24 January 2013

FSB Workshop on Compensation Practices

Washington DC, 19 November 2012

As recommended by the June 2012 implementation progress report on compensation practices, the FSB organized a workshop on 19 November 2012 to share experiences and lessons from the implementation of the FSB *Principles* and *Standards* for Sound Compensation Practices (Principles and Standards) by financial institutions.

The workshop focused on three main areas: alignment of compensation with ex-ante risk taking; alignment of compensation with performance; and the identification of material risk takers. These areas had been identified in the progress report as posing technical challenges to full implementation of the Principles and Standards. Officials from FSB member organisations participating in the FSB Compensation Monitoring Contact Group and senior executives from global systemically important banks (G-SIBs) and from consulting firms were invited by the FSB to take part in the workshop.

1. Overall conclusions

1.1 Firms are generally moving in the right direction

Firms are undertaking significant efforts to advance in their implementation of sound compensation practices, and they have progressed significantly in the direction indicated by the Principles and Standards. Important cultural changes are underway in the way that firms approach remuneration practices. While there are growing areas of commonality, there remains diversity in practices and experimentation among firms and jurisdictions, although it is not yet clear whether this is leading to significantly different outcomes or which approaches are most effective.

1.2 The focus on remuneration is bringing tangible benefits

Although firms state that they require more time for completing the implementation process, they recognize that they are already experiencing some benefits from this process, including in terms of the effectiveness of their risk governance. There is now more focus not just on what risks are taken, but also on who is making those decisions and what controls are in place for them. Another main benefit cited by firms is enhanced internal and external transparency of the rewards processes and greater employee awareness via performance reviews that better reflect employee behaviour and the quality (as opposed to the sheer volume) of the business. Compensation structures are seen as a way to transparently set goals and incentivize sound individual behaviour.

Compensation is also seen as an important tool to engage with members of the firm's board of directors on the risks of the institution and on what is rewarded within the institution, both in terms of performance and behaviour. Having the authority and processes in place to better review qualitative performance and affect rewards has forced risk-related discussions across different parts of an institution and brought sizeable improvements in the articulation of risk appetite, and in the granularity with which risk is integrated in remuneration decisions, both at the level of the bonus pool and of individuals. Ultimately, compensation oversight and approvals ensure that senior managers and boards of directors are accountable for passing the right message down to the organization.

1.3 The main concern seems to be compliance costs rather than a level playing field

Some of the firms raised the issue of the lack of consistency in the rules and expectations among national supervisors. It is important, however, to note that this issue appears not to be about a "non-level playing field", but rather about the higher compliance costs of meeting different local rules and supervisory approaches on compensation. Firms would prefer to design and operate a single set of global compensation packages, but they find challenging to do that if they must satisfy the different rules and priorities of domestic supervisors in the jurisdictions in which the firms operate. This is also because of the fact that supervisory priorities may differ across authorities and may change from one year to the next.

1.4 It is important to maintain the reform momentum

The implementation of the FSB Principles and Standards by significant firms is an on-going process and it is important to maintain momentum in this area. In particular, more work is needed to embed positive risk management in firms' compensation practices and achieve effective alignment with risk and performance.

There also remain practical implementation challenges on specific issues (see below) that require more time to resolve and would benefit from greater supervisory coordination and information sharing. The actual degree of effective implementation can ultimately only be judged on the basis of evidence indicating high correlation between ex post performance, risks taken, and remuneration paid. It is also likely that a full assessment of effectiveness requires some experience of compensation practices during an economic upturn, when the demand for talent in the banking industry will be stronger than today.

2. Take-aways on selected topics

2.1 Ex ante risk alignment

Institutions are still experimenting with a variety of approaches and feel they have more to learn about the best approaches to align compensation with ex ante risk and about balancing risks considerations with other goals of the pay system, such as fostering talent and contributing to the firm's results. It is challenging for firms to demonstrate to supervisors how (and by how much) they are taking risk into account in determining their bonus pools.

Formulaic approaches may lead firms to focus only on modelled risks captured in the formulae and not on other risks, including emerging risks. One key issue is the extent to

which firms use discretion on funding pools. Discretionary approaches can potentially cover risks that are not included in formulaic approaches, and can also be used to incorporate more traditional factors such as rewarding talent and ensuring compensation is "market comparable". However, without appropriate governance, they can lead to outcomes that do not properly align risk and rewards. When discretion plays a big role, it becomes even more challenging for firms to show to their supervisors how risk alignment actually works.

Another challenge is how to align compensation for ex ante risk taking without penalising "good" risk-taking that is consistent with the firms' expressed risk appetite and is being properly managed. Bank representatives noted that, while more sensitivity around risk is a good outcome, what matters is also what the firms does about risk, i.e. what policies and measures the firm takes to monitor and control it. They also noted that the risk alignment process should leave some room for discretionary adjustments. The best approaches are those that closely align compensation to a firm's risk governance, which means ensuring not only that all material risks are captured, but that it is done with the input of the risk management and other control functions and with the full oversight by the board of directors ("it's all about the right people having the right information and incentives to make the right decisions").

Institutions are using a variety of approaches for risk alignment of individuals. The challenge is the extent to which every individual's risk taking can be taken into account and practically measured. There was agreement that poor behaviour / excessive risk taking should have real consequences on individual rewards. Improvements are being observed, with more granularity embedded both in the performance reviews and in setting individuals' objectives in relation to risk taking and other elements of risk culture.

With respect to the use of alternative instruments, some industry representatives expressed strong scepticism about the viability/desirability of bail-in bonds and contingent capital instruments in compensation packages, as they see these instruments as too complex and difficult to explain to both staff and stakeholders. It is difficult to use such instruments to incentivize people in the desired direction without robust market prices and sufficient clarity around their main features.

2.2 Ex post performance adjustments

There were divergent views among firms on the legal enforceability of clawbacks for already vested amounts, since enforceability is unclear or under challenge in several jurisdictions. On the other hand, adjustments before vesting (maluses) are more common and generally thought to be effective. To make them more effective, some firms are extending the deferral horizon beyond three years and increasing the percentage of the bonus amount that is subject to deferral.

Firms are also setting clearer parameters or conditions for vesting that relate to financial and non-financial factors, including compliance, relationship behaviour, and adherence to the values of the institution. Increasingly, qualitative reviews of individuals' behaviour are built into the process. These elements are increasingly being used for deciding both current year compensation as well as maluses over unvested compensation. A number of bank participants expressed the importance of having the power to reduce or eliminate various components of compensation if an adverse event occurs.

One of the main issues in this area is how to manage extraordinary events and changes of the business models that may have occurred during the year, which may impact ex ante performance objectives; the ex post adjustments need to be managed with robust governance rules and transparent processes to override existing compensation package features if needed.

Some bank representatives argued for longer deferral periods, while others worried that with longer deferrals some individuals may discount future awards, putting pressure on fixed salaries or on the short term portion of the compensation package. In this view, longer vesting periods may lead to situations in which the perceived probability of receiving future compensation is reduced to such an extent that, without corresponding corporate culture change or clear communication to employees, it no longer acts as an adequate incentive mechanism on individuals' behaviour. For senior executives, long term incentive plans, based on performance measured over a multi-year horizon, can still be an effective tool to reward strategic contributions and to incentivize adherence to firm culture and objectives.

Another important factor of change in the industry is increased pressure from shareholders and proxy firms. Institutional investors and proxy firms are gaining an increasing role in several jurisdictions, for example via "say on pay" regulations. Some of these firms, however, focus on the level of pay relative to historical performance, which they often measure on the basis of total shareholder return relative to the peer group, rather than on risk-adjusted performance. In addition, some shareholders may take only a short term view of share price performance, while regulators favour a more long-term perspective on risk and return.

2.3 Material risk takers (MRTs)

This is the area where the range of practices across jurisdictions is probably broader, with less consistency in the definition and approaches used by firms and their supervisors. The most important questions are: "what is material and how to define it in a consistent way" and also "what are the consequences of being a MRT". Some banks are implementing similar ex ante and ex post adjustment practices and governance structures for all employees, not just MRTs. Firms asked for more consistent guidance, both on parameters for identification and on the implications of being designated as a MRT. Some firms as well as some supervisors expressed the need for having more than one category of MRTs, with different implications for each in terms of compensation package requirements. Some firms noted their inability to customise pay packages for very large numbers of MRTs as they can for fewer employees ("one can do less with more identified staff, and more with less").

3. Next steps

The FSB welcomes any further feedback on the take-aways from the three topics discussed above. Comments should be sent to fsb@bis.org.

The FSB will prepare its next implementation progress report on compensation practices for the G20 Summit in September 2013. The focus will be on practical issues in implementing the FSB Principles and Standards, especially in the areas identified above.