FSB FINANCIAL STABILITY BOARD

Press release

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FSB highlights implementation progress and gaps on effective compensation practices in financial institutions

The Financial Stability Board (FSB) today published a progress report on the implementation of its Principles for Sound Compensation Practices (Principles) and their Implementation Standards (Standards) in financial institutions.

The report covers the practices of the largest financial institutions in the banking, insurance and asset management sectors. It highlights uneven progress toward implementing the Principles and Standards, with banks relatively more advanced than insurance and asset management firms. This may reflect the more pressing need for banks to align compensation with risk-taking following the 2008 global financial crisis.

Against this backdrop, this report focuses on:

- **The effectiveness of compensation frameworks.** A common approach to assess employee performance and determine variable compensation is to use a balanced scorecard based on key performance indicators, complemented by other inputs. The report notes that it is critical to establish and apply such a framework to promote a sound risk culture in a firm. While in-year adjustments and malus are commonly used, the use of clawback is not widespread due to ongoing legal and practical constraints. The report advocates incorporating clawback terms and severance clauses in employment contracts to enhance their enforceability and effectiveness.

- **Emerging trends.** Non-financial measures and disclosure of compensation-related information are increasingly used to shape and promote a sound risk culture and positive behaviours, as well as to contribute to robust risk management. Firms are increasingly incorporating environmental, social and governance (ESG) aspects to drive accountability for delivering outcomes. This must be underpinned by robust governance, as the increasing application of non-financial measures requires the Board and internal control functions to use discretion and judgement appropriately.

- **Experience during the COVID-19 pandemic.** The report finds that most existing compensation frameworks, and associated governance mechanisms, have demonstrated sufficient flexibility to date. However, while banking authorities in most jurisdictions have powers to direct firms to hold back and/or limit bonuses, especially in cases where there are concerns about capital conservation, or to increase deferral periods, this is much less prevalent in the asset management and insurance sectors.

Notes to editors

The 2008 global financial crisis highlighted that compensation practices in large financial institutions were one of the key contributing factors to the excessive risk-taking that was prevalent in the run up to the crisis. Following the crisis, the FSB developed the Principles and Standards to promote sound compensation practices and align compensation with prudent risk-taking at significant financial institutions. The Principles and Standards require the financial industry to align employee incentives with risk and profitability of the firm over different time horizons.

This is the FSB's seventh progress report on the implementation of the Principles and Standards. The report describes regulatory and supervisory developments; the functioning of governance mechanisms for compensation by firms; the effective use of metrics/criteria and compensation tools; and legal and regulatory challenges to the effective use of compensation tools. It incorporates input from FSB jurisdictions and covers the period 2020-21, including the COVID-19 pandemic. It also incorporates insights from an industry workshop held in May 2021.

The FSB coordinates at the international level the work of national financial authorities and international standard-setting bodies and develops and promotes the implementation of effective regulatory, supervisory, and other financial sector policies in the interest of financial stability. It brings together national authorities responsible for financial stability in 24 countries and jurisdictions, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSB also conducts outreach with approximately 70 other jurisdictions through its six Regional Consultative Groups.

The FSB is chaired by Randal K. Quarles, Governor, US Federal Reserve; its Vice Chair is Klaas Knot, President of De Nederlandsche Bank. The FSB Secretariat is located in Basel, Switzerland, and hosted by the Bank for International Settlements.

For further information on the FSB, visit the FSB website, www.fsb.org.