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FSB's Recommendation for Consistent National Reporting of Data on the Use of Compensation Tools to Address Misconduct Risk

Introduction

The Global Financial Markets Association¹ (GFMA) and the Institute for International Finance (IIF)² thank the Financial Stability Board (FSB) for the opportunity to comment on '*Recommendations for consistent national reporting of data on the use of compensation tools to address misconduct risk*' (the Recommendations). Compensation

¹ The Global Financial Markets Association (GFMA) represents the common interests of the world's leading financial and capital market participants, and speaks for the industry on the most important global market issues. GFMA's mission is to provide a forum for global systemically important banks to develop policies and strategies on issues of global concern within the regulatory environment. The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London, Brussels and Frankfurt, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA.

² The Institute of International Finance is the global association of the financial industry, with close to 450 members from 70 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks and development banks.

lies at the heart of how financial institutions recruit and retain talent and it can also be a hugely important instrument in incentivizing good conduct. Our members have increasingly integrated their incentive-based compensation decision-making with underlying risk management frameworks to help ensure better identification, monitoring, and escalation of risk issues. They have also used compensation to address misconduct when it has been brought to light. The industry has strengthened compensation frameworks and aligned them with safety and soundness objectives. At the same time, regulators have directed attention to improving the link between risk governance and compensation practices to more effectively align compensation with sound risk-taking behavior and virtually all jurisdictions have substantively implemented the FSB's *'Principles for Sound Compensation Practices'*³, as documented in annual progress reports⁴.

We have specific points regarding the proposed Data Set in our answers to the nine questions posed by the FSB as set out below. Before we do so, we also have some more general comments regarding the Recommendations that we would like to establish at the outset. We hope that doing so will be useful in understanding our overarching view and serve as helpful context for digesting our more detailed remarks.

Compensation Reform Over the Past Decade

Compensation in the financial services industry today robustly aligns incentives with the safety and soundness of financial institutions and, alongside other pillars of financial reform, has helped to support a resilient global financial system.

There have been common foundations in the reform of compensation practices across jurisdictions. For example, the G20 Leaders Statement from the Pittsburgh Summit in 2009 agreed to *"implement strong international compensation standards aimed at ending*

³ <http://www.fsb.org/2009/04/principles-for-sound-compensation-practices-2/>

⁴ <http://www.fsb.org/2017/07/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards-fifth-progress-report/>

*practices that lead to excessive risk-taking.*⁵ That commitment has underpinned the development of regimes including the *Capital Requirements Directive IV* (CRD IV)⁶ in the European Union and ‘*Final Guidance on Incentive Compensation*’⁷ by an inter-agency group of regulators in the United States.

At the same time, it has been recognized that individual regulators and financial institutions need flexibility to tailor policies to the unique conditions and cultures of individual markets and to align compensation frameworks with the financial institutions’ risk management appetite and strategic direction. Countries differ, for example, in terms of the supply of financial services-related skills and the degree to which financial institutions compete with other industries for talent. Moreover, within the financial services sector, there are important differences between the constituencies that comprise it – what is appropriate for broker dealers may not be appropriate for banks, insurers or asset managers or vice versa. And even *within* these narrower segments, there are important differences between the financial institutions. Recognizing that diversity, and how it only multiplies at the international level, is a crucial starting point for an exercise of this nature.

Compensation policy has been able to evolve in a way that has promoted safety and soundness worldwide without overly prescriptive global standards. In our view, that overall philosophy, which guides countries while recognizing their differences and the need for flexibility in response to market dynamics, must continue.

We are therefore conscious that, throughout the Consultative Document, there is a switching between principles-based themes versus prescriptive requirements: while the Consultative Document clearly states that these recommendations are intended to “*suggest certain categories of data that may be useful for supervisors when interacting with firms on misconduct risk*” and are “ [not] *designed to be ‘one size fits all’*”, the actual

⁵ https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf

⁶ https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-requirements_en

⁷ <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20100621a.htm>

Recommendations are very prescriptive. We feel this would jeopardize the recognition of individual market circumstances that has been so important to date.

We therefore strongly encourage the FSB to set forth principles that national authorities may use as guideposts and that financial institutions may reference in developing tailored data collection policies that best fit their specific circumstances.

It is also important to recognize that, while compensation practices have evolved in the past decade, and have evolved positively for financial stability, they are but one factor that potentially could impact safety and soundness. Many other changes have been made to the regulation, structure and operations of financial services firms including much higher levels of capital and liquidity. These reforms have also moved in the same direction of making the industry more resilient and enhancing financial stability.

Finally, the Recommendations should be designed in a way that is mindful of the rapid evolution of data protection and privacy rules around the world. An international framework for data has to be compliant with regulations and restrictions that domestic regulators put in place to address national concerns such as risks to privacy.

The Importance of Building on Existing Foundations

The FSB's work should build on the steps that financial institutions have taken since the turn of the decade, by looking to capitalize on much of what is currently done. We believe it should also focus on salient risks to safety and soundness. It is unclear whether the Recommendations envision a broad-reaching collection of compensation and misconduct risk data on all employees or a more limited focused population. **We believe it is of the utmost importance that the Recommendations be revised so that it is clear that they apply to a relatively narrow group of employees whose misconduct likely could impact safety and soundness, (such as Material Risk Takers) and not all**

employees regardless of their potential impact on safety and soundness, for the reasons set out below.

Two concepts are particularly crucial to developing workable Recommendations with an appropriate and meaningful focus: the *previously identified populations* and *Misconduct Risk*:

- **Focus on previously identified populations of individuals whose activities can subject firms to material risk (such as Material Risk Takers)**⁸ - Financial institutions across the G20 have already undertaken extremely careful exercises to designate, individuals whose activities can subject firms to material risk (e.g. “material risk takers”, “covered employees” etc.), in order to align compensation with safety and soundness based on those existing populations. We believe the FSB should capitalize on that work by ensuring that existing designated populations identified by each financial institution serve as the basis for those to whom the Recommendations apply. We believe that focus on this population would produce more meaningful outputs, both in terms of the risk profile of the population in question, but also in terms of ensuring any outputs remain focused and manageable for both the regulator and the organizations.⁹
- **Misconduct Risk** - the Recommendations note that “*misconduct risk is kept for consistency with the terminology used in the FSB work on measures to address ‘misconduct risk’*”. It is extremely important that this approach is adhered to for consistency with the FSB’s 2009 Charter, which requires the FSB to ‘*address vulnerabilities affecting financial systems in the interest of global financial stability*¹⁰. Issues of personal conduct that pose no safety and soundness risk – while important in and of themselves – do not impinge on the stability of the global financial system and should not be a factor for the Recommendations. Misconduct cases are very diverse and require specific and distinct treatment. The FSB should

⁸ Material Risk Taker is used to apply to any such previously designated group from this point forward.

⁹ Firms should have the ability to apply the Recommendations more broadly to the extent they determine it is appropriate.

¹⁰ http://www.fsb.org/wp-content/uploads/r_090925d.pdf?page_moved=1

recognize the practical challenges imposed on financial institutions if the proposed Data Set is intended to apply with respect to every employee and every instance of misconduct and revise the Recommendations so that it is clear they only apply to financial institutions' Material Risk Takers.

Responses to Specific Questions set out on pages iv and v of FSB Consultative Document:

1. Is the proposed "Data Set" sufficient to help (a) supervisors and (b) firms to monitor the effectiveness of the use of compensation tools to address misconduct?

In our view, the proposed Data Set in the Recommendations is too prescriptive and too granular to help assess the effectiveness of compensation tools to address misconduct in the context of financial safety and soundness. This partly stems from what appear to be assumptions underpinning the Recommendations that suggest compensation adjustments are applied formulaically whereas compensation adjustments can be conditional on the specifics of the case, including individualized mitigating factors, and cannot be determined ex-ante. Moreover, not all misconduct risk being considered in a compensation decision can be evidenced by a particular monetary amount; rather, the risk and conduct is measured qualitatively as part of the performance review and as one factor to determine the ultimate compensation number.

We therefore propose that, consistent with taking a principles-based approach, the Recommendations be tailored so that financial institutions can submit information that they determine is appropriate. For example, financial institutions should be permitted to provide a range of the compensation impact that could be applied depending on the type of misconduct along with a list of mitigating factors that may include:

- objective setting processes
- control functions involved in providing input
- feedback surveys

- processes to evaluate risk and performance
- employee history – including prior instances of misconduct/good citizenship.

We further note that, while the data set allows for the monitoring of how compensation tools are used, it will remain difficult for firms and supervisors to isolate how effective compensation tools have been at addressing misconduct. Addressing misconduct requires a multifaceted approach, as recognized by the FSB in its ‘*Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors.*’¹¹

2. *If not, which additional data/information should be collected?*

We believe there is more work needed to *clarify* and *narrow* the scope of the proposed Data Set and that the FSB’s resources should be devoted towards that end rather than prescribing additional metrics or indicators.

In addition, the Consultative Document provides multiple references to reporting aspects associated with the proposed Data Set; however, it is unclear to whom such information would be reported and for what purpose. This lack of specificity is concerning, as external reporting requirements would be a significant new administrative imposition on financial institutions and may be in direct conflict with local laws. Therefore, we ask the FSB to explicitly state that the information will be shared with – and only with – appropriate internal governance bodies and, on a requested basis, with domestic regulatory authorities.

3. *Are there any impediments to (a) firms and (b) supervisors in (i) gathering or (ii) using the Data Set?*

¹¹ <http://www.fsb.org/2018/04/strengthening-governance-frameworks-to-mitigate-misconduct-risk-a-toolkit-for-firms-and-supervisors/>

Yes. First, we feel it is important to fully recognize that prescriptive requirements can sometimes frustrate actual implementation. The Consultative Document itself notes that there are many obstacles to implementing the proposed Data Set. These challenges range from technological (collection of information across multiple source platforms) to potential conflicts with cultural norms / local laws (data privacy and employee protections) to resourcing challenges.

By contrast, a principles-based approach to harnessing data to evaluate misconduct risk is much more likely to provide a financial institution with the flexibility to implement a program that works for it and is harmonious with local requirements. We believe the Recommendations should set forth principles that national authorities may use as a guidepost and that financial institutions may reference in developing tailored data collection policies that may differ in their approach, but are most effective in achieving the shared goal of reducing misconduct.

It may also be appropriate for firms to focus on high-severity cases in the interests of proportionality (whilst not precluding requests for data on low-severity cases where appropriate).

Second, our response to Question 4 below – focusing on specific data requests which we think are either impractical or inappropriate - is also pertinent to this question.

4. Are there any elements in the “Data Set” that may not be relevant to a particular financial sector?

Yes. There are instances in the proposed Data Set where it would not be practical for financial institutions to provide the requested information. Generally, we believe financial institutions should not be required to disclose confidential information, including individual names, identifying titles or identity of clients. Further, some of what is sought is immeasurable. We believe all of the following pieces of data should be removed from or amended in the proposed dataset:

- (a) A.1 requests “*population in scope for the application of compensation tools ... and a description of the criteria/method used to identify MRTs in relation to misconduct risk.*” As set out above, we believe strongly that the FSB should focus solely on the existing Material Risk Taker population or otherwise on the existing category of individuals whose activities can subject the firm to material risk – this data request should therefore be narrowed accordingly.
- (b) A.1.1 requests “*documentation supporting review of the compensation policy, including action items, responsible parties and progress towards those items, to address any gaps raised (e.g. outputs of monitoring and back-testing processes)*”. Instead, we suggest it would be more effective for a financial institution to submit a summary of its process to review its compensation policy, which would allow regulators to assess that process.
- (c) A.2 requests “*a description of the firm’s policies and decision-making procedures for assessing and deciding on the use of the compensation tools ...*” This is a definition of the HR compensation function and there may not necessarily be a policy or procedure that sets out how the organization decides which tools should be used. The tools used will be decided based on a number of factors including the regulatory requirements/expectations, best interest of the bank and technological and resource availability.
- (d) A-3 requests a “*description of the key financial and non-financial metrics (where applicable score cards and dashboards) used to link compensation and conduct*” and “*the percentage of compensation at risk for misconduct issues.*” The Recommendations assume that conduct-related adjustments are pre-programmed into scorecards or that financial institutions otherwise use a formulaic approach to adjustment, which in our experience is not always the case.

- (e) A.4. requests “*Compensation adjustments by compensation tool (in-year adjustments; and ex-post adjustments through malus or clawback). The reporting should include the wording of the malus and clawback clauses.*” This request is potentially duplicative with A.2 or A3 depending on the balance between qualitative and quantitative data sought.
- (f) B.1 requests “*Data on misconduct incidents under examination by the firm (including outstanding cases and new cases that have occurred in the current year) and relevant measures taken, including compensation adjustments as applicable.*” In our view, cases under examination should not be reported as the presumption of innocence should be upheld. We propose that reporting should cover only material events whose review has closed with a final determination regarding the misconduct established.
- (g) B.1 requests “*root cause of the misconduct event*” – however, (i) this may not be determined at the time of the event, (ii) this may never be determined/determinable and (iii) any conclusion may be subjective or speculative.
- (h) B.1.1 requests “*A record of major incidents and near misses.*” What constitutes a ‘near miss’ is highly speculative. We believe financial institutions will find it difficult, if not impossible, to define what constitutes a near miss and will find it even more difficult to implement a process that can identify such a category of incidents. We suggest it should be removed.
- (i) B1.2. “*Data on misconduct incidents for which no compensation adjustment or performance management measures were made.....including a rationale for not taking any action*”. This seems to go beyond the scope of the FSB’s remit with respect to compensation issues and their relationship to safety and soundness and, therefore, we regard this as information that financial

institutions are not required to divulge (although there could be specific and limited cases where national authorities may have grounds for requesting it).

- (j) B.1.4 – “*A copy of relevant independent investigation reports and thematic conduct reviews or audits*” similar to B.1.2. We suggest this should not be required due to confidentiality concerns and other privilege issues. In addition, requiring this type of information may deter employees from escalating issues or participating in reports or reviews.

- (k) B.1.5. – “*Internal analysis conducted by the firm in mapping misconduct, identifying patterns of misconduct and determining the root causes of misconduct*”. We suggest the request should be limited to overall procedures – and captured by section A.

5. *Are there any additional elements that should instead be considered for a particular financial sector?*

See question 2 above.

6. *What elements of the Data Set are not already utilised by firms in their own monitoring of compensation and misconduct risk management practices?*

Financial institutions across all jurisdictions devote significant resources to maintaining robust and technologically sophisticated data systems that help them monitor risk, including misconduct risk, and its relationship to the financial institutions compensation framework. It is important that they retain discretion to do this effectively. A uniform Data Set, such as the proposed Data Set in the Recommendations, will not be appropriate for all financial institutions. Each financial institution should have flexibility to develop a data set based on its business models, size, risk profile. The overly prescriptive and deterministic proposed Data Set in the

Recommendations may direct resources at financial institutions away from analyzing and monitoring data specifically pertinent to their own firm and understanding the particular dynamics within it.

7. What types of information have been most useful to firms in their monitoring and assessments of potential misconduct, and when assessing the effectiveness of compensation tools?

While the information found most useful will vary across financial institutions, what would be most valuable from the FSB, in our view, would be principles that national authorities may use as a guidepost and that firms may reference in developing tailored data collection policies that best fit their specific circumstances. In our experience, compensation programs can (a) incentivize good behavior (i.e., achieving business goals, which can include engaging in ethical behavior and refraining from bad behavior) and (b) punish poor behaviors (i.e. taking away compensation through malus). Therefore, maintaining a coherent and narrowly focused framework regarding misconduct and misconduct risk with respect to Material Risk Takers, as well as recognizing the real strengths and limitations of compensation packages to deter misconduct, will avoid confusion regarding the application of the proposed Data Set and would be consistent with the FSB's traditional focus on safety and soundness issues.

8. What are the most important changes that have occurred in firms' management of compensation and conduct risk in recent years? Do the current Recommendations focus enough on these developments that may help to better achieve alignment of risk and reward?

We suggest that the Recommendations acknowledge this progress more fundamentally upfront. Given the robust improvements already achieved, it is important that resources are not diverted away from systems and processes that have

already shown their worth in terms of the strengthened safety and soundness of the financial system.

9. How do firms monitor and validate the use of compensation tools when misconduct occurs to ensure an appropriate balance between risk and reward? What analytics support firms' judgments in these areas?

These questions are good examples of why the prescriptive data set contemplated by the Recommendations is going to be difficult to implement in practice. Each financial institution has implemented compensation programs that are tailored to its particular business objectives, workforce, and that reflect local laws and cultural norms. Furthermore, a single financial institution may employ multiple monitoring methodologies and evaluation practices to reflect the unique aspects of a particular business unit or differences between employees working in different regions.

Inherent in this diversity of compensation models, frameworks and regulatory overlay, is that there is no single way to monitor compensation tools and no single set of analytic metrics that would support their judgments. Attempting to implement such a regime would not only be extremely difficult in practice, but may unintentionally result the failure to identify areas in need of refinement, because the monitoring program and metrics do not match the underlying compensation program.

Instead, we recommend the Recommendations acknowledge this diversity and encourage firms to develop monitoring and validation programs that best suit their needs and unique compensation programs.

Conclusion

We hope that the concerns we have identified, and how we propose the FSB address them, are constructive and helpful. Specifically, it is our view that by re-orientating the Recommendations towards a more principles-based approach, with a sharper focus on

the most appropriate issues at stake, the FSB will allow financial institutions and regulators to more effectively establish tools for analyzing and monitoring the effectiveness of compensation frameworks in addressing misconduct risk.

It is important that the FSB's work in this area focuses solely on safety and soundness - broadening the boundaries of the work can only dilute that focus. Incentive compensation programs are important in the promotion of financial stability. Attaching excessive and overly prescriptive rules and regulations to incentive compensation governance and execution undermines their ability to play that role. Taking a strictly principles-based approach, adhering closely to actual misconduct risk and focusing on existing and well-established populations of Material Risk Takers, would maximize the chances on the FSB's work meeting its objectives of strengthening the role data can play in understanding misconduct risk.

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