8 March 2018

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

Overview of responses to the consultation

On 20 June 2017, the FSB published a consultative document on *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices*.[1] The FSB received 17 responses from banks, trade associations, non-governmental organisations, investor groups, a central bank and private individuals. One response was submitted on a confidential basis and were therefore not published on the FSB website.

This note summarises the main points from the responses to the consultation, including to the specific questions set out in the consultation and provides an overview of the response to those comments, including changes made to the Guidance.

Responses to consultation questions

Question 1: Should the Guidance be more specific with regard to the respective roles of the board or that of senior managers with regard to compensation and misconduct?

Most respondents agreed that boards of financial institutions have an important oversight role to play with regard to compensation practices. They also agreed that performance management systems should take into account compliance, ethical and responsible behaviour and distinguished oversight responsibilities for boards from the day to day implementation, monitoring and management of such risks which they believed lie with senior management. Many emphasised the need for the Guidance to be principles-based and did not see a need for additional specificity, noting that it would reduce the flexibility needed across different groups and corporate structures.

One respondent noted that the scope of board oversight of compensation arrangements should be restricted to those of senior management, and that senior management in turn should review and assess the arrangements of other company employees. Several raised issues related to coordination of oversight by top-tier holding companies, or alternatively by subsidiary boards. One raised issues related to collective vs individual responsibility of the board. Another

[1] FSB, *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practice,* June 2017 (www.fsb.org/2017/06/supplementary-guidance-to-the-fsb-principles-and-standards-on-sound-compensation-practices/)

suggested the Guidance should make clear that the board may conduct their activities through a dedicated sub-committee.

As stated in the P&S, significant financial institutions should have a board remuneration committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation on behalf of the board of directors.

While there will clearly be a focus on implementation of compensations policies for senior executives and material risk takers more generally, boards have an important role to play in the oversight of compensation policies across all employees and of all forms of risk and appropriate management, including risks related to misconduct. The role of management is to implement and monitor the higher level frameworks agreed by the board.

Therefore, limited changes have been made to the Guidance in the area of governance, to further clarify and better distinguish between the roles and responsibilities of an institution's board of directors and those of senior management. In addition, the role of business lines has been clarified, as well as the responsibility of senior and mid-level management regarding their relevant oversight in relation to the risk of misconduct.

Question 2: The Guidance suggests that qualitative, non-financial assessments should have a direct impact on compensation and that they are important in determining how to align compensation with risk. Would additional guidance be helpful? Please provide data if your firm uses such provisions including the types of metrics used, and a discussion of any challenges you face in their use.

There was general agreement that financial and non-financial criteria should be taken into account when performance management decisions were being made and were important for signalling the importance firms place on appropriate conduct. Most commenters agreed that the guidance was set at an appropriate level although three requested additional guidance in specific areas. Two asked for further details to be provided on non-financial indicators and one respondent asked for more detailed guidance on the use of non-financial metrics

Several commenters emphasised that institutions should be given flexibility in defining the criteria and metrics that should be taken into account and that criteria should reflect the category of employees and their impact on the group/company risk profile. Two commenters spoke to the weighting of non-financial criteria. Three commenters emphasised the need to align non-financial metrics with long-term strategy and business performance goals as well as the need to transparently assess performance against non-financial metrics.

Non-financial performance assessment criteria play an important role in promoting appropriate conduct and financial institutions should be given flexibility to define the specific criteria that are used, provided they meet the principles set forth in the Guidance. The Guidance sets out examples of non-financial assessments that could led to compensation adjustments, which following consultation feedback now makes clear that the examples provided are non-exhaustive. The Guidance has been further clarified to indicate that non-financial metrics should be aligned with the long-term interests of the firm, consistent with the P&S.

The specific criteria used should vary with seniority and the category of employee being reviewed, with particular attention to employees identified as material risk takers and other senior executives.

One commenter asked for clarity on how compensation adjustments and the use of non-financial metrics are relevant to the full lifecycle of employment. The proposed Guidance stated that broader performance management systems should refer to non-financial criteria through the lifecycle of employment (for instance, considerations of conduct records when hiring new employees). The Guidance has been edited to make these points clearer.

Question 3: The Guidance identifies three tools most commonly used to address misconduct: in-year adjustment (adjustment to the current year's variable compensation before it is awarded); malus (reduction of deferred compensation before it has vested or fully transferred); and clawback, which permits recovery of variable compensation that has already been paid and vested. Given the particular characteristics of misconduct risk, do you believe that all three tools need to be available to a firm to establish appropriate incentives to deter misconduct?

Most respondents agreed that firms should have available all three tools (in-year adjustment, malus and clawback) at their disposal although a number emphasised the importance of allowing firms to make decisions about when and how to use such tools and believed tools were not equally relevant across all categories of staff. One emphasised the importance of malus and clawback in particular to limit excessive risk-taking.

A number of respondents noted concerns about the difficulty of applying clawback given labour law restrictions in some jurisdictions.[2] One, however emphasised in particular the need for strong clawback tools.

One respondent noted that while the use of all three tools can be useful, it will only be able to apply malus where deferral has been applied. Since the P&S set out a need for deferrals for selected employees such as material risk takers, this does not seem to be a barrier to application of the Guidance to those employees.

One respondent raised concerns that the use of malus and clawback in contracts led to employees discounting deferred pay and pressing for higher fixed pay. While such pressures may emerge, negating the effective incentives that are created by the use of malus and clawback by increasing fixed pay will be an element of supervisory attention.

One respondent noted the need to effectively communicate to employees the amount of deferred pay which could be subject to clawback. Supervisors would generally expect all firms to clearly set out the potential consequences of misconduct, including the situations under which employees might expect the application of risk adjustment tools to strengthen the deterrent effects of such tools. This does not necessarily result in a requirement to communicate the outcomes of individual compensation decisions across the firm, however it is important that employees understand the potential for such tools to be used and the types of situations under which they would be considered.

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[2] This is an issue which was addressed in the compensation progress report published in July. (FSB, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Fifth progress report*, July 2017 (www.fsb.org/2017/07/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards-fifth-progress-report/))

Question 4: The Guidance suggests minimum scenarios where adjustment of compensation should occur. Are there additional circumstances in which adjustments to compensation should be expected? What are the advantages and disadvantages of suggesting such minimum conditions? In particular, is there evidence from past use of such tools that might be instructive in how to formulate such scenarios?

While many respondents found the scenarios helpful and in line with the types of situations under which they would consider adjustment, they also emphasised the importance of communicating that the minimum scenarios should not be viewed as definitive. Several commenters emphasised that decisions to adjust compensation should be case specific. Several respondents suggested additional scenarios be included, although one noted that the minimum scenarios themselves are too prescriptive and unlikely to apply across financial sectors. One respondent stated that some events should lead to mandatory compensation adjustments to remove the risk that firms may not apply such adjustments in practice.

The Guidance has been edited to clarify that the suggested scenarios identify minimum issues but do not represent an exhaustive list of scenarios under which firms may decide to make compensation adjustments. As the guidance is meant to be principles-based no additional detail on other events that might merit adjustment were included. Firms retain flexibility to add to these as particular outcomes merit.

Question 5: How much variable compensation should be placed at risk of adjustment in order to effectively impact incentives for excessive risk-taking or other inappropriate conduct?

Most respondents agreed that 100% of variable compensation should be put at risk in order to ensure effective incentives, although several respondents believed the Guidance should not establish any particular level of pay at risk or that this decision should be left to the discretion of firms. One respondent suggested that compensation adjustments should be a derivative of the amount of total compensation as well as responsive to the nature of the misconduct. The P&S state the proportions of variable pay subject to deferral should increase significantly along with the level of seniority and/or responsibility. Consistent with the nature of variable compensation, all variable pay should be at risk and considered for reduction when misconduct occurs. The Guidance does not prescribe a particular impact and leaves firms with discretion to assess the appropriate impact given particular facts and circumstances. As set out in recommendation 7, firms should have effective policies and procedures "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."

Question 6: Does the Guidance adequately cover compensation incentives that may be relevant to addressing misconduct risk in all sectors of the financial industry? Are there additional specific provisions that should be considered to better address misconduct risks in particular financial sectors? Are there specific provisions in the guidance that may not be relevant to a particular financial sector?

Most commenters believed that the guidance covered the issues it needs to cover but one commenter underscored that a uniform approach for banks and insurers was not appropriate. Other responses from some insurance trade associations highlighted differences between the business models of banks and insurers. While there are clear differences between these business models, the Guidance and the P&S more generally are written in a principles-based form such that they have applicability across financial sectors.

Some respondents noted the importance of wider governance-related mechanisms for being part of efforts to reduce misconduct. Compensation and broader performance management tools should work in concert with other management tools in discouraging misconduct and promoting prudent risk taking. The FSB work on misconduct[3] specifically considers the role of governance mechanisms in addressing misconduct risk.[4] In relation to this, it has been clarified that the role of compensation systems is to help encourage prudent behaviour and in so doing help prevent and remediate misconduct, but they are not designed as the specific tool to identify and monitor misconduct.

One respondent noted the importance of ensuring that a proportionate approach is taken to the scope of firms covered by the guidance. Since the guidance is focused on significant firms the guidance is designed to be proportionate as it applies to a limited number of globally active firms.

Other comments

A few commenters asked for a specific definition of misconduct risk to support the application of the Guidance. The text has been edited and a footnote inserted to clarify that the 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 and ethical standards. A working level definition has been proposed for the purposes of the Guidance. Based on this working level definition, misconduct risk can generally be understood as conduct that falls short of expected standards, including legal, professional and ethical standards.

In relation to the above, one respondent noted that the Guidance was not specific enough in terms of how recent misconduct cases had raised prudential concerns and how the proposed Guidance would have helped prevented those events or addressed those concerns. In response to this comment further details have been inserted on the examples and effects of misconduct, while the FSB work on measures to address misconduct risk[5] has elaborated further on the role of incentives to prevent misconduct.

While most commenters believed the principles based approach taken in the Guidance was broadly appropriate, two respondents noted that the guidance is too prescriptive while a number of the other respondents asked for more detail. Several commenters emphasised the importance of pitching the guidance at a sufficiently high level, which the Guidance broadly is. Notwithstanding commenters' emphasis on principles based guidance, some commenters asked that the Guidance actually be more specific in certain areas such as the use of non-financial risk assessments and examples on how jurisdictions have implemented compensation adjustments

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[3] FSB, *Reducing misconduct risks in the financial sector: Progress report to G20 Leaders*, July 2017 (www.fsb.org/2017/07/reducing-misconduct-risks-in-the-financial-sector-progress-report-to-g20-leaders/)

[4] FSB, *Stocktake of efforts to strengthen governance frameworks to mitigate misconduct risks*, May 2017 (www.fsb.org/2017/05/stocktake-of-efforts-to-strengthen-governance-frameworks-to-mitigate-misconduct-risks/)

[5] See footnote 3.

Some respondents highlighted the need to avoid creating new standards while others suggested that the Guidance changes the scope of the P&S. One commenter said that the case for developing guidance isn't clear and questioned more generally the need for international standards on compensation. One respondent stated that it is not necessary for firms to have detailed policies on the adjustment of variable remuneration.

The Guidance does not create new requirements or seek to make changes to the P&S. Rather it provides guidance on compensation and wider performance management practices that may help better address the risk of misconduct when implementing the P&S. Supervisors expect firms to be able to demonstrate clear and effective governance of compensation policies, which set out the company's approach to compensation. From this perspective sufficient policies and procedures in the area of compensation are an essential control.

One respondent highlighted concerns that the guidance could be inconsistent with Solvency II. The compensation progress report published in July 2017[6] examined this issue and concluded that Solvency II is consistent with the Principles and Standards and therefore the current guidance, which is derivative of those principles, does not introduce any conflicts.

Two respondents highlighted the importance of linking these issues to codes of conduct used in firms. Since the guidance is deliberately principles-based such further additional guidance was not added.

One respondent said that the guidance does not take account of compensation frameworks already adopted in jurisdictions. The guidance was developed by regulatory and supervisory experts from the FSB member jurisdictions and is designed to be consistent with existing frameworks. Moreover, the Guidance explicitly states that jurisdictions should apply the provisions contained in the Guidance in a manner consistent with local frameworks.

Two firms set out concerns about inconsistent implementation of the P&S and asked for the Guidance to be effectively and consistently implemented. One firm set out concerns about the difficulties that have been created by regulatory standards being applied differently across different financial sectors. These points are addressed in the FSB's progress report[7] on implementation of the P&S. The FSB will continue to make assessments on the consistent implementation of the P&S. The next assessment will be published in 2019.

Changes to the Guidance in response to consultation feedback

A number of changes were made to the consultation as a result of consultation feedback. The key changes include:

- Boards – it had always been the intention that the guidance should make clear that boards should oversee and senior management should implement compensation

[6] FSB, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Fifth progress report*, July 2017 (www.fsb.org/2017/07/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards-fifth-progress-report/)

[7] FSB, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Fifth progress report*, July 2017 (www.fsb.org/2017/07/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards-fifth-progress-report/)

systems. However, some consultation responses set out the need to clarify this point. So this has now been made clear in the guidance.

- Communications – effective communication of the structure and outcomes from compensation policies is a useful mechanism to ensure employees are clear that policies are being followed. It ensures that employees are clear on the expectation firms have of their behaviour. Some respondents to the consultation were concerned that this implied the need to publicly communicate individual compensation outcomes. While some jurisdictions require publication of details on compensation outcomes for senior executives, it was not the intention of the guidance to apply such an approach across all employees.
- Non-financial measures – increasingly firms are assessing employees against non-financial measures, often in the context of balanced scorecards. The guidance sets out the importance of such measures signalling the importance that management should place on appropriate conduct. Ultimately such approaches should align with the business strategy and the long-term interests of the firm. Some changes were made to reflect this point. Some respondents asked for more details on non-financial measures; these have not been added since the guidance is deliberately principles-based.
- Availability of compensation tools – a new section was added to highlight the importance of considering the use of compensation tools in the context of the full range of financial and non-financial incentives in an employment relationship.