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Legal And Regulatory Challenges to the Use of Compensation Tools

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Executive summary

The FSB Principles and Standards for Sound Compensation Practices (Principles and Standards) were developed to promote sound compensation practices and align employees' incentives with the risk and long-term profitability of the firm, particularly at significant financial institutions. They provide a framework for aligning compensation with prudent risk-taking, which is crucial in mitigating the risk of future financial crises.

In addition to promoting prudent risk taking, compensation tools such as in-year adjustments, malus and clawback, along with other measures, can play an important role in addressing misconduct risk by providing both ex-ante incentives for good conduct and ex-post adjustment mechanisms that ensure appropriate accountability.

Since March 2021 several jurisdictions have implemented legal and regulatory changes related to the use of compensation tools.

These changes mainly relate to increases in minimum deferral periods. Some jurisdictions have made changes to in-year adjustments, broadly aimed at ensuring that firms can impose immediate consequences proportionate to the severity of risk and conduct incidents and some have further strengthened the malus provisions. Clawback provisions for variable remuneration of material risk takers have been introduced by some jurisdictions. In addition, many jurisdictions have updated legislation or regulatory or supervisory guidance.

Regulatory progress remains uneven across sectors, with banking regulation being the most advanced and best aligned with the Principles and Standards. Coverage of the asset management sector remains weak.

The lessons from the 2023 banking failures reinforced the lessons from the global financial crisis: compensation must be aligned with prudent risk-taking.

The root causes of the 2023 bank failures included poor risk management and Board oversight, with compensation often linked to short-term profits, leading to poor alignment between compensation and risk. Firms need a sound risk culture, a compensation framework which has a balance of financial and non-financial measures, and transparency in the communication of compensation outcomes. Good governance, and the role of the Board, is critical for effective compensation practices.

Legal and regulatory challenges persist in the use of compensation tools, particularly clawback.

Consistent with findings from previous FSB compensation progress reports, there is complexity and variability in implementing different compensation tools. In-year adjustments are relatively straightforward to implement, whereas malus and clawback provisions present varying degrees of challenges. Clawback provisions are difficult to enforce and often involve prolonged legal battles, especially in the United States and Europe, where cultural or legal hurdles complicate their application. In some jurisdictions restrictive labour laws prevent clawback being applied.

A notable unintended consequence of the existence and application of compensation tools may be the impact on attracting and retaining talent for financial firms.

Challenges to the use of compensation tools are not insurmountable.

This report highlights a number of practical solutions to addressing challenges experienced by jurisdictions and firms applying compensation tools. These centre around:

- **The role played by the Board:** The Board, including the Remuneration Committee, play a crucial role in establishing compensation frameworks that drive the desired risk culture. Boards must also be willing to discharge their responsibilities to apply compensation tools where risk incidents occur, based on appropriate risk reporting from sources such as the Chief Risk Officer and Risk Committee. Many of the challenges in the use of compensation tools can be overcome through uplifting and enhancing compensation practices (for example, clear risk triggers for each tool).

- **The importance of culture:** Compensation practices, and the use of compensation tools, are deeply intertwined with organisational culture. Compensation frameworks should be designed not just to reward financial performance but be adjusted for all risk types, promote positive behaviours and a sound risk culture.

- **The importance of transparency:** Transparency in compensation frameworks and outcomes is essential for a range of stakeholders. Internally, it will foster employee accountability and externally, it will foster confidence where there is often an expectation for enhanced public disclosures in times of crisis.

- **The role of financial authorities:** Regulators and supervisors play an important role by setting expectations and monitoring the use of compensation tools, through guidance, standards and supervisory activities. Continuous development of regulatory expectations is important to evolve and uplift minimum standards.

Many firms have made significant strides in fostering a culture where employees understand the risks associated with their decisions, are incentivised to act in the firm's long-term interest and face consequences for poor outcomes. Nevertheless, despite these improvements, the 2023 banking failures and recent cases of potential misconduct have occurred. This suggests that while progress has been made, continued vigilance and oversight by both Boards and financial authorities is required.

Introduction

The Compensation Monitoring Contact Group (CMCG), composed of global supervisors from Financial Stability Board (FSB) member jurisdictions, is tasked with monitoring and reporting on the progress of national implementation of the FSB's Principles for Sound Compensation Practices and their Implementation Standards (Principles and Standards).[1] The CMCG published its latest Compensation Progress Report in 2021. The report observed that whilst compensation tools, such as in-year adjustments, malus and clawback, were embedded in many firms' compensation regimes, legal and regulatory challenges often hindered their effective use.[2]

The FSB published Supplementary Guidance on the use of compensation tools to address misconduct in 2018.[3] The guidance provided firms and supervisors with a framework to consider how compensation practices and tools could be used to reduce misconduct risk and respond to misconduct incidents. Supervisors and firms have directed considerable attention to improving the link between risk governance and compensation practices to more effectively align compensation with sound risk-taking behaviour, with a view to the long-term health of financial institutions. However, the 2023 banking turmoil highlighted shortcomings in compensation practices, including the use of compensation tools. For example, a report by the Basel Committee on Banking Supervision (BCBS) noted that compensation structures at Silicon Valley Bank encouraged a focus on short-term gains at the expense of sound risk management practice.[4]

Compensation tools, along with other measures, can play an important role in addressing misconduct risk by providing both ex-ante incentives for good conduct and ex-post adjustment mechanisms that ensure appropriate accountability. Consistent with the Principles and Standards, compensation outcomes must be symmetric with risk outcomes. The use of compensation tools should extend, at a minimum, to senior executives and other material risk takers (MRTs). It is for firms to determine which compensation tool is most appropriate for the specific circumstance. Tools commonly used to promote prudent risk management, including addressing misconduct include:

- In-year adjustment ("ex-ante" adjustment): this is the downward adjustment of an anticipated annual variable compensation award to reflect the impact of a negative event or behaviour. It involves dealing immediately with an incident which has arisen through adjustment to the current year's variable compensation.

- Compensation deferral ("ex-post" adjustment): this is the withholding of a portion of variable compensation which is then paid under deferral arrangements over a period of years.

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1 FSB (2009), *Principles for Sound Compensation Practices*, April, and FSB (2009), *Implementation Standards for the FSB Principles for Sound Compensation Practices*, September.

2 FSB (2021), *Effective Implementation of FSB Principles for Sound Compensation Practices and Implementation Standards: 2021 progress report*, November.

3 FSB (2018), *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices*, March.

4 BCBS (2023), *Report on the 2023 banking turmoil*, October.

- Malus ("ex-post" adjustment): this permits the institution to reduce the value of all or part of deferred compensation based on ex-post risk adjustment before it has vested.

- Clawback ("ex-post" adjustment): this is a process under which the individual must return ownership of an amount of variable compensation paid in the past or which has already vested to the institution under certain conditions.

- Severance pay: any payment made, or extended benefit provided, by a firm to an employee on or after the cessation of the employment contract, irrespective of such provisions being part of the employee contract. While severance pay on its own is not considered to be a tool to promote prudent risk management, the adjustment of severance pay, to the extent possible by labour laws, would be.

The CMCG has examined recent developments and industry practices to identify potential ways to address challenges in the use of these compensation tools. The findings in this report are based on questionnaire responses from FSB member jurisdictions across the banking, insurance and asset management sectors.[5] The questionnaire was conducted during April-May 2024 and, as a general principle, covered the period 2022-2024 for current practices and from 2021 for regulatory developments. Each jurisdiction was asked to share case studies (from any sector) in addressing challenges to the effective use of compensation tools to obtain meaningful insights. The questionnaire included a stocktake of lessons learned from the 2023 banking turmoil. The report also incorporates insights from an industry workshop (Workshop) held on 2 July 2024. The Workshop provided an opportunity to exchange information and views on key issues and challenges in the use and implementation of compensation tools. It also considered the unintended consequences, if any, associated with the use of compensation tools. The Workshop was attended by senior executives in the relevant areas (e.g. compensation, reward, performance and human resources) of major banks, insurance companies and asset management firms, as well as consultants and academics.

The report identifies potential ways to address challenges in the use of compensation tools.

1. Legal and regulatory challenges to the use of compensation tools

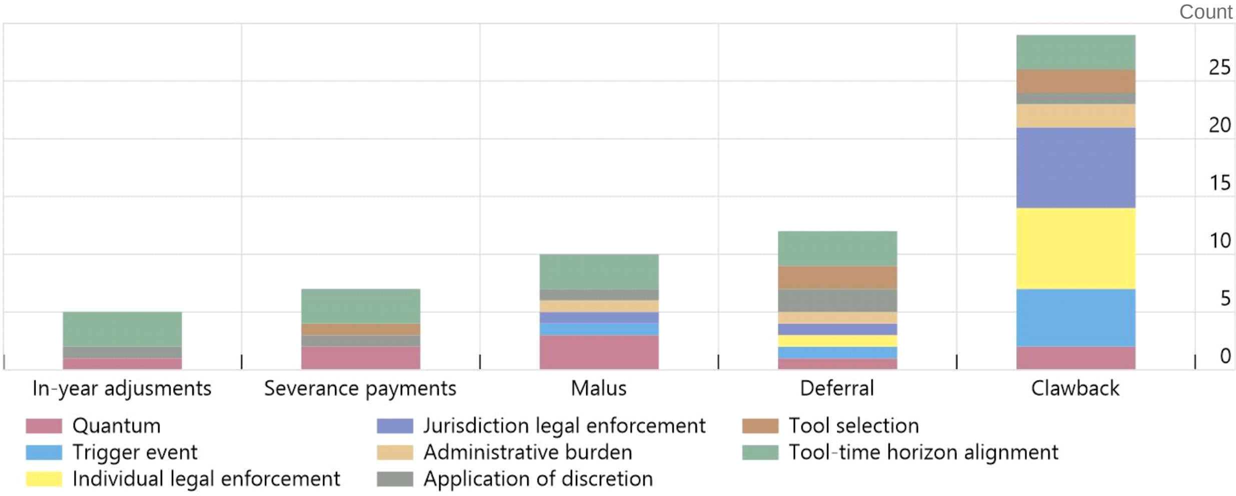
1.1. Legal and regulatory challenges identified by member jurisdictions

Legal and regulatory challenges continue to exist in the use of compensation tools. Graph 1 identifies the challenges experienced by jurisdictions in implementing the various compensation tools across a range of scenarios.

[5] The scope of the questionnaire was per jurisdiction. The following country codes are used for each of the jurisdictions: 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 (Türkiye), UK (United Kingdom) and US (United States). For the questionnaire in the banking sector, the European Central Bank (ECB) provided a uniform response for the five EU jurisdictions (FR, DE, IT, NL, ES) as the Single Supervisory Mechanism (SSM). It is counted as five responses, unless otherwise stated.

Significant challenges experienced by jurisdictions in the implementation of compensation tools **Graph 1**

Number of jurisdictions reporting a "high" level of challenge in the use of a compensation tool [1]



[1] Respondents could select 'high challenge' for multiple scenarios. The graph shows all instances where a significant challenge was indicated for each tool, regardless of how many scenarios were flagged by a single respondent.

Source: FSB Questionnaire

1.1.1. In-year adjustments

Most jurisdictions considered in-year adjustments a comparatively easy compensation tool to use. Five out of 23 responding jurisdictions reported a high degree of challenge in firms applying in-year adjustments.

Determining the quantum of in-year adjustment can be a challenge. In one jurisdiction, the calibration of the entire bonus pool is determined following intense discussions between the Board's Remuneration Committee (REMCO), the Human Resources Department and the Executive Committee. It therefore becomes a challenge to apply in-year adjustments in a way that is deemed fair and consistent.

1.1.2. Severance payments

Jurisdictions also considered severance payments comparatively easy to use. Severance payments are considered as variable remuneration and are generally subject to ex-ante and ex-post adjustments so that they do not reward failure, misconduct or excessive risk-taking.[6]

In certain jurisdictions, the amount of severance pay is influenced by the existing guidelines or regulation. Contract terms offering severance pay beyond what the law stipulates, especially in cases involving the termination of executives, are expected to align with the principles of creating value and managing risks over the long term. Determining a just and equitable severance amount can be challenging because it pertains to individuals who have been dismissed. For

[6] FSB (2021), *Effective Implementation of FSB Principles for Sound Compensation Practices and Implementation Standards: 2021 progress report*, November.

widespread layoffs, it is common for financial institutions to have uniform severance agreements (for instance, one month's salary for each year worked). However, even with these standards, there is a chance of legal action if an employee perceives the severance payment as unjust.

In some jurisdictions, there is no room for application of discretion for severance payments. Such payments are regulated by labour legislation, which requires that payment is made in full at the time of termination of the employment relationship.

1.1.3. Malus

Jurisdictions considered malus easier to apply than deferrals and clawback. Only three jurisdictions reported a high level of challenge with the application of malus.

Typically, the amount by which deferred compensation is reduced through malus is set by established rules within a firm's compensation framework. However, as with in-year adjustments, determining the appropriate amount for a malus that is considered just and equitable by both the firm and its employee, remains challenging. For example, if a loss is reported by a firm within the period of deferral, the unpaid portions of deferred payments are required to be adjusted in line with the decrease in profit. However, various elements, including those not within the firm's control, can affect the profit. Consequently, accurately determining the specific circumstances or triggers that would lead to the activation of malus provisions can present a significant difficulty for both firms and regulatory or supervisory authorities.

Enforceability of malus can be challenging in some jurisdictions due to restrictive labour laws.

Jurisdictions indicated there is substantial administrative burden in applying malus as it requires considerable time and resources. Workshop participants corroborated this and stated that malus, though easier to apply than clawback, still depends heavily on the cultural context of a firm and the willingness of its Board to apply the compensation tool. For example, in the case of Silicon Valley Bank, despite known weakness in the enterprise risk-management program, the firm's REMCO decided not to reduce variable compensation fearing this would lead to increased attrition of senior executives, as executives' compensation was already lower than peer firms.

1.1.4. Deferrals

Six jurisdictions reported a high level of challenge with the application of deferrals. This was largely related to the length of the deferral period and the amount to be deferred, in the absence of explicit requirements or guidance.

Jurisdictions noted that aligning deferrals with the anticipated horizon of risk entails ensuring that the timing and duration of deferrals correspond with the projected period over which the risk is likely to materialise. This is not always predictable. In one jurisdiction, firms often apply a standardised framework for deferrals which does not vary for individual risk exposures.

The application of discretion in deferrals also presents challenges in jurisdictions where regulations determine how variable remuneration must be paid and the length of the deferral period based on the risks and role of the employee. In other jurisdictions, any discretion applied must consider the employment contract and balance the risk and reward appropriately. This process involves deciding the appropriate portion of variable remuneration to defer, and ensuring it aligns with long-term risk horizons and performance metrics.

When identifying the trigger events for deferrals, firms must consider performance criteria, risk outcomes and alignment with long-term business objectives. This adds complexity to determining the necessary criteria for applying a deferral.

1.1.5. Clawback

Clawback was identified as the most challenging tool to apply. Member jurisdictions' difficulty in implementing clawback fell into three broad categories: legal, administrative and cultural. These issues were also highlighted in the Workshop. Workshop participants discussed the deterrent value of clawback. There was broad agreement amongst the firms represented that clawback is overrated as it lacks practical applicability. There is limited evidence of its use, largely due to the legal costs and reputational risk its enforcement entails.

Strong labour laws protect employees' rights and make the application of clawback extremely complex. Jurisdictions noted that legal impediments included restrictive labour laws and challenges reclaiming distributed compensation. Certain labour laws recognise that once payment awards are made to employees, the employer has no right to reclaim any of that amount. There is uncertainty over the legal enforceability of the contractual agreement and the execution of clawback in the event of dispute. The application of clawback involves obtaining a legal opinion or a court decision on the manner of repayment, on the amount to be repaid, and on the tax treatment. Published precedent on the application of clawback has involved lengthy (over multiple years) and complex legal cases. Nevertheless, one Workshop participant noted that their firm had won cases in court for clawback and malus application.

Identifying and proving specific misconduct or poor performance retrospectively is difficult. Jurisdictions noted that there are multiple factors that can impact a firm's results, many of which extend beyond the scope of one individual's responsibility. This makes the process of estimating the amount to clawback highly challenging. Jurisdictions also noted the difficulty in applying clawback to persons that have since left the employment of the firm and the need for significant resources for the tracking and enforcement of clawback.

Jurisdictions also reported challenges with the reliability of the ex-post risk adjustment framework, leading to instances of non-compliance being tolerated and low staff acceptance of clawback provisions.

Workshop participants noted that any deterrent value of clawback or malus can also be eroded when firms and employees find ways to circumvent the measures. Legal frameworks, including courts, grapple with post-tax treatment issues and understanding the connection between the behaviour of the employee, or an event, and the enforcement of clawback. It is easier to apply clawback in courts in southern Europe, for instance, if there is a connection to guilt. However, this conflicts with the nature of clawback addressing consequences or unintended actions. Moreover, in some Latin American countries, compensation tools such as clawback and malus are seen as offensive.

1.2. Increasing complexity of compensation tools

Workshop participants advised that compensation structures are becoming increasingly complex, challenging to implement, and difficult to communicate effectively. Complex compensation structures, and the over-emphasis of consequences, can result not only in a culture of fear in a firm, but also the need to increase fixed remuneration to offset variable remuneration that may be subject to adjustment. Different regulatory expectations and complex frameworks can create practical difficulties and unintended consequences, including disincentivising employees from reporting risk incidents which could trigger compensation adjustments.

Jurisdictions noted that balancing the application of discretion for adjustments with fair pay principles was complex and burdensome. The communication of risk adjustment principles to management teams and staff was also identified as a challenge to the application of compensation tools. A significant risk arises when management lack an understanding of – and belief in – the compensation structure. This may lead to a failure to apply and enforce compensation tools during instances of misconduct.

In the case of firms that are not publicly traded, the payment of a portion of the variable remuneration in instruments entails certain challenges regarding the definition, implementation, and valuation of those instruments.

The use of non-financial metrics, such as economic, social and governance (ESG) factors, is becoming more common, but challenges in measuring and integrating these metrics effectively may have unintended consequences in the effective use of compensation tools.[7]

1.3. Impact on attracting and retaining talent

The Workshop provided additional insights into the challenges firms face implementing compensation tools, including unintended consequences. A notable unintended consequence may be the impact of compensation tools on attracting and retaining talent. Participants noted that regulatory requirements in remuneration are not fully aligned across jurisdictions. This creates an uneven playing field where, in the face of competition, firms may be incentivised to consider arrangements that may result in their employees being remunerated in ways that are less well-aligned with the Principles and Standards.

Regulatory progress is also uneven across sectors: banking regulation being the most advanced and best-aligned with the Principles and Standards. This can also create unintended effects on labour markets, which can be detrimental to more strictly regulated firms.

Competition for employees is not only confined to the financial sector: Workshop participants noted that financial firms face challenges in attracting and retaining talent, particularly from non-financial sectors, due to different compensation structures and regulatory requirements. Employees may find it more attractive to work for firms that are not subject to complex

7 These challenges are detailed in the FSB report on *Climate-related Financial Risk Factors in Compensation Frameworks*.

compensation systems, for example long deferral periods for variable compensation, and that are not required to apply compensation tools such as deferrals, malus and clawback.

2. Regulatory and supervisory developments related to compensation tools

Despite the challenges outlined in the previous section, progress in the implementation of the Principles and Standards in firms continues.

Table 1: Regulatory and supervisory changes since March 2021

	AR	AU	BR	CA	CN	EU	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
Deferral		x						x	x	x		x						x	x		x			x	
In-year adjustments		x							x									x	x					x	
Malus		x							x	x									x					x	
Clawback		x							x	x									x					x	x
Severance payments		x							x															x	
Others						x	x		x		x	x										x		x	

Fourteen jurisdictions have carried out legal and regulatory changes to support the effective use of compensation tools since March 2021 (Table 1 and Graph 2).[8,9] Nine jurisdictions implemented changes related to deferrals, the bulk of which resulted in increases in minimum deferral periods. Five jurisdictions have carried out changes related to in-year adjustments, broadly aimed at ensuring that firms can impose immediate consequences proportionate to the severity of risk / conduct incidents. Five jurisdictions have further strengthened the malus provisions. Six jurisdictions have implemented clawback provisions for variable compensation of MRTs. Three jurisdictions have implemented regulations for severance payments.

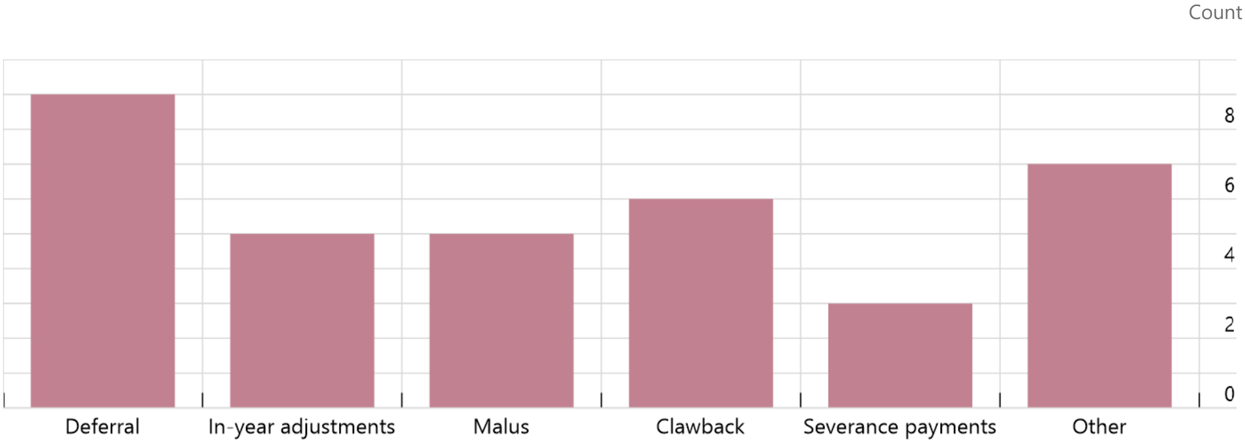
Seven jurisdictions have carried out other changes to legislation or regulatory or supervisory guidance since March 2021.[10] These relate to sustainability risks and ESG goals; misconduct risk and board oversight; conflict-of-interest management; variable compensation practices; and proportionality in defining compensation criteria.

8 Australia, EU/EA, France, Germany, Hong Kong, India, Indonesia, Italy, Saudi Arabia, Singapore, Spain, Switzerland, UK and the USA.

9 See Annex for further details.

10 EU/EA, France, Hong Kong, Indonesia, Italy, Switzerland and the UK.

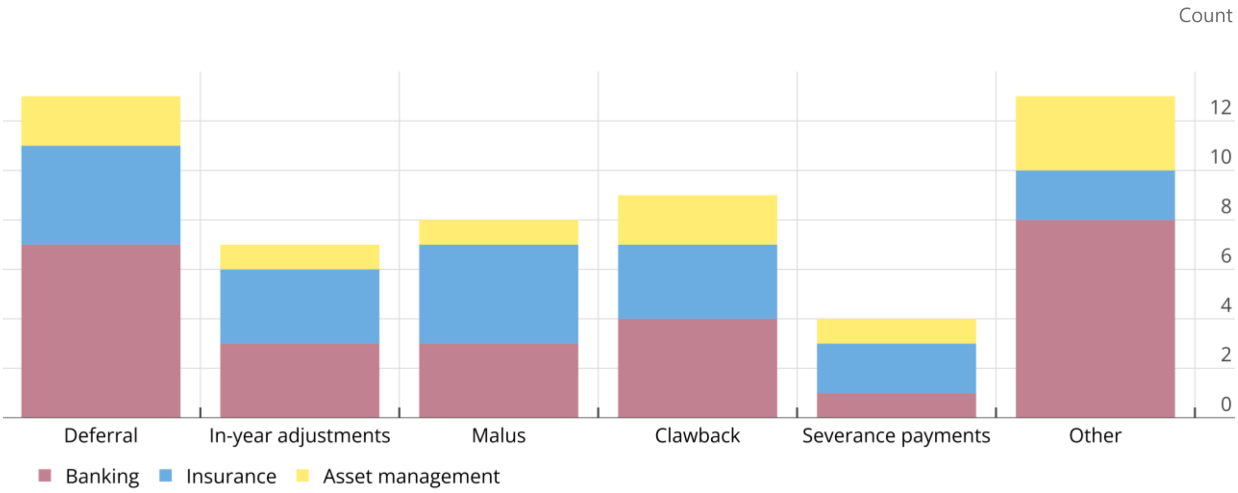
New/updated Regulatory guidance since March 2021	Graph 2



Source: FSB questionnaire

Regulatory progress remains uneven across sectors, with banking regulation being the most advanced and best-aligned with the Principles and Standards. Coverage of the asset management sector remains weak, with much fewer of the legal and regulatory changes since March 2021 applying to this sector (Graph 3).

Sector to which Regulatory change applied	Graph 3



Source: FSB questionnaire

3. Lessons learned from the 2023 banking failures

Compensation practices at financial institutions were a contributing factor to the banking failures of 2023. This section outlines the key learnings from the 2023 banking turmoil that relate to compensation practices.

3.1. Risk culture and Governance

A key learning from the banking failures is the importance of establishing and maintaining a sound risk culture, with a clear tone from the top (i.e. Board and Senior Management), with incentive structures linked to prudent risk metrics. Fundamental failures in risk management and oversight, including the absence of robust and prudent risk metrics, contributed to the 2023 bank failures.

The Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (the Barr Review) found that "Silicon Valley Bank (SVB) failed because of a textbook case of mismanagement by the bank. Its senior leadership failed to manage basic interest rate and liquidity risk. Its board of directors failed to oversee senior leadership and hold them accountable."[11]

Similarly, according to Swiss Financial Market Supervisory Authority's (FINMA) report into the lessons learned from the Credit Suisse (CS) Crisis: "CS's corporate governance was deficient in several respects: Responsibilities were not clearly defined and were often not enforced. The flawed management culture and the weak "tone from the top" over a longer period of time led to a poor risk culture." [12]

Compensation at the failed banks was often tied to short-term financial profits and returns, exacerbating vulnerabilities, leading to misconduct, poor behaviour and/or issues in managing non-financial risks.

The role of the Board is critical in this regard. The FINMA report noted that "As the most senior management body, the Board of Directors defines the bank's business strategy and issues guiding principles for the corporate culture."

The FSB's Supplementary Guidance highlights the importance of robust governance structures in overseeing compensation practices. This includes ensuring that compensation decisions are made by a competent and independent committee. It recommends that "the board of directors should have oversight of compensation policies and practices," ensuring that they are consistent with the firm's risk appetite and long-term strategy.

Workshop participants engaged in an extensive discussion about the importance of Boards. The 2023 bank failures showed clear failures at the Board level, with a lack of experience and independent judgment. Workshop participants noted that Board independence and diligence are crucial for effective risk management and compensation governance. The REMCO must operate independently from management and have appropriate skills. Workshop participants noted that, since the 2008 global financial crisis, there has been an increase in governance charters outlining clearer roles for the REMCO and a stronger focus on risks and performance in compensation decisions. Effective Boards need to move beyond compliance to actively questioning and challenging risk and compensation practices and outcomes.

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[11] Barr, Michael, Vice Chair for Supervision of the Federal Reserve Board (2023), *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*, April.

[12] FINMA (2023), *FINMA Report Lessons Learned from the CS Crisis*, December.

Workshop participants highlighted a renewed focus on enhancing risk management rather than merely redesigning compensation programs following the 2023 banking turmoil. Many firms have implemented and/or uplifted risk overlays in incentives, such as risk scorecards reviewed by the Chief Risk Officer (CRO) and Risk Oversight Board.

FINMA's report into the lessons learned from the failure of Credit Suisse noted that "the lack of an adequate risk and corporate culture, the excessive risk appetite in relation to the control environment, the bank's internal moral hazards, and the business divisions' lack of responsibility for their actions" had been flagged to the Board.

The FSB's Supplementary Guidance stresses that compensation policies should promote a strong risk culture and encourage appropriate behaviour. It advises that compensation should not incentivise excessive risk-taking or short-termism. For instance, it mentions that "compensation policies should support the development of a strong risk culture," which involves fostering an environment where employees understand the risk implications of their actions and decisions. The Barr Review noted that "the incentive compensation arrangements and practices at SVBFG [Silicon Valley Bank Financial Group] encouraged excessive risk taking to maximize short-term financial metrics. SVBFG's compensation practices also did not adequately reflect longer-term performance, nonfinancial risks, or unaddressed audit or supervisory issues. Nor did they include sufficient opportunities for SVBFG's internal control functions to provide feedback or challenge."

Workshop participants emphasised the importance of the CRO and the risk function, highlighting the skills required to fulfil this role, as well as the necessary reporting lines to ensure the role was effective. The way in which CROs are compensated is also crucial, as linking their pay to stock price performance can create adverse incentives. The CRO's compensation must be assessed for any potential conflict of interest, as there is an issue of balance between the interests of the business and the decisions of the CRO.

Overall, the discussions highlighted the necessity for a balanced, transparent, and risk-aware approach to compensation, emphasising the role of governance and independent oversight in preventing future banking failures.

Box 1: Establishing a sound risk culture – Hong Kong Monetary Authority (HKMA) case study

The Hong Kong banking sector remained strong and resilient throughout the 2023 banking turmoil. Notwithstanding this, the HKMA has undertaken a review to identify areas that may warrant additional supervisory and risk management attention. The review has reaffirmed that robust risk governance remains the backbone of safe and sound banking. As a cornerstone of a bank's risk governance framework, the board of directors and senior management bear the ultimate responsibility for the bank's safety and soundness, and for ensuring that the primacy of risk governance is effectively communicated across the institution, including through a strong tone from the top (which is the first pillar underlying the bank culture reform initiated by the HKMA in 2017). Learnings from the 2023 banking turmoil serve to illustrate the importance of fostering a strong risk culture for effective risk governance. Compensation frameworks (as part of the incentive systems, which is the second pillar of the bank culture reform) are a key aspect in banks' culture enhancement efforts.

3.2. The use of compensation tools

Compensation tools were used variably during the banking turmoil. FINMA's report noted that "Although the CS compensation scheme included the consideration of risk behaviour on paper, in practice the assumption of high risks and/or misconduct (risk-adjusted performance) had very little effect on compensation."

The Barr Review noted that "SVB's senior management responded to the incentives approved by the board of directors; they were not compensated to manage the bank's risk, and they did not do so effectively. We should consider setting tougher minimum standards for incentive compensation programs and ensure banks comply with the standards we already have."

Box 2: Aligning employee compensation incentives with the long-term interests and safety and soundness of financial institutions – US case study

In May 2024, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Federal Housing Finance Agency (FHFA), and thereafter the National Credit Union Administration (NCUA), reproposed regulatory text previously proposed in June 2016[13] along with certain alternatives to address incentive-based compensation arrangements and requested public comment.[14]

Under the proposed rule, covered financial institutions with average total consolidated assets of $1 billion or more would be prohibited from structuring their incentive-based compensation programs in a way that encourages inappropriate risks by providing excessive compensation or that could lead to material financial loss to the institution. Specifically, the proposed rule addresses incentive-based pay—bonuses, stock options, and other rewards that are often tied to short-term performance. The proposed rule includes prohibitions on incentive-based compensation arrangements that do not include risk adjustment of awards, deferral of payments, and forfeiture and clawback provisions. Among other things, the proposed rule would subject certain compensation to recovery for at least seven years after vesting if a "senior executive officer" or "significant risk-taker" engaged in misconduct that resulted in significant financial or reputational harm to the institution or committed other specified bad acts.

In addition, the proposed prohibitions emphasize the importance of sound governance and risk management control mechanisms to ensure these compensation structures do not encourage harmful risk-taking. The Dodd-Frank Act requires six federal regulators, including those that introduced the proposed rule and the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission (SEC), to jointly issue regulations or guidelines that (1) prohibit incentive-based compensation arrangements at covered financial institutions that could encourage inappropriate risks or that could lead to material financial loss, and (2) require covered financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate Federal regulator.

[13] On June 10, 2016, an NPR to implement Section 956 of the Dodd-Frank Act was published in the *Federal Register* available here.

[14] Incentive-based Compensation Arrangements: Notice of proposed rulemaking and request for public comment, issued in May 2024 by: (1) FDIC, available here; (2) FHFA, available here; (3) OCC, available here; and in July 2024 by (4) NCUA, available here.

3.3. The role of the supervisor

The 2023 banking failures highlighted gaps in the supervision of compensation. The FSB's Supplementary Guidance advises that "supervisors should review firms' use of compensation and performance management tools to reduce misconduct risk and ensure that compensation schemes include criteria for managing non-financial risks".

Supervisory action was highlighted in the Barr Review, which found that "staff approached supervisory messages, particularly supervisory findings and enforcement actions, with a need to accumulate more evidence than in the past, which contributed to delays and in some cases led staff not to take action."

The report concluded that "stronger or more specific supervisory guidance or rules on incentive compensation for firms of SVBFG's size, complexity, and risk profile – or more rigorous enforcement of existing guidance and rules – may have mitigated these risks."

FINMA's report documents its attempts over the years to align Credit Suisse's compensation practices with the firm's long-term business performance, noting that "This was only partially successful, where the interventions were accepted by the bank." According to FINMA, they avoided more forceful legal actions regarding remuneration due to the regulatory framework, which would have likely resulted in unsuccessful court outcomes. The report concludes that "There is a need to review solutions and existing regulatory principles in order to better anchor requirements for remuneration systems in law."

Box 3: Ensuring authorities have sufficient legal basis in order to be able to address deficiencies in compensation – Credit Suisse case study

Banks' compensation schemes include strong incentives that influence the risk behaviour within the institution. FINMA repeatedly used its influence at Credit Suisse to bring its compensation in line with the long-term business results. This was only partially successful. The Federal Council's report on banking stability noted that: "Over the years, the governing bodies of Credit Suisse were unable to sustainably remedy shortcomings in the bank's organisation that were repeatedly identified by FINMA and reported to the bank. It can be assumed that more specific corporate governance requirements, which also constitute the starting points for supervision, would have assisted FINMA in its work and enhanced its impact on the bank in the Credit Suisse case."[15]

Thus, the Federal Council proposes in its April 2024 report on banking stability to, among other things, strengthen the legal basis for requirements and interventions by FINMA in the area of compensation. This includes to define the requirements for compensation systems and FINMA's intervention options at the appropriate legal hierarchy level (law or ordinance). In addition, the Federal Council proposes to introduce a senior managers regime that is closely linked to the rules on compensation. This strengthens individual accountability and allows misconduct (including inappropriate risks taking) to be sanctioned in a targeted manner. Work has begun on implementing these measures.

Further, the Federal Council already proposed in September 2023 to empower the Federal Council, in cases where state aid has been granted, to oblige the bank to reclaim paid variable compensation from individuals in managerial positions who are largely responsible for the necessity of state aid. A power to ban the payment of variable compensation already exists.

[15] Federal Council (2024), *Federal Council report on banking stability including an evaluation in accordance with Article 52 of the Banking Act*, April.

4. Potential ways to address challenges to the use of compensation tools

Many of the challenges experienced by firms in using compensation tools are not insurmountable. Solutions often require an uplift or enhancement to compensation practices, rather than extensive change. A firm's governance framework establishes roles and accountability in overseeing risk and compensation alignment, particularly the Board's role in applying compensation tools such as malus and clawback. Notably, the culture of a firm and its compensation practices should be soundly aligned to effectively meet firm strategy and appropriately manage risk. When well-aligned, the use of any corrective compensation tool is often infrequent. Where tools are applied, transparency in decision-making and compensation outcomes promotes confidence and commitment to sound risk and compensation practices. Supervisory authorities' role typically includes setting requirements, guidance and monitoring the effective use of compensation tools. Firms that are more mature go beyond these minimum expectations.

This section outlines some practical solutions to address the challenges in the use of compensation tools.[16]

4.1. Role of the board

The Board of any firm, not only financial services firms, performs a pivotal role in compensation governance. To effectively discharge responsibilities, Boards usually seek clarity in their terms of reference or charter, including how they should appropriately use compensation tools. Terms of reference alone are insufficient. Effective application and implementation are critical to enable robust Board decision-making. The appropriate use of discretion is also important in overcoming challenges in respect of compensation tools.

A Board's terms of reference aim to establish its purpose, functions, authority/powers and composition. The terms of reference should guide Board decision making and enable directors to understand their role and responsibilities. Whilst some Boards may discharge or delegate such duties to their REMCO, oversight of compensation frameworks and outcomes remains a Board responsibility. Boards need to consider the use and application of compensation tools and lean into any challenges. During the Workshop, a participant highlighted that practice makes perfect – or at least progress – towards Boards effectively discharging their responsibilities.

Workshop participants examined the importance of Boards having appropriate skills and independence. Workshop participants noted that disparities in Board members' quality and impartiality were often a factor across jurisdictions; but cross-sectoral differences were not significant. The independence of the Board enables objectivity in oversight and the ability to constructively challenge management. REMCO independence is also important.

[16] Many of the examples shared in this section relate to the banking sector, reflecting observations shared by FSB member jurisdictions in the questionnaire. As result, sectoral differences are unable to be determined in this section. It does not infer that the banking sector has greater challenges and/or better approaches to address such challenges. Any sectoral observation is limited to prior CMCG reports, which indicate the banking sector typically has more mature compensation practices.

Whilst compensation tool design is important, effective implementation and application is critical. Guardrails can help guide Board decision-making, enabling high-quality decisions and greater alignment to organisational culture and strategy. Some firms have introduced a hierarchy and framework for Boards to apply downward adjustment to compensation outcomes. A common approach is for Boards to consider in-year adjustment in the first instance, then malus and lastly clawback. This hierarchy is typically based on ease of use and aligns to insights discussed in Section 1. Such a framework supports Boards that have a level of uncertainty over which tool to apply. The intention is to support sound judgement whilst not impeding the application of Board discretion.

Risk reporting is also an important input for Boards in the effective use of compensation tools. To inform deferral, vesting of compensation and downward adjustments, Boards rely on robust risk reporting. One jurisdiction indicated that Board risk reporting utilised significant resources, with rigorous performance and risk assessment of MRT roles undertaken annually. The supervisory authority provided guidance for the firm to formalise and document the risk reporting process with a view to streamlining. A firm in another jurisdiction has uplifted its risk adjustment framework with defined triggers for different compensation tools (e.g. malus, clawback) coupled with a risk adjustment process that outlines inputs to the Board, including risk reporting.

The use of Board discretion in adjusting compensation should be in exceptional circumstances, for example non-recurring instances of risk that may be unplanned, not within a firm's control and material in nature. The use of discretion is often challenging as Boards seek to balance stakeholder interests, including shareholders who expect management to share the burden for poor firm performance. Additionally, Boards often face a moral hazard in diluting management accountability for failures or dismissing compensation adjustments believing they are adequately addressed by other compensation design elements (e.g. performance metrics). The extent to which firms are proactive in the use of compensation tools and addressing any challenges reflects their different stages of maturity in governance practices.

Box 4: Role of the Board in addressing challenges in the use of compensation tools

A bank in Asia Pacific

To support application of Board discretion, a firm introduced decision making guidance to enable consistent decisions notably for non-recurring risk events which are reflected in compensation outcomes. This approach is strengthened through enhanced disclosure of the Board's compensation decision making processes, including the factors considered when making decisions.

An insurer in North America

The Human Resources Committee of the Board is the decision maker in respect to clawback standard and uses its discretion in determining application. Clawback can be ambiguous to effect and implement, meaning that any decision on clawback must be well informed. In turn, the Board receives input and reporting from various functions, including Human Resources and the CRO, who perform thorough investigation, administration, and enforcement actions.

A bank in Europe

Clawback and malus can be lengthy and burdensome processes. A Board of a firm decided to apply malus and urged the application of the clawback following fraud. Whilst it took time, more complex processes were mitigated with an out-of-court settlement agreed with the former employee.

4.2. Importance of culture

A compensation framework aligned with firm culture will incentivise appropriate employee behaviour and performance to achieve the firm's' goals. Workshop participants discussed the interconnectedness and the importance of a culture-based compensation framework, where the Board plays a crucial role in establishing a framework that drives the desired risk culture and fosters acceptance of compensation tools.

While compensation tools cannot solely prevent risk incidents, they can enhance risk culture and promote accountability. Several workshop participants stressed that compensation tools that adjust outcomes downward should be seen as the final lever of any compensation framework, emphasising the need for a sound risk culture at the outset. This should be supported by compensation structures that incentivise appropriate risk outcomes.

The setting of a culture where senior employees are held accountable for misconduct, including misconduct at lower levels in a firm, was discussed in the workshop. Where misconduct occurs, the challenge should not be whether to apply ex-ante and ex-post compensation tools, but rather the level to apply them. This, in turn, should reflect proportionality to the severity of the misconduct. A firm has established an adjustment process where material risk events are reviewed considering the risk tolerance and culture of risk management of the firm. The process considers the use of in-year adjustments (bonus and pool), malus or clawback, as applicable to the material risk event.

Furthermore, accountability is not eliminated when an employee leaves a firm. Often the challenge is twofold: applying malus and/or clawback to the exited employee, whilst ensuring fairness and proportionality for remaining employees. A firm which received an accelerated deferral request, considered factors such as its own risk culture and accountability, and denied the request and maintained the deferral period and its ability to apply malus.

Box 5: Addressing challenges in the use of compensation tools through firm culture

A bank in Asia Pacific

REMCO and the internal risk function collaborated to uplift malus conditions, including triggers and the time horizon of risk. The purpose was to reinforce the bank's culture of accountability and to align with the firm's risk management framework.

A bank in South America

A firm's risk awareness and attitude toward risk is reflected in the implementation of a buyout award policy matching the previous employer's conditions, not being more favourable. Such an approach is overlayed with internal policy and external regulatory requirements.

A bank in Asia Pacific

In setting an appropriate deferral period a firm reflected on its risk management framework to not only align the newly introduced deferral regime with risk, but to also establish appropriate pro-rata vesting and ensure a significant portion of compensation was deferred for meaningful impact.

A bank in South America

Risk management is reflected in a firm applying in-year adjustment, where often the challenge is to maintain minimum salary post any adjustments, the firm has processes and controls in place to monitor and mitigate this risk.

4.3. Importance of transparency

Clear communication of compensation frameworks and how compensation outcomes link to firm performance and prudent risk management is important for stakeholders. Internally, transparency in compensation frameworks and outcomes is essential to foster employee accountability and acceptance. Firms' external disclosures are a key communication tool with stakeholders, including shareholders, investors and customers. It can be challenging at times for firms to balance transparency of compensation, and sensitivities (for example market sensitivities, privacy of individuals) that relate to risk events and the use of corresponding compensation tools like in-year adjustment and malus.

Disclosure of compensation practices and outcomes varies by both jurisdiction and sector. Variations include the level of detail specified for individuals or roles versus aggregated cohort disclosure, the extent of fixed and variable compensation, and the coverage of roles to be disclosed. In most instances where disclosure is a regulatory requirement, it incorporates the CEO and senior roles at a minimum. The BCBS Pillar 3 disclosure requirements set minimum standards for banks disclosure.[17]

In one jurisdiction, following a risk event, a firm published compensation in-year adjustments for disclosed employees, where proportionality, accountability and consistency was evident and transparent in the adjusted compensation outcomes. In some jurisdictions, shareholders vote on disclosures in respect of compensation reports. Compensation tools are often scrutinised publicly where there is misalignment in compensation outcomes to stakeholder expectations.

Transparency in the relationship between compensation and performance was a focal point of the Workshop discussion. Quantitative disclosure alone is often inadequate. Transparency on why performance measures are selected (including financial and non-financial measures), how they are measured, and resultant outcomes is important to stakeholders in understanding the link to compensation. Firms should communicate how and when they should apply tools such as clawback, deferral and in-year adjustment. For example, a firm in Asia-Pacific clearly discloses its deferral policy to demonstrate alignment to risk, helping build trust with shareholders whilst demonstrating an effective risk management approach to the supervisory authority.

Participants of the Workshop also examined the opportunity for firms to streamline compensation frameworks to enhance transparency and effectiveness, whilst mitigating unintended consequences. Clearer and more straightforward processes to apply compensation tools, such as in-year adjustments and malus provisions, can be more effective in modifying compensation based on performance and risk outcomes.

[17] BCBS (2018), *Pillar 3 disclosure requirements - updated framework*, December.

Box 6: Overcoming challenges in the use of compensation tools through transparency

A bank in Asia-Pacific

A firm implemented robust clawback provisions with clear triggers (including misconduct). Detailed disclosure of such provisions in the bank's annual report kept shareholders informed. The transparency maintained confidence in the bank's commitment to risk management and ethical behaviour.

An insurer in Asia-Pacific

Following a risk event, a firm sought to achieve the right balance with executive compensation outcomes and transparent disclosures. Clearer, more transparent disclosures on measures, targets and remuneration outcomes were provided through disclosure to address stakeholder concerns.

4.4. Regulatory and supervisory role

Section 2 outlined the extent of regulatory and supervisory developments related to compensation tools in recent years. Modernising regulatory practices is important in responding to challenges and rapidly changing environments; compensation frameworks and practices are an example of this.

The pivotal role regulators play in overcoming compensation tool challenges was examined in the Workshop. Active supervisory monitoring and engagement, evaluating the effectiveness of compensation tools, assists firms detect weaknesses in their compensation practices early. Workshop participants noted the importance of well-defined, clear and appropriate regulatory policy and/or guidance to set expectations and assist firms in overcoming the challenges in the use of compensation tools. For example, one supervisory authority provided guidance to a firm, which had flagged the resource-intense nature of risk reporting, to formalise and document the risk reporting process with a view to streamlining.

Supervisory authorities also set expectations or provide guidance in respect of firm culture and how it supports sound compensation practices. HKMA's Bank Culture Reform promotes the adoption of a holistic and effective framework for fostering a sound culture within banks. The reform seeks to encourage banks to develop and promote a sound corporate culture that supports prudent risk management and contributes towards incentivising proper employee behaviour that will lead to positive customer outcomes and high ethical standards.

The Australian Prudential Regulation Authority (APRA) has developed a Risk Culture 10 Dimensions (RC10D) framework to assess the risk culture of its regulated entities. The RC10D articulate the key aspects of a firm's risk behaviours and risk architecture that contribute to its risk culture. One dimension is "Performance Management and Incentives" which highlights the importance of good risk management behaviour being rewarded and poor risk behaviour having proportionate consequences.

Box 7: Role of the supervisor in addressing challenges in the use of compensation tools

A bank in Europe

A European firm's compensation outcomes were not aligned with its financial soundness and performance. The supervisory authority published a letter to the firm indicating a prudent approach regarding the adoption and implementation of the compensation policy, including an expectation that the variable compensation of the identified staff should be reduced. As a result, the Board adopted the decision to apply an in-year adjustment and reduce the variable compensation that year.

A bank in Europe

In Europe, a government and its supervisory authority communicated expectations in respect of ex-ante and ex-post adjustment following a material risk incident at the firm, in addition to the firm's own disclosure. The expected obligations were explicit and transparent, with downward adjustment expectations ranging from 100%-25% of variable remuneration depending on accountability/organisational hierarchy.

A bank in Europe

A firm's bonus pool did not align with significant financial losses experienced. The supervisory authority engaged with the REMCO to re-calibrate the bonus pool which resulted in material reductions to variable compensation and avoiding issues like moral hazard and negative public sentiment whilst uplifting risk culture.

A bank in Europe

Challenge to the quantum of malus adjustments proposed by a REMCO prompted a supervisory authority to ask a firm to conduct an internal review with a view to improve the firms link between incident management and compensation adjustments. The regulatory focus in this instance was to strengthen the alignment and operational effectiveness between the firm's compensation, risk and consequence framework.

5. Conclusion

The Principles and Standards play a critical role in guiding financial firms toward responsible risk management. They aim to ensure that compensation structures align with long-term business sustainability and do not encourage excessive risk-taking. Their continued relevance was demonstrated by the 2023 banking turmoil. The collapse of Silicon Valley Bank and Credit Suisse has underscored the importance of adhering to such principles.

The Principles and Standards emphasise that compensation schemes should be structured to incentivise prudent risk-taking, with a focus on long-term performance rather than short-term gains. They advocate for the inclusion of deferral mechanisms, malus, and clawback provisions, which allow institutions to adjust or recover compensation if risk outcomes prove detrimental over time.

While jurisdictions continue to make progress in implementing legal and regulatory changes related to the use of compensation tools, challenges in their use remains. However, there are a number of practical solutions to addressing these challenges. These centre around:

- **The role played by the Board:** Boards must have a clear role in overseeing compensation frameworks and have the requisite skills and independence to ensure that compensation tools are used appropriately.

- **The importance of culture:** a culture of accountability and strong risk management is important. It is crucial to get culture right first in order to reduce the reliance on compensation tools.

- **The importance of transparency:** clear communication of compensation frameworks and the application and alignment of compensation outcomes with firm performance and risk management is important.

- **The role of financial authorities:** Achieving lasting change in behaviour and culture within firms is a long-term challenge requiring a sustained commitment. Supervisory and regulatory authorities play an important role in ensuring firms embed the right culture and effectively and consistently implement the Principles and Standards.

Annex: Regulatory and supervisory developments related to compensation tools

Deferral

Nine jurisdictions implemented changes related to deferrals. The changes made fell into three categories:

- Increase in deferral periods:
  - *Germany, Italy and Spain*: The deferral period in the banking sector has increased from three-five years to four-five years.
  - *Australia*: For significant banking firms, the minimum deferral period increased from four years to six years for CEOs and to five years for senior managers and executive directors other than the CEO. A deferral period of four years was introduced for highly-paid MRTs who are not senior managers. In addition, these deferral periods were introduced for significant insurance and superannuation firms.
  - *Saudi Arabia*: Minimum of 40% to 60% depending on the seniority level over a period of no less than three years for the banking sector.
- Introduction of sector-specific deferral requirements:
  - *India*: Requires 20% of compensation of designated employees of asset management companies to be invested in the mutual fund schemes they manage, with a lock-in of at least three years. In the insurance sector, at least 50% of variable pay under deferral for covered individuals.
  - *UK*: For certain investment firms, at least 40% of variable compensation must be deferred for at least three years, with 60% deferral for high amounts (£500,000 or more). Separate rules apply for systemically important investment firms, which are dual regulated by the Prudential Regulation Authority and the Financial Conduct Authority. For MRTs in a specific group of investment firms (largest non-small and not interconnected), at least 40% of variable compensation must be deferred for at least three years, with 60% deferral for high amounts (£500,000 or more).
- Specific deferral rules and coverage:
  - *Hong Kong*: Specified the minimum coverage of executives whose compensation is subject to deferral and introduced restrictions on vesting, holding, and retention as part of group-wide supervision of insurance groups.
  - *Australia*: Staggered the rollout of deferral requirements based on the nature of firms, with all accountable persons in APRA-regulated entities subject to the Financial Accountability Regime (FAR).

- *Singapore*: Revised its Corporate Governance Guidelines to clarify its expectations that relevant firms (banks and insurers) should defer at least 40% of variable compensation of key management personnel and other MRTs over at least three years, with the proportion increasing with seniority and responsibility.

In-year adjustments

Five jurisdictions carried out changes in ‘in-year adjustments’:

- *Australia*: has set clearly defined triggers to make a downward adjustment.
- *Hong Kong*: has set a risk-adjusted performance measurement framework for covered executives of insurance groups, with adjustments set over a multi-year framework (e.g. three to five years) and incorporating financial and non-financial factors as well as current and future risks, and performance.
- *Saudi Arabia*: has adjusted variable compensation for the banking sector to account for material downturns in performance or fraud and misconduct risk.
- *Singapore*: revised its Corporate Governance Guidelines to clarify its expectations that relevant financial institutions (banks and insurers) should include in their compensation policies for all employees, mechanisms for ex-ante adjustments to compensation for all types of risks, including misconduct. The indicative criteria and scenarios that could trigger ex-ante adjustments to performance and compensation is required to be clearly set out in a firm’s compensation policies and communicated to employees.
- *UK:* MRTs in certain investment firms are expected to ensure that any variable compensation, including a deferred portion, is paid or vests no faster than on a pro rata basis. It should vest only if it is sustainable according to the firm’s financial situation and justified based on the performance of the firm, the business unit and the MRT concerned.

Malus

Five jurisdictions have enhanced their malus provisions.

- *Hong Kong*: has introduced vesting restrictions (activation of malus) for insurance groups based on the financial performance of the group or the performance of the individual concerned.
- *India*: has implemented malus provisions to discourage key managerial personnel in the insurance sector from taking inappropriate or excessive risks for their performance-based variable compensation.
- *Australia*: has introduced malus across all three sectors, whereby all accountable persons in regulated firms are subject to reductions in variable compensation commensurate with the severity of risk or conduct incidents. More broadly, APRA-regulated firms must subject a person’s variable remuneration arrangement to malus.

- *Singapore*: revised its Corporate Governance Guidelines to clarify its expectations that relevant financial institutions (banks and insurers) should include mechanisms and provisions for ex-post adjustments (e.g. malus and clawback arrangements) to variable compensation for key management personnel and other MRTs. The criteria and scenarios that could trigger these adjustments must be clearly defined and communicated to employees.

- *UK*: regulations generally apply malus and deferral provisions only for MRTs in non-SNI (small and not interconnected) investment firms (there are proportionality-based exemptions if firms meet certain criteria).

Clawback

Six jurisdictions have applied clawback provisions for variable compensation of MRTs.

- *Australia*: has prescribed that the variable compensation of executives and other highly paid MRTs of significant financial firms must be subject to clawback for at least two years from the date of payment or vesting, across all three sectors.

- *Hong Kong*: has implemented clawback provisions for insurance groups if the financial performance of the group or the performance measurement of the subject person is proven to be not genuine.

- *India*: has introduced clawback provisions for the compensation of designated employees of the asset management companies for the units of the Mutual Funds scheme allotted to them, in the event of a violation of the Code of Conduct, fraud, or gross negligence by them, as determined by SEBI.

- *Singapore*: refer to change described in the Malus section above.

- *UK*: non-SNI (small and not interconnected) investment firms must set minimum clawback periods as part of their compensation policies.

- *US:* has directed national securities exchanges and associations that list securities to establish listing standards requiring each issuer to develop and implement a policy providing for the recovery, in the event of a required accounting restatement, of incentive-based compensation received by current or former executive officers where that compensation is based on the erroneously reported financial information. The listing standards must also require the disclosure of the policy.[18]

Severance payments

Three jurisdictions have implemented regulations for severance payments.

[18] Additionally, listed issuers must file the policy as an exhibit to their annual reports and include other disclosures if a recovery analysis is triggered under the policy. Congress required the SEC to adopt these final rules as part of the Dodd-Frank Act. See *Listing Standards for Recovery of Erroneously Awarded Compensation*, Rel. No. 33-11126 (Oct. 26, 2022)[87 FR 73076 (Nov. 28, 2022)].

- *Australia*: has prescribed that accelerated vesting on exit is not allowed for executives, MRTs, and risk and financial control personnel. Further, severance payments that relate to and/or include deferred variable compensation must remain deferred and subject to malus and clawback conditions for these employees.

- *Hong Kong*: has mandated that for insurance groups, any severance payment should be in line with the financial condition and performance of the supervised group over a suitable time horizon. There should be no severance payment in cases of failure or threatened failure of the group.

- *UK*: non-SNI firms must ensure that all guaranteed variable compensation, including severance pay, is subject to deferral, malus, clawback, and retention policies. There are proportionality-based exemptions to this.

Other

Seven jurisdictions have carried out changes in other areas.

- *EU / EA*: has mandated the incorporation of sustainability risks in the risk management systems of banks and insurers as part of their compensation policy. Banks have to comply in their policies also with the principles of proportionality and gender neutrality.

- *France:* For its banking sector, France has refined the identification criteria for MRTs and has also clarified how banks can apply for deferral or payment waivers of variable compensation. For the insurance sector, following EU regulations, there is now a requirement for insurers to link executive pay to performance capturing ESG goals alongside traditional financial measures.

- *Hong Kong:* has integrated considerations for misconduct risk in the compensation systems for banks and incorporated enhanced board oversight on the implementation of remuneration systems and related control processes in its 2021 updated supervisory guidance.

- *Indonesia:* For banks in Indonesia, the regulator has been granted authority to oversee and adjust variable compensation payments that do not follow the principles of fairness and equity under specific conditions such as abnormal supervisory status or impropriety in the provision of variable compensation.

- *Italy:* banking and asset management sectors are now required to follow the principle of proportionality and gender neutrality. In addition, a higher maximum level of the ratio between the variable and the fixed component of compensation has been prescribed to the asset management sector, using financial instruments as part of variable compensation. For the insurance sector, the Solvency II Directive is being revised to grant supervisors more powers to restrict or suspend variable compensation when an insurance firm solvency position deteriorates. Insurance firms must also consider sustainability risks while designing compensation policies.

- *Switzerland:* requires that the compensation system shall create no incentives for staff to disregard their statutory duties or conduct themselves in a manner detrimental to clients i.e. variable compensation elements must not diminish the quality of financial services or create conflicts of interest.

- *UK:* the bonus cap, that had limited bankers' bonuses to a maximum of double their base pay, has been lifted for banks, building societies and systemically important investment firms. The removal of bonus cap is expected to make it easier for firms to adjust their variable compensation over time to reflect their financial health. By adjusting down variable pay in the event of a downturn, firms should have more resources that could be used to absorb losses, thereby promoting the safety and soundness of the firm. Having the flexibility to restructure pay faster should also allow for a greater proportion of variable pay to be subject to incentive setting tools, which in turn could contribute to a better alignment of incentives and financial rewards with principles of effective risk management, good conduct, and the long-term interests of the firms. UK regulators also amended some aspects of the remuneration regime to enhance proportionality applicable only to the smallest firms. Small firms that qualify for the simpler remuneration regime do not have to apply rules on malus and clawback.