor in FI's intervention against Carnegie Bank AB and HQ Bank AB. There were limits in both of these cases, but the difficulty in valuing positions and measuring performance and risk, combined with large variable remuneration, creates strong incentives for individual employees to manipulate valuations or take positions that improve the reported result in the short run, but that in the long run can lead to significant losses for the company.

Pursuant to the general guidelines in the remuneration regulations, at

least 60 per cent of the variable remuneration paid to risk-takers should be deferred for up to at least three years. The purpose of this provision is to promote long-term, sustainable risk-taking – if the employee knows in advance that the remuneration will be based on performance measured over a number of years, the temptation to take excessive risk to improve the short-term performance decreases. If the company’s performance deteriorates during the years the payment is in deferral, the company has the possibility of extending the deferral or in full or in part nullifying payment of the remuneration.

Because some companies have not made a proper assessment about which employees can affect the company’s risk profile, they have also not followed the general guidelines regarding deferred payment of variable remuneration to these employees. However, in many cases neither have companies deferred the variable remuneration paid to employees identified as risk-takers. For example, among group management members, senior management members and other management positions assessed to be risk-takers, less than half of the variable remuneration was deferred (see diagram 2). There can be acceptable reasons for this, e.g. if the contracts were binding or if the amounts were small. Some companies, however, have also paid relatively large amounts despite the absence of a binding contract. Other companies reported that they can apply the proportionality principle and therefore do not need to defer the payment of variable remuneration since they are not systemically important. However, this principle does not open the door for companies to completely circumvent the provisions in the regulations.

Diagram 2. Share of deferred variable remuneration to risk-takers



3. THE REMUNERATION POLICY HAS NOT BEEN BASED ON A RISK ANALYSIS

A number of companies that insufficiently adapted to the remuneration regulations appear not to have based their remuneration policies on adequate risk analysis. Furthermore, several companies did not document their risk analysis.

Pursuant to Chapter 2, section 1 of the remuneration regulations, the company’s remuneration policy shall be in line with and promote effective risk management. An adaptation to the regulation requires that the company has conducted a thorough analysis of the risks that can arise in its operations. The identified risks shall then be analysed based on the possibility that the remuneration structure can encourage excessive risk-taking, see also Chapter 3, section 1 of the remuneration regulations. When the company’s board of directors decides on the remuneration policy, it should assess how the company’s risk profile can be affected in

both the short and long term. Even if it is not expressly stated in the regulations that the risk analysis shall be documented, it is naturally a prerequisite that both the company and FI, as a part of its supervision, shall be able to assess the remuneration policy. The type of documentation can, of course, vary to suit the company.

In several of the cases where there was no documented risk analysis, the companies state that their boards of directors received a verbal presentation of the risks or that the risks were taken into account when preparing the remuneration policy.

4. INSUFFICIENT DISCLOSURE OF REMUNERATION

Pursuant to Chapter 5, section 1 of the remuneration regulations, companies shall submit information about remuneration in conjunction with the adoption of the annual report. The general guideline states which information should be disclosed, for example the performance criteria forming the basis for variable remuneration, the risk analysis that serves as a basis for the remuneration policy and the principles for the deferral of the payment of variable remuneration. The company should also disclose the total cost for fixed salaries and variable remuneration, broken down by number of persons and business line or unit. The purpose of the disclosure is to enable not only the supervisory authority but also shareholders, creditors and the general public to analyse the company's risk profile. The disclosed information must therefore be sufficiently detailed and clear.

The survey shows that several companies have not followed the general guidelines in the remuneration regulations regarding the disclosure of more detailed information about remuneration.

Conclusions and supervision targets

FI's survey has identified deficiencies in how a strikingly large number of companies design and apply their remuneration policies.

A number of companies in the survey appear not to perceive variable remuneration to be a risk in their operations. In a number of cases the companies' actions are probably due to an insufficient understanding of the regulatory framework. In others the deficiencies are so remarkable that they leave FI with the impression that the company consciously decided to circumvent the regulations.

FI will investigate more closely compliance with the remuneration regulations in the cases where there were deficiencies. These investigations could result in intervention by FI. FI takes it very seriously that there are financial companies that do not place enough weight on the risks associated with remuneration. Remuneration risks shall, like all other risks in a company's operations, be identified, controlled and managed. Any other approach is unacceptable. To the extent that, following further investigation, there is evidence that a company has intentionally not applied the regulations, FI's intervention will reflect how serious such an attitude is.

NEW REMUNERATION REGULATIONS IN MARCH 2011

On 1 March 2011, the new regulations for the remuneration structures in credit institutions, investment firms and management companies with authorisation to conduct discretionary portfolio management will enter into force. These regulations are based on an EU Directive. The new rules contain only binding regulations, i.e. there are no general guidelines, which means that the rules have been tightened. A stricter regulatory framework is one step along the path to sounder remuneration policies. A second, and equally important, step is that financial companies seriously view variable remuneration as a risk that requires management. The problem areas that are identified, where appropriate, have been taken into account when preparing the new regulations regarding remuneration structures.



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