FSB FINANCIAL STABILITY BOARD

# Implementing the FSB *Principles for Sound Compensation Practices* and their *Implementation Standards*

## Fifth progress report

**4 July 2017**

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# Implementing the FSB *Principles for Sound Compensation Practices* and their *Implementation Standards* Fifth Progress Report

## Executive Summary

This is the fifth progress report on the implementation of the FSB *Principles for Sound Compensation Practices* and their *Implementation Standards* (P&S),[1] which aim to reduce incentives for excessive risk-taking that may arise from the structure of compensation schemes in significant financial institutions. The report, which was prepared by the FSB Compensation Monitoring Contact Group (CMCG), focuses on remaining implementation gaps, key challenges and evolving practices. The report also examines links between compensation and misconduct and provides insight into compensation practices in the securities sector, which were issues of particular focus since the publication of the last report in November 2015. The FSB Compensation Monitoring Contact Group (CMCG) and the International Organization of Securities Commissions (IOSCO) Compensation Experts Group (CEG) organised a joint roundtable on 13 December 2016 with representatives from some of the major participants in securities market activities. In the first quarter of 2017, the CEG conducted a survey of securities regulators in twenty-one IOSCO member jurisdictions regarding the legal and regulatory perspectives on compensation policy, as well as compensation practices and risk alignment in the securities sector.

**The main findings are:**

***Compensation practices at banking organisations***

1. **Almost all FSB member jurisdictions have substantively implemented the P&S for banking organisations including Indonesia and Turkey, which have now addressed significant gaps identified at the time of the last progress report, while South Africa is yet to fully implement the P&S**. While a few gaps remain in a limited number of jurisdictions, for the most part all FSB members compensation practices substantially conform to the P&S (see Annex A). Since the last progress report further changes have continued to been made to legislation, regulation and supervisory guidance in a number of jurisdictions, a sign that jurisdictions continue to work to adjust and refine their frameworks implementing the P&S.

2. **While the oversight of compensation practices is now embedded in banking organisation supervisory practices, there are differences, some significant, between the approaches that are taken on this issue.** Supervisors continue to value the sharing of experience between authorities and believe this helps to raise standards when examples of better practice are shared.

[1] http://www.fsb.org/2009/04/principles-for-sound-compensation-practices-2/ and http://www.fsb.org/2009/09/principles-for-sound-compensation-practices-implementation-standards/

3. **Since the last progress report, supervisors have paid particular attention to links between compensation and misconduct in banking organisations.** This interest has been driven by continuing incidence of misconduct over the past few years. An increasing number of jurisdictions, particularly those where significant cases of misconduct have been identified, are increasingly focused on this issue in their supervisory reviews, while banking organisations are increasingly working to incorporate non-financial and misconduct risk considerations in their performance and rewards assessments and in their governance and control structures.

4. **Supervisors' and banking organisations' efforts are moving toward ensuring the effective implementation of compensation systems by increased use of back testing or validating practices in this area**. Supervisors in some jurisdictions highlight the need for both banking organisation and supervisory reviews to pay more attention to the links between compensation decisions and risk alignment to ensure the effective implementation of the P&S. In a few significant cases banking organisations are developing more sophisticated approaches to test compensation systems for their intended outcomes and in the context of their risk appetite frameworks. This is an area where more progress is needed.

5. **In-year adjustments to compensation continue to be the compensation tool of choice. Application of malus is still rare in many jurisdictions while clawback is subject to more significant legal impediments or enforcement issues in many jurisdictions.** The application of malus ex post is more frequently considered and used in those jurisdictions where variable compensation is a significant component of total pay.

6. **Banking organisations' approaches and regulatory and supervisory frameworks for the identification of material risk takers (MRTs) as well as the governance mechanisms around these determinations continue to differ significantly between jurisdictions.** The significant difference between jurisdictions in terms of the identification of MRTs is an area for further consideration by the CMCG.

### *Compensation practices at insurers*

7. **Progress on implementing and embedding the P&S for the insurance sector lags behind that for banking organisations.**[2] However, since the last progress report a number of jurisdictions have implemented further legislative and regulatory measures to implement the P&S for insurers. In Europe, the introduction of Solvency II has resulted in a number of provisions on compensation governance and structure being implemented that are consistent with the P&S, although not fully aligned.

### *Compensation practices in the securities sector*

8. **Compensation practices vary across the securities sector.** Variations mainly stem from the diversity of firms, which extend from broker/dealers to managers of different types of

[2] Throughout the report, the term "banks" is used to also include bank holding companies that might include banks, insurance companies, broker dealers, asset managers etc. These banking organisations generally employ a global compensation framework across the group.

collective investment schemes, including investment funds (e.g., mutual funds), hedge funds, and private equity funds, and the range of their business models and activities. Firms and securities regulators agree on the need to consider the diversity of the business models in the securities sector in the implementation of the P&S, and consequently give due regard to proportionality in regulation to avoid a "one size fits all" approach.[3]

9. **Most of the IOSCO members that participated in the survey have adopted, either through their general legal framework or through specific rules, compensation related regulation for firms in the securities sector, especially for collective investment schemes/mutual funds/asset management firms.** The jurisdictions' regulations address different aspects of compensation, including governance, compensation structure, risk alignment and disclosure.

10. **Industry participants highlight compensation as a possible tool in the overall risk management toolbox.** Firms highlight a wide range of objectives for compensation policies, such as, promoting firms' long-term business interests and strategy; aligning employees' interests with those of investors and clients; promoting sound and effective risk management and observance of firms' risk and corporate culture; discouraging inappropriate risk-taking; and keeping the level of compensation sufficiently competitive to attract and retain talent. They observe that sound compensation practices may serve as a useful tool in managing misconduct risk, as well as a powerful driver for implementing the desired firm culture.

11. **Risk Perspective: Financial Stability.** Industry participants and IOSCO members are, in general, of the view that there is no direct link between compensation practices in the asset management sector and financial stability, given the agency model of the business. However, it is the opinion of some securities regulators that compensation practices may have potential effects on trust and confidence in the markets and sound compensation practices could assist in addressing them.

**The report identifies the following actions:**

1. **The FSB will continue to focus on the extent to which compensation, together with a range of other measures, can be used to address misconduct risk at financial institutions.** To this end the FSB will finalise by end-2017 its supplementary guidance to the P&S on the use of compensation tools to address misconduct, which is based on better practices. Additionally, in collaboration with the standard-setting bodies, the FSB by end-2017, will develop recommendations for consultation on the consistent national reporting and data collection by national supervisors on the use of compensation tools to address misconduct risk in significant financial institutions.[4]

2. **The FSB, through the CMCG, will explore ways to assess the effectiveness of aligning compensation policies and approaches with risk after these have been implemented.** However, supervisors may need to undertake further work before reaching any conclusions on this issue. Authorities will share their experience of undertaking assessments of the

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[3] The Principles explicitly recognize this aspect for all financial firms, as stated in the introduction to the Principles: "*The Principles…are not intended to prescribe particular designs or levels of individual compensation. One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm.*"

[4] See http://www.fsb.org/2016/09/measures-to-reduce-misconduct-risk-second-progress-report/

effectiveness of compensation requirements and the FSB will continue to conduct work and report in this area. This might include, for example, the extent to which compensation disclosure requirements are an effective mechanism for providing investors with meaningful information on the alignment of compensation with the long-term interests of the firm.

**The next progress report will be published in 2019.**

# Introduction

The November 2011 G20 Summit in Cannes called on the FSB to "undertake an ongoing monitoring and public reporting on compensation practices focused on remaining gaps and impediments to full implementation of the P&S[5] and carry out an ongoing bilateral complaint handling process to address level playing field concerns of individual firms".[6] To undertake this monitoring, the FSB established in early 2012 a CMCG comprising national experts from FSB member jurisdictions with regulatory or supervisory responsibility for compensation practices. The CMCG is responsible for monitoring and reporting on national implementation of the P&S, which aim to reduce incentives for excessive risk-taking that may arise from the structure of compensation schemes. As stated in the introduction to the FSB Principles, the "P&S are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms". The P&S are not intended to prescribe particular designs or levels of individual compensation and recognise that "one size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm."

This progress report summarises the responses provided by FSB member jurisdictions to a questionnaire concerning actions and initiatives to implement the P&S since the November 2015 progress report.[7] It also incorporates reporting on work by the CMCG on the topic of compensation and misconduct, including discussion at a roundtable on compensation tools to address misconduct[8] attended by senior executives from global systemically important banking organisations in May 2016[9] and findings from a stocktake exercise conducted in 2016 on the effectiveness of compensation tools in addressing misconduct risk. Findings from that stocktake were published as part of the second FSB progress report on measures to address misconduct risk.[10]

To date, much of the work of the CMCG has been focused on compensation practices and strategies for addressing misconduct within banking organisations. The 2015 progress report noted that the FSB would, in collaboration with the relevant standard-setting bodies, continue to take stock of compensation practices in other financial sectors and how they can affect risk taking incentives. Financial firms differ in goals and the approaches used in one sector of the

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5 www.fsb.org/what-we-do/policy-development/building-resilience-of-financial-institutions/compensation/

6 www.fsb.org/implementation_monitoring/g20_leaders_declaration_cannes_2011.pdf

7 www.fsb.org/2015/11/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards/

8 www.fsb.org/2015/06/third-fsb-workshop-on-compensation-practices/.

9 www.fsb.org/2016/07/fsb-round-table-on-compensation-tools-to-address-misconduct-in-banks/

10 www.fsb.org/2016/09/measures-to-reduce-misconduct-risk-second-progress-report/

financial industry may not be applicable in others. In particular, in the securities sector, firms are characterised by a higher degree of diversity compared to firms in the banking and insurance sectors. Such variation mainly stems from the diversity of firms, which extend from broker/dealers to managers of different types of collective investment schemes, including investment funds (e.g., mutual funds), hedge funds, and private equity funds, and the range of their business models and activities. For example, compensation at private equity funds is generally vested periodically, mostly annually or at the end of certain investment periods, depending on the success of the investment (i.e. carried interest model). Compensation at hedge fund firms tends to be invested in the firm or its funds. It is therefore a type of "skin in the game", which is different from the compensation structures of traditional asset managers. The asset management sector in general operates with an "agency model", whereby fund managers' interests are contractually aligned through the investment mandate to those of the client. Therefore, compensation is linked to the performance of the fund under management. Nonetheless firms in the banking, insurance and securities sectors conduct similar activities in many instances, and the market for talent cuts across specific sectors and the operation of compensation incentives in one sector may be relevant to the other sectors. This year's report includes a dedicated section on compensation practices in the securities sector that has been prepared by the IOSCO. The section draws from responses from 21 jurisdictions[11] to a questionnaire, which builds on a roundtable discussion on compensation practices and strategies for addressing misconduct with private sector participants. The roundtable was hosted by the FSB and IOSCO on 13 December 2016.[12] An update on compensation practices in the insurance sector has also been provided as part of this report.

The report is structured as follows. Section I describes the overall progress made by national authorities in implementing the P&S for banking organisations since the 2015 progress report as well as recent regulatory initiatives and supervisory actions. Section II outlines the status of implementation by banking organisations and reports on the supervisory authorities' assessment of banking organisations' compensation practices and discusses compensation and misconduct issues. Section III considers work to assess the effectiveness of compensation policies. Section IV considers compensation of insurers and section V considers compensation in the securities sector. Annex A and B provide more detail on the status of implementation of the P&S in the banking sector. Annex C provides the list of banking organisations that are considered by the respective supervisors in the FSB member jurisdictions for the purposes of this report.[13] Annex D reproduces and updates a table published in the 2013 progress report on the criteria for identification of material risk takers.[14] Finally, Annex E provides details on issues surrounding the use and application of compensation tools.

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[11] Of these jurisdictions, 18 are FSB member jurisdictions.

[12] http://www.fsb.org/2017/04/fsb-iosco-roundtable-on-compensation-practices-in-the-securities-sector/

[13] All these firms are considered by the respective authorities as significant for the purposes of the P&S.

[14] http://www.fsb.org/2013/08/r_130826/

# I. Implementation by national authorities

## 1. New regulatory and supervisory initiatives, activities and findings

All FSB member jurisdictions report that they have now fully, or almost fully, implemented the P&S for the banking sector[15] through regulation or as a result of supervisory guidance (see Annex A). Of the jurisdictions that were identified in the 2015 progress report as still presenting some gaps, Indonesia issued in December 2015 a new regulation on governance of compensation for commercial banks and in September 2016 additional regulation to guide banks in implementing the new regulation. The remuneration policy was prepared by Indonesian banks in 2016 and will be used to assess performance in 2017. Supervisors will review implementation in 2018. In Turkey a new guideline was issued in March 2016 which meets all P&S and the Basel Committee on Banking Supervisor (BCBS) Pillar 3 disclosures requirements related to compensation, completing the few remaining gaps in the implementation of the P&S. The regulation which is applied to all banks involves more strict compensation principles for significant banks (as defined in the regulation). In addition to FSB P&S and the BCBS requirements, Capital Requirements Directive (CRD) IV requirements on compensation were taken into consideration when preparing the guideline. In Switzerland, the supervisory authority circular on remuneration policy was revised in September 2016 to close the existing gap with standard 14 (restricting personal hedging strategies) and will come into force in July.

Changes in the regulatory or supervisory framework introduced in other jurisdictions generally reflect efforts to further embed and define existing regulatory and supervisory regimes. For instance, jurisdictions in Europe conducted further work to implement the compensation rules set out in the CRD IV.[16] For example, in the Netherlands, regulation on sound compensation policies was amended in December 2015 to implement new legislation enacted in February 2015 which includes some specific requirements regarding the bonus cap, clawback, severance pay, retention bonuses, transparency and state support.[17] The guidelines developed by the

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[15] For the implementation of the P&S in the insurance sector, see Section IV. Other sectors have not been covered by this implementation monitoring exercise.

[16] This report takes into account the establishment of the Single Supervisory Mechanism (SSM) in November 2014. In particular, such mechanism works as following explained: the European Central Bank (ECB), in cooperation with National Competent Authorities (NCAs), is responsible for the supervision of credit institutions established in the participating EU Member States. This means, among others, that for so-called "Significant Institutions"(SIs) supervisory activity is directly planned and undertaken by ECB Joint Supervisory Teams (JSTs) composed of ECB and National Competent Authorities (NCAs) members; while "Less Significant Institutions"(LSIs) are under the direct supervision of the NCAs and the ECB is responsible for exercising oversight over the functioning of the system. For the purpose of the SSM, credit institutions are considered "significant"- under Articles 4 and 6 (4) of the SSM Regulation - where one of the following condition is met: (i) the total value of a SI assets exceeds EUR 30 billion; (ii) the ratio of a SI total assets over the GDP of the participating Member State of establishment exceeds 20%, unless the total value of its assets is below EUR 5 billion; (iii) following a notification by its national competent authority that it considers such an institution of significant relevance with regard to the domestic economy, the ECB takes a decision confirming such significance following a comprehensive assessment by the ECB, including a balance-sheet assessment, of that credit institution. The ECB, in carrying out its supervisory tasks, applies the CRD provisions as transposed by EU Member States into their national laws. Where the relevant law grants options for Member States, the ECB also applies the national legislation exercising those options. Moreover, in areas not covered by this set of rules, or if a need for further harmonisation emerges in the conduct of the day-to-day supervision, the ECB may issue its own standards and methodologies, while considering Member States' national options and discretions under EU legislation.

[17] https://zoek.officielebekendmakingen.nl/stb-2015-45.html

European Banking Authority (EBA), which provide further details to apply CRD IV provisions, became effective from 1 January 2017 and during 2016 EU countries had to inform the EBA of the extent to which they were intending to comply or explain with the guidelines.[18] In Korea, a new Act on Corporate Governance of Financial Companies was enacted in August 2016 which includes provisions on remuneration committees, bank compensation systems and the public notification of annual reports on payment of remuneration and codified existing standards. In Mexico, changes were made to regulation in January to clarify the different approaches required for compensation of those in control functions. In the UK, new provisions on clawback and deferral were published in June 2015 and were applicable from January 2016. In September 2016, the Prudential Regulation Authority (PRA) published final rules on buy-outs of variable remuneration. The changes were intended to ensure that buy-outs do not blunt the incentives of the existing rules on malus and clawback. In 2016 the PRA published a consultation on expectations on remuneration which led, in April 2017, to the publication of a remuneration supervisory statement.[19] In the US, a proposed rule[20] was published with regard to Dodd Frank Act Section 956. If implemented as proposed, the proposal would require the largest firms to defer up to 60% of incentive compensation for senior executives for four years. For certain adverse events clawback could apply for seven years. The proposed rule also sets out requirements for record-keeping and disclosure to regulators.

The scope of institutions covered by the existing regimes have remained broadly similar to those set out in the 2015 progress report with the exception of Mexico, where regulation now extends to Sociedades Financieras Populares, and Switzerland, where the scope of the compensation regime has been narrowed to globally active financial institutions with complex remuneration schemes and materially relevant total compensation. These changes were implemented as part of a broader effort to address proportionality in the Swiss regulatory regime, while the supervisory authority retains the powers to subject other institutions to the requirements if necessary.

**Table 1**

| **Regulatory framework and/or supervisory guidance** | |
|---|---|
| **No changes since the last progress report** | **Changes since the last progress report** |
| Argentina<br>Australia<br>Brazil<br>Canada<br>China<br>Hong Kong<br>India | Indonesia *(OJK released regulations on compensation policies in banks in December 2015 and September 2016.)*<br>Korea *(In August 2016 the National Assembly enacted the Act of Corporate Governance for Financial Companies which includes provisions on compensation. The Act codified existing practice in Korea.)*<br>ECB SSM *(In addition to the changes to the EU framework, the EBA Guidelines and national* |

[18] The EBA's guidelines on sound remuneration policies, were published in December 2015 and entered into force in January 2017. http://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies_EN.pdf/5057ed7d-8bf1-41b4-ad74-70474d6c3158

[19] http://www.bankofengland.co.uk/pra/Pages/publications/ss/2017/ss217.aspx

[20] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160502a2.pdf

| | |
|---|---|
| Japan<br>Russia<br>South Africa | *implementing measures, the ECB introduced supervisory guidance to assess compensation policies and practices of institutions it directly supervises, in line with the European regulation and best international practices as national implementing measure.)* Germany *(Changes to German Banking Act stipulating a purely fixed remuneration for members of banks' non-executive Board members/supervisory function entered into force in January 2017. Review of the German Ordinance on remuneration systems in banks in the course of 2017 introducing longer deferral periods for senior managers and executive Board members as well as a clawback requirement for material risk takers (MRTs)).*<br>Netherlands. *As example of national implementation measures, Netherlands introduced legislation in 2015 with stricter rules -as national option- on the bonus cap which means that variable compensation can only be a maximum of 20% of fixed compensations although this is higher for activities conducted outside the Netherlands.*<br>Mexico *(Changes were made to the regulation in January 2017 to clarify the different approaches required for compensation of those in control functions.)*<br>Singapore *(The Monetary Authority of Singapore (MAS) issued in December 2015 a notice that set out requirements in relation to the design and operation of a balanced scorecard framework that licensed financial advisers and exempt financial advisers are required to put in place in their remuneration structures for their representatives and supervisors.)*<br>Switzerland *(The Swiss Financial Market Supervisory Authority (FINMA) circular on remuneration schemes was updated to close the gap with standard 14. The requirements will come into force in July.)*<br>Turkey *(A new guideline was issued on 31 March 2016 which completes the few remaining gaps in the implementation of the P&S.)*<br>UK *(New provisions on clawback and deferral were published in June 2015 and were applicable from January 2016. In September 2016 the PRA published final rules on buy-outs of variable compensation. The changes were intended to ensure that buy-outs do not blunt the incentives of the existing rules on malus and clawback. In September 2016 the PRA published a consultation on expectations on compensation which led, in April 2017, to the publication of a remuneration supervisory statement.)*<br>*US (NPR on DFA 956 published)* |

## 2. Supervisory action

As noted in previous progress reports, supervisory activities in most jurisdictions now routinely include the analysis of compensation structures, practices, awards and payouts. Typically this work is undertaken as part of broader governance-based assessments. Most authorities routinely engage with banking organisations to assess oversight of compensation practices by senior management and the board, and the participation of control functions in controlling related

risks. Other forms of supervisory engagement have been through risk management functions or line of business reviews.

It is clear that the intensity of the discussions on compensation varies considerably across jurisdictions which is indicated both in responses from supervisors and anecdotal evidence from firms. A number of authorities have dedicated teams that consider governance, remuneration and/or culture issues in order to provide a centre of expertise. Some authorities undertake horizontal reviews in order to assess the effectiveness of policies and controls across the banking organisations in their jurisdictions. Horizontal reviews can provide for a more in depth analysis of trends and patterns and provide for a degree of benchmarking between peers.

Since the last progress report Argentina, Canada, and Singapore have undertaken horizontal reviews of compensation practices in banks. In the US,[21] horizontal reviews of bank holding companies first initiated in late 2009 continue.[22] In Canada, a cross-system review was last conducted in 2009, while in in 2015 the supervisory authority conducted a review of the six Domestic Systemically Important Banks (D-SIBs) on alignment of compensation policies with the P&S. The review focused on performance objectives and compensation for senior executives to assess and understand their alignment with the bank's risk appetite statements (RAS). The supervisory authority has also undertaken pilot work in the assessment of risk culture, which has included discussions at two D-SIBs regarding the links between compensation and conduct/culture. China made an evaluation of performance by local branches of the largest five banks. In Europe, following the creation of the Single Supervisory Mechanism (SSM), compensation policies and practices are assessed as part of the yearly supervisory and evaluation process and review (SREP) of SSM significant institutions.[23] This focused, among other things, on the identification process for risk-takers, setting out the requirement for remuneration policies to be consistent with a sound capital base, and the approval of variable to fixed remuneration ratios over 100%. The SSM and the UK also contribute to the periodic EBA benchmarking on remuneration and high earners.[24] In 2016 MAS undertook a horizontal desktop review of the compensation structures of front office staff in treasury, private banking, and investment banking functions, to understand the risk indicators used in staff performance measurement. They intend to continue to conduct compensation reviews as part of inspections of banks operating in Singapore. The supervisory authority also piloted in 2016 a structured assessment of risk culture at Singapore's significant banks. In the US, supervisors started a horizontal review of sales incentives on the largest banks. A horizontal review on design and implementation of senior executive compensation is also ongoing.

Other authorities, such as those in Switzerland and the UK include in their annual supervisory review regular programmes of benchmarking and cross-firm peer analysis to understand and analyse broader compensation trends.

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[21] All references to US practice or supervisory approach, other than references in sections IV and V, are based on information provided by the Federal Reserve in conjunction with its supervision of bank holding companies. Information on insurance activities was provided by Treasury's Federal Office of Insurance and the NAIC.

[22] A report on the findings from initial stages of the horizontal is available at: https://www.federalreserve.gov/publications/other-reports/incentive-compensation-report-201110.htm

[23] See footnote note 14

[24] Detailed findings are explained in the EBA Reports https://www.eba.europa.eu/documents/10180/1359456/EBA+Op-2016-05++%28Report+on+Benchmarking+of+Remuneration+and+High+Earners+2014%29.pdf

A number of authorities are taking steps to effectively embed the review of compensation into their supervisory frameworks and practices. A new Governance, Culture and Remuneration Team has been established in Australia to better understand industry practices and to further develop the Australian Prudential Regulation Authority's (APRA) supervisory approach and framework in this areas. The team is set to examine compensation practices in a sample of banks and insurers during 2017. The overall objective of the review is to assess the effectiveness of remuneration practices in encouraging behaviour that supports long-term financial soundness and the risk management framework. The SSM is taking steps to ensure a consistent and harmonised approach to compensation across the European jurisdictions that are part of the SSM.[25]

***Risk alignment***

Risk alignment is a key pillar of the P&S. Aligning compensation policies with the long-term interests of firms helps to reduce the incentives for short-term thinking which can contribute to financial instability. Compensation policies should in the first instance be structured to incentivise long-term thinking, for instance ensuring that overall bonus schemes align with the long-term sustainable interests of the firm. Taking such an approach helps to ensure that financial institutions adopt sound risk-taking behaviour and that risks being taken by material risk takers are consistent with the risk appetite statement for the institutions in relation to its financial resources.

Risk alignment involves both ex ante and ex post alignment of compensation. Ex ante risk alignment involves developing compensation policies, structures and performance objectives that avoid incentives that are overwhelmingly based on short-term goals.[26] Ex ante risk adjustments may play a role in setting the total bonus pool, pools across business lines, and in allocating pools to individuals' incentive compensation. These decisions should explicitly consider the banking organisations' policies on risk together with capital and liquidity resources.[27] Ex post alignment describes activities undertaken after a performance period to align compensation with the outcomes that the firm has seen. So for instance, reducing bonuses in-year or reducing unvested variable compensation in response to adverse outcomes, to ensure that the compensation received by employees is more closely aligned with the risks that materialised in the firm.

A number of authorities are taking steps to ensure that the risk alignment of compensation policies is effectively embedded into processes. For example, supervisors in Canada expect banks to demonstrate a clear link between statements made in banks' risk appetite frameworks and the compensation packages that are agreed for senior executives. The supervisory work in

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[25] In this regard, the EBA published in Nov 2016 an overview of existing practices among EU countries on the application of the proportionality principle to the remuneration provisions laid down in the Capital Requirements Directive in response to a request for advice from the European Commission.

https://www.eba.europa.eu/documents/10180/1667706/EBA+Opinion+on+the+application+of+the+principle+of+proportionality+to+the+remuneration+provisions+in+Dir+2013+36+EU+%28EBA-2016-Op-20%29.pdf

[26] For instance, awarding compensation based on annual profitability metrics without taking account of associated risks that may impact the firm or the medium to long-term risk exposure.

[27] Risk adjustments should consider likely losses under stressed conditions, and not merely business-as-usual, so that larger, but lower-probability loss outcomes can influence incentives to take risk.

this area has highlighted (i) the significance of management judgement in risk adjustments (ii) the importance of documenting decisions on the allocation of variable compensation in order to allow for consistent application and effective oversight (iii) enhancements to publicly disclosed information (iv) that risk appetite frameworks need to be well developed and cascaded to appropriate levels within the bank if such frameworks are to be effectively aligned with compensation policy. The increased focus on strengthening the linkage between risk appetite statements and compensation structures and outcomes is also reported in Singapore and in Europe. In the SSM, supervisors formulated expectations on the need to strengthen the link between risk and compensation in line with CRD IV, highlighting the importance to improve the implementation of risk indicators in the calculation of compensation, the transparency of the compensation system and its ability to be understood by the employees.

US authorities note that although the quality of risk information provided to boards has improved and the stature of compliance and risk management functions have increased in recent years, processes and related controls that ensure adequate documentation of performance and disciplinary outcomes could be improved at most banking organisations. Supervisory work in the US has highlighted the importance of internal reviews and audits of compliance with policies and procedures to ensure that incentive compensation systems are implemented as intended. For example, if procedures require that specific quantitative measures of risk are to be included in financial performance measures used in decision-making, but they are not, the sensitivity of decisions to risk taking probably would not be as intended. Though internal audit functions often play a key role in this activity, other functions such as risk management, finance, and human resources are often involved. Such work has underscored the risk that an incentive compensation system may be implemented as intended, but still fails to achieve the desired relationship between risk and reward because features of its design and operation do not work as intended. Detecting such problems requires that a firm monitor relationships among measures of short- and long-run financial performance, amounts of incentive compensation awards, measures of risk and risk outcomes, amounts of ultimate payments of deferred incentive compensation, and other factors relevant to incentive compensation decisions. Such monitoring bears some resemblance to the "back-testing" that is often done for risk-management models and systems. To be effective, such monitoring should generally include some quantitative analysis, but because all incentive compensation systems involve some exercise of human judgment in decision-making, effective monitoring is not likely to be purely quantitative or mechanical. Many banking organisations also test outliers (in either the quantum of incentive compensation received, or the amount of profit generated, or in terms of performance more generally) to ensure that intended alignment between risk-taking and compensation occurs in practice as well as design.

Some authorities flag the need for better aligning bank compensation practices with the long-term risks faced by the banking organisations in their jurisdictions. One authority has expressed concerns that competitive pressures for talent can override compensation policies that are meant to effectively align risk and compensation incentives, in particular where total compensation is driven by market pressure and this affects the variable component, or where there is a desire to retain talent regardless of the financial institution's performance.

In order to understand whether compensation policies have been effectively aligned with risk, supervisory practices might benefit from the use of greater information and data on the application of compensation policies and on the use of compensation tools. In a number of

jurisdictions whilst information is not collected as part of regular data requests, supervisors do ask firms to provide this information on an ad hoc basis, often as part of ongoing supervisory reviews or in response to specific incidents which require ex post root cause analysis reviews. In Europe, information collected and assessed in the context of the EBA benchmarking on compensation and high earners allows a periodic analysis of such aspects. However there are also jurisdictions in which information on the use of compensation tools is not currently collected by supervisors.

Additionally, there are a number of jurisdictions in which disclosure of the information on the use of compensation tools is partial or even where it is not published (e.g. Brazil, Canada). In Europe, disclosure is broadly covered by the CRD and Capital Requirements Regulation (CRR) requirements as well as by the EBA Guidelines on disclosure requirements under Part Eight of Regulation (EU) No 575/2013 published in December 2016.[28]

In March 2017 BCBS published updated guidance on Pillar 3 disclosures,[29] which amongst other things includes disclosures on compensation policy and on the use and application of compensation tools. The BCBS disclosures include qualitative information about how banks' compensation policies are structured and quantitative disclosures to set out the outcomes from these policies. In particular, the quantitative disclosures include disclosure of the amount of outstanding deferred remuneration exposed to ex post explicit or implicit adjustment,[30] as well as the amount of compensation amendment during the year due to ex post explicit and implicit adjustments.[31]

# II. Implementation by firms: overall assessment, challenges and evolving practices

**Box 1 (Reproduced from 2015 progress report) High level objectives of the P&S**

The high-level objectives of the P&S cover three specific areas: governance of compensation, risk alignment, and external stakeholder engagement.

- In terms of governance, the P&S require that significant firms have a dedicated committee of the board that actively oversees the design and operation of the compensation system; that staff engaged in financial and risk control functions be independent, have appropriate authority and have an appropriate role in the performance assessment process, including input on effective risk-adjustment of compensation; that compensation systems

28 https://www.eba.europa.eu/documents/10180/1696202/Final+report+on+the+Guidelines+on+disclosure+requirements+under+Part+Eight+of+Regulation+575+2013+%28EBA-GL-2016-11%29.pdf/20370623-9400-4b5e-ae22-08e5baf4b841

29 http://www.bis.org/bcbs/publ/d400.pdf

30 The definitions used in the BCBS guidance are as follows:

*Outstanding exposed to ex post explicit adjustment*: part of the deferred and retained remuneration that is subject to direct adjustment clauses (for instance, subject to malus, clawbacks or similar reversal or downward revaluations of awards).

*Outstanding exposed to ex post implicit adjustmen*t: part of the deferred and retained remuneration that is subject to adjustment clauses that could change the remuneration, due to the fact that they are linked to the performance of other indicators (for instance, fluctuation in the value of shares performance or performance units).

31 These include various types of adjustments, including in year adjustments, application of malus and clawback, but also other adjustments made for example in relation to termination of contracts.

be subject to robust controls and periodic reviews to ensure their integrity; and that compensation and risk outcomes should be regularly reviewed for consistency with intentions.

- The alignment of remuneration with prudent risk-taking is intended to be achieved via provisions to ensure that compensation is adjusted for all types of risk; that firms use an appropriate mix of quantitative and qualitative methods in making ex-ante risk adjustments; that compensation outcomes are appropriately sensitive to risk outcomes including the time horizon of risks; that subdued or negative financial performance of the firm and inappropriate risk-taking leads to a 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; that compensation is delivered in the form of instruments that create incentives aligned with long-term value creation and the time horizons of risk including cash, equity and other forms of compensation; and that firms identify material risk takers for compensation purposes.
- For effective stakeholders' engagement, the P&S indicate that firms should disclose clear, comprehensive and timely information on their compensation practices to facilitate constructive engagement of all stakeholders.

# 1. Overall assessment of implementation by banking organisations

Supervisors assess the level of implementation by banking organisations reviewed for this report[32] mostly as high, confirming the findings of previous reports.

Table 2 sets out more details on the changes in practices that have been observed since the last progress report and remaining areas for improvements, by making reference to a set of indicators to support assessment of progress in the implementation of the P&S for the areas of effective governance of compensation, effective alignment of compensation with risk, and stakeholder engagement.[33] Broadly, changes have reflected further implementation of compensation regimes, including work to better embed and to improve the effectiveness of risk alignment (e.g. back testing and other mechanisms employed to achieve balance between risk and reward). One authority highlighted that compensation outcomes are better aligned with board-approved risk metrics, although work continues to better enhance alignment with the risk appetite frameworks. Another authority highlighted best practices represented by the use of a mix of qualitative and quantitative metrics as gate conditions, to ensure a more consistent application of the compensation policy across a banking organisation and remove discretion from line management. Gate measures include achieving capital/liquidity standards, compliance with risk limits and for individuals it can include not being involved in misconduct (depending on the severity of the offense), although the authority notes that in some cases the use of qualitative metrics could be further developed.

In terms of monitoring systems to regularly review compensation and risk for intended outcomes, a number of authorities have observed progress with improved internal processes and systems and other monitoring and surveillance activities. A few authorities note that firms have started to apply back testing procedures to ensure that compensation outcomes are aligned with risk outcomes at least in some business divisions, and at least one authority requires significant financial institutions to monitor and validate the effectiveness of their programmes. Some banking organisations have started to develop data analytics to support their assessment (for example to detect and highlight unusual trading and sales activities and patterns), but

[32] Jurisdictions have surveyed for the purposes of this report 77 banks. All these firms are considered by the respective supervisors as significant for the purposes of the P&S (see Annex C).

[33] In particular, these indicators are drawn from the P&S themselves or from the supporting explanatory text which clarifies the intended objective of the P&S.

generally authorities note room for improvement in the development of management information to better track and document compensation and risk outcomes and promote consistent consequence management, including for misconduct events. In the UK the creation of the Senior Managers' Regime places a focus on individual accountability which is also reflected in a strengthening of some compensation rules (e.g. longer deferral for senior managers). In South Africa, section 66 of the Companies Act uses the term "prescribed officers" which could be compared to the UK Senior Managers' Regime as it leads to greater personal accountability for certain senior managers. Gathering evidence of operational effectiveness of compensation policies and practices is an area where several authorities have highlighted potential for improving practices.

**Table 2**

| **Change in practices and areas for improvement[34]** | | |
|---|---|---|
| **Indicators supporting assessment of effective implementation** | **Changes in practices observed in 2015-2016** | **Remaining areas of weakness and causes** |
| **Governance of compensation** | | |
| **Boards have a dedicated committee to govern compensation arrangements** | • Compensation committees made significant changes to processes, with more frequent meetings and a greater number of topics discussed.<br>• Compensation committees in subsidiaries have become more prevalent.<br>• Introduction of individual accountability on compensation for the Chair of the Compensation Committee.<br>• Expectations of the level of oversight and challenge provided by the Compensation committee generally increased. | |
| **Boards actively oversee the compensation system's design and operation.** | • In one jurisdiction, new requirement from 2016 onwards for an individual non-executive director to be given the prescribed responsibility for oversight of compensation policies and practices at each firm.<br>• Boards submit reports to the shareholders meeting on the application of compensation policy for the previous performance year. | |
| **Staff engaged in financial and risk control are independent and have appropriate authority** | • At one firm, the Board's Enterprise Risk Committee and Audit Committee further review and approve compensation for the Chief Risk Officer and Corporate General Auditor, respectively. | |

[34] This is not an exhaustive list of changes and remaining weaknesses in the implementation of the P&S and does not necessarily represent consensus views of the CMCG. Rather it is a snapshot of activities and issues highlighted by individual CMCG members for some of the FSB member jurisdictions.

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| **Firms include the risk management and control function in the performance assessment process** | • Introduction of conduct assessments performed by second and third lines of defence.<br>• In some cases the amount of variable remuneration has been made dependent on the financial performance and the risk function providing opinions on the allocation of variable remuneration to business areas and individuals. A negative opinion from the risk function negatively affects variable remuneration.<br>• At a number of firms independent control functions—including audit, compliance, finance, human resources, legal, and risk—provide direct feedback to the Compensation Committee on executive officer performance.<br>• Senior management and independent control functions, including risk officers, annually review and certify incentive plans.<br>• At many large firms, independent control functions collaborate on proposals for the design, operation, and monitoring of incentive compensation programs and take part in formalised reviews that identify and evaluate events that may merit forfeiture or clawback. | |
| **Compensation systems are subject to robust controls and periodic reviews to ensure integrity** | • A number of firms have improved their systems and processes to improve the link between compensation intentions and outcomes, particularly how the assessment of behaviours have impacted reward decisions. | • Internal audit and compliance functions assess the compensation system on a regular basis. However the controls carried out by the two functions could be further enhanced. |
| **Compensation and risk outcomes are regularly reviewed for consistency with intentions** | • Credit institutions developed internal processes and procedures mainly in response to statutory or regulatory requirements.<br>• Introduction of a bifurcated rating approach (e.g. performance and behaviour are assessed).<br>• In one jurisdiction, all significant banks are required to have monitoring and validation programmes in place. The quality of such programmes is part of ongoing supervisory assessments.<br>• Many boards evaluate not only compensation structure but also related processes and governance in assessing whether compensation policies support prudent risk-taking, and have established new governance structures to support this goal, for instance, management committees comprising senior representatives of Enterprise Risk Management, Compliance, Corporate Audit, Finance, Legal and Global Human Resources groups which play a role in formally assessing incentive compensation arrangements and risk | • The development of management information to better track compensation and risk outcomes (including e.g. misconduct events and the consistency of consequence management actions and any resulting differences in variable pay reduction) are still work in progress.<br>• Consistency of financial incentives with risk and conduct objectives could be strengthened. In some banking organisations financial incentives are still not fully consistent with risk and conduct objectives.<br>• Banking organisations have not developed specific indicators to monitor the effects of compensation frameworks on risk-taking behaviour and conduct. |

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| | behaviours throughout the organisation, including decisions related to malus and clawback. | • Evidence of operational effectiveness of compensation policies and practices still lacking. Regular effectiveness testing in certain business areas. |
| **Firms have in place monitoring systems to effectively monitor activities that could provide an early warning on misconduct** | • Some banking organisations have started to develop data analytics to detect and highlight unusual trading and sales activities and patterns, which could potentially provide an early warning on misconduct.<br>• Improvements include:<br>- the introduction and periodic review of Key Performance Indicators or "Scorecard Objectives" or Ethical, Social & Governance indicators, representing from a risk perspective the core drivers and criteria of the institution (financial and non-performance performance);<br>- the introduction of a compliance and behaviour assessment review tailor-made for different categories of staff and related identification of the impact on compensation per category of findings;<br>- Red flag processes to address poor performance or "minor" cases of misconduct, additionally to existing disciplinary processes.<br>• Monitoring and surveillance of trading activities and behavioural (misconduct) patterns activities introduced.<br>• A number of firms have introduced a conduct focus for their management/human resources committee to monitor levels of misconduct risk and consider any indicators of increased risk. | • The development of forward-looking conduct risk metrics is at an early stage.<br>• Although firms generally have monitoring systems, the ability to provide early warning on misconduct is still limited but improving over time. |

| Risk alignment | | |
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| **Compensation outcomes are symmetric with risk outcomes at the firm level** | • The industry continues to adjust the alignment of its indicators to the risk appetite of each entity.<br>• For some banking organisations, compensation outcomes are now better aligned with board-approved risk appetites.<br>• Best practices observed for some banking organisations are represented by systems that link remuneration with risk at various stages. This is obtained including risk related metrics simultaneously:<br>- for bonus pool determination purposes;<br>- as gate conditions;<br>- in individual balanced-scorecard;<br>- as malus conditions. | • Banking organisations continue to enhance alignment with the risk appetite framework.<br>• Firms have started to apply back testing procedures which have shown that compensation outcomes are symmetric with risk outcomes in certain business divisions but not all. |
| **Firms identify material risk takers for compensation purposes** | • Evidence of firms identifying additional roles as MRTs based on conduct risk considerations. | |
| **The mix of cash, equity and other forms of compensation is consistent with risk alignment** | • Among recent design trends that stand out in one jurisdiction are: heightened use of Performance Share Units (PSUs) for long-term incentives;; less use of stock options; and reduced use of leverage (125-150% upside leverage among financial services companies versus 200% across other industries). | • Many banking organisations assert that their equity prices are affected by domestic and external drives independent of the banking organisation's own performance. Therefore, equity prices are not seen a good performance indicator. Moreover, banking organisations indicate some concerns arising from areas such as tax issues related to the use of non-cash instruments. |
| **Firms use an appropriate mix of quantitative and qualitative methods in making ex ante risk adjustments** | • The use of a mix of qualitative and quantitative metrics as gate conditions and of balanced-scorecards for ex ante adjustment at an individual level can be considered as a best practice.<br>• Relevance of qualitative factors has increased.<br>• All firms are increasingly focused on non-financial performance metrics. Practice in this area continues to evolve. | • Some of the risk-adjusted performance measures at the business unit or firm level may not be directly linked to the individual performance of material risk-takers.<br>• In some cases the use of qualitative methods should be more extensive. |
| **Firms make use of malus and clawbacks where there have been material breaches** | • Banking organisations have included in their internal policy events which may trigger the use of malus and clawback, especially to deal with misconduct actions.<br>• Increased emphasis on the use of malus, with more frequent application of this tool expected from 2016 onwards. | • There is limited evidence of clawback as firms tend to rely on in-year adjustment and malus in the first instance to address material breaches<br>• As there is a general preference of banking organisations for using in-year adjustments before considering the application of malus and clawback, in practice firms have applied malus to outstanding |

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| | | deferrals only in a limited number of cases and the effectiveness of the malus and clawback tools remain to be seen.<br>• Banking organisations have experienced in a number of circumstances that in some jurisdictions even malus provisions are sometimes difficult to be legally enforced. It remains a challenge to address the gap that exists between labour law statutes at a country-level and separately developed regulatory requirements for compensation structures. |
| **External stakeholder engagement** | | |
| **Firms' compensation policies are publicly disclosed and timely** | • In some jurisdictions public disclosure for certain information on compensation is required by regulation and disclosure guidelines. In one jurisdiction an overview at aggregate level is provided in a periodic publication on remuneration and high earners. | |
| **Firms' compensation policies (including on compensation governance and risk alignment) are clear and comprehensive** | • In one jurisdiction in 2016 senior management at banking organisations engaged in conversations on compensation, which is regarded as an important shift in the communication policy and helped address concerns related to equity and transparency of compensation systems. | • In some cases compensation policies are complex and not transparent. For banking international/global groups the consistency of policies across the group is an area of attention, given the differences in national legislation. In some cases, banking organisations are working on the implementation of a group-wide remuneration policy document, since they did not have one single remuneration policy applicable to all staff in the group but a combination of different policies applicable at local levels. |
| **Shareholders and other stakeholders are engaged with firms on compensation policies** | • In Europe the role of shareholders is required by CRD IV and transposed national legislation where the firm seeks an increase in variable to fixed remuneration. In some cases, depending on the national legislation, shareholders are entrusted with broader powers, such as approving – with a binding vote – the overall remuneration policy, stock-options plans and criteria for the award/pay of golden parachutes. | |

***Engagement with stakeholders***

Engagement with stakeholders, especially shareholders, is a key pillar of the P&S. Although in some jurisdictions there is a growing focus on shareholder engagement on compensation it is difficult for the FSB and the authorities to assess the extent to which shareholders are actively engaging on these issues and the extent to which this engagement impacts practice at significant financial institutions.

In some jurisdictions however additional provisions focus on the role that shareholders play to influence compensation policy. In the UK, for example, quoted companies are required to hold a shareholder vote on the directors' remuneration policy at least every three years. The company must also carry out an annual advisory shareholder vote on the implementation of that policy.[35] In the EU, the recently amended Shareholders' Rights Directive encourages long–term shareholder engagement and increased transparency, with specific requirements that apply to remuneration of directors and transparency for institutional investors, asset managers and proxy advisors.[36] In Italy, shareholders of all banks are required to express annually their binding vote on the overall remuneration policy and the incentive plans based on financial instruments (e.g., stock-options) as well as to set criteria and limits for payments related to the early termination of contracts (e.g. golden parachutes). In its work on corporate governance the FSB has highlighted the importance of engagement by investors on compensation policies in financial institutions.[37]

The revised BCBS Pillar 3 standards on remuneration disclosure (see Section I.2) may contribute to more homogeneous disclosure of compensation policies and application of compensation tools, thereby facilitating a more active engagement of external stakeholders and investors on the topic of compensation.

## 2. Compensation and misconduct

Ethical conduct, and compliance with both the letter and spirit of applicable laws and regulations, is critical to public trust and confidence in the financial system. Misconduct is also relevant to prudential oversight as it can potentially affect the safety and soundness of a particular financial institution or the financial system more generally. In 2015 the FSB published a workplan for reducing misconduct risk which addresses this issue through a range of preventive measures, focusing on (i) improvements to financial institutions' governance and compensation structures to reduce misconduct risk; (ii) improvement to global standards of conduct in the fixed income, commodities and currency (FICC) markets, including through codes of conduct and through related regulatory and enforcement tools in wholesale markets; and (iii) reforms to major financial benchmark arrangements to reduce the risks of their

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[35] Enterprise and Regulatory Reform Act 2013 See http://www.legislation.gov.uk/ukpga/2013/24/section/79 .

[36] See Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement – See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2017:132:FULL&from=EN.

[37] See http://www.fsb.org/2017/04/fsb-publishes-thematic-peer-review-on-corporate-governance/

manipulation.[38] This work considers appropriate steps to reduce misconduct risk following significant examples of misconduct in a number of firms.

Since the last progress report the CMCG has undertaken three main elements of work related to compensation and misconduct:

- A stocktake to review the regulatory and supervisory frameworks surrounding the use of compensation tools such as in-year adjustments, malus and clawback in connection with misconduct. The review also covered the extent to which significant banking organisations have used these compensation tools to help reduce misconduct risk.
- Provided an update on the FSB's work on compensation and misconduct in the FSB progress report on misconduct risk published in September 2016,[39] which was informed by the stocktake.
- Published for consultation supplementary guidance to the FSB's P&S to consider the use of compensation tools to address misconduct. The FSB launched the consultation on 20 June 2017[40] and will finalise the guidance by year-end.

The stocktake, which included a survey of FSB members on how banking organisations in their jurisdiction were using compensation practices to reduce the chances of misconduct and a roundtable discussion with banking organisations on their practices, reached the following conclusions which were published in the misconduct progress report in September 2016:

- Jurisdictions have taken different approaches in setting expectations around the use of variable compensation, deferral and ex post adjustment mechanisms (including malus and clawback) to reduce misconduct risk.
- Despite jurisdictional differences, there is broad agreement among those surveyed and supervisors on the importance of compensation tools and related performance management mechanisms as one element of the toolkit for reducing misconduct risk.
- The effectiveness of compensation frameworks in reducing misconduct risk should not be considered in isolation.
- Financial institutions and supervisors have signalled the importance of shifting the supervisory focus to positive measures aimed at building a culture of good conduct.
- The changes in culture – attitudes, policies, processes – that are underway will take time to embed.
- Consistent metrics for monitoring and assessment will need to be developed.

### *Deferral, malus and clawback*

Deferral of compensation provides a key mechanism for aligning the longer-term interest of those that work for financial institutions with that of the sustainable longer-term interests of the

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[38] See FSB, *Measures to reduce misconduct risk: progress report*, November 2015 (www.fsb.org/wp-content/uploads/Misconduct-risk-progress-report.pdf).

[39] See FSB, September 2016 www.fsb.org/2016/09/fsb-publishes-second-progress-report-on-measures-to-reduce-misconduct-risk/

[40] See FSB, June 2016 http://www.fsb.org/wp-content/uploads/R200617.pdf

institution. In-year adjustment, malus and clawback are the tools by which the deferral policies can be used to effectively adjust for performance ex post. Given the importance of these tools for effective ex post risk alignment, including in instances of misconduct, this is an area that the FSB has explored in detail. Annex E provides a summary of the findings from the 2016 stocktaking exercise related to the use and application of malus and clawback across jurisdictions. In a number of jurisdictions the application of ex post tools, in particular clawbacks, faces challenges due to differences between jurisdictions' labour law statutes and their regulatory requirements for compensation structures.

The response to the 2017 questionnaire highlights that in a number of markets there is an increasingly greater focus on misconduct. In some cases, this includes work to ensure more effective use of data to identify misconduct issues and a particular focus on how non-financial indicators such as the assessment of behaviour, and non-financial incentives such as eligibility for promotion, has impacted reward decisions. Particular attention has been paid to misconduct risk by authorities in Singapore, the SSM jurisdictions, Switzerland, UK and US. A number of authorities have also indicated that greater attention is being paid by firms in making bonus decisions not only on whether performance objectives are achieved but *how* they were achieved, including through explicit scoring mechanisms or balanced scorecards that include non-financial performance measures. Conduct considerations also explicitly factor into promotion and compensation decisions. In Singapore, for example, banking organisations incorporated weightings to both financial and non-financial performance measures in their balanced scorecards to signal to employees the importance of non-financial measures, such as audit ratings, regulatory compliance, adherence to firm's values, etc. In other jurisdictions firms have introduced periodic reviews of key performance indicators; ethical, social and governance indicators; and "red flag" processes to signal poor performance or minor cases of misconduct. In the UK, the Financial Conduct Authority (FCA) reviews individual adjustments at larger firms on a line by line basis for misconduct events to ensure policies are being consistently and robustly applied.

Firms, predominantly banking organisations, have also increasingly focused on the steps they can take to more effectively align compensation policies and practices to reduce misconduct risk. For instance, firms in the UK have deemed additional employees MRTs as a result of an assessment that considered conduct risks related to their roles, and malus has increasingly been used to increase the signalling effect. In the US malus and clawback cover a broader group of staff, as boards are increasingly focused on creating a culture that is long-term and focussed on sound risk management. This progress notwithstanding, experience on the use of malus and clawback tools continues to be limited in most jurisdictions and their effectiveness remains to be seen.[41] A few authorities noted that some banking organisations have encountered legal issues in enforcing malus. However cases of application of these tools, including clawbacks, in particular in significant instances of misconduct are starting to materialise.[42]

*Addressing the time lag of misconduct incidents*

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[41] For an analysis of the triggers of ex post performance adjustment tools, see 2015 progress reports, Appendix F. http://www.fsb.org/2015/11/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards/

Evidence of misconduct can often take time to emerge. Another challenge to the application of ex post compensation tools may arise in presence of relatively short deferral periods, and situations where application of ex post tools is linked to the compensation awarded only in the period in which misconduct occurred. If deferred compensation has already vested by the time an incident is discovered, ex post compensation adjustment may be difficult, undermining the incentives that are meant to be built into effective compensation schemes.[43] Supervisors have taken a number of steps to address these issues. In the UK for instance, for senior managers only, firms must have the ability to extend the clawback period for up to a further three years at the end of the existing seven year period for all MRTs, if regulatory or internal investigations are outstanding. Some firms freeze unvested variable pay during investigations.

***Data and information on the use of compensation tools to address misconduct risk***

The 2017 questionnaire shows that more work is required to effectively develop and embed misconduct risk considerations into compensation policies. For instance, one authority notes that the development of management information for monitoring misconduct is still a work in progress as are forward looking conduct risk metrics. Developing such management information and introducing compensating controls will be key to spotting and addressing misconduct and embedding these considerations in to compensation decisions. Authorities have suggested that a range of data could be useful on the use of compensation tools in relation to cases of misconduct.

The data can broadly be categorised into the following groups:

- **Identification of MRTs** – lists of MRTs and justifications for their identification.
- **Governance** – compensation policy reviews and changes, use of risk indicators in performance management, use and weightings of non-financial performance metrics.
- **Misconduct data** – incidence and severity of misconduct incidents.
- **Compensation actions** – adjustments to deferred compensation, compensation actions in relation to misconduct incidents, pattern analysis (e.g. roles and functions involved in misconduct, geographic incidence of misconduct events), and tracking of consequence management and related disciplinary actions.

In terms of information available to supervisors, a variety of sources exist. Some jurisdictions have substantial public disclosure requirements related to compensation,[44] BCBS Pillar 3

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[43] For instance, with regard to the manipulation of Libor, there was evidence on manipulation in early 2005, issues were raised with regulators in late 2007 but enforcement action wasn't completed until mid-2012. This shows the considerable tail that can emerge with misconduct cases and the difficulties that can emerge where deferral periods are shorter than the time it takes for misconduct cases to emerge or for them to be settled.

[44] According to the US authorities, extensive regulation for listed firms ensures that a large set of the information required by the Basel III's Pillar 3 standard is disclosed; additional information is also disclosed, such as for example about the relationship of the firm's compensation policies and practices to risk management, if risks arising from such policies and practices are reasonably likely to have a material adverse effect on the company. In the US through requirements administered by the Securities and Exchange Commission, publicly held companies are subject to public disclosure and exchange listing requirements related to executive compensation, compensation committees at the board level, and use of compensation consultants. Among other things recently enacted provisions include the adoption of exchange listing standards to address the independence of the members of a compensation committee; the committee's authority to retain compensation advisers; the committee's consideration of the independence of any compensation advisers and responsibility

standards require banking organisations to disclose annually the use of compensation tools but do not require a break out for application of malus in relation to misconduct, and several jurisdictions collect information as part of the supervisory process. In the SSM and the UK banking organisations are required to provide data on malus and clawback through EBA templates[45] and the information is periodically published, although misconduct incidents are not disaggregated. In the UK misconduct incidents are broken down in regulatory returns. In a number of jurisdictions (SSM, US), in addition to substantial information that must be publicly disclosed by some organisations (see, e.g., footnote 39), regulated financial institutions may be subject to requirements to make information available to their supervisors upon request but such information may not be disclosed publicly. Horizontal examinations provide an opportunity to collect such information and analyse peer practices, including whether banking organisations use similar definitions and taxonomy. In Brazil, according to a regulation that will come into force in November 2017, financial institutions must implement customer relation policies and procedures which align with their compensation policy, including compliance monitoring with metrics and indicators.

A few authorities have also provided details on the indicators collected internally by the firms, mostly with the objective to propose revisions to the existing compensation and governance policies and improve the link between compensation and conduct. Examples include (i) non-financial performance indicators; (ii) number and types of transgressions; (iii) severity of misconduct; (iv) outcome of internal audit reviews; (v) disciplinary actions taken; (vi) , the exercise of malus and clawback and (vii) the nature and underlying cause of misconduct cases. In the US, authorities observed that, more recently, many significant banking organisations have also undertaken self-assessments with a broader focus and on design issues (such as how to properly incentivise certain employees) and how to discourage misconduct more generally.

As part of the workplan on measures to address misconduct risk, the FSB, in collaboration with standard-setting bodies, will develop by end-2017 recommendations for consistent national reporting and data collection on the use of compensation tools to address misconduct risk in significant institutions. This could include recommendations on the frequency with which supervisors should collect such data, and recommendations for reporting on the types of tools deployed (both ex ante and ex post), the reasons for their use and the variable compensation affected by the tool. It is expected that the recommendations will be subject to public consultation by end-2017.

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for the appointment, compensation, and oversight of the work of any compensation adviser. The SEC also amended proxy disclosure rules to require new disclosures about companies' use of compensation consultants and conflicts of interest and has issued proposals to implement the following sections of the Dodd-Frank Act: Section 953(a), requiring disclosure of the relationship between "executive compensation actually paid" and the issuer's financial performance; Section 954, calling for exchange listing standards requiring issuers to adopt and disclose clawback policies for recovering from current and former executive officers, and Section 955, requiring disclosure regarding employee and director hedging practices. Finally, the SEC adopted final rules on pay ratios under Section 953(b) to require the disclosure of the median of the annual total compensation of employees and some pay ratios between minimum and maximum remuneration and the median (see https://www.sec.gov/rules/final/2015/33-9877.pdf). The rules apply generally to public companies other than emerging growth companies, smaller reporting companies, and foreign private issuers.

[45] In line with EBA/GL/2014/08 "the information to be provided on ex post adjustments, including clawback and malus, refers to the application of these arrangements for remuneration already awarded. These amounts should be reported separately and should not be deducted from the amount of variable remuneration reported".

# 3. Identification and treatment of material risk takers (MRTs) and design of compensation structures

Identification of MRTs is a key pillar of the P&S. Identifying MRTs helps banking organisations and supervisors to understand which employees have the potential to expose the firm to significant risk and consider the extent to which the structure of their compensation is effectively risk aligned.

The 2014 progress report concluded that "methodologies for identifying MRTs differ across jurisdictions. In most jurisdictions, identification is largely the responsibility of individual firms, albeit with guidance, oversight and monitoring from regulators/supervisors". The 2014 report also observed that generally, larger firms have more complex systems to identify MRTs. Criteria for the identification of MRTs included: role (e.g. level of seniority), remuneration (variable and/or fixed) and responsibilities (e.g. control function roles, material risk taking, membership in specific business units or committees, authority to design and approve products, ability to impact a firm's capital and liquidity positions including the wider business group).

Based on the answers to this year's questionnaire, there have been no significant changes in the approaches and methods for identification of MRTs since 2014, so this appears to be an area of relatively few developments (see annex D, largely unchanged from the table published in the 2014 report).

There are a number of jurisdictions where there is either not a precise definition of MRTs (Argentina, India, Mexico[46]) and/or where there is no requirement to identify them because of the limited scope of application of the relevant regulation. For example, Brazil, where the regulation only applies to board members and executive officers, or Korea, where the regime is limited to executive officers and employees who engage in the design, sales and management of either securities or derivative products. In some jurisdictions, for example Mexico, even though banking organisations are not required to identify MRTs they do undertake an assessment and apply this globally. In South Africa, there is not a definition of MRTs however banking organisations are required to identify their material risks and if the supervisor has concerns about the approach being taken by firms it can require banking organisations to tighten their risk management policies, processes and procedures. The number of MRTs identified varies dependent on the size, structure and business focus of the institutions, with banking organisations or business units engaging in investment banking activities usually identifying larger numbers as a percentage of total staff.

There are differences across jurisdictions concerning the extent to which supervisors engage with firms on the approach and final list of MRTs developed by firms. A number of jurisdictions undertake no review or evaluation of the numbers of MRTs (Australia, Canada, China, Mexico, Russia, Turkey), whereas in other jurisdictions (Argentina, Hong Kong, India, Indonesia, Japan, Singapore, SSM, Switzerland, UK, US) supervisors as part of regular supervisory engagement engage with banking organisations in discussions about the suitability of the process for developing the list and the number of MRTs that are effectively identified. For example, Singapore reviews the number of MRTs in comparable banking organisations to identify

[46] Mexican regulation requires banks to define the group of employees that will be considered as Risk Takers according to the banks' internal policies.

outliers and underlying reasons, and the supervisor engages the banking organisations' board and/or senior management if there are any significant areas of concern. In Europe (SSM and the UK) MRTs are identified pursuant to EU regulation, according to which institutions have to carry out an internal self-assessment, ensuring full compliance with the regulation. A wide list of qualitative criteria are defined to capture employees with a material impact on the risk profile of institutions (based on their role/responsibilities or the significance of their business unit/corporate function), as well as quantitative thresholds which automatically determine the identification of MRTs.[47] In Saudi Arabia and Russia banks are required to publicly disclose the total number of MRTs and the compensation paid to them.

One jurisdiction has indicated that banking groups normally start with titles and designate everyone above a certain threshold as an MRT. Below that level individuals who can potentially expose banks to material risks are identified either through the nature of their activities, the relative volatility or complexity of their business, or the significance of exposure limits that have been allocated to them. Another authority indicated that banks identified as MRTs either employees that commit or control significant amounts of a firm's resources or over a certain threshold of pay. Another authority indicated that MRTs are identified based on filters which include application of: (i) compensation related criteria; (ii) risk-related criteria; (iii) function based reviews (managers, products, hierarchy, committee membership, responsibilities); (iv) compliance oriented reviews; (v) completeness check (inclusion under other jurisdictions' methodologies). The approaches banking organisations take to the identification of MRTs for staff employed by them undertaking activities in the securities sector appears to be broadly similar to the approach taken in other parts of their business.

In some jurisdictions authorities would like to see improvements in the MRT identification processes undertaken by the banking organisations they supervise, given the importance of MRT identification for ensuring effective risk alignment and focussing supervisory oversight. The MRT identification process could be an area to be further explored by the FSB in its analysis of the effective implementation of compensation reforms, including the degree to which current methodology effectively identifies those who can take or commit the firm to risks, including the potential for reputational and other forms of risk, and the potential scope for greater consistency across jurisdictions.

### *Design of compensation structure*

In practice, there are significant differences across FSB member jurisdictions in terms of the key elements of compensation structures. For example, jurisdictions continue to flag significant differences between the deferral periods for material risk takers. Regulatory requirements, or related guidance, for deferral generally ranges between a minimum of around three years (Argentina, Brazil, China, EU, Hong Kong, India, Indonesia, Japan, Korea, Russia, Singapore, Switzerland, Turkey) and can range up to five years or more for some portions of the MRT

[47] The qualitative criteria mainly rely on the staff member's roles/responsibilities or the business units'/group entity's riskiness for the bank/group; the quantitative criteria identify staff members based on the amount of total remuneration awarded in the preceding financial year. Only when specific conditions are met, set out in the Regulation itself, staff members identified pursuant to the quantitative criteria only might be not considered as risk-takers (the competent authority is in charge of assessing the notification received by the institutions intending to exclude some staff members and of authorising the exclusions of staff members awarded with amounts of total remuneration above predefined thresholds).

population (Italy, SSM,[48] US). In the UK for the most senior managers this increases to a minimum deferral of seven years.

The proportion of fixed remuneration as a percentage of total remuneration for senior executives and MRTs varies significantly from around 30% at the Swiss G-SIBs, 35% in Australia, China, 22-56% in Singapore, 54% in the UK, 58% in Hong Kong and SSM jurisdictions, to about 60% in India. As a result of the implementation of the bonus cap in Europe the proportion and amount of fixed pay in compensation packages at banking organisations have increased.[49] In the UK fixed pay as a proportion of total remuneration in the major UK banking organisations increased from 28% to 54% across the MRT population from 2013 to 2014. Argentina, Brazil, Canada, Indonesia, Russia, South Africa and the US either do not set out requirements or do not collect data on this although in jurisdictions such as the US use of variable remuneration is generally significant in some cases.

Equally, the proportion of variable compensation that is deferred generally varies in the order of 25-60% in Canada, 40% in Argentina, Australia, Brazil and Hong Kong, 33-54% in Singapore, to more than 40% in China and Turkey, 40-55% in India, 40%-60% in SSM jurisdictions, the UK and the US, to 50-70% in Korea, and 70%-75% in Switzerland. Use of deferral may vary within certain portions of the MRT population. In the US, for example, senior executives now have more than 60% of their incentive compensation deferred on average, and some of the most senior executives have more than 80% deferred with additional stock retention requirements after deferred stock vests. In some jurisdictions there are no specific regulatory requirements on the proportions of compensation that need to be deferred (Indonesia, South Africa).[50] In Japan the range differs between those MRTs captured by international regimes and those covered only in Japan, where the levels of variable compensation and deferral are lower, reflecting local compensation practices and regulations.

Given these differences in approaches, it is not possible based on the information available to assess whether compensation structures for similar positions are comparable in different jurisdictions and markets. Ultimately, assessing effectiveness would require an evaluation of the incentives provided by the different practices in different markets of operations. Firms are increasingly seeking to adopt group wide compensation policies to ensure consistency across their employees, at least in terms of the expectations. However, this is not an easy process. Some concerns have been raised about the complexity of compensation policies and structures, especially for international banking organisations, that need to comply with multiple national regimes. For example, in Europe institutions note that a consistent compensation policy across an international group may be difficult, depending on the local framework and practices.

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[48] In line with art. 94 CRD as transposed in the national laws. Furthermore, EBA GLs on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013, Section 15.2 say: "Institutions should in any case apply, at least for members of the management body in its management function and senior management, deferral periods of at least five years and defer a significant higher portion of the variable remuneration paid in instruments".

[49] In this regard, see EBA Report – Benchmarking of remuneration practices at the European Union level and data on high earners (data as of end 2014) EBA-OP-2016-05 30 March 2016. https://www.eba.europa.eu/documents/10180/1359456/EBA+Op-2016-05++%28Report+on+Benchmarking+of+Remuneration+and+High+Earners+2014%29.pdf

[50] South Africa requires that variable compensation be deferred but does not prescribe the portions that should be deferred.

# III. Towards assessing effectiveness: indicators on the evolution of pay practices and their use

Assessing the effectiveness of policies is a key part of the policy development cycle. Since the P&S have increasingly been implemented in many of the FSB member jurisdictions, it is appropriate that authorities make an assessment of the extent to which policies have achieved their intended policy outcomes. When they were released in 2009 it was noted that the Principles were "intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes". Similarly, as policies have been implemented in FSB member jurisdictions, many authorities have noted that the intended policy outcome was effective risk alignment of compensation policies and practices with the long-term sustainable interests of firms. Table 3sets out some examples of the intended policy outcomes for different authorities.

**Table 3**

| **Examples of intended outcomes of reforms to compensation policies and information used by authorities to assess their effectiveness** | |
|---|---|
| **Intended policy outcome** | **Data or Information used to assess effectiveness of outcome** |
| • Alignment with prudent risk-taking and risk appetite. | • Results of supervisory work conducted, results of annual review of compensation disclosure.<br>• Inclusion of deferrals/malus/clawbacks in contracts, reductions, sign on bonuses, guaranteed bonuses, severance payments.<br>• Back testing and monitoring and validation results. |
| • Alignment with the long-term interests of the entity.<br>• Promoting an effective and sound risk management. | • Proportion of deferred variable remuneration and ex post risk-adjustment mechanisms (malus and clawback).<br>• Payment in non-cash instruments. |
| • Effective oversight of compensation programmes by the board and senior management. | • Output of supervisory work conducted. |
| • Appropriate balance of risk and reward. | • Amounts deferred, amounts at risk, leverage, use of options, performance metrics and equity retention policies. |
| • Effective governance of compensation. | • Oversight of senior executive compensation<br>• Oversight of ex post adjustments – use of discretion, MIS systems that allow for pattern and outlier analysis<br>• Charter of the remuneration committee<br>• Internal Audit findings |
| • Effective risk management framework/controls with respect to compensation. | • Use of compensation metrics/reporting to board.<br>• Role of risk management and control functions in design and implementation of incentive contracts.<br>• Role in development and adjustment of bonus pools.<br>• Monitoring and validation of compensation policies.<br>• Independence of internal control functions. |

Assessing whether the structure of compensation has helped reduce excessive risk taking is difficult, given that a number of other factors may play a role. However, to a great extent, the benefits from implementation of compensation policies are ensuring a greater focus by senior managers on compensation and the discussions that take place between supervisors and firms on this issue.

Indicators can be a useful input to help assess the effectiveness of policies. While jurisdictions have detailed views on the intended policy outcomes, most of them do not collect data and have not developed indicators to measure the effectiveness of the compensation practices in relation to their intended objectives. There are a few exceptions, however, at least in terms of data collected for supervisory purposes. For example in Europe the EBA benchmarking exercise collects significant amounts of data. In the UK the PRA and FCA also collect extensive data annually on the remuneration policies and practices of the largest firms. In the US, substantial information – such as the level and length of deferrals, amounts at risk, use of leverage and stock options, adequacy of MRT identification, performance metrics, up front risk adjustments and malus and clawback triggers – are gathered as part of the supervisory review process and included in relevant examination reports. Brazil reports a plan to introduce new supervisory indicators to monitor and assess the implementation of the P&S.

One area to which supervisors and firms are increasingly devoting their attention is risk alignment of compensation, given the relevance in terms of providing risk taking incentives compatible with the stated risk appetite of the firm. In particular authorities and firms have focused their efforts to articulate what risk alignment means in practice and to ensure that compensation policies and systems are effectively aligned with firms' risk appetites. Metrics are a key mechanism for banking organisations to align their compensation schemes with their risk appetite. Table 4 provides a series of indicators suggested by authorities that could be used to assess risk alignment and more generally the effectiveness of compensation policies in meeting the intended policy outcomes. Such indicators have to be considered over a long-term implementation horizon and within the broader context of the policy frameworks implemented by jurisdictions.

**Table 4**

| **Indicators that supervisors would consider most useful to assess effectiveness** | |
|---|---|
| **Suggested data/indicator** | **Justification for data/indicator** |
| • Use of in-year adjustments, malus and clawback by banking organisations.<br>• Total amount of variable compensation "at risk". | • Indicates the alignment of remuneration policies with risk-taking. |
| • Analysis of the remuneration paid to material risk takers across banking organisations over a period of time. | • Are banking organisations adjusting remuneration to take into account longer-term performance based on risk. |
| • Total variable pay vs results of the entity. | • Risk alignment. |
| • Total variable pay v total pay. | • Compensation composition. |
| • Deferred pay vs. total pay, deferral in years. | • Role for ex post performance adjustment, including effectiveness of compensation in addressing misconduct. |

| | |
|---|---|
| • Variable compensation outcomes compared to capital levels. | • Proxy for alignment between bonuses and financial soundness of institution. |
| • Number and amount of risk that have materialised compared to those associated with each job profile.<br>• Downward adjustments compared to significant breaches. | • To assess whether compensation practices take into account weaknesses in the institution's risk management framework. |
| • Number of misconduct cases and action taken. | • Whether the compensation tools used have given intended outcomes. |
| • Evidence of market pressure that justifies the level of (total) compensation. This occurs where the variable compensation component is a "derivative" of high levels total compensation driven by market competition; and where there is a desire to retain talent regardless of the financial institution's performance. | • Basic element for assessing the effectiveness of the compensation reforms. |
| • Back testing of an individual's total compensation based on his/her performance and behaviour assessment. | • Evidence of equal treatment and effectiveness of misconduct policies. |
| • Development of economic contribution vs development of bonus pool. | • Evidence of economic sustainability of the bonus pool in relation to accumulation of capital resources |

Some authorities highlighted potential impediments to assessing the effectiveness of compensation policies. These include limited resources and other supervisory priorities, and the need for sufficient time to ensure that the policies have been implemented and settled. One factor that for example might create impediments to implementation – and therefore to the assessment of effectiveness of the policies – is when there is market pressure driving up compensation and limiting the possibility for compensation to be effectively aligned with risk. As institutions compete for senior talent, trying to reconcile pressures to sign or retain key staff with the need to risk align a compensation package can be difficult.

**Box 3: The assessment by the European Commission**

In 2016 the European Commission published an assessment of the effectiveness of its compensation rules in meeting the intended policy objectives. [51] The Commission studied available academic literature and commissioned a study from an external contractor to assist with its assessment. It undertook a public consultation, a fact-finding stakeholder event and bilateral meetings with industry representatives, together with discussions with authorities, including the EBA. Overall it concluded that there is a "…largely positive assessment of the rules on the governance of remuneration processes, performance assessment, disclosure and pay-out of the variable remuneration of identified staff, introduced by CRD III. These rules were found to contribute to the overall objectives of curbing excessive risk-taking and better aligning remuneration with performance, thereby contributing to enhanced financial stability."

The review noted that "there is still room for better incorporating risk-adjusted criteria in the assessment of performance" but noted that deferral has increased considerably since the introduction of legislation on compensation. The Commission believes that deferral has ensured long-term performance alignment and deterred excessive risk-taking. It noted that some stakeholders have concluded that in certain cases a longer deferral period would be better aligned with the length of financial cycles.

[51] http://ec.europa.eu/justice/civil/files/company-law/com_2016_510_f1_report_from_commission_en.pdf

The review also revealed that "the deferral and pay-out in instruments requirements are not efficient in the case of small and non-complex credit institutions and investment firms, and of staff with low levels of variable remuneration." Moreover, "with regard to the maximum ratio between variable and fixed remuneration introduced by CRD IV, the review found that for the time being there is insufficient evidence to draw final conclusions."

# IV. Implementation of the P&S by insurers

Implementation of the P&S for insurers continues to lag behind that of banking organisations both in terms of the extent to which authorities have implemented the requirements and the extent to which firms have changed their compensation policies. As a result there are important differences in the implementation of the P&S in the insurance sector across jurisdictions. A number of jurisdictions have not implemented the P&S in insurance regulation. In others, where regulation has been introduced insurance firms use compensation policies and structures similar to those of banking organisations, for instance they include deferral (e.g. Australia, Europe, Singapore). However even in these jurisdictions, the regulatory and supervisory regimes do not have the same intensity as those applied to banking organisations.

**Table 5**

| **Implementation of the P&S for the insurance sector** *(Updated from 2015 progress report)* | |
|---|---|
| **Jurisdictions for which the P&S are incorporated in insurance regulation** | **Jurisdictions for which insurance regulations have not fully incorporated the P&S** |
| Australia | Argentina |
| Canada | Brazil |
| China | India *(information not provided)* |
| Hong Kong | Indonesia |
| India | Mexico* |
| Japan | Russia |
| Korea | Saudi Arabia |
| Singapore | Turkey *(information not provided)* |
| South Africa | US |
| Switzerland | |
| In the European Union (France, Germany, Italy, Netherlands, Spain, UK) Compensation requirements implemented through Solvency II [52] | |

* In Mexico, companies should report to the supervisor how the board sets the remuneration policy for executive officers but the regulation doesn't contain minimum aspects that should be considered in terms of compensation policies.

[52] The Solvency II Directive became fully applicable on 1 January 2016. The Article 275 of the Solvency II Delegated Regulation sets out remuneration requirements which are directly binding on EU insurers. The requirements are broadly consistent with the P&S. See box 2 for more details. EU Member States are required to ensure that their national laws are consistent with the Solvency II framework, which is based on the 'maximum harmonisation' principle. Any additional requirements on remuneration can only be introduced at the EU level through amendments to the existing framework.

Since the last progress report the most significant development is the passage of Solvency II in Europe. With the implementation of Solvency II a number of FSB member jurisdictions in Europe have implemented compensation requirements that are broadly consistent with the P&S.

**Box 2: EU remuneration requirements for insurance companies**

With effect from 1 January 2016, the remuneration requirements in article 275 of the Solvency II Delegated Regulation which are directly binding on EU insurance companies came into force. The requirements apply to the administrative, management or supervisory body, persons who run the undertaking or have other key functions and material risk takers. The regulation in particular requires firms to:

- Defer a substantial portion of the variable remuneration of affected staff for a period of not less than three years with vesting no faster than on a pro rata basis.
- Ensure performance measurement is based on the performance of the individual, the business unit and the institution using financial and non-financial criteria with scope for downwards adjustment for exposure to current and future risks.
- Structure the variable remuneration of staff engaged in control functions so that it is independent from the performance of the business units submitted to their control.

The Solvency II Directive contains detailed provisions[53] for the system of governance in insurance[54] undertakings. These provisions notably include (i) sound and prudent management of the business, (ii) fit and proper requirements for persons who effectively run the undertakings or hold other key functions, (iii) proof of good repute, (iv) risk management requirements, (v) internal control, (vi) internal audit, (vii) actuarial function and (viii) outsources activities. In addition, the prudent person principle[55] provides that the investments and derivative usage by insurance undertakings are appropriate.

To ensure effective compliance with the above provisions (and other requirements of the Directive), the Solvency II Delegated Regulation provides for requirements on remuneration for the purposes of the sound and prudent management of the business and in order to prevent remuneration arrangements which encourage excessive risk-taking. Insurance undertakings are required to document their remuneration policy.

The legally binding requirements for remuneration policy[56] cover the FSB Principles as well as FSB Standards whilst retaining the elements of proportionality and responsiveness to risks faced by insurance undertakings, given that Solvency II is applicable to all insurance and reinsurance undertakings.

In some areas, Solvency II goes beyond the P&S and addresses the specificity of the insurance business in the EU, for example by requiring that consideration be given to remuneration structure during the validation of internal models.

In one particular area, Solvency II takes a policy approach that differs from the P&S. The P&S require a substantial proportion of compensation to be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance Due to legacy practices in the insurance sector, Solvency II requires that both fixed and variable components shall be balanced so that the fixed or guaranteed component represents a sufficiently high proportion of the total remuneration to avoid employees being overly dependent on the variable components.

In summary, the EU framework for remuneration policies is largely consistent or exceeds the P&S, while tailored for the application to the insurance industry in Europe.

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53 Solvency II Directive, Chapter IV, Section 2, Articles 41-50.

54 The provisions apply to insurance as well as reinsurance undertakings.

55 Solvency II Directive, Article 132.

56 Solvency II Delegated Regulation, Article 275

In addition to changes in Europe, there have been a number of changes in other jurisdictions. In Brazil, although requirements are not in place to implement the P&S in the insurance sector, a recent circular established that risk managers need to assess whether compensation policies may have a negative impact on risk management. In Hong Kong a new compensation supervisory guideline[57] was issued by the Insurance Authority which requires insurers to establish prudent and effective remuneration policies which support their risk management frameworks and do not bring any adverse impact to their risk profiles. The policies must include deferral of variable compensation, alignment of performance measurement criteria with risk-adjusted performance based on both financial and non-financial criteria, identification of key persons in control functions and a compensation structure that is not solely linked to the business units subject to their control or oversight. This guideline is largely aligned with P&S as well as the applicable Insurance Core Principles published by the International Association of Insurance Supervisors. Also, remuneration policies should be in line with the insurer's objectives, business strategies and long-term interests. In Indonesia, a regulation issued in December 2016 requires insurance companies to implement remuneration policies for boards of directors/board of commissioners which is in line with the long-term interests of the company and policyholders. In Korea, similar to bank supervision, a new statutory regime has been implemented, similar to the supervisory regime that had previously been developed that requires (i) that insurers need to establish remuneration committees, (ii) that executive officers do not take excessive risks as a result of compensation policies and (iii) that fixed pay is between 60-70% of total compensation. Additionally, details on executive compensation also need to be publicly disclosed.

Other than these changes it does not appear that there are significant planned additional legislation or regulatory changes that will occur in the near future. This means that a number of FSB member jurisdictions will not have implemented regimes for the insurance sector that are fully consistent with the P&S.

Notwithstanding the lesser degree of attention if compared to supervisory practices in banking organisations, since the last progress report a number of authorities have undertaken supervisory activity in relation to compensation in the insurance sector. In Canada, a "Risk Culture Pilot" was conducted at two large life insurance companies which included discussions regarding the links between compensation and conduct/culture. In China, an on-site inspection found in 2015 that compensation in some local branches was not linked to performance assessment results. The supervisor issued letters to those firms requiring them to rectify this issue by a certain deadline. In Italy, the competent supervisor published letters on compensation policies in January 2016 and 2017 and it undertook thematic work regarding compensation issues which included meetings and inquiries with some insurance firms. Firms made changes to their compensation policies where issues were highlighted. In the Netherlands supervisors investigated the practices of ex ante and ex post assessment by insurers of variable compensation, financial and non-financial performance[58] indicators and targets for variable compensation and the disclosure of compensation schemes. It found that insurers generally

[57] The guideline (as part of the Guidance Note on the Corporate Governance of Authorized Insurers) is available at http://www.oci.gov.hk/download/gn10-eng_20161007.pdf

[58] The Dutch Act on Financial Supervision (chapter 1.7) requires financial institutions to include both financial and non-financial criteria for variable pay.

comply with the regulation but could improve with regards to several elements related to governance. Singapore reviewed the compensation structures and key performance indicators used in performance evaluations as well as appraisal reports for selected individuals during its inspections of firms. Areas identified for improvement included the need to formalise documentation on key performance indicators for staff and performance reviews conducted. Spain recently reviewed the supervisory practices concerning the system of governance, compensation policies and practices of insurance undertakings. Switzerland conducted an assessment of compliance with its supervisory circular on disclosure requirements. In the UK, larger insurers submit data in a template provided by the supervisor. In the US, state regulators review and assess the compensation practices of insurers and require significant disclosures and subject them to regular review.

# V. Compensation practices in the securities sector

The Fourth FSB Progress Report proposed to take stock of compensation practices in the securities sector. Towards this end, the FSB CMCG and the IOSCO CEG organised a joint roundtable on 13 December 2016 (hereinafter referred to as the "roundtable"). Industry experts represented some of the major participants in securities market activities, and most represented managers of collective investment schemes,[59] including investment funds (e.g., mutual funds), hedge funds and private equity funds, some of which were affiliated with global systemically important banks. Broker/dealers affiliated with global systemically important banks also attended. The roundtable, which was designed as a fact-finding exercise, enabled industry participants[60] to exchange views on the similarities and differences in how firms approach compensation issues in the securities sector.[61] Additionally, in the first quarter of 2017, the CEG conducted a survey of securities regulators in twenty-one IOSCO member jurisdictions regarding the legal and regulatory perspectives on compensation policy, as well as compensation practices and risk alignment in the securities sector.[62] The information gathered through the survey responses (hereinafter referred to as "survey responses") and the roundtable, as well as from the discussions at two joint CMCG-CEG meetings, form the basis for this section.

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[59] The term "asset management firm" is used throughout this document to refer to different types of managers of collective investment schemes. Unless the word "asset management firm" is specifically stated, however, when the text refers to "firms," it is referring to firms in the securities sector in general, including broker-dealers, or a subset of those firms.

[60] The text refers to "industry participants" throughout this section, when it makes reference to feedback from the roundtable.

[61] The summary of the roundtable was posted on the FSB and the IOSCO websites for public feedback by 15 May 2017.

http://www.iosco.org/library/pubdocs/pdf/IOSCOPD559.pdf

http://www.fsb.org/wp-content/uploads/FSB-IOSCO-compensation-practices-roundtable-summary.pdf

[62] Twenty-one IOSCO members participated in the survey: Argentina (CNV); Australia (ASIC); Canada (Ontario OSC and Quebec AMF); China (CSRC); France (AMF); Germany (BaFin); Hong Kong (SFC); Ireland (CBI); Italy (CONSOB); Japan (JFSA); Korea (FSS); Malaysia (SC); Mexico (CNBV); The Netherlands (AFM); Saudi Arabia (CMA); South Africa (FSB); Switzerland (FINMA); Turkey (CMB); UK (FCA); and US (SEC). For the US, group-wide compensation policies for bank holding companies, including those applicable to securities activities that take place in the bank holding company or its subsidiaries, are described in the banking organisations section of the report, based on information from the Federal Reserve.

# 1. Compensation practices vary across the securities sector and jurisdictions

The observations of the joint FSB-IOSCO work show that compensation practices vary across firms in the securities sector (hereinafter referred to as "firms"). Such variation mainly stems from the diversity of firms, which extend from broker/dealers to managers of different types of collective investment schemes, including investment funds (e.g., mutual funds), hedge funds, and private equity funds, and the range of their business models and activities. While this section is about securities markets more generally, much of the discussion is particularly relevant to the asset management sector, based on the feedback received from the roundtable and the survey.

As an example, compensation at private equity funds is generally vested periodically, mostly annually or at the end of certain investment periods, depending on the success of the investment (i.e. carried interest model). Compensation at hedge fund firms tends to be invested in the firm or its funds. It is therefore a type of "skin in the game", which is different from the compensation structures of traditional asset managers. The asset management sector in general operates with an "agency model", whereby fund managers' interests are contractually aligned through the investment mandate to those of the client. Therefore, compensation is linked to the performance of the fund under management.[63]

The information gathered from the roundtable and survey responses suggest that while compensation practices vary across firms, compensation generally includes a meaningful proportion of variable compensation, and many regulators expect or encourage firms to use compensation structures, management or supervisory structures and policies, and/or other tools to help promote alignment of incentives with the interests of investors and clients.

## 1.1. Objectives of compensation policies

Industry participants and survey respondents highlight a wide range of objectives for compensation policies, such as, promoting firms' long-term business interests and strategy; aligning employees' interests with those of investors and clients; promoting sound and effective risk management and observance of firms' risk and corporate culture; discouraging inappropriate risk taking; and keeping the level of compensation competitive enough to be able to attract and retain talent.

In relation to the latter point, industry participants noted that the asset management sector is competitive and, therefore, asset management firms typically determine the compensation for portfolio managers relative to the industry level. Particularly, in the case of hedge funds and private equity funds, industry participants commented that investors (who are mostly institutional investors) also can play an important role in determining compensation levels, because they inquire about the level of compensation paid to portfolio managers and are willing to pay for skilled ones.

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[63] Other firms in the securities sector may not necessarily operate under an "agency model".

In their survey responses,[64] a number of securities regulators noted that risk management is an important goal of firms' compensation policies. For example:

- Compensation can play an important role in risk management, especially when aligning the long-term interests of clients, the firm and its staff. An effective performance management and a compensation review process supported by a strong and independent governance structure enables firms to pay for performance in a way that promotes sound and effective risk management within a firm's risk management appetite, while at the same time helping to retain and attract talent.
- The main purpose of compensation policies is to align staff incentives with the long-term interests of the firm and its clients. For that purpose, compensation policies and practices must be consistent, and promote sound and effective risk management. In addition, compensation policies should favour risk taking that is consistent with the firm's/investment fund's risk profile and that is aligned with the duty to act in the best interest of the client/investment fund.

## 1.2. Firm Practices

***Responsible body / Compensation policy***

The survey analysis revealed that, in general, the board of directors (or its equivalent depending on the corporate structure and legal framework) is responsible for approving compensation policy. The board of directors (or its equivalent)[65] may also be responsible for implementation and oversight of the compensation policy. In most cases, board committees, such as the compensation committee, risk committee, audit committee or compliance/human resources departments assist the board of directors to fulfil these responsibilities, with the latter bearing the responsibility for approval of the compensation policy.[66]

The survey responses suggested that compensation framework in firms is generally reviewed and updated once a year by the compensation committee (or its equivalent), with the participation of the compliance/human resources department and the board of directors. The compensation framework may also be included in the internal audit review and in some cases in the external audit review. The compensation committee is chaired by a non-executive member of the board of directors (or its equivalent) and is mostly (or in some cases, exclusively) comprised of non-executive directors who are independent. Members from other committees or divisions such as human resources, compliance, and risk may also be part of the compensation committee or at least provide it with assistance.

According to survey respondents, the compensation committee typically reviews performance (e.g., the performance of the funds under management) on a regular basis, and defines a pool

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64 For simplicity, this section refers to responses by one or more IOSCO member regulators without specifying their name, although in some cases reference is made to a specific region to which the respondent belongs to.

65 References to the board of directors is also intended to refer to its equivalent depending on the corporate structure and legal framework of the firm.

66 In some cases, a senior level committee or a compensation committee (or its equivalent) is responsible for determining the compensation policy. However, even when this is the case, the compensation committee reports to the board of directors, which carries the ultimate oversight and approval responsibility on the policy.

of variable compensation at the firm and/or division level. However, discretion plays an important role in determining the amount of compensation at the individual level.

Regarding the use of discretion in compensation practices, some survey respondents indicated that:

- Discretion is commonly employed at all levels, and individual awards are allocated predominantly on a discretionary basis in accordance with performance factors. Discretion is also used to determine ex-post adjustment decisions.
- Whenever judgement is used for performance measurement or risk adjustment, there generally should be a clear policy outlining relevant parameters, documentation on final decisions and involvement of the compensation committee.

In relation to the impact of compensation practices from other sectors, there was a general sense (with some exceptions) among industry participants and survey respondents that developments in other sectors, mostly the banking sector, have impacted compensation practices and also regulation in the securities sector to a certain extent.[67]

***Compensation Structure / Fixed vs Variable Pay***

According to survey responses, in many jurisdictions, market practice or regulation dictates that the fixed and variable components of total compensation generally should be appropriately balanced. In some cases, the fixed component represents a sufficiently high proportion of the total compensation to allow for a fully flexible policy on the variable components. Compensation for those who are in control functions is typically made up of a higher proportion of base (fixed) pay relative to variable pay, while front office employees, high earners, or senior level staff receive a larger proportion of their pay in variable compensation.

Survey responses reported that variable compensation is usually a mixture of cash and equity, which vests over a two-to-five-year period. The variable component can also include a discretionary part, which might be composed of a combination of immediately payable cash and deferred compensation and is used as an incentive to align employee behaviour with the firm's long-term interests. The proportion of cash and deferred compensation can vary according to seniority level, with more senior staff granted more deferred compensation. Industry participants also stated that the higher the performance, the higher the percentage of equity-based compensation in relation to cash. Some asset management firms are trying to imbue a shareholder, rather than an employee, mindset in individual portfolio managers which encourages the investment of their compensation in the asset management firm even if the firm itself is not publicly listed.

Variable compensation at asset management firms is not only linked to a fund's performance, but also to other factors, such as compliance with applicable policies and values of the asset management firm, as well as compliance with the regulatory framework (please also refer to the section below "Role of compensation in addressing misconduct risk"). In many asset management firms, performance assessment is set in a multi-year framework in order to ensure

[67] Survey responses indicate that, in the EU, compensation related regulation in the securities sector mirrors the regulation in the banking sector to a large extent. The main difference is in how the bonus cap is applied, with application to all banking organisations but only a sub set of investment firms that are affiliated with banking groups.

that the assessment process is based on a longer-term performance and takes into account the alignment of employee behaviour with client interests.[68]

In their survey responses, EU jurisdictions noted that compensation structures are designed to help ensure that compensation policy is consistent with sound and effective risk management. The US noted the use of both short and long-term incentive compensation in the securities sector and highlighted that some firms have already incorporated the use of deferral mechanisms to align compensation and risk.

### *Application of Malus and Clawback*

Many survey respondents reported that the variable component of compensation can be subject to malus or clawback provisions. According to survey responses, the majority of asset management firms (and many broker-dealers) have malus and clawback policies, which enable them to claim back unvested deferred compensation and vested compensation under certain circumstances. Examples of the triggers for exercising these policies include, among others, adverse performance/outcome, misconduct, improper/excessive risk-taking, or lack of compliance with the firm's risk and control framework.

However, in the survey some IOSCO members noted that legal restrictions (e.g., labour laws) might potentially conflict with the potential use of these tools after payments have vested. Additionally, further practical problems may emanate from payroll-accounting or income-tax regulation. Despite these challenges, many firms see the use of ex-ante and ex-post compensation tools as a means to reinforce alignment of employee behaviour with the firm's risk framework and culture. The responses to the survey indicate that, although practice varies, many jurisdictions mandate firms to incorporate some form of effective forfeiture of variable compensation as a tool for risk management.

At the roundtable, industry participants highlighted recent trends in a number of firms' compensation practices, including the use of malus and clawback, more use of deferred compensation, and introduction of various firm-level internal checks and balances. However, asset management firms that participated in the roundtable also mentioned that, although clawbacks may be included in employment contracts, in practice these tools have not been applied, mainly because the agency model used in the asset management sector confines the portfolio manager to a contractually defined investment mandate. Industry participants noted that restricting portfolio managers to an investment mandate can reduce the likelihood of clawbacks being triggered (including as a consequence of misconduct).

### *Identification of Material Risk Takers*

Survey responses reported that firms, particularly those affiliated with banks, identify material risk takers (MRTs) as part of their compensation framework. Such identification can vary depending on the responsibility level, functions performed, or level of employee compensation. For instance, MRTs can include executive and non-executive members of the management body, senior management, control functions, sales staff, individual traders, or employees with compensation above a certain threshold.

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[68] According to survey responses, portfolio managers are often assessed against the investment performance of the funds they manage (one year or a longer time period, e.g. three years).

According to survey responses, in most jurisdictions MRTs could include persons whose professional activities have a material impact on the firms' risk profile or on the fund being managed. In EU member jurisdictions, the European Directives form a common framework for the identification of MRTs for various types of businesses in the securities sector.

## 1.3. Regulatory framework and approach

Most of the IOSCO members that participated in the survey stated that they have adopted, either through their general legal framework or through specific rules, compensation related regulation for firms in the securities sector, especially for collective investment schemes/mutual funds/asset management firms.[69]

Most responding jurisdictions stated that they have already made progress in implementing the P&S in the securities sector and some of them are taking further steps in this area (Argentina, France, Germany, Italy, Korea, Malaysia, Mexico, Netherlands, and the UK), while others are considering or have launched specific regulatory proposals on compensation (Australia and the US).

The regulations put in place in responding IOSCO member jurisdictions address different aspects of compensation, including governance, compensation structure, risk alignment and disclosure. Depending on the characteristics and design of the regulatory framework, compensation related provisions can be found in a specific financial law, e.g., securities code and CIS regulation (Malaysia); secondary regulation or specific rules (i.e. circular, communique) (Mexico and Switzerland); regulatory/supervisory guidance (Australia, China, and Japan); and corporate law/corporate governance codes (Korea and South Africa). As a different approach, some jurisdictions have incorporated compensation provisions into different levels and types of regulation, including one or more of the aforementioned (Argentina, Ireland, Saudi Arabia, and EU member jurisdictions).[70] Compensation regulation may range from mandatory provisions to voluntary principles (Turkey) or letters to firms by the securities regulator drawing attention to the need to observe the P&S (Hong Kong). In terms of scope, regulation may apply to asset managers but not to hedge funds (China), or may apply to broker-dealers and publicly held equity firms (Turkey).

The survey responses also highlighted differences in regulatory approaches to compensation across regions and/or jurisdictions. In North America, for example, securities regulators use some or all of a variety of approaches, including: disclosure requirements or principles-based limits on fees and commissions charged by firms; disclosure about, or limits on, conflicts of interests resulting from compensation practices; minimum standards of conduct or compensation limits in sales of mutual fund units and other securities; and requirements for disclosure of the compensation of certain senior officers of public companies. In the EU, there

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[69] Responses to the survey also indicated that in certain jurisdictions other types of firms, such as issuers (Argentina) or credit rating agencies (Saudi Arabia), are also subject to different types of compensation regulation.

[70] Survey responses highlighted that firms may be subject to one or more of the applicable regimes covering compensation issues, depending on the nature of their business. For instance, firms in the EU could be subject to compensation requirements under the Capital Requirements Directive (CRD), the Alternative Investment Fund Managers Directive (AIFMD) and/or the Undertakings for Collective Investments in Transferable Securities Directive (UCITS) if such firms conduct business regulated by one or more of these frameworks.

is more specific and prescriptive regulation of compensation, with some national authorities also giving consideration to prudential (solvency) aspects or conflicts of interest issues in their regulatory approach to compensation. [71] In Asia, some jurisdictions primarily rely on disclosure of compensation practices by firms. Securities regulators in all regions, in general, have powers to take corrective action when firms disclose incomplete, misleading or false information.

The securities regulator is generally the competent authority for supervising the compensation practices of firms, to the extent that firms are subject to applicable regulation or supervisory expectations on compensation. In some responding jurisdictions, the securities regulator shares this responsibility with the stock exchange, a self-regulatory organisation or the banking regulator or the prudential authority (Italy, Malaysia, UK, and US).[72]

There are responding jurisdictions where compensation policies are approved as part of the authorization process for a firm to be licensed to conduct business in the securities sector (France, Ireland, Netherlands, and Saudi Arabia). Once approved, compensation policies can be modified, however, such changes are generally subject to prior authorisation of the securities regulator. In these jurisdictions, the securities regulator has the power to reject the proposed changes or to require changes to the current compensation policy of a regulated firm. In some responding jurisdictions, in addition to the approval of the compensation policy during the licensing process, the regulator continues to monitor compensation through on-going supervision (Italy and the UK). Other responding jurisdictions that do not approve the compensation policy as part of the licensing process review compensation issues through off-site and on-site inspections.

When the securities regulator finds deficiencies or non-compliance with the applicable regulation, it can take a wide range of actions, depending on its powers and scope of competence. These regulatory actions may include calling for a board meeting (Italy), imposition of fines (Malaysia), or ordering changes to the compensation policy (Ireland). In some responding jurisdictions, securities regulators can also suspend or partially limit the payment of excessive compensation in response to prudential concerns, for instance, if there is a deterioration in the capital position of the broker-dealer (Mexico), or prevent the payment of awards to individuals where such payment would be in breach of applicable compensation regulation (UK).

Some responding securities regulators have recently conducted horizontal reviews on compensation (i.e., evaluation on compensation issues across several firms) for one or all the subsectors under their regulatory or supervisory scope of competence (Australia, Canada, Saudi Arabia, and the UK) or are planning to conduct horizontal reviews in the near future (Korea).

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[71] In the EU, two different sets of compensation rules may apply to firms: rules that focus on sound compensation policies to avoid solvency risks (CRD/CRR), and rules that prevent conflicts with client interests caused by misleading incentives (MiFID/UCITS/AIFMD).

[72] According to survey responses, if a firm is regulated by both the conduct and the prudential authority, then it is subject to compensation rules issued by the prudential regulator, in addition to the ones issued by the conduct authority. Similarly, both authorities can inspect the firm to review compensation related issues. In the US, bank holding companies generally have group-wide compensation policies that would include, for example, the material subsidiaries such as the bank and a broker-dealer. As the primary supervisor for the bank holding company, the Federal Reserve supervises the application of these compensation policies.

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### 1.4. Proportional application of the P&S and regulatory considerations

Firms and securities regulators agree on the need to consider the diversity of the business models in the securities sector in the implementation of the P&S, and consequently give due regard to proportionality in regulation to avoid a "one size fits all" approach. [73]

Many industry participants, in particular firms that belong to banking groups, highlighted concerns that fragmentation and multiple layers of compensation regulation in asset management may lead to an unlevel playing field, which in turn could hinder the implementation of a global compensation policy within the group structure. For instance, there is differential treatment of the same type of activity being performed by asset managers that are part of a banking group vis-à-vis other asset managers that are not part of a banking group.

Asset management firms that participated in the roundtable also called for further progress in achieving homogeneity of regulation across jurisdictions and consistency in regulatory requirements. They flagged that prescriptive and onerous regulation is particularly challenging for smaller firms to comply with.

## 2. Role of compensation in addressing misconduct risk

Industry participants highlighted compensation as a possible tool in the overall risk management toolbox. They commented that sound compensation practices may serve as a valuable tool in managing misconduct risk, as well as a powerful driver for implementing the desired firm culture. However, industry participants noted that compensation, as a standalone, may not be sufficient in addressing misconduct risk. Industry participants opined that a holistic and multi-faceted approach to risk management and conduct may be necessary to address misconduct and suggested that the focus should generally be on improving a firm's culture, since it shapes individual behaviour. In this context, industry or firms' self-regulation, the tone from the top, and sound firm culture were highlighted as major tools in avoiding excessive risk taking and addressing misconduct risk.

A number of survey responses indicate that firms take into account good conduct, and adherence to firm culture and values as main drivers in performance assessments. For instance:

- Individual awards in asset management firms can be driven by performance against financial and non-financial objectives. Non-financial metrics usually include adherence to a firm's risk and control framework. Many firms require individuals to have specific risk related objectives.
- Malus or clawback arrangements can help address misbehaviour or serious error by the staff (e.g., breach of code of conduct and other internal rules, especially related to risk management).
- Firms can adopt criteria that encourage employees to act in the best interest of clients. Such criteria may include reduction in the amount of compensation to be awarded to an employee who has caused harm to the client either because of malice or negligence."

[73] Survey responses indicate cases in which securities regulators are taking into account proportionality in implementation of compensation requirements, e.g. size of the firm, internal organisation and the nature, scope and complexity of activities.

Industry participants highlighted various checks and balances that firms have in place to mitigate misconduct risk, which mostly arises from individual behaviour, rather than from the firm's structural issues. For example, those firms closely monitor the trading behaviour of portfolio managers and are alert to small breaches, which may signal impending instances of misconduct.

Survey responses indicate that control functions generally review the firm's performance against its risk and control objectives and report to the compensation committee. Such reports typically include details of any significant risk events and recommend when a discretionary adjustment to the bonus pool is required as a result. This may also include an assessment of the firm's performance against factors such as client suitability controls, its capital base and liquidity considerations, its underlying financial performance, compliance breaches and risk failures, reputational events or incidents of misconduct.

Firms may also use internal sanctions as a deterrent, because the message that is conveyed by such sanctions impacts a large cross section of employees and enhances their understanding of what type of behaviour is acceptable and what is not. Non-financial incentives such as training and promotions are also used to promote or reward appropriate behaviour. Moreover, many asset managers have training and qualification requirements for portfolio managers, particularly for those who are dealing with more risky products.

Industry participants also recognised that it is impossible to completely eliminate all types of risks, particularly misconduct risk, with detailed prescriptive regulation.

## 3. Risk Perspective: Financial Stability

Industry participants and responding IOSCO members were, in general, of the view that there is no direct link between compensation practices in the asset management sector and financial stability. This is mainly because the use of own balance sheet and leverage is highly limited in asset management activities. Furthermore, assets under management are segregated from the asset manager's own assets and kept in a custodian bank.

Relatedly, industry participants reiterated that asset management is an agency business. They observed that there are controls in place that restrict portfolio managers from acting outside investment mandates and client instructions and from taking excessive risk. Because portfolio managers are restricted to investing within an investment mandate, which is contractually defined, they effectively reflect the risk appetite of their clients. Therefore, asset managers' compensation incentives are generally aligned with the investment mandate and client interests.

This said, in general, some securities regulators opined that compensation practices may have potential effects on trust and confidence in the markets, and to the extent that there are these potential effects, sound compensation practices could assist in addressing them.

# Annex A: Status of national implementation for banking organisations

The table below provides a snapshot of the status of implementation in FSB member jurisdictions as of May 2017. The table does not provide an assessment of the degree of compliance with the particular Principle or Standard, but is an indication of the extent to which regulatory or supervisory initiatives have been taken to implement the Principles and Standards (or elements thereof).[74] The table was developed by the FSB Secretariat based on the responses to the template by FSB member jurisdictions, and national entries have been checked for accuracy by the relevant authorities.

| | AR | AU | BR | CA | CN | FR | DE | HK | IN | ID | IT | JP | KR | MX | NL | RU | SA | SG | ZA | ES | CH | TR | UK | US |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Effective governance of compensation*** | | | | | | | | | | | | | | | | | | | | | | | | |
| **P1** | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | R | R | R | R | R | R | S | R | R |
| **P2** | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | R | R | R | R | R | R | S | R | S |
| S1 | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | R | R | R | R | R | R | S | R | R |
| **P3** | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | R | R | R | R | R | R | S | R | S |
| S2 | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | R | R | R | R | R | R | S | R | S |
| ***Effective alignment of compensation with prudent risk-taking*** | | | | | | | | | | | | | | | | | | | | | | | | |
| **P4** | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | R | R | R | R | R | R | S | R | S |
| S3 | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | S | R | R | R | R | R | S | R | R |
| S4 | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | S | R | S | R | R | R | S | R | S |
| **P5** | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | R | R | R | UC | R | R | S | R | S |
| S5 | R partly | R | R* | S | S | R* | R | S | R | R | R | S | R | R | R | R | R | S | UC | R | R | S | R | S |
| **P6** | R | R | R | S | S | R | R | S | R | R | R | S | R | R | R | S | R | R | R | R | R | S | R | S |

[74] The effective implementation of the Principles and Standards can be achieved through a variety of approaches, including different mixes of regulation and supervisory oversight.

* R* for Standard 5 indicates that malus is legally established in regulation but clawback may have legal impediments to its application.

| | AR | AU | BR | CA | CN | FR | DE | HK | IN | ID | IT | JP | KR | MX | NL | RU | SA | SG | ZA | ES | CH | TR | UK | US |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| S6 | R | S | R | S | S | R | R | S | R | R (partly) | R | S | R | R | R | S | R | S | R | R | R | S | R | S |
| S7 | R | S | R | S | S | R | R | S | R | R | R | S | R | R | R | S | R | S | R | R | R | S | R | S |
| **P7** | R | S | R | S | IP | R | R | S | R | R | R | S | R | R | R | S | R | R | R | R | R | S | R | S |
| S8 | R | S | R | S | IP | R | R | S | R | R (partly) | R | S | R | R | R | S (partly) | R | S | R | R | R | S | R | S |
| S9 | R | S | R | S | S | R | R | S | R | R | R | S | R | R | R | S | R | S | R | R | R | S | R | S |
| S11 | R | S | R | S | S | R | R | S | R | R | R | S | R | R | R | S | R | S | R | R | R | S | R | S |
| S12 | R | S | R | S | S | R | R | S | NA | R | R | S | R | R | R | S | R | S | R | R | R | S | R | S |
| S14 | R | S | IP | S | S | R | R | S | R | R | R | S | R | R | R | S | S | S | R | R | R | S | R | S |



*Legend: R – regulatory approach (including applicable laws, regulations, and a mix of both regulation and supervisory oversight); S – supervisory approach (including supervisory guidance and/or oversight); IP – initiatives under preparation; UC – initiatives under consideration; NA – not addressed or not relevant. (S19 not included.)*

*Acronyms: AR – Argentina; AU – Australia; BR – Brazil; Ca – Canada; CN – China; FR – France; DE – Germany; HK – Hong Kong; IN – India; ID – Indonesia; IT – Italy; JP – Japan; KR – Korea; MX – Mexico; NL – Netherlands; RU – Russia; SA – Saudi Arabia; SG – Singapore; ZA – South Africa; ES – Spain; CH – Switzerland; TR –Turkey; UK – United Kingdom; US – United States.*

# Annex B: Remaining gaps in national implementation for banking organisations[75]

| Country | Remaining gaps in national implementation | Principle not yet implemented | Standard not yet implemented | Reason / additional information |
|---|---|---|---|---|
| **Argentina** | Effective alignment with risk-taking | | 5 (partly) and10 | In Argentina there are legal restrictions on clawback clauses. With regard to Standard 10, it has not been legally established that supervisors can restructure compensation schemes of a banking institution. The Financial Law N° 21526 Section 35 and complementary measures establish the legal framework for the restructuring of such institutions. See http://www.bcra.gov.ar/pdfs/marco/MarcoLegalCompleto.pdf. |
| **Brazil** | Effective alignment with risk-taking | | 10 and 14, 15 (partly) | The implementation of Standard 14 is under preparation. After the 2012 progress report Brazilian authorities started studies regarding the implementation of standard 14, which is still in course. To date, Standard 10 is not applicable in Brazil since the Fiscal Responsibility Law prohibits the injection of public funds in failing banks. Current regulation (Resolution CMN 4,019, September 2011) allows the Central Bank of Brazil to set limits to fixed and variable remuneration in cases of inappropriate exposure to risks, deterioration of the institution's financial situation and internal control deficiencies. As regards Standard 15, the BCBS's 2013 regulatory consistency assessment of Basel III risk-based capital regulations in Brazil (http://www.bis.org/bcbs/implementation/l2_br.pdf) reports that the Pillar 3 remuneration disclosures requirements have not been implemented due to security concerns. The authorities report that for listed companies, pre-existing regulation addressed several disclosure requirements on compensation of directors and senior executives. |
| **China** | Effective alignment with risk-taking | 7 | 8 | Currently, compensation is overwhelmingly paid in cash. China is considering increasing the use of long-term incentive plans with stock-linked instruments. |



[75] For Indonesia, Switzerland, Turkey, the double strike through formatting indicates that gaps identified in previous reports have been addressed.

| Country | Remaining gaps in national implementation | Principle not yet implemented | Standard not yet implemented | Reason / additional information |
|---|---|---|---|---|
| **India** | Effective alignment with risk-taking | | 12 | Standard 12 has not been implemented as any payment of compensation to whole time directors and CEOs during and after employment requires RBI approval on a case-by-case basis. Given the above, the authority is of the view that no further measures are required to be taken. |
| ~~**Indonesia**~~ | ~~Effective alignment with risk-taking~~ | ~~5, 6, 7~~ | ~~4-14~~ | ***The Indonesia FSA issued a regulation on 23 December 2015 (45/POJKPOJK.03/2015) concerning the implementation of governance in remunerations for commercial banks which will be effective for performance evaluation (bonus) 2017. The regulation includes all FSB P&S and BCBS disclosure requirements and will be implemented in 2017.*** |
| **Russia** | Effective alignment with risk-taking | | 8 (partly) | Legislative and market practice constraints (most institutions are non-listed companies, and remuneration with debt instruments is not allowed). |
| **South Africa** | Effective alignment with risk-taking | 5 | 5, 10 | The P&S on effecting changes in remuneration structures of executives in financial institutions and more specifically malus and clawback has not yet been fully and formally addressed in the South African regulatory framework. Although the King Report on Corporate Governance contains similar requirements, it is a form of moral suasion and not part of the regulatory framework. |
| ~~**Switzerland**~~ | ~~Effective alignment with risk-taking~~ | | ~~14~~ | ***FINMA's circular 2010/1 has been revised to address this issue. Switzerland will be compliant with Standard 14 as of 1 July 2017.*** |
| ~~**Turkey**~~ | ~~Effective alignment with risk-taking~~ | | ~~7 (partly), 8, 9 (partly), 14~~ | ***The Turkish Banking Regulation and Supervision Agency issued a supervisory guideline on 31 March 2016 about sound compensation policies and procedures for the Turkish banking system. This guideline includes all of FSB P&S on compensation and BCBS disclosures requirements related to compensation. By adoption of this guideline, remaining gaps in the implementation of the P&S were eliminated.*** |
| **US** | Disclosure | | 15 | The US is in the process of preparing a rule related to Pillar 3 compensation disclosure guidance. Much of the information required by the BCBS guidance is already disclosed by major banking organisations. |

# Annex C: List of banking organisations surveyed by national supervisors for the purposes of the 2017 progress report on compensation practices[76]

| Country | Firms |
|---|---|
| **Argentina** | 1. Banco Galicia<br>2. Banco Santander Rio<br>3. HSBC Bank Argentina |
| **Australia** | 4. Australia and New Zealand Banking Group<br>5. Commonwealth Bank of Australia<br>6. Macquarie Bank Limited<br>7. National Australia Bank<br>8. Westpac Banking Corporation. |
| **Brazil** | 9. Bradesco<br>10. Itaú |
| **Canada** | 11. Bank of Montreal<br>12. Canadian Imperial Bank of Commerce<br>13. Royal Bank of Canada<br>14. Scotiabank<br>15. Toronto-Dominion Bank |
| **China** | 16. Agricultural Bank of China<br>17. Bank of China<br>18. China Construction Bank<br>19. Industrial and Commercial Bank of China |
| **France** | 20. BNP Paribas<br>21. BPCE<br>22. Crédit Agricole<br>23. Société Générale |
| **Germany** | 24. Commerzbank<br>25. Deutsche Bank<br>26. Landesbank Baden Württemberg |
| **Hong Kong** | 27. The Hongkong and Shanghai Banking Corporation Limited<br>28. Standard Chartered Bank (Hong Kong) Limited |
| **India** | 29. Axis Bank<br>30. HDFC Bank<br>31. ICICI Bank<br>32. Kotak Mahindra Bank |
| **Indonesia** | 33. Bank Central Asia<br>34. Bank Danamon<br>35. Bank Mandiri |

[76] All these firms are considered by the respective authorities as significant for the purposes of the P&S.

| Country | Firms |
|---|---|
| **Italy** | 36. Unicredit<br>37. Intesa San Paolo |
| **Japan** | 38. Mitsubishi UFJ Financial Group<br>39. Mizuho Financial Group<br>40. Sumitomo Mitsui Financial Group |
| **Korea** | 41. Kookmin Bank<br>42. Shinhan Bank |
| **Mexico** | 43. Banco Mercantil del Norte (Banorte)<br>44. Banco Nacional de México (Banamex)<br>45. Banco Santander<br>46. BBVA Bancomer<br>47. HSBC México |
| **Netherlands** | 48. ING Group<br>49. Rabobank |
| **Russia** | 50. ALFA-BANK (JSC)<br>51. Bank FC Otkritie<br>52. Gazprombank (JSC)<br>53. JSC Raiffeisenbank<br>54. JSC Rosselkhozbank<br>55. JSC Sberbank<br>56. JSC UniCredit Bank<br>57. PJSC Promsvyazbank<br>58. PJSC ROSBANK<br>59. VTB BANK (PJSC) |
| **Saudi Arabia** | 60. National Commercial Bank<br>61. SAMBA Financial Group |
| **Singapore** | 62. DBS Bank<br>63. Oversea-Chinese Banking Corporation<br>64. United Overseas Bank |
| **South Africa** | 65. Nedbank<br>66. Standard Bank |
| **Spain** | 67. BBVA<br>68. Santander |
| **Switzerland** | 69. Credit Suisse<br>70. UBS |
| **Turkey** | 71. Yapı Kredi Bankası<br>72. Garanti Bankası |
| **UK** | 73. Barclays<br>74. HSBC Holdings<br>75. Lloyds Banking Group<br>76. The Royal Bank of Scotland Group<br>77. Standard Chartered |

| Country | Firms |
|---|---|
| **USA** | 78. Bank of America<br>79. Bank of New York Mellon<br>80. Citi<br>81. Goldman Sachs<br>82. JP Morgan Chase<br>83. Morgan Stanley<br>84. State Street<br>85. Wells Fargo |

# Annex D: Proportionality and identification of Material Risk Takers for banking organisations

| Country | Identification of Material Risk Takers (MRTs) – Quantitative and qualitative criteria used by banking organisations |
|---|---|
| Argentina | **No explicit regulatory definition.** The common criterion used by systemic institutions for the identification of material risk takers is qualitative and depends on the responsibility assigned to them, their positions in the organisation structure, and their contribution and impact to the business. |
| Australia | **Supervisory guidance.** MRTs are defined as all other persons for whom a significant portion of total remuneration is based on performance and whose activities, individually or collectively, may affect the financial soundness of the institution.<br>Firms identify MRTs by the role and remuneration.<br>The application aligns with APRA's Governance standard and Remuneration prudential practice guide, which focuses on employees who receive substantial variable pay linked to volume or other non risk-based metrics (financial market traders, other transaction-oriented staff, commissioned sales personnel and intermediaries such as agents and brokers). |
| Brazil | **Regulatory guidance.** Only administrators (board of directors and executive officers) are subject to the provisions of the Resolution 3921/2010.<br>Some institutions have adopted internal criteria to define MRTs (treasury executives, all the personnel who earn more than a fixed amount as variable compensation)<br>A few firms follow a uniform group-wide approach. |
| Canada | **No explicit regulatory definition.** Firms are expected to have in place sufficient processes to identify MRTs.<br>By and large, the process of identifying MRT's begins with assessing individuals' titled position within the firm, with more senior positions flagged for consideration.<br>Then, quantitative (e.g. size of incentive compensation or the amount of risk an individual can expose the firm to) and qualitative criteria (e.g. complexity of products, volatility of risk in business, and/or riskiness of strategy) are considered to confirm (or not) that an individual is an MRT. This assessment is also performed for those who, by virtue of their job activity (e.g. traders), may expose the bank to significant risks.<br>Some firms report that groups of employees, who in aggregate may expose the firm to material amounts of risk, can be classified as a collective group of MRTs.<br>The proportions of MRTs are mostly allocated to wholesale/capital market businesses.<br>Firms apply uniform group-wide criteria; however, in some instances, additional processes are established to meet local requirements. |
| China | **No explicit regulatory definition.** Firms normally identify group level senior management, heads of domestic tier-one branches and heads of major business units of the group. |
| France | **See SSM** |
| Germany | **See SSM** |

| Country | Identification of Material Risk Takers (MRTs) – Quantitative and qualitative criteria used by banking organisations |
|---|---|
| Hong Kong | **Supervisory guidance.** Authorized Institutions are required to identify senior executives, key personnel and other relevant employees for the purposes of application of the HKMA's Remuneration Guideline based on the following criteria:<br>a. Senior management and key personnel (including but not limited to executive directors, the chief executive and other senior executives who are responsible for oversight of an Authorized Institution's key business lines or risk management or control functions);<br>b. Staff members whose duties or activities in the course of their employment involve the assumption of risk or the taking on of exposures on behalf of the institution (including but not limited to proprietary traders, dealers, and loan officers);<br>c. Staff members who are incentivised to meet certain quotas or targets by payment of variable remuneration (including but not limited to personnel in marketing, sales and distribution functions); and<br>d. Staff members within risk control functions (including but not limited to risk management, financial control, compliance, and internal audit).<br><br>Firms follow a uniform group-wide approach. |
| India | n.a. |
| Indonesia | **Regulatory guidance**<br>There are 2 approaches to identify MRT:<br>1) Qualitative Approach<br>Directors and/or Employees who due to their duties and responsibilities have to make decisions which have significant impact to the risk profile of Banks shall be established as MRT.<br>Based on this criteria, CEO (President Director) is an MRT.<br>2) Quantitative Approach<br>The Directors, Board of Commissioners and/or Employees receiving Variable Remuneration with a large amount shall be categorized as MRT.<br>- By quantitative approach, non MRT but receiving Variable Remuneration equal to or more than the amount of Variable Remuneration received by MRT shall be established as MRT.<br>- Banks can also add other method in the determination of MRT based on quantitative approach, among others through the establishment of a certain limitation of the Variable Remuneration amount. |
| Italy | **See SSM**. |

| Country | Identification of Material Risk Takers (MRTs) – Quantitative and qualitative criteria used by banking organisations |
|---|---|
| Japan | **Regulatory and supervisory guidance.** "Identified Employees" - for the purposes of compensation disclosure requirements - are those who satisfy both the following two conditions:<br>- highly remunerated; and<br>- the employee's action has a material impact on the risk profile of the firm.<br>The supervisory guidelines state that employees remunerated more than the senior management at headquarters in Japan can be Identified Employees if their actions have material impact on the risk profile of the firm.<br>Quantitative criteria are an average annual compensation of directors through 3-4 years (major banks have bars at 30-50 million yen). Qualitative criteria are materiality of employees' duty and impact on bank's profit and loss. |
| Korea | **Regulatory Guidance.** The Presidential decree limits to (i) executive officers (except outside directors, non-standing directors, audit committee members compliance officer and risk management officers), (ii) the employees(financial investment managers in charge) appointed by the resolution of the remuneration committee among the employees who engage in the design, sales and management of either securities or derivative products. The deferral period of their performance compensation shall be three years or more.<br>Firms follow a uniform group-wide approach. |
| Mexico | **No explicit regulatory definition.** Banks should define which employees are subject to their remuneration system, depending on whether they are risk takers. Common criteria used by the firms include: (i) personnel in charge of finding new costumers or business lines; (ii) personnel in charge of granting of new products or services to existing customers; (iii) personnel in charge of authorising new business lines; (iv) senior management; and (v) the amount of risk brought-on by an employee's operations.<br>Consistency is observed between foreign group practices and their application to Mexican subsidiaries. |
| Netherlands | **See SSM.**<br>Moreover since institutions are required to use this supervisory guidance, which includes the categories of executive board, senior management, control staff, staff in the "same remuneration bucket" and other risk takers, for the latter, the Dutch National Bank distinguishes three categories: decision takers, staff who execute activities within the risk profile and monitoring functions. |
| Russia | Material risk-takers are defined by Federal Law N 86-FZ "On the Central Bank of Russian Federation (Bank of Russia)" and Instruction No. 154-I of 17/06/2014 "On the Procedure for Conducting Assessment of a Remuneration System of a Credit Institution and the Procedure for Submission to a Credit Institution an Order to Eliminate Violations in its Remuneration System". According to these acts the material risk takers are members of executive bodies of credit institution and other executives (employees) who make decisions on the credit institution's implementation of operations and transactions, whose outcomes may affect its compliance with the required ratios or lead to other situations which pose a threat to the interests of its depositors or creditors, including the grounds for taking measures to prevent its insolvency (bankruptcy).<br>Annex 2 to Instruction No. 154-I contain a List of recommended credit institution material risk takers other than executive officers. |

| Country | Identification of Material Risk Takers (MRTs) – Quantitative and qualitative criteria used by banking organisations |
|---|---|
| Saudi Arabia | **No explicit regulatory definition.** Banks identify and disclose MRTs based on their internal policies and supervisory guidance provided by the Saudi Arabian Monetary Agency (SAMA). This is mainly based on the qualitative factors, area of business, nature of activities of the employees, their level in hierarchy, etc. Banks are required to take into account the guidance provided in the BCBS document on "Range of Methodologies for Risk and Performance Alignment of Remuneration". Banks are also required to publicly disclose the number of employees engaged in material risk taking activities and the compensation paid to them. These disclosures are reviewed by SAMA to ensure consistency across the industry.<br>Firms follow a uniform group-wide approach.<br>The percentage of staff identified as MRTs on average ranges between 3-10% of total staff for most of the banks. |
| Singapore | **No explicit regulatory definition.** Banks identify MRTs based on a range of quantitative and qualitative criteria, such as decision making authority proxied by role and designation, amount of variable remuneration awarded, the ratio of variable to fixed pay, as well as employees with high risk mandates in the form of risk-weighted assets and trading limits.<br>Firms follow a uniform group-wide approach. |
| South Africa | **No explicit regulatory definition.** |
| Spain | **See SSM** |

| Country | Identification of Material Risk Takers (MRTs) – Quantitative and qualitative criteria used by banking organisations |
|---|---|
| SSM | **Regulatory guidance based on EBA Guidelines on remuneration.**<br>MRTs are identified in accordance with commission delegated regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile.<br>This regulation imposes a methodology for identifying staff that is consistent across the EU. They are based on a combination of qualitative and quantitative criteria and have to be applied by all institutions subject to the Capital Requirements Directive (CRD). An internal self-assessment still has to be carried out by each institution to ensure full compliance with CRD requirements.<br>As a general principle, staff shall be identified as having a material impact on the institution's risk profile if they meet one or more of the following criteria:<br>Standard qualitative criteria: related to the role and decision-making power of staff members (e.g. staff is a member of a management body, is a senior manager, has the authority to commit significantly to credit risk exposures, etc.).<br>Standard quantitative criteria: related to the level of total gross remuneration in absolute or in relative terms. In this respect, staff should be identified if:<br>▪ their total remuneration exceeds, in absolute terms, EUR 500,000 per year, or<br>▪ they are included in the 0.3% of staff with the highest remuneration in the institution, or<br>▪ their remuneration is equal or greater than the lowest total remuneration of senior management and other risk-takers.<br>Exclusion criteria: the regulation allows in justified cases, under additional conditions and subject to supervisory review, the exclusion of staff identified only according to standard quantitative criteria. In this respect, for staff with an awarded total remuneration of EUR 500,000 or more, institutions need to notify exclusions to the competent authority. For staff with a total awarded remuneration of EUR 750,000 or for staff included in the 0.3 % of the highest earners, a prior approval of exclusions from the competent authority is required. For staff with a total awarded remuneration of EUR 1,000,000 or more, prior approval of exclusions from the competent authority is required and should only be granted in exceptional circumstances. Moreover, competent authorities need to inform the EBA about such intended exclusions before the decision is made. Institutions have to submit the notification or application and demonstrate that the excluded staff on the basis of the business unit they are working in, as well as of their duties and activities have indeed no material impact on the institution's risk profile. |
| Switzerland | **Regulatory and supervisory guidance.** "Key Risk Takers" are generally interpreted to include the management board and CEO and the institution's highest earners, as well as key decisions makers across the institution, including heads of divisions, heads of control functions, individuals having the ability to make or influence major financial or risk decisions or making major commitments on behalf of the company. The compensation arrangements for this group are subject to higher conditions and are expected to receive greater oversight by the Board of Directors.<br>Firms usually identify the leadership team of the company and high earners, along with additional persons named after an analysis of key functions and positions in the firm, which might have a material impact on the risk profile of the firm.<br>Firms would use a group-wide uniform approach, if they were not confronted with different definitions and approaches across the jurisdictions.<br>Percentages are lower for institutions that do not outsource back offices and other functions, and have therefore a proportionately higher number of lower level employees. |

| Country | Identification of Material Risk Takers (MRTs) – Quantitative and qualitative criteria used by banking organisations |
|---|---|
| Turkey (REV) | **Supervisory Guidance.** The definition comprises categories of staff including board of managers, senior management, and other risk takers whose professional activities have a material impact on the firm's risk profile and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and other material risk takers.” |
| United Kingdom | **Regulatory guidance based on EBA Guidelines on remuneration.** .<br>The EBA published regulatory technical standards (RTS) to identify categories of staff whose professional activities have a material impact on the risk profile of an institution (MRTs), in accordance with Article 94(2) of CRD IV.<br>The RTS sets out minimum qualitative and quantitative criteria for the identification of MRTs falling within the scope of Article 92(2) CRD. The PRA takes the view that all staff members carrying out activities which enable them to expose the firm to a material level of risk should be identified as MRTs, even where these staff members do not fall within any of the mandatory criteria established under the RTS.<br>The requirements on the identification of MRTs apply uniformly across each firm. Firms are expected to have a robust internal process in place. A proportionate approach is applied at the individual level: certain provisions do not apply, based on thresholds of variable remunerations or total remuneration. |
| United States | **Supervisory guidance.** Supervisory guidance requires banking organisations to distinguish “covered employees” from other employees, based primarily on control and influence over risk: those receiving incentive compensation who have an ability, either alone or as a member of a group, to take or influence risk that is material to the bank or a business within the bank.<br>A jurisdictional approach is used to identify covered employees within the United States.<br>Firms generally follow a group-wide approach. |

# Annex E: Use and application malus and clawback

The 2016 stocktake examined regulatory and supervisory requirements related to application of malus and clawback, based on the informed judgement of supervisors. "Use" refers to the insertion of these clauses in employee contracts, award terms, compensation policies or similar such binding documents. "Application" refers to instances in which the firms have sought to apply the terms in employee contracts (or similar documents) to either reduce unvested pay with malus or to apply a clawback of vested pay in the case of clawback.

This is the picture that emerges:

### 1. Deferrals

All FSB member jurisdictions require some deferral of variable compensation, with senior managers and/or material risk takers most commonly covered by the requirements. In some jurisdictions this potentially extends to all employees. All FSB jurisdictions, with the exception of Indonesia, Japan and South Africa, have requirements or supervisory expectations for a certain *percentage* of deferral of variable pay.

### 2. Applicability of malus and clawback under local law

*Malus* is allowed under local law in all FSB member jurisdictions surveyed.

*Clawback*, which relates to the recovery by an employer of vested compensation that has already been paid, is generally subject to stronger procedural and substantive legal safeguards. Three jurisdictions (Argentina,[77] Brazil, Mexico[78]) report that clawback is not permitted under local law. In two jurisdictions (Germany and Russia) there is no legal tradition of using clawback or similar tools and due to general labour law considerations the possibility of using clawback appears to be problematic.[79]

### 3. Regulatory and supervisory requirements

*Malus.* In all FSB member jurisdictions there are regulatory or supervisory requirements to use ex post compensation adjustment tools[80] (Australia, Mexico require the use of such tools but

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[77] In Argentina, Section 131 of the relevant labour law expressly prohibits use of clawback. Once compensation is received, it becomes part of the employee's property rights, and may not be subject to any fines, deductions, or withholding. As a public policy rule, rights provided for in a labour contract may not be waived (section 12); conditions for compensation as part of that contract —whether specifically agreed upon with the employee, set out in regulation or arising from an institution's usual practices— may not be changed to the detriment of employees.

[78] Mexican Federal Labour Law prohibits the imposition, by the employer, of any kind of "fine" on employees, no matter the cause; nor are employers permitted to retain or seize an employee's salary (with exception of alimentary pension) or impose any deduction not authorised by law.

[79] In Russia, there is currently no generally accepted legal interpretation of the issue. For Germany, see footnote 83.

[80] In the EU, the provision in Article 94(1) in of CRD IV is: "The variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the institution as a whole, and justified on the basis of the performance of the institution, the business unit and the individual concerned. Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the institution occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus or clawback arrangements. Up to 100% of the total variable remuneration shall be subject to malus or clawback arrangements. Institutions shall set the specific criteria for the application of malus and clawback. Such criteria shall in particular cover situations where the staff member:

do not stipulate which tools need to be used). The requirements apply generally to senior management and/or material risk takers but in some jurisdictions these may apply to all employees. In six jurisdictions there are no specific requirements to use malus clauses in relation to misconduct (Argentina, Brazil, Mexico, Russia, Saudi Arabia and South Africa).

*Clawback.* Fifteen jurisdictions (Canada, China, France, India, Indonesia, Italy, Japan, Korea, Netherlands, Saudi Arabia, Singapore, Spain, Turkey, UK and US[81]) set out some requirements, either legislative, regulatory or supervisory guidance that require the use of clawback, generally for senior managers and/or material risk takers although in some jurisdictions it is required for all employees. Australia does not define which tools should be used but does require compensation tools. Eight jurisdictions (Argentina, Brazil, Germany,[82] Hong Kong, Mexico, Russia, South Africa and Switzerland) have no requirement for clawback.

### 4. Application

*Malus.* Nine jurisdictions (Argentina, Brazil, China, India, Indonesia, Japan, Mexico, Russia and Saudi Arabia) report that there has been no application of malus clauses. Thirteen jurisdictions (Australia, Canada, France, Germany, Hong Kong, Italy, Korea, Netherlands, Singapore, South Africa, Spain, Switzerland and Turkey) report that malus has been applied in a limited number of cases over the period for the survey (2013-15). As from 2016, Switzerland expects the application of this tool on a more frequent basis. Malus has been applied more frequently by UK and US headquartered firms than by firms in other jurisdictions.

*Clawback.* Fourteen jurisdictions (Australia, Canada, China, France, Hong Kong, India, Indonesia, Korea, Saudi Arabia, South Africa, Spain, Switzerland, Turkey and UK) report that there are no examples of application of clawback even though clawback is allowed under local law. Clawback has been applied a limited number of times in four jurisdictions (Italy, Netherlands, Singapore and US).[83]

### 5. Enforcement Issues

*Malus.* Twenty-one jurisdictions (Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, UK and US), including those that do not explicitly require malus, note that there are generally no impediments to the application of malus (i.e. countervailing legislation), although in most of these jurisdictions there will be a risk of litigation, a right of appeal and possible judicial review. Two jurisdictions (Japan, and Turkey) report that there are some legal impediments, beyond litigation, appeals and judicial review.

*Clawback.* Seven jurisdictions (Canada, France, India, Japan, Spain, Switzerland, Turkey) report that there are likely to be some legal impediments to the application of clawback, over

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(i) participated in or was responsible for conduct which resulted in significant losses to the institution; (ii) failed to meet appropriate standards of fitness and propriety."

81 In the US for example, clawback is required for listed companies as a result of three different regulations (Sarbanes Oxley Section 304, Emergency Economic and Stabilization Act Section 111(b)(3)(B) and Dodd-Frank Section 954).

82 The German Ordinance on the Supervisory Requirements for Institutions' Remuneration Systems as well as the BaFin Interpretation Guide to the Ordinance on the Supervisory Requirements for Institutions' Remuneration Systems were in the final stages of review when the FSB's progress report was being written. Besides the implementation of new guidance provided in the EBA Guidelines on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013, the review will also introduce the requirement for clawback regarding the compensation structures of material risk takers (MRTs).

83 In some cases clawback has been applied beyond financial sector firms, which also helps to establish precedent.

and above the possibility of appeal. Twelve jurisdictions (Australia, China, Hong Kong, Indonesia, Italy, the Netherlands, Korea, Saudi Arabia, Singapore, South Africa, UK and US) report that clawback is, or would appear to be legal, and there are no impediments to application, although appeals and judicial review could be possible.

# Annex F: Members of the FSB Compensation Monitoring Contact Group

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|---|---|
| **Argentina** | **Adriana Antonelli**<br>Senior Manager, Financial Institutions<br>Central Bank of Argentina |
| **Australia** | **Fahmi Hosain**<br>Head, Governance, Culture and Remuneration Group<br>Australian Prudential Regulation Authority |
| **Brazil** | **Keiichi Nakayama**<br>Coordinator, Supervision of Banks and Banking Conglomerates<br>Central Bank of Brazil |
| **Canada** | **Maria Moutafis**<br>Managing Director, Corporate Governance Division<br>Office of the Superintendent of Financial Institutions (OSFI) |
| **China** | **Mingxin Wang,**<br>Deputy Director, Large Commercial Bank Supervision Department, China Banking Regulatory Commission. |
| **France** | **Frédéric Hervo**<br>Director, International Affairs<br>Autorité de Contrôle Prudentiel et de Résolution (ACPR) |
| **Germany** | **Stefan Andresen**<br>Senior Advisor, International Financial Stability and Regulation<br>BaFin |
| **Hong Kong** | **Cheng Ying-ying**<br>Senior Manager, Banking Supervision Department<br>Hong Kong Monetary Authority |
| **India** | **S C Misra**<br>Chief General Manager, Banking Supervision<br>Reserve Bank of India |
| **Indonesia** | **Nursantyo Nursantyo**<br>**Assistant Director**<br>Otoritas Jasa Keuangan (OJK) |
| **Italy** | **Teresa Colarossi**<br>Senior Officer, Banking Supervision 2 Department<br>Bank of Italy |

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| **Japan** | **Atsushi Yamada**<br>Supervisory Coordination Division<br>Financial Services Agency |
| **Korea** | **Sang Won Park**<br>Head, Prudential Banking Business Team<br>Financial Supervisory Service |
| **Mexico** | **Luis Emmanuel Juarez**<br>Deputy General Director, Supervision<br>Comisión Nacional Bancaria y de Valores |
| **Netherlands** | **Wieger Kastelein**<br>Remuneration Expert<br>De Netherlandsche Bank |
| **Russia** | **Nataliya Elizarova**<br>Chief Economist, Financial Stability Department<br>Bank of Russia |
| **Saudi Arabia** | **Abdulaziz Al Sowail**<br>Banking Examiner, Banking Supervision<br>Saudi Arabian Monetary Agency |
| **Singapore** | **Sin Wun Yi**<br>Deputy Director, Banking Department I<br>Monetary Authority of Singapore |
| **South Africa** | **Unathi Kamlana**<br>Head, Policy, Statistics and Industry Support Department<br>South African Reserve Bank |
| **Spain** | **Isabel Payo**<br>Head, Regulation Unit<br>Bank of Spain |
| **Switzerland** | **Manuela Luzio**<br>Senior Specialist – Supervision, Banks Division<br>Swiss Financial Market Supervisory Authority (FINMA) |
| **Turkey** | **Ozge Gokcan**<br>Sworn Bank Supervisor<br>Banking Regulatory and Supervisory Agency |

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| **UK** | **Alan Murray**<br>Senior Manager Remuneration<br>Cross-sectoral policy division - Prudential Policy Directorate<br>Bank of England |
| | **Laura Royle**<br>Manager, Governance and Professionalism Policy<br>Financial Conduct Authority |
| **USA** | **Meg Donovan**<br>Senior Supervisory Financial Analyst, Corporate Governance<br>Board of Governors of the Federal Reserve System |
| **ECB** | **Armin Leistenschneider**<br>Head of Section, DG/MS4/MSD<br>Single Supervisory Mechanism |
| **European Commission** | **Giulia Bottazzi**<br>Policy Officer, DG Justice |
| **FSB Secretariat** | **Simonetta Iannotti**<br>Member of Secretariat |
| | **Joe Perry**<br>Member of Secretariat |
| | **Vijay Tata**<br>Member of Secretariat |