

27 June 2014

FSB 2014 Workshop on Compensation Practices

Paris, 1 April 2014

The FSB organised in Paris on 1 April 2014 the second workshop on compensation practices to share experiences and lessons on the implementation of the FSB [Principles](#) and [Standards](#) for Sound Compensation Practices (P&S) by financial institutions. The workshop focused on three main areas: the identification and treatment of material risk takers (MRTs); the use of malus and clawback clauses as part of the alignment of compensation with risk taking and performance; and governance frameworks, including the role of compensation structures in supporting a sound risk and compliance culture at financial institutions. Officials from the FSB Compensation Monitoring Contact Group and nineteen senior executives mainly responsible for remuneration, primarily from global systemically important banks, participated in the workshop.

In discussing practical implementation challenges on specific compensation issues, the 2014 workshop built on the findings of the [2013 progress report](#) which found that while good progress has been made, more work is needed to embed positive risk management in firms' compensation practices and to achieve effective alignment with risk and performance. The 2013 report, which included [findings from the first workshop](#)¹ organised in November 2012, recognised that assessing implementation effectiveness is a multidimensional task because the relationship between compensation, performance, governance and risk taking differs across firms and time depending on the nature of business and of business conditions.

This summary reflects the main points raised in the discussion at the workshop. These points do not necessarily represent the views of the authorities nor should they be understood to be consensus views expressed by financial institutions at the workshop. The findings from the workshop will be included in the next progress report on compensation practices, which will be prepared in advance of the G20 Summit in November 2014.

The FSB welcomes any feedback on the topics discussed at the workshop and summarised in this note. Comments should be sent to fsb@bis.org by **30 July 2014**.

¹ The conclusions of the first workshop were that: firms are generally moving in the right direction, having undertaken significant efforts to advance in their implementation of sound compensation practices; the focus on remuneration is bringing tangible benefits, including in terms of increasing the effectiveness of firms' risk governance; the main concern seems to be compliance costs (rather than a level playing field) stemming from the lack of consistency in the rules and expectations among national supervisors; it is important to maintain the reform momentum in order to embed positive risk management in firms' compensation practices and achieve effective alignment with risk and performance.

1. Overview

1.1 Notwithstanding some operational challenges, progress continues to be made in embedding risk management in firms' compensation practices

Improvements in the governance of compensation practices and better integration of risk and control functions in compensation decision-making by firms are evident. In particular, firms report: greater engagement of their boards of directors and remuneration committees on compensation policies and the link to incentives; greater involvement of the risk function in setting performance objectives and informing award and payout decisions; and more interaction and shared responsibility between risk and human resources functions in this area. This is contributing to greater awareness and understanding by employees of the structure and drivers of the compensation approach of the firm, and incorporation of better practices in compensation policies and practices.

Operational challenges remain in some areas. Embedding risk management in firms' compensation practices is a long-term effort and gives rise to a number of challenges. These include, for example, selecting metrics to assess risk aligned performance; educating Board members about compensation-related risk factors and the variety of balancing mechanisms which may help to address them, including robust criteria for the use of malus and clawback; and determining the extent of discretion that should be applied by the board and remuneration committee in implementing compensation policies across the firm and over time. These efforts need to continue so as to continue to steer behaviour and support a sound risk culture.

1.2 Changes to regulatory landscape and increased complexity

Adapting to different regulatory approaches is a primary challenge and a cause of concern for firms. The need for firms to adapt their compensation frameworks to reflect certain regulatory developments was seen as the primary challenge currently confronting them in the area of compensation policy. This continuing effort to comply with changes in legislation was perceived by some firms as substantially increasing the amount of time needed to oversee compensation issues, and complicating the task of ensuring effective implementation of the P&S. Some firms also argued that more prescriptive and sometimes overlapping rules created impediments to a truly global playing field.

Some global institutions noted that, while two years ago they were all largely facing the same set of technical challenges, ongoing revisions to regulatory frameworks for compensation required them to adapt to different legal conditions in different regions. Firms headquartered or operating in the European Union (EU) are facing the greatest challenges because of the entry into force of CRD IV/CRR and related regulatory technical standards. However, a number of firms in other jurisdictions are also potentially impacted because of the scope of application of these rules and their effects on pay practices in their domestic markets. The introduction of the maximum ratio between fixed and variable compensation in CRD IV/CRR was cited by firms as potentially adversely affecting their ability to better align pay to risk-adjusted performance and as leading to unintended consequences. For example, some firms saw a risk that increases in the fixed component of pay “across the board” could, in conjunction with other developments like the use of role-based “allowances” in a few EU jurisdictions, create competitive pressures for domestic firms in other jurisdictions where

global institutions operate, since competition for talent could force domestic firms to follow global firms and adjust their pay structure accordingly.

A number of firms also commented on the diminished attractiveness of banking as an employment option, with some acknowledging that this was at least in part “self-inflicted” but others pointing to increased regulation (among other factors) as a deterrent for both current and potential new employees.

Some participants noted that it would be important to ensure that compensation policies remain consistent with the FSB P&S, such as an effective alignment with prudent risk-taking and the consequent need to have a substantial proportion of compensation in variable form subject to risk outcomes over an appropriate time horizon. Better cross-border coordination could help increase the consistency in approaches and thus facilitate better implementation of the P&S in jurisdictions with different regulatory frameworks. In that respect, greater interaction between regulators and firms is useful to minimise differences in jurisdictional approaches that could create unintended effects and exacerbate competitive concerns.

Increasing complexity. Partly as a result of overlapping rules, as well as the need to balance regulatory requirements with shareholder pressures that pay be performance-related, compensation structures within individual institutions are becoming increasingly complex. Firms expressed the view that it would be better, wherever possible, to “keep it simple”, have less onerous requirements on compensation, and balance the pace of new regulatory changes with effective implementation of the rules. At the same time, there is a recognition that the learning process from implementing different approaches (e.g. for the identification of MRTs) has served as a useful check on firms’ own definitions and practices. This has led to an appropriate level of scrutiny on current practices and brought a better understanding and alignment of risk incentives and a more rigorous approach to the identification of the functions within a firm that have a significant impact on its risk profile.

2. Selected topics

2.1 Identification of material risk takers

The session focused on the internal criteria and processes used by banks to identify MRTs, the implications of being identified as a MRT, and the implementation challenges in seeking to manage remuneration policies for MRTs on a consistent basis across the institution.

Firms generally reported that processes to identify MRTs have evolved from a “broad stroke approach” to being more refined and articulated, with better understanding by both employees and managers of the identification process, the role of risk within that process, and the implications of identification on compensation structures.

This learning process has enabled firms to better define risk-related objectives for performance reviews. Human Resources (HR), Risk Management (RM) and other control functions more consistently work together to share a global perspective on employees’ role, responsibilities and risk profiles. One of the main challenges is to improve the communication process and relationship with employees, and train managers on their treatment and performance assessment of identified MRTs. The implications for compensation of being identified as MRT are increasing and this in turn requires better communication with these

employees in order to ensure they understand the process and the reasons for it and to assuage any concerns about the increased scrutiny of their performance that this brings.

Many banks pointed to the related challenge of continuing to attract and retain talent, at least in part because the reputation of the industry has suffered in the wake of the financial crisis and because the relative attractiveness of other industries (e.g. consulting, technology and other sectors such as chemicals and automakers) and non-banks (e.g. investment managers and hedge funds) has increased. More generally, competitive pressures from smaller competitors in local markets where domestic rules may be less stringent and where different pay structures prevail were also cited as influencing banks' ability to compete for talent.

The main external challenge reported by firms in the area of MRTs is the need to comply with different legal frameworks applicable to the identification of this category of staff. In that respect, the entry into force of CRD IV/CRR in the EU and the related Regulatory Technical Standard (RTS) are seen as a "game changer", considering that in the EU there is now a common, detailed and binding definition of MRTs that will greatly impact firm practices in this area. Some firms expressed concerns about the use of absolute levels of pay in the RTS as an indicator (albeit rebuttable) of a person's impact on the firm's risk profile, which they argued was challenging their ability to determine on their own who impacts the risk profile and adopt a consistent and more appropriate internal definition across global operations, while creating a "false sense of security" for individuals below the thresholds. It was also recognised that, while differences in requirements across jurisdictions can make it challenging for firms to effectively operate their internal process for identifying MRTs, they can also contribute to testing and improving that process.

The level of pay is seen as one of the component criteria to identify MRTs, and its relevance will depend on the institution's business model and risk culture as well as on employees' specific roles and responsibilities. In addition, some firms feared that the potential increase in the number of MRTs as a result of application of the RTS could put a strain on the institution's ability to effectively review and manage MRTs at the board level. However, other industry participants noted that this need not result in greater responsibilities for Boards. For instance, some institutions have processes where boards focus on a smaller number of key risk takers who are likely to have greater influence on behaviour within the institution, while the risks posed by the larger group of MRTs are managed and monitored by other review processes within the institution that rely heavily on the input of independent control functions.

It was also noted that, in spite of the extensive discussions on this topic and work to improve disclosures on compensation practices, there is still no publicly available and internationally comparable data on MRTs across institutions. In the EU, data on MRTs is now being collected and published by the EBA as a consequence of the entry into force of CRD IV.

Finally, some participants noted that, in terms of their ability to manage remuneration consistently at the group level, it is still unclear how MRT frameworks would apply to non-bank financial institutions within the group (e.g. asset management companies).

2.2 Use of malus and clawback clauses

The session on malus and clawback explored emerging lessons, challenges and better practice on ex post risk adjustment through the use of malus, clawback and other mechanisms that reduce bonuses after remuneration awards have been made and/or have vested.

Banks reported that progress has been made on the boards' commitment to use malus and clawbacks, as well as on relevant employees' awareness and understanding that part of their compensation is at risk. Institutions report increasing use of malus, but less use of clawbacks to date. The different use can be attributed to a number of factors, including perceived legal challenges. Differences exist also on the proportion of variable pay that is subject to malus and clawbacks.² Some banks commented that risk alignment is reduced when the percentage of compensation at risk of forfeiture or clawback is low. This can occur, for example, when the percentage of permissible variable pay is reduced. Notwithstanding these concerns, banks saw malus and clawback as an important part of the toolkit for risk alignment.

Banks also commented that an institution's ability to use malus and clawbacks is affected by the enforceability of the instruments due to legal obstacles in some jurisdictions and the costs when an employee brings a challenge in court. Nonetheless, clawbacks may be useful for their "incentive effect" as they can deliver very powerful messages to employees, and some banks noted that they continue to use clawbacks despite the challenges outlined above. At some firms clawbacks are used only in "egregious cases", often involving senior staff. Participants noted that there is value in applying malus and clawbacks differentially across employees depending on particular circumstances, though with a common objective of encouraging appropriate risk-taking behaviour. They also noted the important role of annual performance evaluations (which now increasingly embed either risk metrics or a qualitative assessment of risk-taking behaviour) to adjust compensation at least for the year in question. Firms also reported making efforts to improve malus and claw-back processes through improved governance structures, such as committees that include representatives of independent control functions charged with making objective decisions on the application of malus and clawbacks.

Participants noted that clarity of communication is critical to informing and obtaining acceptance by employees that will ultimately lead to changes in behaviour. Some common "success factors" are being identified, such as: malus and clawbacks should be 'owned' by the business lines where the risks are created, but overseen by an independent process with input from control functions (and in certain cases the Board) for effectiveness and consistency reasons; institutions must be clear about the circumstances under which clawback and forfeiture will be applied, so that employees know what is expected of them and that there is an appropriate impact on risk-taking behaviours; the insertion of explicit clauses into staff contracts and compensation plan literature increases legal certainty, improves understanding of these tools, and strengthens incentives to behave in ways that do not trigger their use (which can also help reduce litigation risk for the bank); and ensuring a reasonable connection between actions and the consequences of those actions is key to effective implementation.

The effectiveness of malus and clawbacks also depends on the specific triggers used, the underlying compensation structure (including how much is deferred), the relative timespan over which malus versus clawback clauses would apply, and the interaction between these factors. Some participants called for greater consistency in the design of malus and clawback clauses in terms of triggers (e.g. different risk and compliance events), time periods, and the population to whom they apply, while others noted that clawbacks are best used in more

² It was noted in this regard that, for firms in the EU, CRD IV has introduced a requirement that up to 100% of variable remuneration should be subject to malus and clawback arrangements.

egregious circumstances and/or for more limited portions of the employee population. Some firms suggested that supervisors should provide more guidance in this area.

Banks also commented on technical challenges related to tax and accounting conventions, including whether applicable law would enable firms to recoup gross versus net amounts, and raised questions related to the valuation of compensation paid in non-cash instruments.

2.3 Governance of compensation arrangements and links to risk culture

The session focused on governance processes supporting the implementation of remuneration policies by firms, and the role of compensation practices as part of effective risk governance and risk culture frameworks.

Participating institutions noted that governance is probably the area with the most tangible improvement in recent years. There is a higher degree of involvement by the board in compensation issues, more frequent meetings of remuneration committees, and greater interaction between risk, audit and remuneration committees. There is also a more prominent role for independent risk reviews in compensation processes and a greater awareness of the importance of working effectively with control functions in making compensation-related decisions. One bank noted that risk reviews performed by independent functions were “the strongest lever we have” in terms of advancing cultural change. The quality of discussion has also drastically improved, with more remuneration committee members having a financial background and interest in risk matters. However, effective risk governance that delivers compensation that is fully consistent with the firm’s risk appetite framework still presents challenges. It takes time for relevant board members to fully understand complex risk metrics and other risk-related aspects of compensation in order to appropriately utilise discretion and assess the extent to which compensation packages are effectively aligned with risk.

While there is a regulatory tendency to prefer more objective approaches for risk alignment, participants noted that there is always room for a degree of judgement so as to appropriately take into account other factors (e.g. the specific facts at hand, volatility, legacy positions reflecting non-performing instruments, model changes impacting relevant risk metrics etc.). A judgemental overlay is therefore needed, which should be provided in an analytical and transparent manner by an independent function. Banks also highlighted various metrics used to assess risk alignment that are qualitative in nature (e.g. customer satisfaction levels/trends, personal conduct etc.) and therefore require the use of some discretion to interpret.

Assessing the effectiveness of compensation policies in impacting behaviour and risk-taking practices is difficult and varies by business segment, given the different cultures and pay structures involved. Further discussions are needed within firms and with the regulators in order to embed good compensation practices as part of a sound risk culture.