FSB FINANCIAL STABILITY BOARD

8 March 2019

FSB compensation workshop: Key takeaways

London, 9 October 2018

On 8 October 2018 the Financial Stability Board (FSB) hosted a workshop in London for international banks to discuss their experience with regulation and supervisory practices that implement the FSB's *Principles for Sound Compensation Practices*[1] and their *Implementation Standards*[2] (Principles and Standards). The objective of the day was to gather information on key compensation issues and challenges and inform the FSB's biennial progress report on compensation practices. The workshop focused on:

i) **Big picture – a decade on from the crisis** – the baseline before reforms, how compensation structures have changed since the crisis and thoughts on further changes in the coming years.

ii) Implementation by banks of the FSB's Principles and Standards on compensation – the practical steps banks have taken to implement reforms on compensation practice including details on which individuals are designated as material risk takers (MRTs).

iii) **Effectiveness** – steps banks are taking to assess the effectiveness of current compensation policies and practices in terms of better aligning risk and reward.

Executives responsible for managing processes related to compensation at 17 large internationally active banks and officials from the FSB Compensation Monitoring Contact Group (CMCG) participated in the workshop. The CMCG is responsible for monitoring and reporting on national implementation of the Principles and Standards. This summary reflects the understanding of regulators and supervisors who attended the workshop concerning the main points raised in the discussion, which was conducted under the Chatham House rule. It does not therefore represent an assessment of activities across a large number of banks but rather a summary of issues discussed. It does not necessarily represent the views of authorities nor consensus views expressed by banks at the workshop.

The FSB welcomes any feedback on topics discussed at the workshop and summarised in this note. Comments should be sent by **Tuesday 7 May 2019** to fsb@fsb.org.

Key takeaways

- ***Big picture*** – Firms reported significant changes to compensation structures post-crisis following the introduction of legislation, regulation and supervisory expectations on compensation. Changes are most pronounced in the European Union and United States, and

[1] FSB, *Principles for Sound Compensation Practices*, April 2009 (http://www.fsb.org/2009/04/principles-for-sound-compensation-practices-2/)

[2] FSB, *Implementation Standards for the FSB Principles for Sound Compensation Practices*, September 2019 (http://www.fsb.org/2009/09/principles-for-sound-compensation-practices-implementation-standards/)

in general in jurisdictions where the dialogue with supervisory authorities on compensation policies and practices has been continuous. Banks generally emphasised the importance of the dialogue with supervisors including discussions on the effectiveness of compensation policies.

- Some participants expressed a view that reforms in areas such as culture, including greater emphasis on how results are achieved, are more impactful than changes in remuneration structures and noted that significant amounts of time were spent calibrating performance goals to achieve desired behaviours. Several banks emphasised the long history of deferral regardless of requirements to identify MRTs and also observed that malus and clawback protections often extend to populations beyond MRTs. Other banks emphasised that in some areas, such as risk management expectations, there is no difference in how MRTs and other employees are treated.
- Banks report that they continue to face legal challenges with the application of malus and, to a greater extent, clawback. Clawback is rarely used. There were differing views about the extent to which compensation adjustments should be from deferred compensation through malus and clawback or through in-year adjustments.
- Banks reported more active and engaged boards. Boards more thoroughly understand both the technicalities and the implications of different compensation structures including on individual compensation outcomes for senior executives. Banks reported that compensation processes are now conducted with greater oversight. While human resources (HR) functions predominantly run the process, there is significant input from risk and compliance functions. Control functions are increasingly helping to develop and ensure effective and consistent implementation of compensation structures, and HR functions are increasingly playing a control function role. Participants noted that a key next step will be to ensure front office functions take ownership to embed the cultural shift in day to day operations and behaviours.
- Firms noted that it is vital for the industry to continue to be competitive with new digital and technological challengers. Firms believe that attracting and retaining talent is a key factor in remaining both competitive and profitable.
- While the broader conduct agenda has grown in importance, another challenge relates to finding the right balance between exploring how to serve customers more effectively in a digital age and ensuring appropriate conduct. Some banks expressed a concern that fear of a significant failure could impede innovation. The challenge firms articulated therefore was to be prepared to take appropriate risks to allow their businesses to grow, embracing new opportunities such as FinTech that can give a competitive edge, while "managing risk positively" and encouraging the right behaviours. New forms of intermediation may imply new forms of compensation and different ways to provide the right incentives.
- A key question for firms is the extent to which there has been a shift in behaviours, and whether the progress is really culturally embedded so that the employees say that "we do this because we believe it is the right thing to do" and that this continues to permeate the firms at every level.
- ***Performance management*** – Banks reported a range of data they use to more effectively assess the performance of staff. For example, one bank pointed out that the focus on sales

has shifted from products to clients in their operations with more emphasis on controlling sales quality and reducing customer complaints. One tool employed is validation of sales efforts, for instance by callbacks post sale to asses both positive and negative feedback from clients. Another reported that they had become more focused on customer outcomes and this was resulting in a better relationship with customers. Most banks noted that metrics on controls and compliance had been added to performance management metrics. There is an increasing use of non-financial indicators in compensation and performance management processes that include assessments of "what" and "how" in the way staff achieve their performance in order to ensure a focus on long-term sustainability. Banks reported that they are increasingly using mixed scorecards against which they assess performance, as well as increased use of gateways in which a certain condition has to be met (e.g. completion of compulsory training before any variable compensation is awarded). At the same time firms noted that there are often competing interests, for instance investors want a heavy financial focus on measureable profits and some are unwilling to accept a heavy balance on strategic or "softer" metrics. Firms are striving for an effective balance between the two.

- ***Conduct*** – The increased focus on conduct risk continues to shape conversations around behavioural impacts and how to incentivise and reward the desired culture. One bank spoke about the important role that retail staff have to play as the "face of this industry to the customers on the high street". Banks agreed that compensation had a role to play in improving conduct standards in firms. A number of banks mentioned the importance of tackling what would have previously been considered minor infractions in order to set a clear expectation with staff that misconduct would not be tolerated. One bank mentioned that an increased use of "trip wires" (alerts that flag possible compliance or other breaches) had led to a reduction in the number of reported misconduct incidents as less severe issues were being tackled earlier. Several banks emphasised that there had been a fundamental shift towards incentivising and rewarding positive behaviours, while embedding the conduct agenda at every level of the employee population. Employees are increasingly proactive about their own accountability and the set of behaviours they are responsible for. There is also increased focus on the accountability of line and senior management. A number of banks cited the importance of having management accountability in place so that, where appropriate, compensation actions can be taken against senior management that were accountable for the relevant business. As one bank noted, "people at the top of the house need to understand they're responsible for incidents further down the chain".
- ***MRTs*** – In those jurisdictions that have regulation or supervisory guidance on the identification of MRTs, the number identified increased significantly in the early post-crisis years but has now plateaued. Many banks noted that the MRT identification process has become more structured and consistent across businesses and between banks, in part as a result of increased regulatory and supervisory guidance. In many banks the process for MRT identification draws heavily on risk assessments conducted by control functions. While investment and corporate bankers have traditionally made up a significant proportion of identified staff, given the magnitude of the balance sheet risks they can pose, increasingly conduct risk is seen as an important aspect of MRT identification.
- A number of banks headquartered in the European Union expressed concerns about the bonus cap and its impact on their ability to compete for talent globally. Some banks

emphasised that treating people consistently with overlapping rules has been a challenge. Firms emphasised the complexities of managing several regimes. Banks mentioned that implementation in different operating entities can result in inconsistent outcomes, for instance where an accountable executive in a subsidiary is captured but a more senior manager at a group level is not captured. In addition, developments such as the need to pay for skills and outputs rather than for roles or jobs, the introduction of flatter structures, and the insertion of new technical roles to foster innovation in financial technology, all pose new challenges in terms of MRT identification. Banks stressed that they need to attract talent in order to remain competitive in a fast developing market and this requires flexibility in dealing with the changing workforce. The changes in generational drivers of behaviour, the different meaning and dimensions of being a MRT for the firm in a more technologically developed environment and the faded memory of the financial crisis in new generations, create challenges in providing the right set of incentives.

- ***Level playing field –*** Banks reported challenges attracting talent when compared with other financial sectors and technology companies. In addition, they noted concerns about competing for talent while keeping to higher global standards in jurisdictions in which the regulatory or supervisory bar on compensation is set lower. At the same time banks stressed a preference for a principles-based rather than a rules-based approach to compensation. While they would welcome greater convergence some banks noted that they would rather have to manage an uneven playing field than have everyone be consistent with the most prescriptive forms of regulation, as this would hamper the flexibility that is needed to administer compensation schemes. However, consistent outcomes continues to be highlighted as potentially challenging for global banks.
- ***Effectiveness*** – Banks are increasingly considering the effectiveness of their compensation regimes, however finding the right metrics and process for these reviews is not simple. There appears to be a significant difference in the approaches firms take in this area. Most firms are engaging in yearly review processes, analysing positive and negative outcomes, while a few supplement this with additional monitoring and validation efforts. That said, banks report that disentangling the different drivers of change is difficult. Generally firms stress the importance of shifting the focus to outcomes, and focussing on what the rules are meant to achieve rather than on the rules per se. Firms indicated that changing behaviour is a long-term journey.
- ***Use of technology*** – A limited number of banks reported increased use of technology as part of efforts to ensure the effectiveness of compensation regimes. This included algorithms for identifying outliers, plus back testing and regression analysis.