

**Supplementary Guidance to the FSB Principles and Standards on  
Sound Compensation Practices**

**The use of compensation tools to address misconduct risk**

9 March 2018

The Financial Stability Board (FSB) is established to coordinate at the international level the work of national financial authorities and international standard-setting bodies in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. Its mandate is set out in the FSB Charter, which governs the policymaking and related activities of the FSB. These activities, including any decisions reached in their context, shall not be binding or give rise to any legal rights or obligations under the FSB's Articles of Association.

---

**Contacting the Financial Stability Board**

Sign up for e-mail alerts: [www.fsb.org/emailalert](http://www.fsb.org/emailalert)

Follow the FSB on Twitter: [@FinStbBoard](https://twitter.com/FinStbBoard)

E-mail the FSB at: [fsb@fsb.org](mailto:fsb@fsb.org)

**Contents** **Page**

Foreword ..... 1

Background ..... 3

1. Governance of compensation and misconduct risk..... 7

2. Effective alignment of compensation with misconduct risk ..... 9

    2.1 Consideration of misconduct risk and performance..... 10

    2.2 Aligning compensation and misconduct risk ..... 11

        2.2.1 Compensation tools and the employment lifecycle..... 11

        2.2.2 Scope of performance adjustment ..... 11

3. Supervision of compensation and misconduct risk ..... 13

Annex ..... 15



## Foreword

Since the publication of the FSB Principles and Standards on Sound Compensation Practices (P&S) in 2009,<sup>1</sup> supervisors and firms have directed significant attention to improving compensation and related risk adjustment practices.

The P&S note that compensation should be adjusted for all types of risk. They emphasise that subdued or negative financial performance of a firm should generally lead to a considerable contraction of a firm's total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously awarded, including through malus or clawback arrangements. Although the P&S do not specifically address the issue of misconduct risk or provide guidance on the operation of compensation tools in the event of misconduct, the role of compensation as an important influence on incentives is clearly recognised. This guidance does not propose a definition of misconduct and posits that each firm should internally define misconduct risk based on the firm's characteristics and business and in a way that promotes adherence to legal, professional, internal conduct and ethical standards.<sup>2</sup>

Inappropriately structured compensation arrangements can provide individuals with incentives to take imprudent risks that are inconsistent with the firm's long-term value creation and time horizon of firm's risk. Costs may be imposed on firms and their customers not only by inappropriate risk-taking but also by misconduct that can result in harm to institutions, and their customers and other stakeholders<sup>3</sup> and impair trust in the financial system more generally. Compensation tools, along with other measures, can play an important role in addressing misconduct risk by providing both ex ante incentives for good conduct and ex post adjustment mechanisms for appropriate accountability when misconduct occurs.

Compensation and broader human resources policies (eg hiring and promotion policies and disciplinary codes) are important elements of a toolkit for limiting the risk and cost of misconduct. Firms should embed compensation tools in wider risk management and governance frameworks in order to support effective prevention and accountability for misconduct.

The choice of which tool to apply for compensation adjustments and the effects on compensation are decisions for firms to make. As part of normal supervisory processes, supervisors review the appropriateness of frameworks under which such decisions are made in order to promote safe and sound operating conditions.

Regulators recognise that compensation serves a number of important goals for firms, including attracting and retaining skilled staff. However, these goals should not override the need for firms to implement compensation systems that discourage misconduct or other imprudent risk-taking behaviour.

The FSB, in collaboration with the standard-setting bodies, has prepared guidance to supplement the P&S in the form of recommendations on better practice that specifically address the link between compensation and conduct. The Supplementary Guidance takes

existing supervisory regimes into account and should be read in conjunction with the P&S. Implementation by supervisors should take into consideration the underlying nature of the financial activities undertaken by the firm.

The recommendations on better practice address :

- (i) *the full range of responsibility*, from boards to senior management to the front line and control functions, for conduct issues arising from firms' risk culture and commitment to ethical conduct;
- (ii) *the integration of non-financial considerations* relating to conduct in a balanced approach to performance assessment and compensation;
- (iii) *the alignment of compensation incentives to the longer time frame* misconduct risk may take to materialise; and
- (iv) *the use of transparent, consistent and fair compensation policies* and procedures that establish and promote clear expectations and accountability for conduct.

The Supplementary Guidance also frames supervisory expectations that supervisors should use, within the scope of their authority, to monitor and assess the effectiveness of firms' compensation policies and procedures in managing misconduct risk.

---

<sup>1</sup> FSB, *Principles for Sound Compensation Practices*, April 2009 ([www.fsb.org/2009/04/principles-for-sound-compensation-practices-2/](http://www.fsb.org/2009/04/principles-for-sound-compensation-practices-2/)) and *Implementation Standards for the FSB Principles for Sound Compensation Practices*, September 2009 ([www.fsb.org/2009/09/principles-for-sound-compensation-practices-implementation-standards/](http://www.fsb.org/2009/09/principles-for-sound-compensation-practices-implementation-standards/))

<sup>2</sup> For the purposes of this guidance, misconduct risk can generally be understood as conduct that falls short of expected standards, including legal, professional, internal conduct and ethical standards.

<sup>3</sup> Stakeholders will vary by country depending on local customs, regulation and legislation, but it is likely in many jurisdictions for instance to include investors.

# Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices

## The use of compensation tools to address misconduct risk

### Background

The FSB Principles and Standards (P&S), which apply to significant financial institutions,<sup>4</sup> were published in 2009, in the aftermath of the global financial crisis and at a time when there was more limited regulation of compensation. Since the issuance of the P&S, many supervisors and firms<sup>5</sup> have directed considerable attention to improving compensation and related risk adjustment practices with a particular focus on individuals whose actions have a material impact on the risk exposure of firms. There has been greater consideration of the impact compensation and related performance management mechanisms can have on risk-taking and the long-term health of financial institutions.

The P&S note that compensation generally should be adjusted for all types of risk including difficult to measure risks.<sup>6</sup> Costs may be imposed on firms, their customers and other stakeholders not only by inappropriate risk-taking, but also by improper conduct that can result in harm to financial institutions and their customers, and impair trust in the financial system more generally. Significant misconduct cases such as the manipulation of interest rate benchmarks and foreign exchange trading as well as mis-selling practices have raised broad prudential concerns about effective governance, risk management, controls and incentive-based compensation practices, particularly in relation to misconduct. According to one estimate, post-crisis fines and restitution from recent misconduct events at large banks have totalled more than \$320bn for the 50 largest European Union (EU) and US firms.<sup>7</sup> Some estimates have suggested that fines at some banks had a material impact on their prudential standing.<sup>8</sup> In 2015 the

---

<sup>4</sup> The FSB Principles on Sound Compensation Practices note: “The FSF Principles for Sound Compensation Practices are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms”. “Significant financial institutions” are those that competent authorities consider significant for the purposes of the P&S.

<sup>5</sup> The P&S use the term “financial institutions” and “firms” interchangeably. Both terms are used in this guidance and they should be understood, as the context may require, as referring to different types of institutions or firms in the broad financial sector.

<sup>6</sup> The P&S in particular specify: “Compensation must be adjusted for all types of risk. [...] Risk adjustments should account for all types of risk, including difficult-to-measure risks such as liquidity risk, reputation risk and cost of capital”. (Principle 4).

<sup>7</sup> Boston Consulting Group, *Global Risk 2017: Staying the Course in Banking*, March 2017 ([http://image-src.bcg.com/BCG\\_COM/BCG-Staying-the-Course-in-Banking-Mar-2017\\_tcm9-146794.pdf](http://image-src.bcg.com/BCG_COM/BCG-Staying-the-Course-in-Banking-Mar-2017_tcm9-146794.pdf))

<sup>8</sup> The Group of Thirty found that in a sample of banks between 2009-14 conduct-related fines, client litigation and redress accounted for an average of 34% of total provisions for credit losses by the banks with numbers increasing after 2014. The same survey found that this accounted for 7.5% of the operating cost base of the banks and concluded that this was a key driver of weak performance (i.e. return on equity for most firms had been in the 5-7% range during this period, below the cost of capital for the banks). (Group of Thirty, *Banking Conduct and Culture*, July 2015 ([http://group30.org/images/uploads/publications/G30\\_BankingConductandCulture.pdf](http://group30.org/images/uploads/publications/G30_BankingConductandCulture.pdf)).

European Systemic Risk Board found that fines would erase all the capital issued by the EU's global systemically important banks between 2010 and 2015.<sup>9</sup>

The risks posed by such events have focused the attention of many supervisors and financial institutions more intensively on the need to develop robust frameworks for identifying, preventing and remedying misconduct. Serious failures have resulted in large fines and have undermined trust in financial institutions and markets more generally. As a result, many supervisors are increasingly focused on the need to strengthen relevant policies and supervisory expectations, with a particular focus on significant financial institutions.

Compensation and related performance management mechanisms help signal the importance that financial institutions place on prudent management of risk and acceptable standards of behaviour, including compliance with related laws, regulations and supervisory expectations.

In addressing accountability, firms should have a range of tools available to consider using when misconduct occurs, including the specific compensation tools discussed in this guidance. It is consistent with sound practice, and the nature of variable compensation, that all variable pay should be at risk of reduction when misconduct occurs. The choice of which tools to use, and in which circumstance, remains with the firm but use of the tools should be consistent with sound risk management practices. Risk management failures and misconduct can often take years to come to light. However, performance adjustment could still be applied to the extent that the relevant individuals have variable compensation at risk. The duration of the look back period during which such events may be identified will be a function of firm policies and procedures consistent with applicable national laws and regulations.

Cases of misconduct have demonstrated that misconduct can by itself pose significant risk to a firm's safety and soundness. The P&S refer specifically to reputational and operational risk, which can both include misconduct risk (though not explicitly mentioned).<sup>10</sup> Moreover, the FSB has expressly addressed misconduct risk issues as part of its guidance on risk appetite frameworks and risk culture.<sup>11</sup> Both of these include broad references to compensation incentives.

In 2016, the FSB agreed to develop guidance on better practice regarding the application of the P&S to misconduct risk. The Supplementary Guidance is designed to apply to significant financial institutions. FSB members should apply the guidance on better practice in a manner consistent with each jurisdiction's applicable law and regulation.

At the centre of the guidance is the effective use of compensation tools based on strong governance and management of misconduct risk through compensation practices, including robust performance management practices. Competent authorities should take into account the specificities of the financial sectors within their respective mandates. The guidance is structured in three parts:

---

<sup>9</sup> European Systemic Risk Board, *Report on misconduct risk in the banking sector*, June 2015 ([https://www.esrb.europa.eu/pub/pdf/other/150625\\_report\\_misconduct\\_risk.en.pdf](https://www.esrb.europa.eu/pub/pdf/other/150625_report_misconduct_risk.en.pdf))

<sup>10</sup> Firms may choose to address misconduct as a stand-alone risk or may incorporate misconduct in existing risk categories such as operational or reputational risk and manage it through enhanced, but existing processes.

<sup>11</sup> FSB, *Principles for an Effective Risk Appetite Framework*, November 2013 ([http://www.fsb.org/2013/11/r\\_131118/](http://www.fsb.org/2013/11/r_131118/)) and FSB, *A Framework for Assessing Risk Culture*, April 2014 ([http://www.fsb.org/2014/04/pr\\_140407/](http://www.fsb.org/2014/04/pr_140407/))

1. Governance of compensation and misconduct risk.
2. Effective alignment of compensation with misconduct risk.
3. Supervision of compensation and misconduct risk.

The Supplementary Guidance is consistent with the P&S and provides guidance on better practice for addressing misconduct risk without adding any new or additional principles or standards.

## **Supplementary Guidance to the FSB P&S on the use of compensation tools in addressing misconduct risk**

*This guidance does not establish additional principles or standards beyond those already set out in the FSB Principles and Standards for Sound Compensation Practices published in 2009 (P&S). The FSB has developed this supplementary guidance in the form of recommendations on better practices at financial institutions considered significant for the purposes of the P&S (“significant financial institutions”).*

- 1. The board should oversee and senior management<sup>12</sup> should implement a compensation system designed to promote ethical behaviour and compliance with laws, regulations, and internal conduct standards.**
- 2. Sound governance, robust risk management frameworks and adequate involvement by control functions, including human resources, in compensation design and decision-making are critical to the effectiveness of compensation incentives in addressing misconduct risk.**
- 3. The ultimate responsibility for ensuring accountability for misconduct lies with the board of directors. Boards are accountable for overseeing compensation systems that promote prudent risk-taking behaviours and business practices. They should hold senior management accountable for implementing and participating in the design of a compensation system that effectively delineates how compensation tools address misconduct risk.**
- 4. Senior management should hold line of business management accountable for communicating, implementing and meeting expectations regarding ethical behaviour and business practices in compliance with laws, regulations, and internal conduct standards. Internal communications should ensure that the potential consequences of misconduct on compensation are clearly explained to all employees.**
- 5. Consistent with the P&S, compensation should be adjusted for all types of risk, including difficult to measure risks. These include risks associated with misconduct that can result in harm to firms, customers and other stakeholders. The processes for managing misconduct risk through compensation systems should include, at a minimum, ex ante processes that embed non-financial assessment criteria such as the quality of risk management, degree of compliance with laws and regulations and the broader conduct objectives of the firm including fair treatment of customers, into individual performance management and compensation plans at all levels of the organisation and as part of the broader governance and risk management framework.**

---

<sup>12</sup> The FSB recognises that there are significant differences in the legislative and regulatory frameworks across jurisdictions regarding the use of terms and concepts of “board”, “senior managers”, “control functions” which may limit or further guide the relevance of certain principles or provisions therein. For instance, financial institutions may be organised as partnership or other forms of business associations, in which supervisory and management functions are exercised through structures other than “boards”. Each jurisdiction should apply the provisions in a manner consistent with local frameworks.

Such processes should be supported by ongoing programmes including formal training courses that reinforce appropriate standards of behaviour.

6. To effectively accommodate the potentially longer-term nature of misconduct risk, compensation systems should provide for mechanisms to adjust variable compensation, including, for instance, through in-year adjustment, and malus or clawback arrangements, which can reduce variable compensation after it is awarded or paid.<sup>13</sup>
7. Compensation policies and procedures are an important control on misconduct. To ensure consistency, fairness and transparency in the application of compensation adjustment, it is important that effective policies and procedures are in place to decide cases that may result in reductions to variable compensation, based on clear specification, ex ante, of the misconduct triggers or other mechanisms that may result in such reduction.
8. Supervisors should, within the scope of their authority, monitor and assess the effectiveness of firms' compensation policies and procedures, including the application of compensation tools in addressing misconduct risk and related misconduct outcomes. National regulations and/or guidance should set out clear expectations, within the scope of applicable legislative and regulatory frameworks, on the use of compensation tools in addressing misconduct risk and related misconduct outcomes and the criteria for their application.

## 1. Governance of compensation and misconduct risk

### Supplementary guidance to the FSB Principles and Standards

<p><b>1. The board should oversee and senior management<sup>14</sup> should implement a compensation system designed to promote ethical behaviour and compliance with laws, regulations, and internal conduct standards.</b></p>
--

---

<sup>13</sup> Tools commonly used to address misconduct include:

- In-year adjustment (“ex ante” adjustment): this is the downward adjustment of an anticipated annual variable compensation award to reflect the impact of a negative event or behaviour, ie (dealing immediately with an issue which has arisen through adjustment to the current year’s variable compensation). In some jurisdictions this mechanism may be referred to as an “ex ante” adjustment, i.e., an adjustment before the time at which an award would otherwise be granted.
- Malus: this permits the institution to reduce the value of all or part of deferred compensation based on ex post risk adjustment before it has vested.
- Clawback: this is a process under which the individual has to return ownership of an amount of variable compensation paid in the past or which has already vested to the institution under certain conditions.

It is for firms to determine which tool is most appropriate for the specific circumstance. Consistent with the Principles, at a minimum, compensation outcomes should be symmetric with risk outcomes. The possibility to use such tools should extend, at a minimum, to all material risk takers and senior executives.

<sup>14</sup> The FSB recognises that there are significant differences in the legislative and regulatory frameworks across jurisdictions regarding the use of terms and concepts of “board”, “senior managers”, “control functions” which may limit or further guide the relevance of certain principles or provisions therein. For instance, financial institutions may be organised as

- 2. Sound governance, robust risk management frameworks and adequate involvement by control functions, including human resources, in compensation design and decision-making are critical to the effectiveness of compensation incentives in addressing misconduct risk.**
- 3. The ultimate responsibility for ensuring accountability for misconduct lies with the board of directors. Boards are accountable for overseeing compensation systems that promote prudent risk-taking behaviours and business practices. They should hold senior management accountable for implementing and participating in the design of a compensation system that effectively delineates how compensation tools address misconduct risk.**
- 4. Senior management should hold line of business management accountable for communicating, implementing and meeting expectations regarding ethical behaviour and business practices in compliance with laws, regulations, and internal conduct standards. Internal communications should ensure that the potential consequences of misconduct on compensation are clearly explained to all employees.**

- Firms should have an internal definition of misconduct based on their characteristics, values and business and which promotes adherence to legal, professional, internal conduct and ethical standards.
- Risk appetite statements should reflect clear and well-understood values and conduct standards that are tailored and cascaded to individual business units and taken into account when assessing performance and promotion potential.
- Individuals should be held accountable for ensuring that his or her own conduct is consistent with these standards.
- The oversight of the firm's compensation and performance management policies should be a core task of the board. The board should satisfy itself that such policies appropriately balance risk and reward and that the performance assessment takes into account compliance with law and regulations, adherence to internal conduct standards and ethical and responsible behaviour.

The board of directors should oversee and hold senior management accountable for implementing and participating in the design of compensation programmes that effectively contribute to preventing and remediating misconduct. Regular monitoring of the compensation policy and the effective management of compensation and misconduct risk should remain the duty of senior managers.<sup>15</sup>

---

partnerships or other forms of business association, in which supervisory and management functions are exercised through structures other than "boards". Each jurisdiction should apply the provisions in a manner consistent with local frameworks. The guidance is intended to cover both the supervisory function and the management function, as appropriate.

<sup>15</sup> It is for individual firms to determine how misconduct risk should be incorporated into their risk management framework. Firms do not necessarily need to create a new risk category to address misconduct risk.

- Boards of directors should actively engage with senior management, including challenging senior management’s compensation assessments and recommendations if warranted when serious or recurring misconduct occurs and ensure that root cause analysis is performed, lessons learned are promulgated firm-wide and new rules and policies are adopted, as necessary, to prevent it from happening again.
- The roles and responsibilities of the control functions (including human resources, risk management, compliance, and internal audit) with respect to assisting in the design of appropriate compensation policies, the development of risk and conduct related performance metrics, and the identification, monitoring and reporting of misconduct should be clearly described in the institution’s policies and procedures. For example, the human resources, compliance and risk functions and the business lines should define the criteria and/or metrics against which employees should be assessed and the situations which constitute misconduct. These criteria should be validated and periodically reassessed by senior management.
- Business lines should be held accountable for identifying, monitoring and reporting on relevant indicators of misconduct risk, as well as for escalating and remediating identified deficiencies or other important matters in an appropriate and timely fashion, in such a way as to allow inclusion of relevant feedback and changes in the performance assessment process if need be.
- Senior and middle management have important roles to play in promoting, developing and communicating conduct expectations and clearly linking compensation and conduct standards, including as part of the performance assessment process throughout each employee’s tenure with the firm. Specifically, the expectation that compensation tools will be used to ensure that there will be consequences for misconduct should be consistently and clearly communicated to all employees.

## **2. Effective alignment of compensation with misconduct risk**

### **Supplementary guidance to the FSB Principle and Standards**

- |   |
|---|
| <p><b>5. Consistent with the P&amp;S, compensation should be adjusted for all types of risk, including difficult to measure risks. These include risks associated with misconduct that can result in harm to firms, customers and other stakeholders. The processes for managing misconduct risk through compensation systems should include, at a minimum, ex ante processes that embed non-financial assessment criteria such as the quality of risk management, degree of compliance with laws and regulations and broader conduct objectives of the firm, including fair treatment of customers, into individual performance management and compensation plans at all levels of the organisation and as part of the broader governance and risk management framework. Such processes should be supported by ongoing programmes including formal training courses that reinforce appropriate standards of behaviour.</b></p> |
|---|

## 2.1 Consideration of misconduct risk and performance

- Non-financial measures of performance, including conduct related goals, help signal to employees the importance that management places on appropriate conduct. Consistent with the approach set out in the P&S, the non-financial criteria and metrics for assessing performance should align with the business strategy, values and culture and the long-term interests of the firm and be transparent within the assessment framework. In some instances, it may be appropriate for the firm to determine that non-financial consideration of performance overrides financial considerations. This should reduce the potential for conflicting signals that may occur when short-term financial drivers of measures of performance (such as revenue or profit) compete with non-financial measures (such as assessments of the employee's effectiveness in managing risk, the individual's compliance with laws and regulations, or assessments against other conduct-related performance standards) intended to support the long-term health of significant financial institutions.
- Well-structured incentive schemes should include the use of qualitative and/or quantitative assessments of an employee's conduct. Specific criteria should vary depending on the underlying nature of activities. Conduct goals and performance targets should work together as a part of employees' incentive compensation plans to drive good behaviour and address potential conflicts of interest.
- Sound performance management practices should include consideration of conduct both when setting performance objectives and when measuring actual performance against those objectives.
- Performance assessments and compensation outcomes should consider the full spectrum of risks, including those associated with revenue producing activities and those stemming from conduct that may not be consistent with laws, the broader regulatory framework, internal policies and procedures or the firm's risk management framework.
- Performance assessments of senior and mid-level management should also include considerations regarding their relevant oversight responsibility in relation to the risk of misconduct within their business line.
- Adequate amounts of variable compensation should be placed at risk of reduction, to help alignment of compensation outcomes with adverse outcomes and/or risks that may manifest only with time.
- At a minimum, adjustment should occur (i) in cases of misconduct that have led to significant loss to the institution, its customers or counterparties; or (ii) where there is fraud, gross negligence or material failure of risk management controls, including serious breach of internal rules or regulation, regardless of the scale of the damage. The preceding set of circumstances is not exhaustive. Firms are encouraged, where appropriate, to address other significant instances of misconduct as well.

## 2.2 Aligning compensation and misconduct risk

### Supplementary guidance to the FSB Principles and Standards

6. To effectively accommodate the potentially longer-term nature of misconduct risk, compensation systems should provide for mechanisms to adjust variable compensation, including, for instance, through in-year adjustment, and malus or clawback arrangements, which can reduce the variable compensation after it is awarded or paid.
7. Compensation policies and procedures are an important control on misconduct. To ensure consistency, fairness and transparency in the application of compensation adjustment, it is important that effective policies and procedures are in place to decide cases that may result in reductions to variable compensation, based on clear specification, ex ante, of the misconduct triggers or other mechanisms that may result in such reduction.

#### 2.2.1 Compensation tools and the employment lifecycle

- To be effective, compensation practices should be considered within the context of performance management systems that take into account the full range of financial and non-financial incentives in an employment relationship (eg as part of hiring, performance review, promotion, succession planning and talent development strategies).
- Firms should have the flexibility to use a range of tools to adjust compensation to address misconduct risk. Compensation and broader performance management tools should work in concert with other management tools in discouraging misconduct and promoting prudent risk taking.
- The impact on compensation should be commensurate with the severity of the issue or events that have occurred.
- Firms should be careful to ensure that actions taken in one part of the compensation package are not undermined by actions taken on other forms of compensation or by other performance management actions.

#### 2.2.2 Scope of performance adjustment

- Performance adjustment should allow firms to adjust compensation to take account of risks that have subsequently crystallised, including instances of employee misconduct or material error, material downturn in performance or a material failure of risk management.
- The possibility to use compensation tools should extend, at a minimum, to all material risk takers and senior executives.

- Responsibility for misconduct may not necessarily be limited to those most directly involved. The use of performance adjustment may extend beyond those directly responsible for misconduct, eg where there has been a material failure of risk management for misconduct. Specifically, performance adjustment should be considered for the heads of internal control functions and for those employees in control or direct line of business functions who by virtue of their role could be considered responsible or accountable for the failure or for the weakness in the control framework relevant in the employee misconduct.
- Where consistent with the local legislative or regulatory framework, firms may wish to consider the application of performance adjustment to those senior employees or members of the governing body who, while not directly responsible were either aware, or could have been reasonably expected to be aware due to their seniority or role in the firm, of the failure or misconduct at the time, but failed to take adequate steps to promptly address it.

### ***2.2.3 Policies and procedures for performance adjustment***

#### **Policies**

- Performance adjustment policies should set out indicative criteria and scenarios that could trigger the use of performance adjustment for compensation purposes, including examples of circumstances in which employees' variable compensation may be adjusted down to zero regardless of the individual's performance in meeting their expected financial targets.
- At a minimum such scenarios should include, cases in which: (i) the individual was accountable for misconduct that led to significant losses for the institution or significant adverse outcomes for its customers or counterparties; or (ii) there is fraud, gross negligence or material failure of risk management controls, including serious breach of internal rules or regulations, regardless of the scale of the damage.
- Performance adjustment policies should provide for firms to take into account the following factors, as a minimum, for those under review when determining accountability for adverse risk events:
  - culpability or proximity to the misconduct;
  - rank and role;
  - intent or motivation (eg personal gain, malice, fraud, ignorance, lack of training);
  - negligence or recklessness in exercise of duties;
  - level of participation in and responsibility for the events under review;
  - history of misconduct;
  - actions that were taken or could have been taken to prevent the misconduct from occurring, including any failures within the firm to internally supervise and oversee staff; and
  - the root cause of the events triggering review.
- When deciding the amounts of compensation to be adjusted, performance adjustment policies should provide for firms to take into account all relevant indicators of the severity of impact, which may include the cost of fines and regulatory actions, direct and indirect financial losses and/or the impact on profitability attributable to the relevant failure, any

reputational damage, the impact of such events on customers, and costs to redress the events under review.

- Where compensation adjustments are made before the full impact of the risk management failures or misconduct is known, appropriate subsequent adjustments should be made to ensure that the final adjustment fully reflects the impact of the incident or misconduct. The duration of the look-back period during which such events may be identified will be a function of both national laws and regulations and the firms' compensation policies and procedures consistent with those laws and regulations.<sup>16</sup>
- Performance adjustment policies should provide that the granting and vesting of all awards made to individuals undergoing internal or external investigation may be frozen until the investigation has concluded and the firm has made a decision and communicated it to the relevant employee(s).

### **Procedures**

Performance adjustment should be governed by clear procedures that:

- Indicate the processes for reporting, escalating to human resources and control functions and to senior management and deciding cases that may trigger the use of performance adjustment for misconduct and who should play a role in such processes;
- Ensure that control functions, including human resources, are appropriately involved in the processes, except for those persons who may also fall within the scope of the investigation;
- Set out clear processes to determine responsibility or accountability, including ensuring that individuals under investigation are able to make representations;
- Make clear the role of discretion in such processes, who is authorised to use such discretion and how such discretion would be appropriately bound by supporting governance and risk management processes;
- Require adequate documentation and rationale of final decisions; and
- Ensure transparency by providing for clearly communicating in writing to all affected individuals the value of performance adjustments made to variable compensation and the reasons for such adjustments.

## **3. Supervision of compensation and misconduct risk**

### **Supplementary guidance to the FSB Principles and Standards**

**8. Supervisors should, within the scope of their authority, monitor and assess the effectiveness of firms' compensation policies and procedures, including the application of compensation tools in addressing misconduct risk and related misconduct outcomes. National regulations and/or guidance should set out clear expectations, within the scope**

---

<sup>16</sup>Given that often the full impact or details of events take some time to come to light, it is reasonable that firms should have the ability to make subsequent additional adjustments, where appropriate, to variable compensation for the applicable period. It is therefore important to ensure alignment between the length of the time period over which the impact of misconduct is likely to materialise and the length of the period over which variable compensation remains at risk, in accordance with applicable provisions on periods of limitation.

**of applicable legislative and regulatory frameworks, on the use of compensation tools in addressing misconduct risk and related misconduct outcomes and the criteria for their application.**

**Supervisors should, with due regard to supervisory authority, proportionality, and risk-based analysis:**

- Analyse the use of compensation tools in mitigating misconduct risk, as part of overall assessments of firms' compensation, corporate governance, risk culture or wider risk management practices;
- Review regular reports from firms, such as those prepared for the board and senior management, on the use of compensation and related performance management tools to reduce misconduct risk;
- Consider the firm's use of non-financial assessments of performance, including whether the firm's policies provide for effective management of misconduct risk;
- Require firms to address and remedy material weaknesses identified through the broader compensation and performance management system and review how they do so; and
- Take into account in supervisory assessments:
  - A firm's overall approach to governance, including the role of the board in overseeing misconduct risk management as well as appropriate linkage to the firm's wider risk management framework and risk appetite;
  - Whether compensation schemes include ex ante criteria of non-financial risks such as assessments of performance against conduct, and related compliance and risk management standards;
  - Whether performance management systems and communication to staff sufficiently reflect firms' expectations in respect of misconduct and its influence on staff's compensation;
  - The effectiveness of compensation tools in aligning compensation paid and awarded with misconduct risk and related adverse outcomes; and
  - Disclosures that make clear the manner in which misconduct risk is managed, including through the use of compensation system and tools.

## Annex

### FSB Principles and Standards relevant for the purposes of the Supplementary Guidance

**Principle 1.** The firm's board of directors must actively oversee the compensation system's design and operation. The compensation system should not be primarily controlled by the chief executive officer and management team. Relevant board members and employees must have independence and expertise in risk management and compensation.

**Principle 2.** The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended. The compensation system should include controls. The practical operation of the system should be regularly reviewed for compliance with design policies and procedures. Compensation outcomes, risk measurements, and risk outcomes should be regularly reviewed for consistency with intentions.

**Standard 1.** [the Board, through the Remuneration Committee, should] work closely with the firm's risk committee in the evaluation of the incentives created by the compensation system;

**Principle 4.** Compensation must be adjusted for all types of risk. Two employees who generate the same short-run profit but take different amounts of risk on behalf of their firm should not be treated the same by the compensation system. In general, both quantitative measures and human judgment should play a role in determining risk adjustments. Risk adjustments should account for all types of risk, including difficult-to-measure risks such as liquidity risk, reputation risk and cost of capital.

**Standard 4.** For significant financial institutions, the size of the variable compensation pool and its allocation within the firm should take into account the full range of current and potential risks, and in particular:

- the cost and quantity of capital required to support the risks taken;
- the cost and quantity of the liquidity risk assumed in the conduct of business;
- consistency with the timing and likelihood of potential future revenues incorporated into current earnings.

**Principle 5.** Compensation outcomes must be symmetric with risk outcomes. Compensation systems should link the size of the bonus pool to the overall performance of the firm. Employees' incentive payments should be linked to the contribution of the individual and business to such performance. Bonuses should diminish or disappear in the event of poor firm, divisional or business unit performance.

**Standard 5:** Subdued or negative financial performance of the firm should generally lead to a considerable contraction of the firm's total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.

**Principle 6.** Compensation payout schedules must be sensitive to the time horizon of risks. Profits and losses of different activities of a financial firm are realized over different periods of time. Variable compensation payments should be deferred accordingly. Payments should not be finalised over short periods where risks are realised over long periods. Management should

question payouts for income that cannot be realised or whose likelihood of realisation remains uncertain at the time of payout.

**Standard 6.** For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm:

a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance;

**Standard 9.** The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually. In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line

**Principle 8.** Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action. Supervisors should include compensation practices in their risk assessment of firms, and firms should work constructively with supervisors to ensure their practices conform with the Principles. Regulations and supervisory practices will naturally differ across jurisdictions and potentially among authorities within a country. Nevertheless, all supervisors should strive for effective review and intervention. National authorities, working through the FSF, will ensure even application across domestic financial institutions and jurisdictions.

**Principle 9.** Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders. Stakeholders need to be able to evaluate the quality of support for the firm's strategy and risk posture. Appropriate disclosure related to risk management and other control systems will enable a firm's counterparties to make informed decisions about their business relations with the firm. Supervisors should have access to all information they need to evaluate the conformance of practice to the Principles.