COMPENSATION REFORM IN WHOLESALE BANKING 2011: ASSESSING THREE YEARS OF PROGRESS

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IIF
INSTITUTE OF INTERNATIONAL FINANCE

OLIVER WYMAN

FOREWORD

On behalf of the Board of Directors of the Institute of International Finance (IIF) and the IIF's Steering Committee on Implementation, we are pleased to present *Compensation Reform in Wholesale Banking 2011: Assessing Three Years of Progress.*

Compensation practices in the banking industry have come a long way since the Institute first issued its seven Principles of Conduct in the July 2008 *Final Report of the Committee on Market Best Practices*. The results of our third annual survey of compensation structures in wholesale banking, conducted by the management consultancy firm of Oliver Wyman, show that the industry has made significant progress on the core requirements of the Financial Stability Board (FSB) by putting in place effective risk-aligned compensation structures including deferral, clawbacks and enhanced governance systems.

This report provides the industry, regulators and the public with an overview of steps taken by the industry in applying the FSB's Principles and *Implementation Standards* and in establishing risk-aligned compensation systems. The report identifies areas where there has been significant progress such as embedding the use of risk metrics, using deferrals and clawbacks, and strengthening governance systems. The survey also indicates areas where further work is needed such as on disclosure, further risk data refinement and stress testing. Finally, the report highlights key industry and public sector challenges to the consistent interpretation and application of compensation principles across jurisdictions and various segments of the market.

The Institute is grateful for the participation of the 51 member firms who contributed to the survey and the individual supplementary interviews that form the backbone of this report. Special thanks go to the project team at Oliver Wyman for their expertise and dedication and to the IIF Working Group on Compensation for reviewing drafts and for providing valuable feedback. We hope that this report will serve as a useful aid in support of the industry's constructive engagement with the public sector, informing discussions with regulators and, more broadly, in the public arena.

We believe that continued progress in the reform of compensation systems, in the broader context of strengthened industry practices, remains a priority for the industry in the period ahead. Given the results of our survey, a period of consolidation may now be required to allow individual firms to address specific technical issues related to the more granular implementation of standards as firms align their practices more closely with FSB and national standards. The Institute will continue to promote the improvement of compensation practices as part of its broader mission to advance sound industry practices in risk management and governance across the financial system.

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1. CONTEXT FOR THE REPORT

This report presents the results of the 2011 joint Institute of International Finance (IIF) and Oliver Wyman survey on compensation in wholesale banking, conducted in April-July 2011. As the third IIF compensation survey since the financial crisis, this work continues to track progress in implementing global compensation standards based on answers from 51 leading financial institutions including both standalone wholesale banks and wholesale divisions of larger banking groups. This year's survey saw increased levels of participation from Banks across all regions. Survey respondents include representatives from all geographic regions[1] and combined, account for over 70% of the global wholesale banking revenue pool:

- Asia Pacific: 7
- Europe: 26
- Middle-East and Africa: 4
- Americas: 14
- **Total: 51**

Compensation schemes in banking have been the subject of numerous debates in the last few years. It is now two years since the FSB implementation standards were released. This exercise benchmarks progress to the FSB standards however, firms are also responding to two other factors in addressing the topic of compensation

- Banks are responding to extensive national guidance on compensation. These national guidelines are generally consistent with the FSB Principles, although they differ in the interpretation of these Principles into specific supervisory guidelines.
- Compensation reforms are taking place in the context of broader industry efforts in the wake of the financial crisis to improve overall governance and risk management standards

It should be noted that the findings of this report are consistent with recent publications by both the FSB and the Federal Reserve. The intention of this report is not to repeat the core outlines of the FSB Principles or to reiterate areas of progress observed in previous years. The results of previous reports can be obtained on request. Instead, this report will focus on three main areas of change from previous years' results:

1. Key areas of industry progress
2. Key areas of focus for further work
3. Forward-looking implications for regulators and the industry as a whole

1 Geographic split based on the locations of respondent institutions' headquarters

2. EXECUTIVE SUMMARY

2.1. GENERAL STATE OF THE INDUSTRY: DEVELOPING RISK-ALIGNED COMPENSATION SYSTEMS

Since the onset of the crisis, the wholesale banking industry has been undergoing an intensive review of market practices across all areas of activity, including compensation. In this connection, compensation reform has sought to develop a more robust, **risk-aligned system of compensation that would guard against imprudent risk taking and therefore contribute to financial stability.** The Principles of Conduct on Compensation published by the IIF in July 2008 represented an early industry effort to address the shortcomings of prevailing compensation practices at the time by linking compensation to risk adjusted performance and by relating it to overall performance of the firm. The Financial Stability Board's (FSB) Principles on Compensation issued in April 2009 set out global benchmarks intended **to make both the overall financial system and the individual firms within it more stable.**

Significant industry progress in terms of FSB Principles and Implementation Standards has been made since the last IIF Compensation Survey report in September 2010. This is the result of continued considerable efforts by the industry. Survey results indicate that **the trajectory of change is positive across the compensation agenda** and that the wholesale banking industry is now focusing on practical implementation of the FSB's Principles for Sound Compensation. However, as compensation reform has been implemented, **some unintended consequences** have started to emerge which merit the attention of both regulators and management of wholesale banks.

2.2. A YEAR OF SIGNIFICANT INDUSTRY PROGRESS; SOME CHALLENGES REMAIN

Survey respondents are well into the process of implementing substantial changes to their compensation models and it is now possible to observe areas where the industry can consider that most of the improvements that align compensation practices with FSB standards are in place. Notable areas of significant progress include

- Improved use of risk adjusted metrics and the involvement and compensation of the Risk Function. **Profit after risk charges is the primary metric used for bonus pool setting at 75% of respondents** and the involvement of the Risk Management function in compensation setting has increased. This also aligns with the

findings of the IIF report 'Making strides in financial services risk management' (April 2011).

- Changes to payout structures to provide further alignment between risk takers' incentives and the banks' risk profile. Deferred compensation structures are in place across the survey respondents and **91% of respondents have vesting periods of 3 years or longer for deferred compensation.**
- **Strengthening of core governance practices with an increased emphasis on risk alignment** – the role, composition and activities of remuneration committees and their links to risk governance have been significantly restructured since the crisis.
- Developments in the application of guarantees – the usage of **multi-year guarantees is now negligible.**

In addition to these changes, we note **a gradual shift in culture** and a move to employee engagement on compensation reform. When asked to identify the main obstacles to industry alignment with the FSB Principles and Implementation Standards only 5% of respondents cited "*resistance to change among business heads.*" Such resistance was found to be common in the IIF's first survey in 2009. Better understanding and appreciation of compensation reform are increasing at senior levels and banks are now focused on ensuring that such understanding is transmitted throughout the organization – 'employee

EXHIBIT 1: OVERVIEW OF PROGRESS VS. FSB IMPLEMENTATION STANDARDS

	Key FSB principles (April 2009)	Implementation standards (released Sep 2009)	Survey findings
GOVERNANCE	• Active Board involvement • Involvement of the Risk function • Control functions independence	• Remuneration Committee (RemCo) should involve majority non executives and work closely with the Risk Committee • Remuneration for control staff should be adequate and independent	• Continued governance developments – core FSB standards in place • Improved engagement and independence of Risk
BONUS POOL CALCULATION AND FUNDING	• Risk adjustment of remuneration • Link to Group performance • Implications for capital position	• Risk adjustments should reflect the cost and quantity of capital consumption as well as the liquidity risk • A firm's financial performance should be reflected in bonus pool sizing • Capital build up to take priority over remuneration payouts – regulators to limit bonus payouts when it hinders build out of a sound capital base	• Strong progress in adoption of key risk metrics • Ongoing work required to develop and apply these metrics further (capital a key area being developed at many banks)
DETERMINATION OF INDIVIDUAL REMUNERATION	• Risk adjustments in bonus allocation • Accountability in performance measurement	*No new guidance in Sep 2009; previous guidance includes* • Thorough measurement /stress testing of risk positions • Effective approach to capital allocation for the risk exposure • Reliance on expert judgement to reflect opaque risks	• As above - challenge in drilling down risk metrics • Room for improvements in stress testing
PAYOUT STRUCTURES AND SCHEDULES	• Link to BU/individual performance • Sensitivity of payouts to risk time horizon of the business and future performance • Use of non-cash instruments • No use of unconditional multi-year guaranteed bonuses	*Specific guidelines introduced to level the playing field globally* • Mandatory use of payout conditions (e.g. malus / clawbacks) • 40-60% of bonus should be deferred; >60% for the senior-most management (% increasing with level of pay/seniority) • At least 3 years deferral period; should be higher for businesses with a higher risk holding period • >50% of bonus to be awarded in non-cash instruments; stock based instruments subject to appropriate vesting policy	• Basic payout structures / conditions in place (e.g. deferrals, vesting periods, non-cash rewards) • Good progress on guarantees (e.g. multi-year guarantees negligible) • Challenges in practical application of clawbacks
DISCLOSURE	• Disclosure requirements	• RemCo should submit a remuneration review to regulators / public annually. Internal / external review if appropriate) • Detailed description of remuneration framework and quantitative impact of current / deferred remuneration	• Improved disclosure to regulators vs. 2009 • Range of approaches to public disclosure

Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

buy-in to new compensation structures' was identified as the 4th most important implementation challenge in this year's survey (up from 9th place last year).

The focus of regulators and financial firms has been on *structural changes* to compensation and in spite of the political and reputational pressures faced by the industry, **the purpose of reforms has not been to set compensation levels.** This would de-link compensation from risk alignment and would therefore not contribute to the core stability objective. The debate around compensation levels continues but is not the focus of this report. Indeed the focus of the debate on levels might divert attention from effectively completing the valuable work undertaken by regulators and the industry on compensation structures.

Even with all the progress that has been made, reform of compensation structures is a process that needs to adapt to changing conditions in the regulatory and market environment as well as to changes in the firms' own business models. The principles and objectives guiding this effort, however, remain broadly valid throughout this process.

As expected, several challenges are still being addressed and compensation **reform remains on the agenda as 54% of respondents plan to continue to improve their variable compensation structures over the next 12 months.** Banks may now have completed core changes such as increasing the frequency of remuneration committee meetings and applying risk adjustment to profit measures, but they are still working on changes that are technically and organizationally more difficult to implement. Key areas for further work include

- The **need for continued efforts on risk data and stress testing.** Data challenges are an ongoing area of work for all banks and the survey highlighted that the majority of respondents are continuing work on the accuracy of their data.
- **Technical issues related to new measures such as bonus-malus and "clawback" clauses**. These features are now in place but many banks note that they need to address some remaining practical issues over the application of performance based bonus-malus and "deferral at risk/ clawback" clauses.
- The treatment of material risk takers (MRTs). Institutions are complying with the requirement to identify MRTs and tailor their compensation approaches to these individuals. However, **a wide range of approaches can be observed in the identification and treatment of MRTs** making it difficult to make meaningful comparisons across banks.

Managing disclosure was identified as a challenge in previous years. **90% of survey respondents now disclose core items to regulators in line with FSB standards.** In addition, steps have been taken at a number of institutions to engage with the public and improve the qualitative explanations of compensation approaches (without disclosing confidential data). **However, a broader debate remains over public disclosure.** It is appropriate that each institution should take a strategic view on how much information they wish to disclose publicly given their business model and the long term interest of their shareholders.

2.3. THE WIDER IMPLICATIONS OF REFORM – FOR THE INDUSTRY AND FOR REGULATORS

As reforms take hold, banks and regulators can now begin to take stock of the impact of compensation reform and start to assess if all elements of compensation regulation are achieving their desired results.

As is noted throughout this report, **significant progress has been made in line with the key objectives of the FSB Principles.** The end goal

of these reforms is to **contribute to financial stability by instituting incentive systems designed to minimize imprudent risk taking through risk alignment, phasing of payouts and better accountability.** The efforts noted above on governance, payout structures and risk management align directly with these goals.

However, **it is still too early to come to a final assessment of what the broader overall result of compensation regulation on the industry will be – in terms of both intended and unintended consequences.** Some side effects can already be noted – driven in part by compensation reforms but also by broader industry restructuring post-crisis. For example, although recourse to multi-year bonus guarantees, which are inconsistent with the FSB principles, is now negligible, the increased intensity of competition for talent has led to a rise in the usage of single-year bonus guarantees to new hires. The survey also highlights the increase in fixed salaries as a percentage of total compensation across both the Front Office and the Risk Function. This development could have the effect of potentially reducing the flexibility of compensation pools, reducing the alignment with performance and increasing the fixed cost base of wholesale banking activities.

As firms continue their reform efforts, many survey respondents voiced concerns about the different ways in which these global principles are being implemented in local jurisdictions. This report does not seek to propose a global 'one-size-fits-all' approach to the details of compensation reform. National regulations and supervisory approaches, while consistent with the FSB Principles, may differ in line with the varying legal, cultural and market environments. Survey respondents highlighted the following two challenges they feel they face in the implementation process:

1. Lack of regulatory consistency across or within jurisdictions in the implementation of specific standards (94% of respondents)
2. First-mover disadvantages to changes in compensation structure especially versus the non-bank sector (and potentially less advanced peers) (69% of respondents)

When probed further, respondents from all regions identified further related concerns that regulators could and should seek to address. For example, the application of regulations within (as well as across) regions (e.g. the EU) and the appropriate balance between prescriptive and supervisory regulatory approaches.

In summary, the 2010 compensation cycle has been a year of notable progress on the core compensation principles laid down by the FSB and the results of this survey indicate a step change for the industry from pre-crisis compensation approaches. However, looking forward, the boundaries of the debate are now shifting as banks grapple with the hardest elements of compensation reform and face practical/technical issues and inherent market challenges and fluctuations in the competition for talent.

Evidence of the impact of compensation reforms on the industry will become clearer as the industry progresses over the next few years. This will increase the pressure on bank management to assess the impact of compensation changes on their business models in terms of business area focus, cross-selling and cross-business synergies and overall culture. It will also increase the pressure on regulators to respond to bank concerns regarding regulatory clarifications and real life implementation issues.

3. BUILDING A RISK-ALIGNED SYSTEM OF COMPENSATION: KEY AREAS OF INDUSTRY PROGRESS

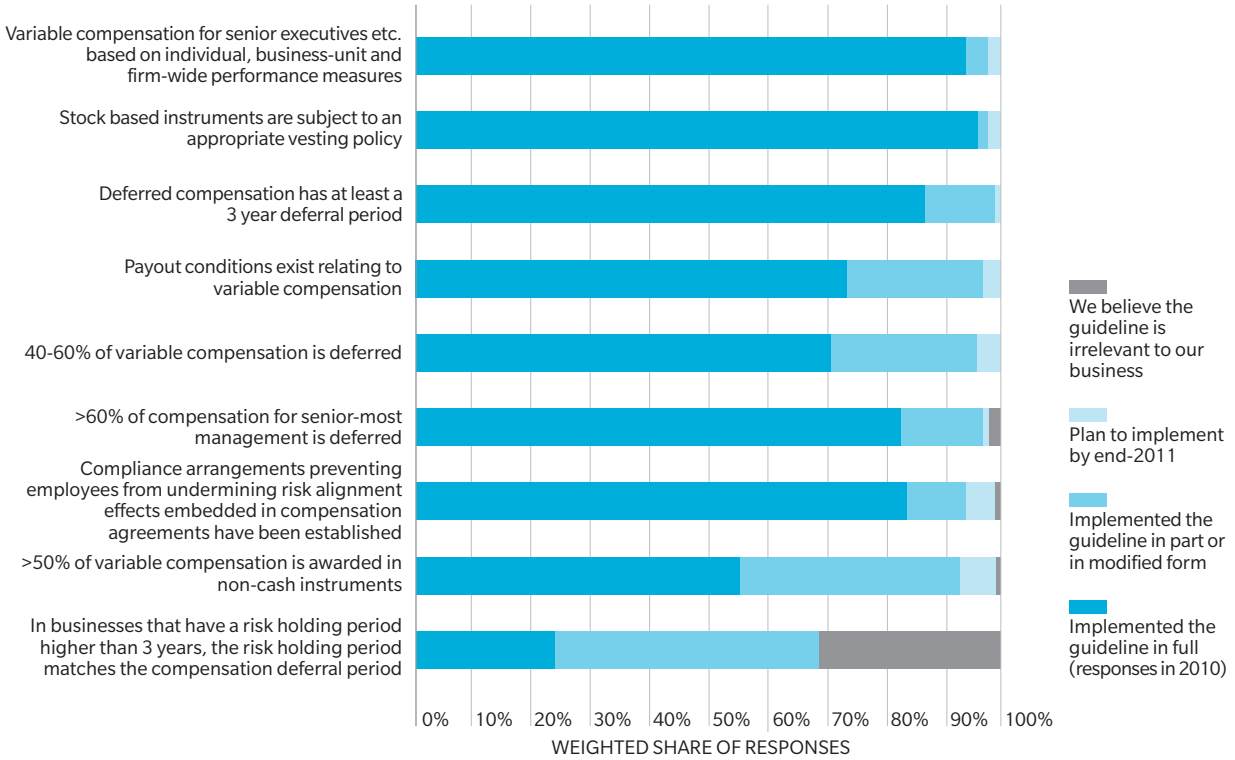
The survey shows that banks have made substantial changes in several key areas that contribute directly to the closer alignment of compensation with prudent risk-taking:

3.1. PAYOUT STRUCTURES

The adjustment of payout structures to align more closely with the risk time horizon of business performance has been a key focus of compensation regulation. This year's survey indicates that payout structures have now developed in line with FSB guidelines.

Firstly, the FSB Implementation Standards recommend that 40% to 60% of variable compensation for senior executives, material risk takers and high earners should be deferred over a number of years in line with the risk profile of the business. These measures have now been incorporated into virtually all national guidelines and the industry has been responding.

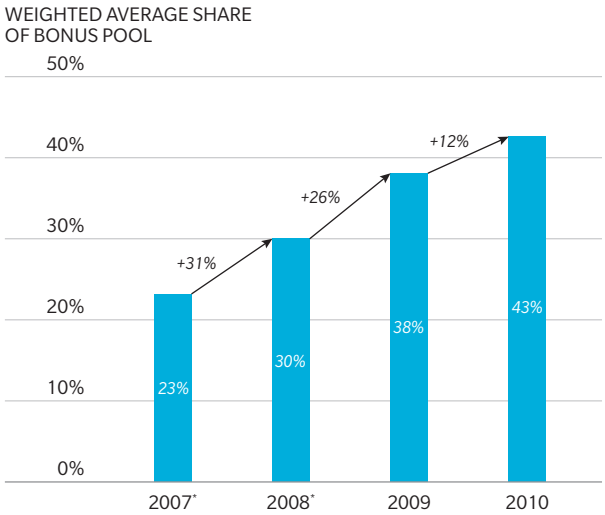
EXHIBIT 2: LEVELS OF ALIGNMENT WITH THE IMPLEMENTATION STANDARDS REGARDING PAYOUT STRUCTURES



Shows responses weighted by 2010 wholesale banking revenues.

Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

EXHIBIT 3: DEFERRED COMPENSATION AS A SHARE OF TOTAL WHOLESALE BONUS POOL



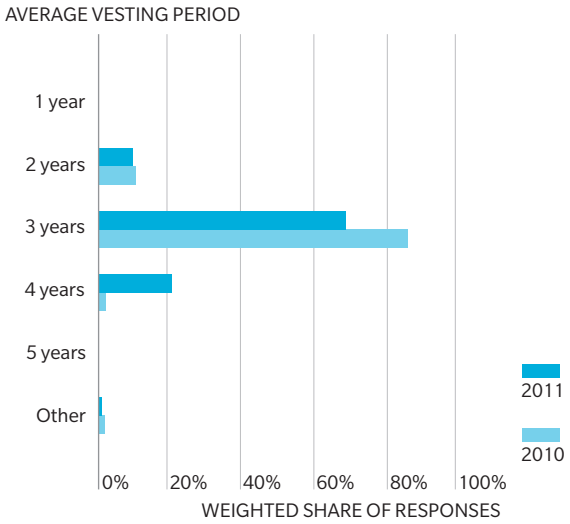
Shows responses weighted by 2009 (*) and 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2010 (*) and 2011 Compensation Survey

Responses on deferral rates suggest that average industry practices are in line with this requirement. On average, 43% of the total wholesale bonus pool was deferred in the 2010 compensation round. This is a significant change. The portion of payout deferred has almost doubled since 2007 and has increased almost five percent since last year. Moreover, this average ratio understates the rate of deferral for top earners. The average marginal deferral rates, i.e. deferral ratio for amount surpassing a threshold, for top earners are now clearly above 60%. According to the results from this year's survey the **average marginal deferral ratio is now 68%, a considerable increase from 45% in the 2008/09 survey.**

Secondly, the FSB Implementation Standards recommend that the deferral period should not be less than three years, provided that the period is correctly aligned with the risk time horizon of the business. **This requirement is now met by 90% of respondents that vest the deferred compensation for a period of 3 years or more.** A significant proportion of survey participants have increased the deferral period even further this year with almost 20% of respondents indicating vesting periods of up to 4 years.

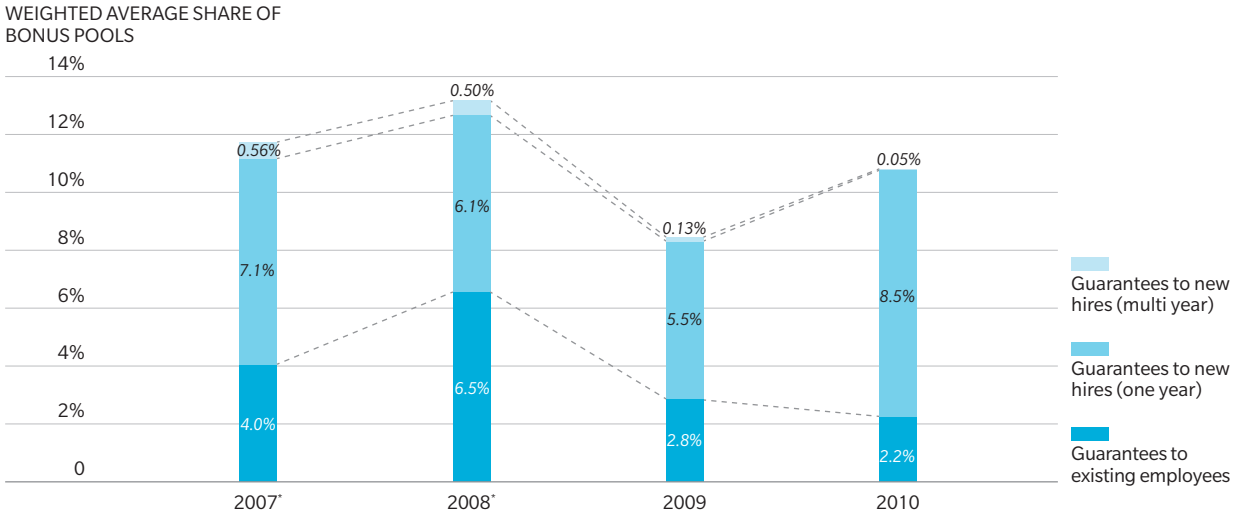
Thirdly, the FSB Implementation Standards propose that a substantial proportion (e.g. >50%) of variable compensation should be awarded in shares or share-linked instruments (or, where appropriate, other non-cash instruments), as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk. **The vast majority of banks (92%) indicate that they have implemented this guideline in full or in a modified form,** and most of the remaining banks plan to implement this by the end of 2011.

EXHIBIT 4: VESTING PERIODS FOR DEFERRED COMPENSATION



Shows responses weighted by 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

EXHIBIT 5: DEVELOPMENT OF BONUS GUARANTEES AS A PERCENTAGE OF THE TOTAL BONUS POOL



Shows responses weighted by 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

3.2. USE OF BONUS GUARANTEES

The industry has made considerable changes in the use of bonus guarantees since 2007. The clear regulatory priority has been the elimination of multi-year guarantees and guaranteed bonuses to existing staff on the basis that such guarantees are incompatible with the principle of the alignment of compensation with risk and performance. Significant progress continues to be seen on these issues.

Guaranteed bonuses are used in the marketplace as a mechanism to compensate employees who leave their employers to work for a competitor for the lost unvested pay. As such, they contribute to a more flexible market for talent, but multi-year bonus guarantees are not consistent with the pay-for-performance principle and therefore the FSB Implementation Standards recommend that minimum bonuses should only occur in the context of hiring new staff and be limited to the first year. Multi-year bonus guarantees and guarantees to existing employees are thus deemed detrimental to sound risk management practices.

In the additional commentary provided to supplement survey responses, many participants stressed their support of the principle that guarantees should be applied only in exceptional circumstances and specifically in relation to compensation for senior new hires forgoing remuneration at their previous employer as a result of their move.

Results of this year's survey show that multi-year guarantees have virtually disappeared. The share of multi-year bonuses to new hires in the average bonus pool decreased from 0.13% to 0.05% in the 2010 compensation round.

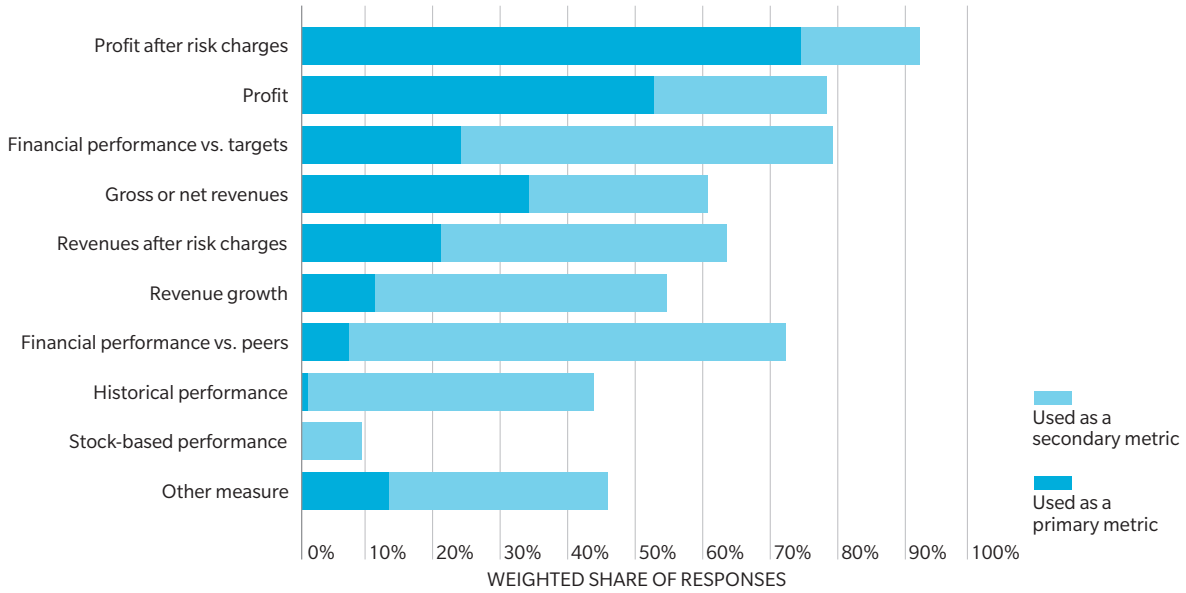
Bonus guarantees to existing employees are also becoming less frequent. According to the survey results, the share of bonus guarantees to existing employees in the average bonus pool decreased from 2.8% to 2.2% in the 2010 compensation round from the year before. Survey participants commented that guarantees to existing hires should only be granted under exceptional circumstances and should be subject to appropriate governance processes.

Although the use of one year bonus guarantees to new hires has increased in 2010, caution should be taken in reading too much into these data. Bank hiring patterns naturally fluctuate over time and many survey respondents explained that these one year guarantees were exceptional decisions in direct response to senior staff hiring pressures during 2010. As such, this is not necessarily an immediate topic of concern but it is an area that warrants ongoing monitoring to ensure that, as expected, it reflects a one-off response to market circumstances rather than a structural shift.

3.3. RISK DATA AND ENGAGEMENT WITH THE RISK FUNCTION

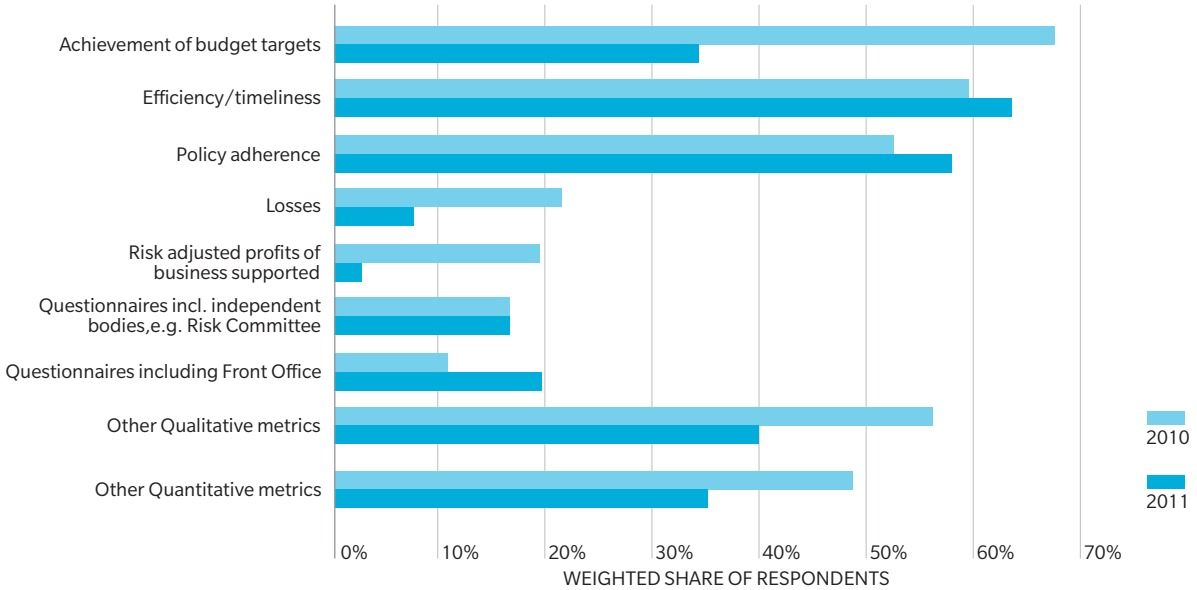
Data quality represents a continuous challenge. Banks have made good progress but continue to work on the underlying data and risk support function structures needed to underpin and deliver on compensation reform.

EXHIBIT 6: FINANCIAL METRICS USED TO DETERMINE THE SIZE OF THE WHOLESALE BANKING BONUS POOL



Shows responses weighted by 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

EXHIBIT 7: THE METRICS USED TO DETERMINE RISK FUNCTION COMPENSATION



Shows responses weighted by 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

3.3.1. RISK DATA

Progress has been made on the application of risk-adjusted data to compensation. Profit after risk charges is now the most important financial metric used to determine the size of the wholesale banking bonus pool and **82% of respondents have implemented the risk adjustments requested by the FSB Implementation Standards in full or modified form.**

While good progress has been made to get to basic risk adjustment metrics, risk data and measurement methodologies are a complex topic. Many banks have ongoing programmes of work underway to develop their capabilities and improve the granularity of their risk-adjusted data.

3.3.2. RISK FUNCTION COMPENSATION

Progress has also been made on reforming the compensation structures of the Risk function. To guarantee independence, remuneration for all control functions (Risk, legal compliance etc.) should be adequate and should be independent from the results of the business they support in order to guard against a distortion of incentives in relations with supported businesses. Prevailing good practices on Risk function remuneration are illustrated by one survey respondent's comment below:

> *"To maintain the independence of control functions [...] annual cash incentive compensation awards in these groups are based on overall [firm] performance as well as individual performance, and not on the performance of the [business] supported. Individual performance is primarily assessed against: i) execution of governance accountabilities, and ii) results against goals related to the control function and/or [firm] overall."*

The results from this year's survey show that in 2010 firms had in place a clear separation of the Risk function from the performance of the business units supported, with **only 3% of respondents using the risk-adjusted profits of supported business to calculate Risk Management staff compensation**. This compares with 19% in 2009 and represents a considerable step towards more independent Risk function remuneration. The results also show an increased use of qualitative assessment in the calculation of the Risk bonus pool.

This year's survey results show that the average ratio of incentive compensation to base salaries for Risk function employees decreased in the 2010 performance period (in line with a general shift from incentive compensation to higher base salaries). The median ratio of incentive compensation in 2009 and 2010 was about 30% and only ~5% of participants responded that they did not use any incentive compensation in Risk function remuneration.

EXHIBIT 8: LINKAGE OF RISK MANAGEMENT FUNCTION COMPENSATION TO BUSINESS PERFORMANCE METRICS

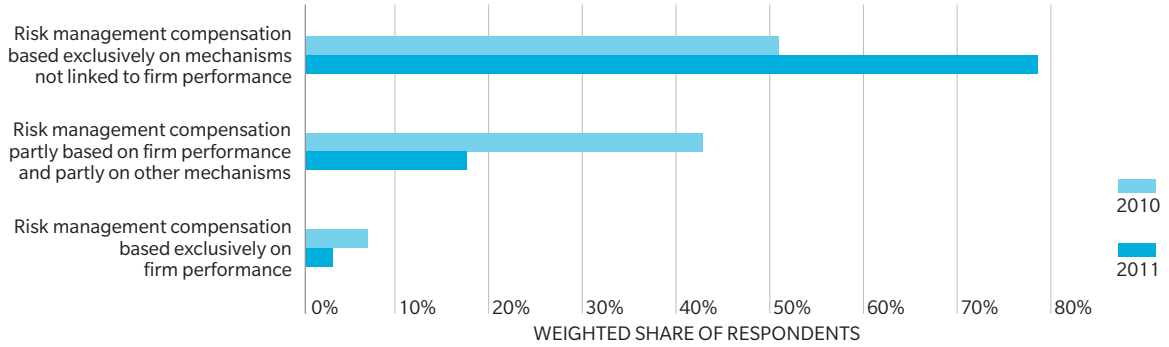
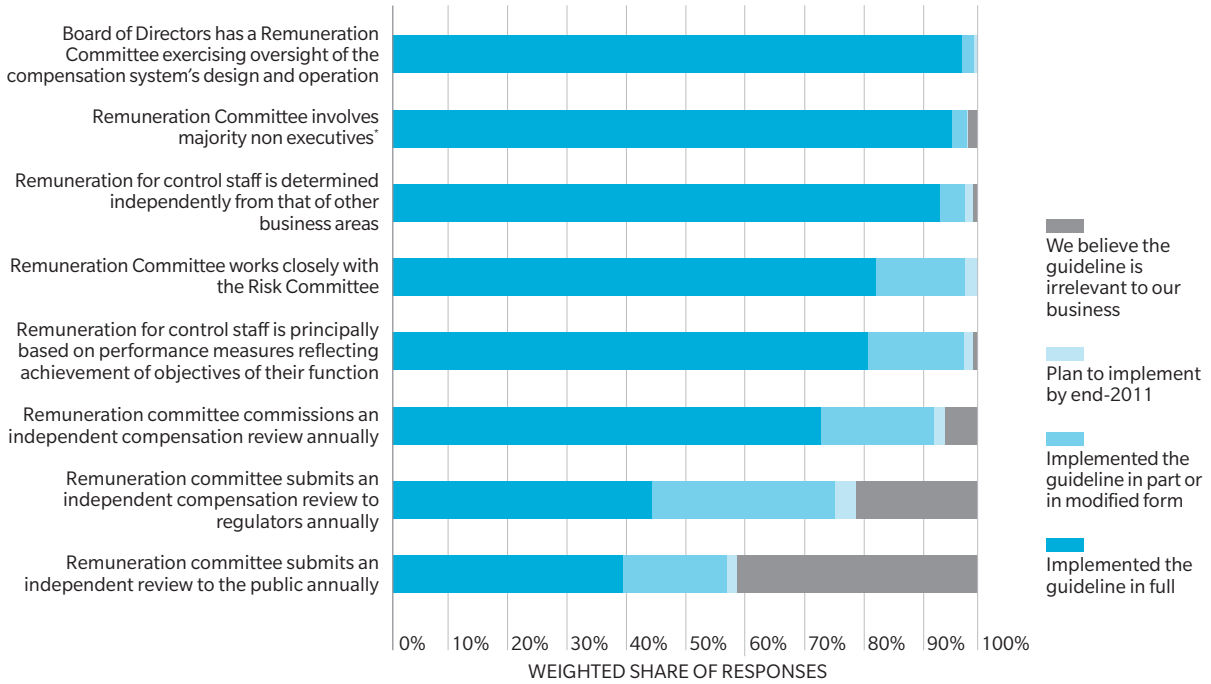


EXHIBIT 9: LEVELS OF ALIGNMENT WITH THE FSB IMPLEMENTATION STANDARDS REGARDING COMPENSATION GOVERNANCE

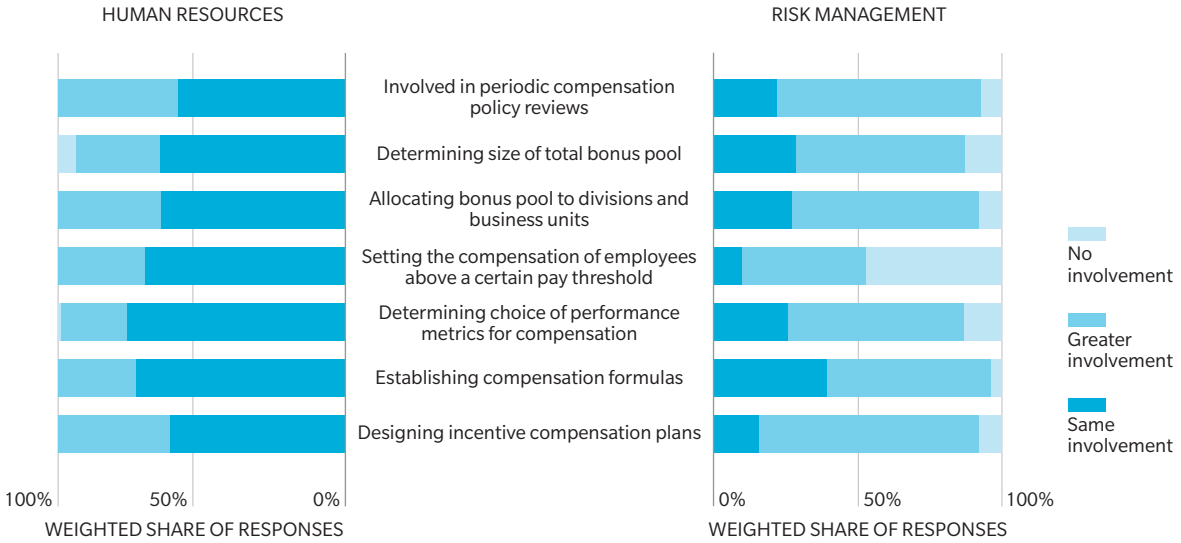


Shows responses weighted by 2010 wholesale banking revenues (both Exhibits 8 and 9).

*Including supervisory board of two-tier board structures

Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

EXHIBIT 10: INVOLVEMENT OF THE HUMAN RESOURCES AND RISK MANAGEMENT FUNCTIONS IN COMPENSATION DECISION MAKING



Shows responses weighted by 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

3.4. GOVERNANCE AND THE INVOLVEMENT OF BOARDS AND RISK STAKEHOLDERS

Effective governance structures are an essential supporting factor in building a risk-aligned compensation model. This year's survey continues to build on the positive governance messages observed in last year's results. Survey responses indicate significant involvement of management stakeholders in the compensation decision making process; 100% of respondents indicate there is involvement in compensation from the following key management stakeholder groups: the board-level remuneration committee, divisional management, human resources and finance.

Involvement of the Risk Management Function has been an area of focus since the financial crisis. The results of the 2008/09 survey showed that involvement of the Risk Management in compensation decision making was not common industry practice. Since then however, engagement with Risk has been a major area of compensation reform and the results from this year's survey show a **significant increase in the Risk Management function's involvement rate from 46% in 2009 to 98% this year.**

The quality of interaction with Risk Management on compensation has also improved and deepened, with 60% of respondents indicating higher levels of Risk function involvement across the compensation process. The nature of this increased participation from the Risk function over the past 18 months varies across participants and includes, for example, increased involvement in remuneration committees, quantitative and qualitative performance assessment, and a greater say in the design of compensation structures. This is significant progress from pre-crisis involvement and we can now conclude that the risk management function's role in the compensation decision process in most institutions is well established.

EXHIBIT 11: EXAMPLES OF INCREASING RISK ENGAGEMENT IN COMPENSATION GOVERNANCE

"The Remuneration Policy is now incorporated within the Risk Management Framework. [...]; The assessment of all incentive plans by Risk has been strengthened; Performance assessment and remuneration outcomes for Risk control personnel are determined independently from the business which they support"

"CRO is member of the Incentive Committee and takes part in all the decisions. [Risk] is also involved in the definition of the risk takers positions for the design of a deferral compensation policy for these positions.

"Greater involvement of the CRO who attends both Risk Committee and also the Remuneration Committee. In addition, the establishment of the risk appetite framework as one of the inputs to the pay review process."

"[Risk] is now tasked with developing and introducing risk based performance measures into the bank e.g. RAROC"

"[Remuneration] Committee involves the [Risk Committee], as well as the CFO and CRO, in assessing the financial performance of [the company and business units/lines]. This assessment includes the sustainability of earnings, performance against risk appetite goals, client and employee metrics, and any control, compliance or audit concerns that should affect funding."

"[...] Over the past 18 months Risk has had a larger input into ex-ante bonus pool adjustments, ensuring performance measures are risk-adjusted and providing a risk perspective on divisional performance."

"In 2010, remuneration risk evaluation committee was formalized as the body that evaluates the quality of results, incurred risks and compliance. This committee participated in 2010 bonus process for the first time."

4. KEY AREAS FOR ONGOING WORK

In addition to the progress made in the areas listed above, several priorities have been identified where the industry needs to continue to focus its efforts going forward:

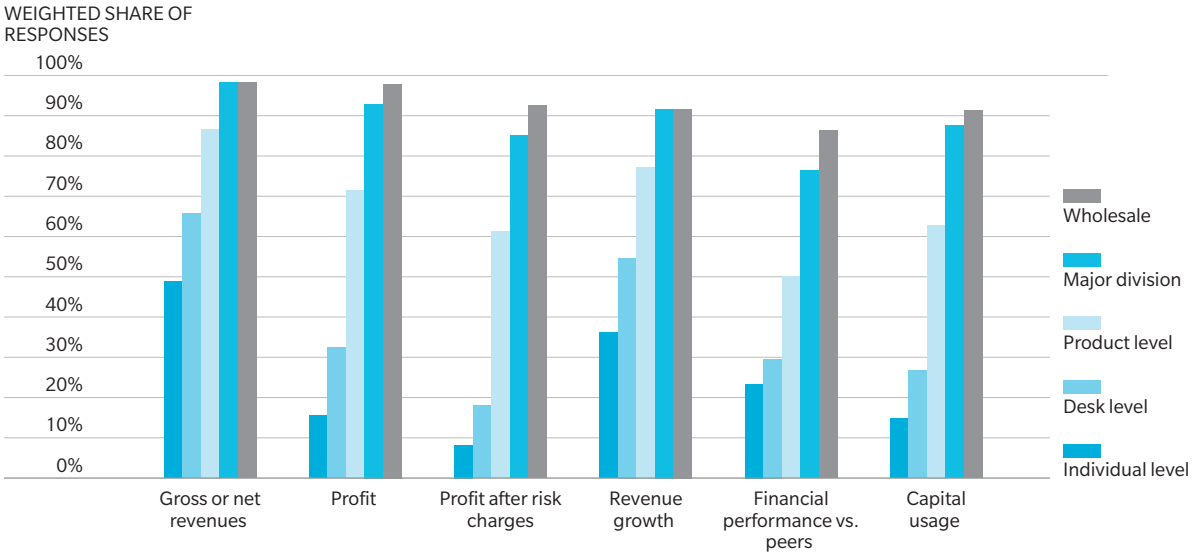
4.1. DEVELOPMENT OF RISK DATA

As noted above, overall survey responses demonstrate that clear progress has been made in the use of risk adjustments in the compensation decision making process. Nevertheless, survey respondents do recognize the continued need for further work on risk data and are continuing to develop their metrics and methodologies.

Risk adjustments are currently commonplace only at the highest organizational levels. The results from this year's survey indicate that 93% of respondents are able to calculate profit after risk charges at the wholesale bank level, but 39% of survey respondents are not yet able to reliably calculate risk-adjusted profits at the more granular level of the product.

As with last year's survey, the measurement and incorporation of risk into the compensation process at all required levels remains the second largest implementation challenge identified by respondents, preceded only by the alignment of deferrals with multi-year risk time horizon by business. Overall, survey responses demonstrate that further work needs to done on metrics and methodologies and survey respondents recognize this. Many banks commented in their responses that they

EXHIBIT 12: GRANULARITY OF DATA AVAILABILITY FOR DIFFERENT PERFORMANCE METRICS



Shows responses weighted by 2010 wholesale banking revenues.

Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

EXHIBIT 13: EXAMPLES OF AREAS WHERE SURVEY RESPONDENTS PLAN FURTHER WORK ON RISK METRICS

"Current FTP model being revised in next 12 months"

*"**Direct costs and cost allocation:** Working on enhancements to: (i) improve transparency; (ii) ensure alignment of allocations with business drivers / performance; **Capital usage:** Working on enhancements to better understand the business drivers that impact capital usage levels to ensure appropriate utilization (and allocation) of capital; **Technology:** Metrics / methodologies are in place in the most relevant situations"*

"Product Level capital usage; Capture and segregate by geographies, as well as existing approach by product line [for past book of business]; Performance Adjusted Factors [for franchise value]; Triangulation using Gauge Financials [for support/tech]"

"Work done to ensure FTP treatment meets characteristics of products; direct costs recorded at lowest level; indirect costs allocated to drivers of costs; Capital aligned to assets driving capital and recorded at lowest level."

"Allocation of funding costs; attribution of direct personnel and operating costs; attribution of direct personnel and operating costs and directly attributable indirect costs; additional allocation via keys or quantities; via direct attribution of RWA."

"Franchise value is taken into consideration as one of the components in determining performance for the business, however, it is not a formulated input in sizing up the bonus pool."

"The Group currently uses a qualitative approach to adjusting for risk. The Group is looking to move to an Economic Capital measure in future."

have work already underway on improving their data. For example, capital usage is highlighted as a particularly active field of work with 47% of respondents indicating that further development is planned in this area.

4.2. MULTI-YEAR PERFORMANCE DATA

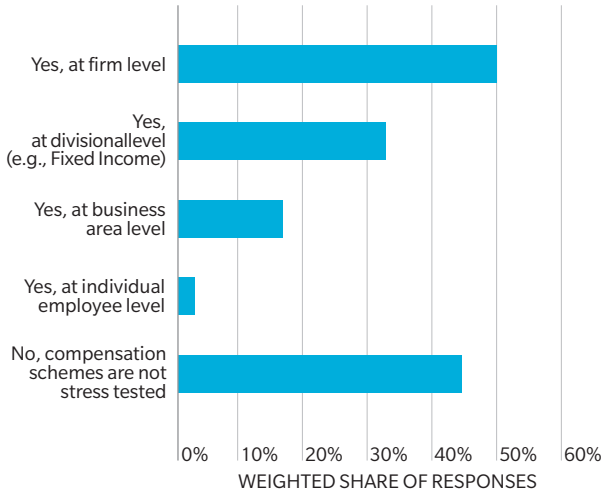
Responses to this year's survey indicate that 34% of respondents use multi-year performance to determine the bonus pool size. At-risk deferrals and clawback clauses already introduce a multi-year element to compensation models. The use of multi-year performance metrics therefore provides a potential additional method of improving alignment between the risk horizon of the business and the timeline of compensation. The use of multi-year performance assessment periods is encouraged in order to ensure that the assessment is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle.

4.3. STRESS TESTING

This year's survey assessed the status of compensation stress testing within respondent banks for the first time. Stress testing of compensation structures and bonus pools is not part of the FSB Principles but some institutions do find it valuable as a management tool in that it allows senior management to test the linkage between compensation pools and performance under extreme macro-economic or performance downturn conditions.

Stress testing of compensation schemes should be viewed as a longer term development target rather than a regulatory concern and approaches to stress testing vary with most institutions focusing on basic testing of linkages between compensation and overall financial performance and / or employee behaviours. This year's survey found that 45% of respondents do not yet conduct any stress tests on their compensation schemes. Where firms do conduct stress tests, this is done predominantly at a firm level to evaluate the outcomes of different performance scenarios, or, in the case of some respondents, to evaluate different attrition rates and test new compensation instruments.

EXHIBIT 14: PERCENTAGE OF SURVEY RESPONDENTS WHERE COMPENSATION SCHEMES ARE STRESS TESTED UNDER DIFFERENT PERFORMANCE SCENARIOS



The alignment of pay with risk and performance is a key component of the FSB principles and stress testing offers banks a valuable practical tool in this regard. It allows bank management to test how variations in performance can or should impact compensation. It also equips management with quantified scenarios for management action in case of underperformance. As such, the survey results indicate that many wholesale banks could benefit from further development of stress tests and scenario analysis for their compensation schemes.

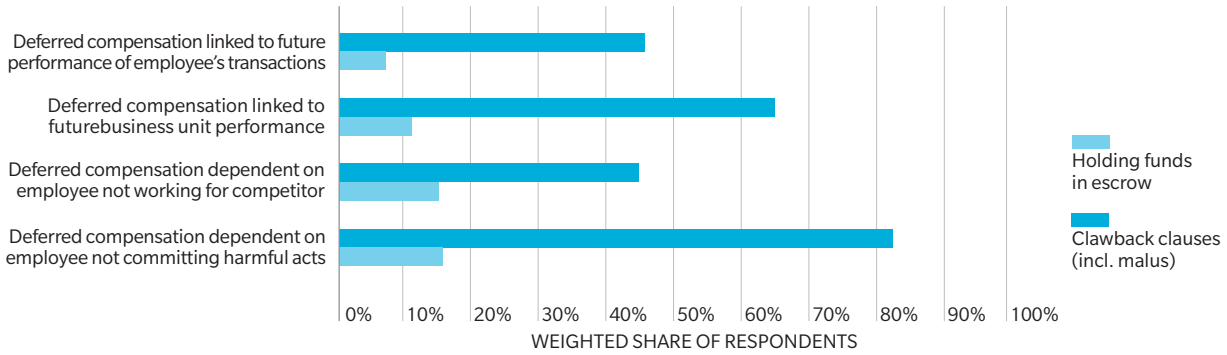
4.4. PLACING DEFERRALS AT RISK

Deferred payments align the risk profiles of employees only when the deferred compensation is placed at-risk on the basis of future performance, and subject to bonus-malus or clawback clauses. These tools offer ways to strengthen the linkages between the risk time horizon of the business and the timeline for deferred payouts of compensation, i.e.

- At-risk deferral allows firms to link deferred compensation to future performance; deferred compensation is held at risk and may be decreased depending upon risk behaviours (e.g. rule breaking) and risk-based outcomes (future losses).
- Clawbacks allow already vested compensation to be reclaimed, usually based on gross negligence or other malfeasance.
- Bonus-malus allows deferred compensation to decrease/increase in value based on future performance. Typically applied to unvested awards.

There may be practical difficulties associated with the application of these tools. Performance-linked deferrals are cumbersome to introduce and their introduction has been rated as the third greatest

EXHIBIT 15: USAGE OF CLAWBACK/MALUS CLAUSES



Shows responses weighted by 2010 wholesale banking revenues.

Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

"Deferred remuneration may be reduced or eliminated having regard to any adverse ourcomes that have arisen to protect the financial soundness of [the company]. Deferred rumenation will be forfeited upon resignation/termination."

"The Group's deferral instruments have both an implicit and explicit performance adjustment which, when taken together, provide incentives for employees to align their behavior to the perfomance of both their division and the Group as a whole."

"[If] an employee leaves the organization, deferred compensation may be forfeited in the event that they work for a key competitor..."

"Conditions relate primarily to Groupe-wide performance, however malus [...] provisions could be triggered at the level of major business unit [...] or division."

implementation challenge to compensation reform for the second consecutive year[1].

The survey results above indicate that performance-related clauses are often used on unvested deferred compensation but they are not yet pervasive; 65% of respondents have clauses linked to employee's or company's future performance while more than 80% have clauses dependent on employees not committing harmful acts.

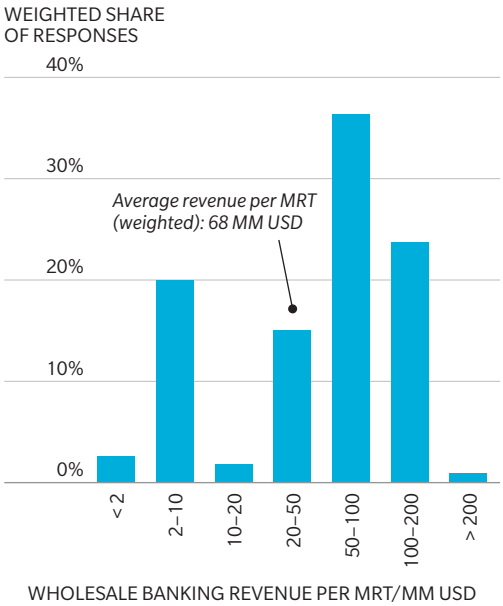
1 The top two practical implementation challenges identified by survey participants also remain the same as last year i.e.
   1. Measurement and incorporation of risk in the compensation process
   2. Alignment of deferrals with risk time horizon by business/roles

4.5. TREATMENT OF MATERIAL RISK TAKERS

As a more recent regulatory development, different regulators have started to advocate special treatment for employees whose professional actions can have a material effect on the bank's risk exposure, or material risk takers (MRTs) as they have come to be known. This year's survey included a question to assess the treatment of MRTs for the first time.

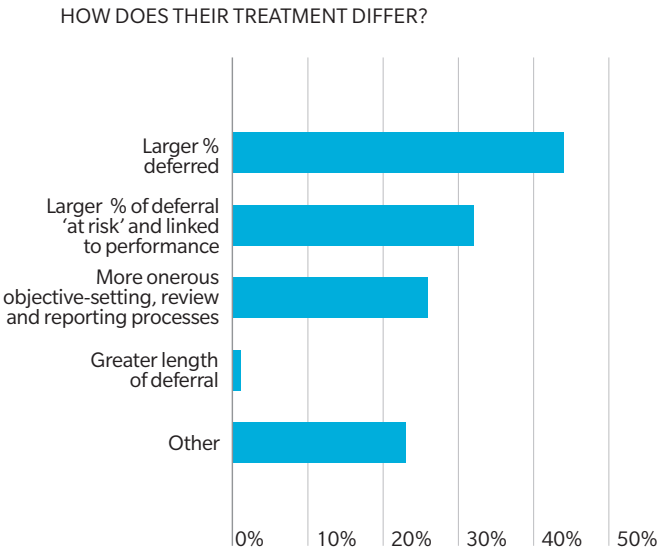
The overall message from the survey results is that respondent banks are actively making special efforts to identify and manage their MRTs and are responding to regulatory concerns on differentiating the compensation of these key staff. However, given dramatically different regulatory interpretations, the treatment of MRTs varies greatly across the industry and regions. Several respondents emphasized that their definitions of MRTs are aligned with those of the respondents' corresponding national regulations (e.g. UK FSA "code staff"), while some other banks apply general organizational guidelines (e.g. all employees above certain rank and pay level) to define the MRT pool.

EXHIBIT 16: WHOLESALE BANKING REVENUES IN RELATION TO THE NUMBER OF IDENTIFIED MATERIAL RISK TAKERS



Shows responses weighted by 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

EXHIBIT 17: ADDITIONAL COMPENSATION MECHANISMS APPLIED TO MATERIAL RISK TAKERS



Shows responses weighted by 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

"Limit on cash bonuses, plus shareholding requirement"

"Upfront equity award with retention period, retention period following vesting of deferred equity awards"

"Specific governance processes and disclosure requirements"

"Retention in all shares payments and to cash deferral"

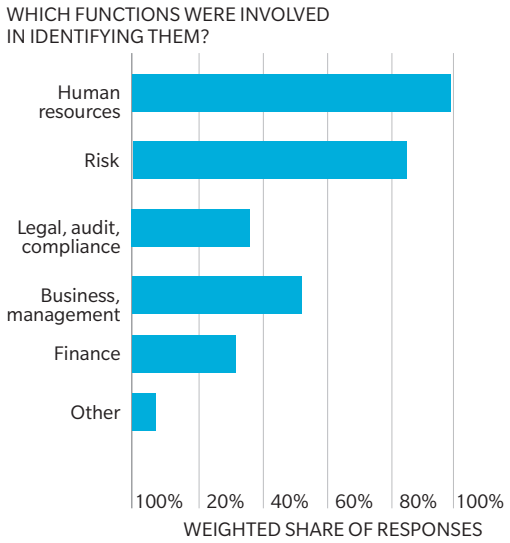
"Enhanced level of clawback / ex-post risk adjustment and additional retention period after shares have vested"

"Special independent feedback process [...] separate year-end compensation review"

"Retention period following vesting of deferred equity awards"

"Stricter rules under the FSA Remuneration Code

EXHIBIT 18: FUNCTIONS MOST OFTEN INVOLVED IN IDENTIFYING MRTS ARE HR AND RISK



Shows responses weighted by 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

"The definition of Covered Employees is set out in the Compensation Policy which was issued by the Board of Directors."

"Human Resources, Risk, Compliance - signed off by RemCo and Board."

The number of MRTs ranged widely, from ~125 to ~5000 amongst survey respondents, and the impact of these different approaches to MRTs is also apparent when scaling the number of MRTs by the respondent banks' respective wholesale banking revenues. The ratio of MRTs to wholesale banking revenue varies enormously across institutions; from less than two million US dollars to over 200 million US dollars per MRT. This variance is an order of magnitude higher than the differences in employees' average productivity.

Identified MRTs are subject to a range of various special treatments across the respondent banks:

- Approximately half of the respondents apply a higher deferral rate for MRTs' variable compensation.
- Almost one third increase the percentage of deferred compensation at risk as well as applying more onerous objective-setting, review and reporting processes.

These more bespoke monitoring and reviewing processes necessitate a smaller, more manageable number of MRTs – firms with larger MRT pools tend to apply simpler 'one size fits all' approaches.

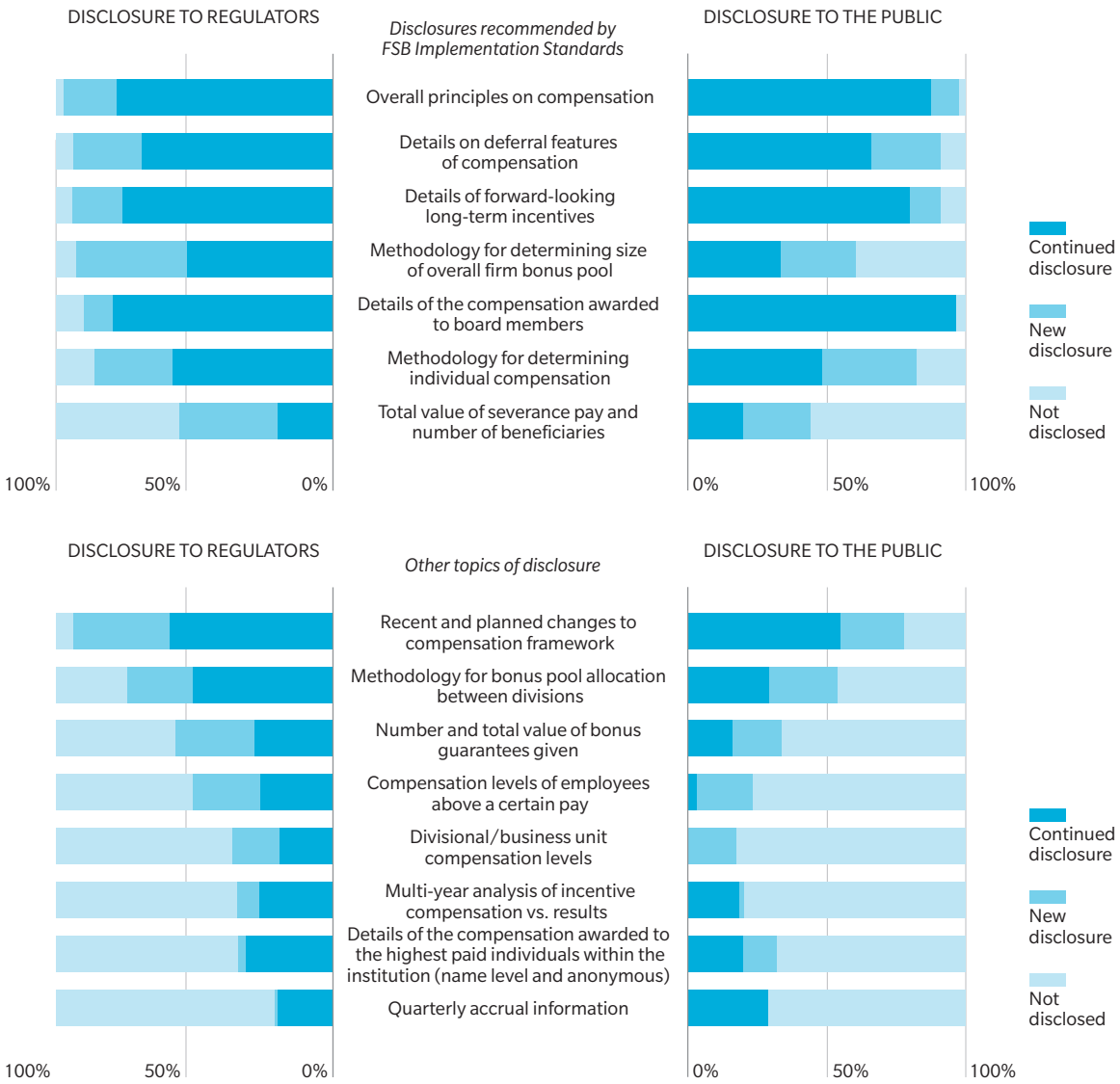
Given these more demanding requirements on MRT remuneration, the significant differences we see in how many MRTs regulators require is a major source of cross-jurisdictional inconsistency.

Most respondents identified MRTs based on their role in the organization and quantitative risk limits. Consequently, the functions most often involved in identifying MRTs were Human Resources and Risk.

5. PROGRESS ON COMPENSATION DISCLOSURE

Disclosure was identified in last year's survey report as an area of slow industry progress. Disclosure is important in the context of building an effective risk-aligned system of compensation in that effective disclosure allows banks to demonstrate to all external stakeholders that they have understood and are acting upon the regulatory requirements in order to minimize imprudent risk taking within their organization.

EXHIBIT 19: CHANGES IN DISCLOSURE TO REGULATORS AND TO THE PUBLIC



There are two different areas of disclosure that need to be considered:

1. Regulatory disclosure in which firms need to engage in detailed discussion of the technical aspects of their compensation frameworks (e.g. risk alignment, stability safeguards)
2. Public disclosure which has the broader goal of assuring all stakeholders as well as the public that the institution is managing compensation effectively and ensuring that incentives do not support imprudent risk taking

This year's results show that disclosure standards have improved in line with the points required by the FSB Implementation Standards, but vary widely by jurisdiction and by bank type. The Pillar 3 requirements of the Basel Committee build on the FSB Principles and set expectations that disclosure should be sufficiently granular and detailed to allow meaningful assessments by market participants of the banks' compensation practices, while not requiring disclosure of sensitive or confidential information. Regulators acknowledge the principle of proportionality in that there is not a uniform 'one size fits all' approach to disclosure.

Regulatory disclosure is the natural priority for survey respondents and almost all firms now disclose the core elements required by the FSB. The average disclosure rate across the items required by the FSB is 87% (and for items not required by the FSB the disclosure rate is 54%).

Disclosure of additional compensation information to the shareholders and the public varies significantly by institution (depending on culture, geographic location and levels of shareholder activism etc.) Compensation is a commercially sensitive topic and each bank needs to make a decision on how much information it is prepared to disclose publicly beyond that required by the regulators. Survey respondents illustrated varying approaches ranging from minimal disclosure in line with regulation to a policy of additional public communication of principles and approaches. In cases where respondents have increased levels of public disclosure the emphasis has been on providing information on their changing compensation methodologies, in particular, new approaches to deferrals.

EXHIBIT 20: ILLUSTRATION OF RANGE OF RESPONDENT APPROACHES TO DISCLOSURE

"An important objective of the Compensation Policy is to provide all relevant internal and external parties with appropriate information and transparency, thereby promoting a thorough understanding of the Group's compensation practices."

"Disclosure is formulated in strict compliance with relevant national requirements. As compared to 2010, much more detail has also been disclosed."

"Disclosures are made annually in a published annual report to stakeholders. Separate disclosures are not made to regulators."

6. LOOKING AHEAD: IMPLICATIONS FOR THE INDUSTRY AND FOR REGULATORS

As reforms continue to be implemented, banks and regulators can now begin to review the impact of compensation reform and start to assess whether the desired outputs of all elements of the compensation regulation package are being achieved.

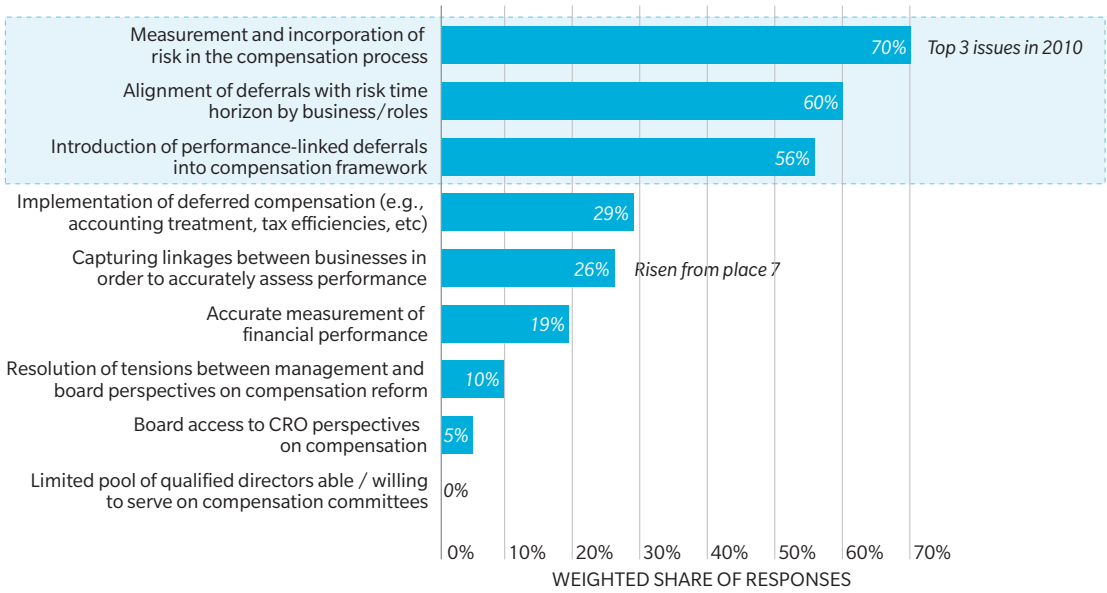
6.1. INDUSTRY IMPACT AND UNINTENDED CONSEQUENCES

As noted throughout this report, significant progress has been made on compensation reform. The central purpose of the FSB Implementation Standards was to limit imprudent risk taking and the emphasis of much of the work done (on compensation payout structures, risk management and governance) directly supports this original goal. However, significant changes are underway more broadly across the industry and it is still too early to come to a final assessment of the overall combined results of compensation regulation on the industry. Some aspects of the reforms appear to have given rise to unintended consequences. Examples of these can already be noted, including a changing profile of guarantees within the bonus pool and a shift in the cost base and mix between fixed and variable compensation. This shift away from variable reward and towards fixed salaries naturally implies a potential reduction in the link between compensation and risk-adjusted performance.

Although the use of multi-year guarantees (as condemned by the FSB Principles) is now negligible, the increased intensity of competition for talent in the wake of the crisis led to an increase in the use of single-year bonus guarantees to new hires due to a difficult recruiting market. Survey results show that after two years of consecutive decreases, the use of single-year bonus guarantees for new hires rose from 5.5% of the average bonus pool in 2009 to 8.5% in 2010. However, caution should be taken in reading too much into this information. Bank recruitment needs and hiring costs naturally fluctuate over time and this should not necessarily be viewed as a sustained increase in bonus levels. Ongoing monitoring will be needed to confirm that this shift in single year bonuses was indeed due to temporary market conditions and does not represent a structural shift back towards single year guarantees. 2011 is showing new challenges for wholesale banks and hiring dynamics are changing as many leading wholesale banks have publicly announced reductions in headcount and restructuring of business units.

Changes in the approach to compensation are also driving changes in the overall cost base for wholesale banking at many institutions. Employee costs are increasing overall and are becoming less flexible as compensation emphasis has shifted from bonuses to base salaries. Front office salaries have been increased during the last 12 months among ~60% of respondents and further increases are expected for the coming year by 27% of banks. A similar story can be observed for the Risk Management function. The impact of this in terms of potentially reducing the

EXHIBIT 21: FROM YOUR FIRM'S PERSPECTIVE, WHICH OF THE FOLLOWING COMPENSATION ISSUES PRESENT THE GREATEST IMPLEMENTATION CHALLENGES TO COMPENSATION REFORM?



Shows responses weighted by 2010 wholesale banking revenues.
Source: Institute of International Finance & Oliver Wyman 2011 Compensation Survey

flexibility of compensation pools and increasing the fixed cost base of wholesale banking activities has already been noted by industry analysts.

Survey respondents voiced concerns that an uneven playing field may exist between banks that operate under differing regulatory structures with a fear that some institutions – particularly non-banks – may be able to offer more attractive compensation structures in the competition for talent.

The final impact of all these changes on the industry overall is not yet certain but what does seem clear is that bank management will need to pay increasingly close attention to the effect of compensation changes on their business models over the next few years.

6.2. IMPLICATIONS FOR REGULATORS

Regulators also face some challenges – as they continue their work on compensation reforms they also need to remain aware of the potential trade-offs and unintended impacts that may result from the implementation of compensation regulation in the various jurisdictions and in the different segments of the financial markets. Regulators need to adhere to the FSB Principles in their design and implementation of national regulations, but this will naturally still result in variations in approach and interpretation in different jurisdictions depending on the specific market context.

Banks have responded to and continue to work on the principles for sound compensation set out by the FSB. However, global banks face a challenge in addressing multiple regulatory approaches to the issues and many survey respondents voiced concern over how these global principles are being interpreted by local regulators. The two most important obstacles to effective implementation of the FSB standards identified by the survey were:

1. *Lack of regulatory consistencies across or within jurisdictions in the implementation of specific standards (94% of respondents)*

   The aim of the FSB reforms is to set consistent compensation principles internationally but there will naturally be differences in implementation by local regulators. This report does not subscribe to the notion that what is needed is a global 'one-size-fits-all' approach to compensation reform, but regulators do need to consider the implementation challenges faced by banks. The way regulators coordinate with each others, deal with subsidiaries of foreign banks and consider practices which have been agreed with home regulators should be areas for further consideration by regulators to ensure effective implementation.

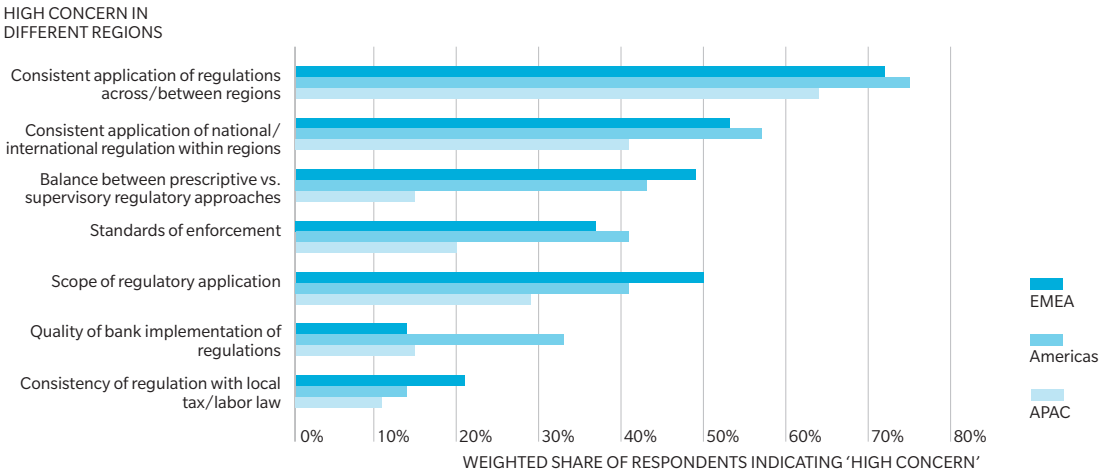
2. *Concern over potential first mover disadvantages (69% of respondents)*

   Given the progress noted in this year's survey we expect that this concern should become less prevalent. It is clear that increasing numbers of banks are now aligned with the FSB's principles and as such, the issue of first mover disadvantage should be less relevant in practice than many banks still perceive it to be. However, some concerns will remain as long as there are inconsistencies in compensation requirements among banks and between banks and the non-banking sector.

   The notion of proportionality has been acknowledged by regulators as a sensible approach to allowing differentiation in the practical treatment banks of different sizes and business profiles. However, in practice, proportionality is being implemented differently across different jurisdictions, adding a layer of complexity for international banks managing global compensation schemes.

   Concern over bank disadvantages in compensation compared with the non-banking sector is linked to the notion of first mover disadvantage. Competition for talent from non-regulated entities was the third most significant challenge as identified in the chart below.

EXHIBIT 22: KEY REGULATORY ISSUES AND CONCERNS BY REGION



When assessing the implementation concerns identified above it is noticeable that banks are not highlighting fundamental barriers to change. Instead, their core concerns relate to regulatory issues and questions around the market and business impact of compensation reform and around the practical application difficulties. The survey respondents have for the most part completed the core changes required by the FSB principles and as such, 'softer' issues such as employee engagement and more granular implementation of the standards are now moving up the agenda.

When probed further, respondents from all regions identified specific concerns that regulators could and should seek to address, for example, the application of regulations within (as well as across) regions and the appropriate balance between prescriptive and supervisory regulatory approaches.

It is noticeable banks from all regions need to deal with the challenge of operating across multiple regulatory regimes – a challenge that is inherent in the nature of being a global bank and is not unique to the topic of compensation.

7. SURVEY METHODOLOGY

The Institute of International Finance and Oliver Wyman Compensation Survey was conducted between April and July 2011.

Wholesale banking divisions, and in particular investment banking and capital markets sales and trading, account for the majority of variable compensation paid out in the financial services industry and have been the area of focus for compensation reform. Therefore, this report and survey is focused exclusively on this part of the financial services industry. 79 Institute of International Finance member firms with significant wholesale banking operations (both standalone wholesale banks and the wholesale divisions of larger groups) were invited to participate in the compensation surveys. Out of this sample, which 51 submitted a response and 5 declined to participate on the basis that they felt the survey was less relevant to them based on their specific business mix or geographic location. These responses have been supplemented by a series of interviews with leading wholesale banks conducted by Oliver Wyman. These banks together represent about 70% of total global wholesale banking revenues in 2010.

The survey questionnaire was prepared by the IIF and Oliver Wyman with input from the IIF Technical Advisory panel. The main questionnaire contained 46 questions divided into the following sections.

- Crisis-related compensation reform
- Compensation governance
- Wholesale banking front office compensation
  - The compensation process
  - Performance measurement
  - Delivery
- Bonus guarantees
- Risk management compensation

All analysis presented in the report is performed using weighted response rates, where weights reflect the respondents' relative share of industry revenues. Separate analysis has been performed on unweighted data where relevant, in order to validate the survey results and to determine to what extent the observed results are driven by a group of larger banks only. It is found that while a difference between weighted and unweighted results does exist, this difference is reasonably small.

All analysis has been calculated on the actual responses to the individual question.

Questions in the main questionnaire have, with rare exceptions, been answered by 75% or more of the respondents, the average completion rate being 85%.

Where charts have been produced analysing data over time, the analysis has been done on a consistent sample, i.e. excluding responses from institutions where data from one or more years has been missing.

A.1. GLOSSARY

Technical terms and abbreviations used in the report are those in standard usages in the Financial Services industry. For the reader's convenience, these terms and abbreviations are defined in the list below.

- **At-risk deferral:** Deferred compensation approach in which part of the bonus awarded each year is held at risk and may be subtracted from in the subsequent or current year, depending on performance
- **Bonus-malus:** Deferred compensation 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
- **Business unit:** Sub-unit of Division
- **Capital:** Capital as defined in Annex 1a of the Basel II accord or any comparable regulatory standard for establishing minimum capital, as applicable to the responding institution
- **Claw-back:** Already vested compensation is reclaimed based on gross negligence or other malfeasance
- **CRD:** The EU Capital Requirements Directive (Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions)
- **Director (D):** Typically the second most senior level in a division, under Managing Director (MD)
- **Division:** Sub-unit of Wholesale banking business area, for examples see activities included in Wholesale Banking below
- **Front office:** Client facing functions such as sales, trading, structuring and coverage, excluding support functions such as risk management, audit, compliance etc.
- **FSB Implementation Standards:** The Implementation Standards to the FSB Principles on Sound Compensation adopted on 25 September 2009. Also referred to in the report as the "Implementation Standards" or the "Standards"
- **KPI:** Key Performance Indicator
- **Managing Director (MD):** Business head or equivalent; senior-most cadre
- **Material Risk Taker (MRT):** In general, employee whose actions has a material impact on the company's risk exposure (precise definitions are given by regulators)
- **RemCo:** Board-, Group- or Business area-level remuneration committee
- **Risk taker:** Employee whose actions have a material impact on the risk exposure of the firm.
- **VaR:** Value at Risk
- **Vice President (VP):** Direct report to Director, a more junior role
- **Wholesale banking:** Any of the activities below
  - Investment banking businesses including mergers and acquisitions, debt capital markets, equity capital markets, syndicated loans, and related activities
  - Fixed income businesses including rates, credit, foreign exchange, securitization businesses, derivatives, commodities, and related activities
  - Equities businesses including cash equities, derivatives, and prime brokerage
  - Principal finance busines

COMPENSATION WORKING GROUP

MICHAEL ALDRED
Reward Director
Barclays

DOMINGO ARMENGOL CALVO
Corporate Secretary
BBVA

JOHN BRADLEY
Group Head
Human Resources
UBS AG

JAVIER BUGALLO
Head of Compensation and Mobility
Human Resources
Banco Santander

SYLVIA D. CHROMINSKA
Group Head
Global Human Resources and Communications
Scotiabank

MICHAEL CURRAN
Managing Principal
Towers Perrin MGMC

NEIL A. CUTHBERTSON
Group Head
Performance, Reward and Benefits
Standard Chartered Bank

MARGOT DARGAN
Group General Manager
Remuneration & Rewards
Australia and New Zealand Banking Group Limited

BRIAN DUNN
Chairman McLagan and
CEO Global Compensation
Aon Hewitt.

VICKI ELLIOTT
Senior Partner
Mercer

STEPHANIE EMERY
Head of EMEA Compensation and Benefits
JP Morgan

MIGUEL ESCOBEDO
Chairman of the Board
Reaseguradora Patria, S.A.B.

JAMES FANTO
Professor
Brooklyn Law School

GUIDO FUHRMANN
Director
HR Reward Governance
Deutsche Bank AG

SERGIO GUILLINET FAJERMAN
Head of Performance, Compensation and Benefits
Itaú Unibanco S/A

COLLEEN HARRIS
Executive General Manager
Human Capital Strategy
National Australia Bank

MATT HOLMES
Director
Government Affairs
Deutsche Bank

PHILIPP HÄRLE
Director
McKinsey & Company

ANNE MARION-BOUCHACOURT
Head of Group
Human Resources
Société Générale

SEAN MULLEN
Vice President
Basel II Pillar 3 Business Lead
Bank of America

RUPAL PATEL
Group Reward
Human Resources
Royal Bank of Scotland

TRISTRAM ROBERTS
Head of Group
Performance and Reward
HSBC

KENNETH SAX
Risk Management Executive
Enterprise Capital Management
Bank of America

ROBERT M. SEDGWICK
Partner: Executive Compensation
Morrison Cohen LLP

HARALD P. STOEHR
Managing Director and Senior Advisor
Credit Suisse AG

JON TERRY
Partner
Pricewaterhouse Coopers LLP

MICHIEL VAN DEN BERG
Head of Group Remuneration and Organization Effectiveness.
Erste Group Bank AG

ALISTAIR WOODLAND
Partner
Clifford Chance LLP

MARC-DAVID VAN DER MOLEN
Managing Director, Global Head Compensation and Benefits
Corporate Human Resources
ING Bank

PROJECT TEAM

INSTITUTE OF INTERNATIONAL FINANCE

GEORGE T. ABED
Senior Counselor

DAVID SUNSTRUM
Senior Policy Assistant

JULIEN STEINBERG
Regulatory Affairs

OLIVER WYMAN

BRUNO DE SAINT FLORENT
Partner

NICK STUDER
Partner

SARAH HABBERFIELD
Senior Manager

MIKKO LEHTONEN
Consultant

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