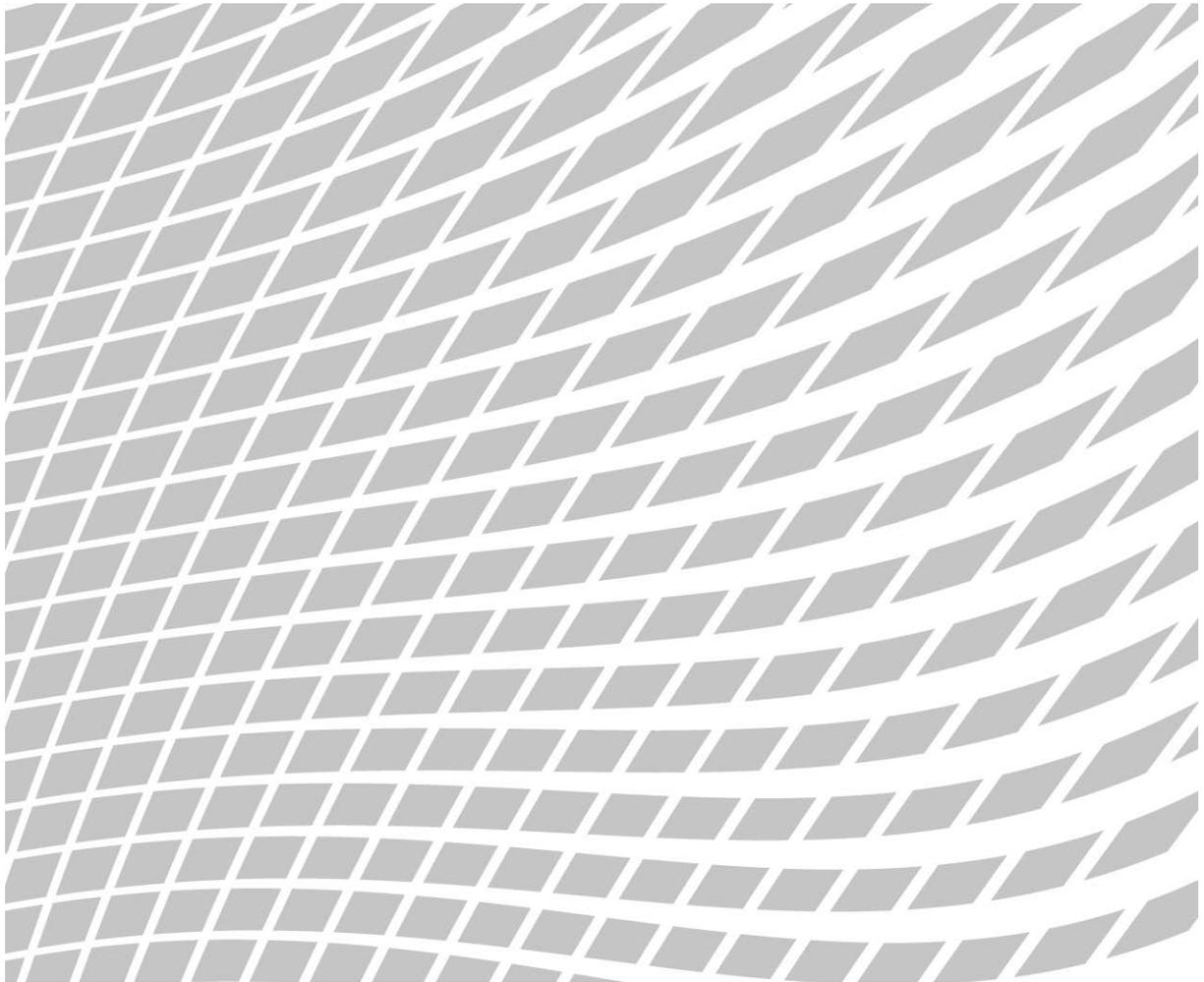


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## Key points of the Circular on remuneration systems

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**FINMA is opening the consultation period for the Circular on remuneration systems, which will enter into force on 1 January 2010. The Circular will have a direct impact on the remuneration systems of the financial institutions concerned. The Circular will aim to ensure that remuneration systems do not provide incentives to take inappropriate risks that could threaten the stability of financial institutions. As a result, financial institutions will have to structure their variable remuneration packages (bonuses) on a sustainable and long-term basis in line with economic profit while taking into account the costs related to all risks entered into. Furthermore, Boards of Directors will have to discharge their duties more carefully. They are responsible for the remuneration policy of the entire company and will have to disclose the remuneration policy in a remuneration report. The consultation period for the Circular will run until 14 August 2009.**

## **Increasing risk awareness**

Inappropriate risks and false incentives can threaten the stability and profitability of a financial institution. Remuneration systems can also set false incentives, leading to inappropriate risk taking. Recent events have shown that remuneration systems play a key role in risk management at financial companies.

In accord with international committees such as the Financial Stability Board and financial market supervisory authorities abroad, FINMA is proposing that, based on the organisational requirements of effective financial market legislation, the remuneration policy of financial institutions be made subject to supervisory regulation. In contrast to comparable international regulations, the Circular will apply not only to large, systemically relevant banks, but to all financial institutions supervised by FINMA.

Remuneration systems should increase employees' risk awareness. This not only includes financial risks, such as credit defaults, losses from trading positions or liquidity problems, but also operational risks, for example legal and compliance risks, which can severely damage a financial institution and must therefore be included in a risk assessment. High risk must result in lower variable remuneration than low risk. This applies at the level of the entire company, at business unit level, and all the way down to individual employees. This provides all employees at a financial institution with an incentive to act in a risk-aware manner.

## **Variable remuneration as a contribution to success**

FINMA believes that steep restrictions or a blanket ban on variable remuneration would not be a sensible option. Variable remuneration provides an incentive for employees to pursue the goals and interests of the company and enables them to share in its success. It also allows institutions a degree of cost flexibility. Provided the interests of the company owners are taken into account and there is no inducement to assume inappropriate risks, variable remuneration can benefit all stakeholders of an institution.

However, FINMA expects remuneration systems to place an emphasis on sustainable business conduct. It views variable remuneration as the employees' stake in the success of the company and requires that all variable remuneration paid out must actually have been earned by the company over the long term. By contrast, variable remuneration is not paid if a company does not perform well.

FINMA defines success based on economic profit. In contrast to an accounting assessment, economic profit considers a company's full cost of capital, and thus also the risk cost to investors/shareholders. As a result, a company only creates value added if an excess remains after deducting the full risk-adjusted cost of capital. The larger an institution's risk, the smaller this excess. This concept does not directly limit the amount of variable remuneration. However, it prevents high variable remuneration being paid when large risks are entered into.

When setting variable remuneration, institutions must take into account the long-term trend in economic profit. This prevents disproportionately inflated variable remuneration being paid during boom phases; however, it also enables companies to limit variable remuneration during brief downturns in business. Both encourage companies to look at the long-term picture. The more sustainable a company's positive performance, the more employees can benefit from variable remuneration.

### **Long-term-oriented award criteria**

FINMA requires that the criteria used to award variable remuneration are not based on the short-term performance of individual company units and employees. This is to prevent employees pursuing targets that have little to do with the long-term success of the company or that do not take into account the risks entered into. FINMA does not consider targets such as turnover, net new money, sales volumes or profits for a given period to be suitable as the sole criteria for awarding variable remuneration.

Nowadays, remuneration packages at many financial institutions include a deferred remuneration component. Examples of this include restricted shares or options. FINMA also encourages "clawback" and "malus" provisions, as they allow for a withdrawal of variable compensation upon negative events. Furthermore, individual clawbacks can be more directly linked to risks in an employee's area of responsibility..

Employees can access deferred compensation only after the holding period has expired. By deferring payment, remuneration can be subject to a risk even after it has been awarded. The duration of the holding period is based on the time horizon of the risks and must be at least three years. Both employees at higher hierarchy levels receiving comparatively large overall remuneration packages and employees that can pose significant risks should receive a deferred remuneration component.

Deferred remuneration components must be subject to fluctuations in value during the holding period so as to further increase risk awareness and the incentive for sustainable business. Employees benefit from their company performing well, for example, if the company'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. A key factor is striking the correct balance between

the company's success, risks and the value of the deferred remuneration component, in addition to ensuring that employees are appropriately impacted by the company's performance, whether negative or positive. If the company performs negatively, deferred remuneration should make up the majority of the variable remuneration, as it is linked to the company's success and only increases in value once the economic situation of the company has improved.

## **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 regulation for all areas. However, FINMA is aware that market mechanisms have not functioned properly in recent years. This may have contributed to the significant rise in remuneration levels in recent years. As a result, FINMA is to increase market discipline by introducing new transparency and reporting obligations.

However, FINMA does not intend to insist that individuals' names be disclosed with the remuneration received; indeed, there would be no legal basis for such a requirement. Instead, financial institutions are to be required to disclose their remuneration policies to the market in a remuneration report. Third parties, such as shareholders and analysts, should be able to assess the structure of the remuneration system, allowing them to compare the variable remuneration with the performance of the company. The proposed provisions with regard to transparency go beyond specific initiatives on an international level and the current requirements under Swiss law. While the current company and stock market disclosure legislation only requires disclosure of the remuneration received by senior management, FINMA is calling for summary disclosure of the remuneration structure for all employees.

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

In regulating remuneration systems, 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 had tended to favour the latter, meaning that nowadays variable remuneration 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 framework of Swiss employment law makes it difficult to defer variable remuneration in line with circumstances, or to reduce it as a result of economic conditions. In this instance, legislators must amend employment legislation in line with the current conditions, thus taking into account the nature of variable remuneration and the interests of employers and employees in a balanced manner.

There is a similar problem with regard to tax legislation. The deferred remuneration components being promoted by FINMA and which are prevalent across the sector must in some cases be taxed before employees can have access to them. As a large proportion of remuneration for employees in upper hierarchy levels is paid on a deferred basis, these employees may face a large tax bill in excess of the remuneration they receive in cash. Furthermore, in certain circumstances the employee may be taxed on income that he or she may never receive as a result of the deferred remuneration falling in value before the end of the holding period. In this respect, it should be considered whether it would be sensible to defer the tax burden on the deferred remuneration component until the employee has access to the remuneration without any restrictions.

### **Keeping competition balanced**

Remuneration regulation initiatives abroad mostly address large banking institutions. FINMA however believes that remuneration systems should not only be regulated for systemically relevant firms. The increasing complexity of risks is placing the same strain on the risk management and risk control functions in all financial institutions. To ensure a level competitive playing field within Switzerland in this respect, the Circular should apply equally to all financial institutions. The Circular is not intended to distort competition within the Swiss financial market in any way.

The market for highly qualified specialists for certain key positions has a global dimension. Companies have to fight hard to recruit and retain such employees, part of which often revolves around the remuneration offered. Every additional regulation governing remuneration places yet another competitive limitation on financial institutions. If one company has to comply with stricter regulations than its competitors, it will be disadvantaged in the competition for qualified staff and will be weaker over the medium term, not only with regard to the job market. FINMA is going further with its proposals than any other initiatives yet seen outside of Switzerland. However, it must consider the impact its remuneration regulations will have abroad; otherwise these regulations may result in only Swiss financial institutions being disadvantaged, which in turn would threaten the Swiss financial centre as a whole.

### **Public consultations to run until 14 August 2009**

FINMA has opened the public consultation phase and is inviting all supervised entities and other interested parties to submit suggestions to FINMA. **These suggestions must be received by 14 August 2009.** FINMA will continue with its international dialogue throughout the consultation phase. It plans to set out the definitive provisions in September 2009, with the Circular entering into force as of 1 January 2010. This will give financial institutions a transitional period during which they can bring their remuneration systems into line with the new requirements. FINMA expects the remuneration systems of all financial institutions concerned to comply with the principles set out in the Circular from 1 January 2011 onwards.