

FSB Round Table on Compensation Tools to Address Misconduct in Banks

Basel, 10 May 2016

Key takeaways and selected topics

On 10 May 2016 the FSB hosted a round table on compensation practices to share experiences and lessons on the use of compensation tools to address misconduct in banks. The round table considered the processes for governing and applying compensation and related risk management tools to help better identify, mitigate and redress misconduct risk. Participants also explored challenges related to use of current tools, including differences in their application among jurisdictions, and discussed the relative importance of compensation tools compared to other approaches to handling misconduct.

Senior executives responsible for risk and remuneration functions at 22 large internationally active banks and officials from the FSB Compensation Monitoring Contact Group (CMCG) participated in the round table. The CMCG is responsible for monitoring and reporting on national implementation of the *Principles for Sound Compensation Practices* and their *Implementation Standards* (Principles and Standards). This summary reflects the understanding of regulators who attended the round table concerning the main points raised in the discussion, which was conducted under Chatham House rules. It does not necessarily represent the views of authorities nor consensus views expressed by banks at the round table.

One high level takeaway from the round table was that compensation tools are just part of the toolkit used in reducing the risks of misconduct. Some banks advocated more (principle-based) dialogue between firms and supervisors on the full set of tools used to manage talent and culture with a focus on promoting good behaviors, including via the effective use of compensation tools, enhancing individual accountability at all levels of the organisation, and providing guidance on what “good behaviours” look like. Compensation tools are less relevant in markets that either do not have high levels of compensation and/or where levels of variable pay are low.

Participants also indicated that there has already been significant change in the way firms view compensation as a tool to address misconduct. Banks are at different stages in this process, but practice seems broadly to be converging and focusing on the key things. While firms recognise that compensation and conduct are directly linked, and are increasingly looking to actively manage conduct via compensation tools both *ex ante* (explicit performance targets and encouragement of positive behaviour) and *ex post* (ensuring appropriate consequences for poor behaviour), they also noted that compensation tools should not be overemphasised. More generally, banks are focused on turning values into actions and ensuring that lines of business “own” conduct risk. At most banks codes of conduct set the framework for expected behaviour, and explicit expectations surrounding roles and responsibilities are emphasised. There has been

steady progress linking performance objectives to the values or ethics reflected in codes, and increased weight is being given to related assessments of risk management and conduct in year-end performance assessments. Importantly, there is also recognition that other values may pull away from these goals, for instance conduct and profitability drivers may clash. Banks pointed to the importance of “tone from the top” in signalling where to place the balance between performance and customer and counterparty interests, while recognising the importance of long-term relationships with all customers. One bank pointed out that even if doing the right thing for the customer pushes on profitability in the short-term, it will pay off in the long-term.

Banks emphasised the importance of allowing time to embed already issued regulations and guidance setting forth supervisory expectations and of communicating a constant set of expectations in this area. They noted that to be effective and to actually change culture and values, a holistic approach to culture, conduct, and employee development and reward systems must be developed, and this takes time. A number of banks noted that they would welcome more guidance from regulators on “what good looks like” and that they welcome initiatives such as round tables to share examples of better practice. Supervisors have an important role to play in identifying better practices and conveying them to the industry. It would be beneficial for banks to know whether they are on the right track.

Finally, banks emphasised that a challenge of large organisations is consistency across markets. Although banks would like to see greater consistency between principles that are applied, there was less desire for uniform rules, i.e. to see those principles implemented in exactly the same way at every firm given the range of business models employed. There was also widespread support for further development of views on better practice

More detailed findings from each session of the round table are indicated below. The FSB welcomes any feedback on topics discussed at the round table and summarised in this note. Comments should be sent to fsb@fsb.org by 21 August 2016.

1. Processes and governance around the use of compensation policies to reduce misconduct

1.1 Banks report that progress has been made in developing and implementing compensation policies informed by and designed to promote effective risk awareness and good conduct within banks. In particular, banks point to the development of governance structures and processes surrounding identification, prevention, review and remediation of misconduct risk and to the importance of training in deterring future misconduct. Specifically, banks reported the following better practices:

1.2 *There is a range of misconduct:* Some firms categorise types of misconduct (i) “honest mistakes” and events that present a learning opportunity, (ii) events that rise to the level of some degree of sanction, including possibly compensation adjustments on variable amounts, and (iii) serious, termination events. Firms must have a robust governance process, including a clear definition of misconduct and an effective detection process (with important roles for audit and other control functions, managers, and colleagues in the form of whistle-blowing) complemented by serious investigation to establish necessary proof,

and transparent, codified consequences when such events occur. This differentiated approach allows for proportionate outcomes.

- 1.3 *Substantive senior management and board involvement and diligence around promotion processes, as well as routine input from control partners when such decisions are made, sends a transparent and visible signal on the importance of good conduct and helps integrate compensation, risk and conduct policies and support related decision-making.* For compensation and conduct policies to have optimal impact, visible oversight by the board and effective senior management implementation are considered as essential by the industry. The tone from the top has to be clear and CEOs need to ensure that their direct reports are role modelling expected behaviours. These mechanisms are increasingly becoming (better) practice and are reinforced through regular reports to bank boards as well as to designated compensation and risk oversight committees (such as remuneration committees), or in response to regulatory and supervisory developments (for example, the Senior Managers Regime in the UK). At the management level, the mapping of responsibilities to specific roles has helped to enforce accountability in some jurisdictions e.g. through ex post accountability reviews. In some institutions, joint and more frequent meetings of remuneration and risk committees have raised the quality and consistency of discussions and decisions around misconduct, and have more directly engaged the board, management and control functions.
- 1.4 *Banks are increasingly focused on the tone in the middle: all facets of the business need to incorporate and act on conduct and other firm values.* It is important for review processes to be owned by lines of business, i.e. tone from the top and input from control functions is not enough. Business line managers increasingly recognise ethics and conduct as their responsibility as evidenced by significant increases in self-identified audit issues at some firms (which allow issues to be addressed at an earlier stage), and by more formal risk and other review processes. Firms emphasised the importance of building a culture of problem identification and escalation, starting with on-boarding programmes for new employees and reinforcing such values through continued training and compliance oversight. Firms also noted the importance of challenging sub cultures that can emerge within firms. In some banks where instances of misconduct have occurred reviews have been undertaken to consider whether actions also need to be taken against managers in the reporting chain and whether such events signal the need for remedial action in other areas of operations.
- 1.5 *Being more explicit about behaviours that reinforce firm values and clearer about conduct expectations: Communication, Transparency, Consistency and Reinforcement.* Banks noted that codes of conduct have long been in place, but insistence on adherence to conduct standards in assessing performance requires repetition and reinforcement of key messages, periodic check points, reviews within business teams and the input of risk and control functions. Banks have become more explicit about the application of codes with more firms requiring employees to annually certify compliance with employee codes of conduct and many have developed frameworks and example-based training that allows for discussion of “grey areas” and promotes sharing of lessons learned as conduct issues arise. Banks emphasised the need for decisions on performance and promotion across the firm to be consistent with stated values. Participants also noted that it is important to clearly set out expectations relating to good conduct as well as to rigorously and consistently enforce rules against misconduct. Clear rules and well-specified procedures help set clear expectation.

- 1.6 *Striking the right balance: discretion and consistent judgments.* While codes and rules assist all stakeholders in understanding shared expectations, not all decisions relating to conduct and compensation can be strictly rule-based because there is diversity across business lines and circumstances are generally case-specific. Therefore determinations regarding conduct and compensation will always involve judgement made by management. Banks emphasised the importance of exercising discretion subject to appropriate governance in order to help ensure fairness, consistency and proportionality. Documentation of conduct incidents and responses is important for consistency and fairness, as well as for ensuring the effectiveness of measures taken. Banks also noted the importance of a centralised employee relations unit as well as centralisation of control function processes in regard to misconduct risk management (“decentralised processes in the line of business tend to end there”). Such approaches help to achieve common outcomes and pre-empt the emergence of sub-cultures along business lines.
- 1.7 *Reconciling conflicting messages.* Banks noted the challenge of dealing with the tension which arises between conduct and other non-financial measures of behaviour on the one hand, and objective financial performance measures on the other hand. Mixed messages and conflicting signals can arise when expectations reflected in codes of conduct and ethics are exposed to budget and other financial pressures. Alignment between metrics used for performance assessment and compensation and for business/performance management is therefore essential, as well as consistent communication from top and middle management on the importance of appropriate conduct. Banks emphasised the utility of “balanced scorecards” containing financial and non-financial measures of performance, and the involvement of human resources, risk and other control functions along with middle management when compensation decisions are made.
- 1.8 **Addressing misconduct risk effectively requires going beyond compensation tools, particularly ex post measures such as malus and clawback, and addressing conduct, ethics and culture more broadly, focusing on longer term management and development of people, talent and performance.**
- 1.9 *Banks emphasised the need to shift to a focus on shaping the future rather than on punishing the past.* Ex post compensation tools are essential to ensure fairness and appropriate consequences in cases of misconduct and to establish a “zero tolerance” policy for misconduct. This poses a credible deterrent to misconduct occurring in the first instance. However, banks noted the importance of instilling good conduct through positive, ex ante measures focused on recruitment, training, succession planning and talent development and performance of employees in a longer term relationship with the firm. They noted that ultimately, what is at issue is the behaviour of individuals; therefore people management, and the long-term relationship between an employee and employer should be the focus. Important questions include: how to identify the right person for the job and train them effectively; how to identify and promote role models who are cultural leaders; and how to motivate staff to go above and beyond requirements and ensure they are rewarded for doing so. One bank noted that role models in this area “ask additional

questions, escalate issues, detect patterns of behaviour and notice connections between different areas of operations”. Positive ex ante incentives that promote good conduct are particularly critical for “shaping the future”.

1.10 *Limitations of compensation tools should be recognised.* Compensation decisions are often subject to confidentiality protections, so their deterrent effect on others in the firm may be limited when compared to other more visible performance management tools such as promotions, *reassignments* or transfers. Compensation tools are also retrospective -- for egregious misconduct, ex post adjustment to compensation may be “too little, too late”. Several banks expressed the view that an overemphasis on punishment and severe consequences for misconduct may have negative consequences on recruitment and retention because of the potentially negative messaging about the industry. Moreover, a focus on negative compensation tools may oversimplify the issues of accountability and responsibility for a firm’s conduct, culture and business practices by focusing primarily on individual staff at fault rather than addressing the larger issue of underlying cultures which allow the misconduct to manifest itself in the first instance.

1.11 *The importance of a well-articulated ex ante approach to promote good conduct.* Discouraging misconduct is not equivalent to building a sound culture of good conduct. Promoting good conduct requires focusing more broadly on people and talent management plus performance management. The performance management process begins with intake and recruitment policies and the emphasis on positive behaviour, the subsequent training process, and the visible processes of promotion and reward. Integrity and values must be part of goal-setting for compensation purposes, and performance assessments should focus on both the *what* and the *how*. Some firms use qualitative criteria and identify non-financial objectives (such as compliance with consumer protection and other legal requirements, cooperation with control functions and regulators when misconduct is investigated and timely redress of outstanding audit items) to assess performance. Some firms also use balanced scorecards that may specify the weight attributed to conduct goals and qualitative factors such as behaviour, conduct and values; others establish minimum standards or scores for “good conduct” as gateway conditions to access variable compensation based on financial performance. Banks emphasised the importance in client facing roles of balancing sales driven cultures with effective compliance and values but also cautioned on potential unintended consequences when setting such objectives. One bank provided an example of a metric adopted on “timely sign off of P&L” as an objective measure that had such unintended consequences. The behaviour incentivised was timely submission of sign-offs but not necessarily accurate submissions. The use of indicators and explicit measurement frameworks may help make firm values more explicit and can be useful in reinforcing employee attention on conduct issues. For example, efforts are being made to develop measures of reputational risk that apply even when there has not necessarily been a loss to the bank.

1.12 *Acknowledging areas of risk and enhancing training.* Transparent processes for dealing with difficult questions when misconduct issues arise can help demonstrate how best to analyse and address these issues. Such processes provide an opportunity for employees to be engaged actively on dialogue surrounding misconduct issues and help reinforce the

importance of good conduct. Training is also important in preventing misconduct risk. Developing and promoting a positive definition of conduct can also foster everyday good practice, which in turn can be rewarded. This positive definition should refer to tangible behaviours which are visible to employees and to which they can concretely aspire. Banks emphasised the need for business lines to engage in this process, as the circumstances of good/bad conduct can vary depending on the line of business. It is crucial to invest in management's capability to make all this work.

2. Data and indicators for the identification and remediation of misconduct

2.1 Strengthening the focus on ex ante determinants of misconduct and indicators, along with frameworks for monitoring conduct-related performance and risks, will help better align compensation with ex ante misconduct risks and adjust it when ex post conduct related events occur. Better management information systems and increased use of data and control function judgments is part of the answer. Recognition of patterns is also key.

2.2 *Tailored definitions of misconduct for business lines.* Many banks emphasised the need for flexibility to tailor definitions of misconduct to reflect the risk of particular business lines, markets and jurisdictions. While a diversity in definitions may present a challenge for consistent data gathering and monitoring, it allows firms to better tailor and integrate positive behaviours and values into different operating models, as misconduct may have a different meaning depending on the population in question (management, board, sales force, trading desks). Banks noted that the focus should be a common goal of good conduct rather than a common definition of misconduct across diverse business lines and circumstances.

2.3 *Proactive identification of vulnerabilities: monitoring and risk detection.* Misconduct risk is typically considered part of compliance risk within the broader "operational risk framework". Some firms set out their approach as part of their risk appetite framework. Recognising patterns is key as small occurrences may be a symptom of something larger ("broken windows"). The locus for identifying misconduct is usually through compliance functions, or proactive analysis within lines of business and by control functions that oversee those lines of business. As an ex ante risk management measure, monitoring unusual activity - such as significantly exceeding sales targets or enhancing a firm's focus on areas of business that are considered "hot spots", for example enhanced clearing for higher margin products when concentrations of these products are detected in certain branches or a "follow the money" approach - can alert management to emerging risks that need to be addressed and help ensure that appropriate incentives can be more effectively integrated into all decisions including compensation. Banks underscored that broad-brush approaches to identifying misconduct risk may not be appropriate, and fine-tuning is necessary based on the risks inherent in the activity.

Audits and anonymous tip lines are also widely used methods for identifying misconduct according to banks. Monitoring complaints is also useful for risk identification as well as for better focusing training and mentoring. A number of firms reported that whistle-

blowing tip lines set up to anonymously report concerns about conduct are an effective mechanism for identifying issues, with some firms receiving large volumes of calls. Some banks look at incidents of misconduct in other banks to see whether similar patterns have developed in their own institution. A number of banks said “objective, measurable” metrics were important, in particular to evaluate big numbers from branch networks, for which it is difficult to use a judgment-based system. A balanced scorecard including qualitative but measurable objectives (compliance, customer satisfaction, quality of service) is best. Other banks pointed to difficulties that sometimes occur when interpreting data. For example, if a training around risk leads to a spike in tip-line calls, it could be either a positive or negative indicator (i.e. driven by either higher awareness or a fundamental weaknesses in that area of operations.)

- 2.4 *Record keeping.* Good internal record keeping and reporting, including documentation and reporting of all sanctions to internal control functions, is also essential to monitoring and assessing the fairness and effectiveness of a bank’s conduct risk management processes. Firms report that systematically collecting data and documenting the specific circumstances surrounding misconduct events helps identify the root cause of such issues. Banks generally reported increasing use of misconduct data and closer cooperation between control functions on these issues. Information on misconduct is not generally disclosed, except as required by regulators, and is usually aggregated. Although there has been progress in the development and use of data, firms note that this is a relatively new area and therefore further improvements can be expected.

3. Lessons learned on the effectiveness of compensation tools to address misconduct risk

- 3.1 **Compensation tools are adequate but in order to establish a culture of good conduct they need to be considered as part of a larger toolkit involving both ex ante and ex post tools.**

- 3.2 *The range of compensation tools to manage misconduct is generally adequate.* Banks noted that, with the recent strengthening of internal policies aligning variable compensation to longer term risk horizons for relevant business activities, and requirements for in-year bonus adjustments, malus, and in some cases, clawback, they have the full range of tools they need to implement effective compensation schemes designed to deter misconduct. Most banks generally apply an in-year bonus reduction for all but the most serious issues of misconduct (when malus and/or dismissal may be a more appropriate option). This approach is mainly driven by the ease with which in-year bonus reductions can be applied compared to the steps needed when malus is applied. One bank representative noted that their bank prefers to link directly compensation adjustments for misconduct issues to deferred compensation from the year in which an incident occurred, applying malus to unvested compensation from that year in order to ensure a more direct link between conduct and compensation.

- 3.3 *Using ex post tools.* There was general recognition of the importance of mechanisms for recovery and other ex post adjustment tools, but also recognition of the challenges of using

such tools. Malus can be used effectively in many cases. Clawback faces larger legal obstacles in a number of jurisdictions; for instance some labour laws may prevent inclusion of clawback in compensation contracts. One bank pointed out that legal and tax regimes have not yet caught up with compensation regulation, and there is a real risk that they are not aligned. However, in most jurisdictions where variable compensation is a significant portion of remuneration, some form of clawback has been adopted. Banks noted that while enforceability remains untested in some jurisdictions, the importance of such provisions is the deterrent effect, and the expectation of being held accountable over the period of time in which risks are likely to materialise. One bank noted that they require their employees to sign terms of reference for bonuses which state that there is a clawback provision, even though in most jurisdictions the provision can never be invoked. Some banks pointed out that while clawback was a helpful deterrent, other remedies should first be exhausted. They also stressed that one should not underestimate the discount employees apply to remuneration with such conditions attached. In some jurisdictions (e.g. UK) increased deferral periods for malus may mean that difficulties in the application of clawback are not as pressing because deferral periods are sufficiently long to ensure issues are identified in time to apply malus or in-year adjustments.

- 3.4 *The importance of having sufficient compensation at risk.* Banks noted the impact of the European legislation related to the bonus cap. In particular, a concern was expressed that restrictions in the amount of remuneration at risk may limit the use of variable remuneration as a tool to incentivise better behaviour. Firms also noted the competitive issues they face from less regulated industries with fewer compensation rules.
- 3.5 *Is there a need for more consistency?* Given difficulties enforcing clawback and inconsistency across jurisdictions including in the deferral periods, banks were asked whether additional guidance might be helpful. Views were divided: different views on the enforceability of clawback reflect different legal traditions and different approaches to the power of the employer to recover compensation. Some industry participants expressed a preference for greater consistency across jurisdictions, although others noted that practices are nonetheless converging and banks are trying to move things in the right direction, but it takes time. The diversity of jurisdictions and different philosophies of compensation do not suggest a one-size fits all solution. A principles based approach is seen as best for complex organisations since it allows flexibility and banks to tailor institution-wide policies while ensuring compliance across jurisdictions. Nevertheless, it was noted that global inconsistencies can make it difficult for globally active firms to treat employees operating in different jurisdictions consistently. In particular, a few banks noted that inconsistency in deferral periods results in further inconsistency in the ability to apply malus. Notwithstanding the shared sense of the need to have time to consolidate and refine current practice as opposed to issuance of additional regulation, there was widespread support for the development of further views on better practice and some support was expressed for guidance with respect to compensation tools and misconduct.
- 3.6 *Compensation buy outs by new employers means that the link between compensation and conduct can break down.* Regulators noted that while much progress has been made in integrating conduct and behaviour into compensation decisions, there remains a tension

between shorter-term business targets and profits and longer-term perspectives on reputational risk and market standing. These short-term goals are often reinforced by investors and other stakeholders, as well as by practices such as buy out. Banks and regulators noted the significant difficulties of applying compensation tools when employees have left their firms. One bank noted that one solution could be to record any action on deferred awards in the employee statements to make clear to future employers that an issue is being investigated with that employee. Some banks expressed a view that unless a collective agreement within the industry was reached, labour law dictates that the key relationship is between employee and current employer and that it would be difficult to enforce decisions made by previous employers. Banks were concerned, however, about the risk that 'bad apples' could move between firms while noting limitations they face on these issues, especially where an employee is moving out of the banking sector. More generally, there is room for improvement in resolving the tension between short-term profit and longer-term business value and reputation of the firms and the industry overall.