Effective Implementation of FSB Principles for Sound Compensation Practices and Implementation Standards

2021 progress report

4 November 2021

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Effectiveness of compensation framework

There has been uneven progress toward implementing the Financial Stability Board (FSB) *Principles for Sound Compensation Practices* and their *Implementation Standards*. Implementation by banks tends to be relatively more advanced than the insurance and asset management sectors. This may reflect the more pressing need for banks to align compensation with risk-taking following the global financial crisis in 2008.

The FSB has explored the effectiveness of compensation frameworks, in particular the measures used to assess employee performance and determine variable compensation. A common approach is to use a balanced scorecard based on various key performance indicators (KPIs). The goal of this approach is to strike an appropriate balance between financial and non-financial measures and to have a holistic view of employee performance.

These may be complemented by reviews and input from other colleagues and discretion by the Board and/or senior management, to measure areas that may be difficult to capture solely through KPIs. It is critical for firms to establish and apply the framework in such a manner as to promote sound risk culture in the firm.

In-year adjustments and malus are commonly used across sectors and jurisdictions. In case of material breach of risk appetite or misconduct, variable compensation is ordinarily expected to be significantly reduced or even forfeited. The use of clawback, however, is not widespread due to ongoing legal and practical constraints. Meanwhile, severance payments have garnered increased attention as the application of malus and clawback conflict with labour laws that tend to protect severance payments, and hence, potentially circumvent the alignment of risk and compensation. Incorporating clawback terms and severance payments clauses in an employment contract may enhance their enforceability and effectiveness.

Emerging trends

Use of non-financial measures as well as disclosure of compensation-related information have increased to shape and promote a sound risk culture and positive behaviours, as well as to contribute to robust risk management. This is largely a result of firms' own initiatives, driven predominantly by stakeholder expectations.

In particular, firms are increasingly incorporating environmental, social and governance (ESG) aspects in those non-financial measures to drive accountability for delivering outcomes. Other types of common non-financial measures include those that support prudent risk management, including operational incidents, anti-money laundering (AML) and know-your-customers (KYC). Non-financial measures can be both quantitative and qualitative, and so are not necessarily non-quantifiable.

The use of non-financial measures reflects the roles and responsibilities of the individuals concerned. While Chief Executive Officer (CEO) compensation is often determined predominantly by financial measures to drive business forward, these measures adopt a long-time horizon and are also supplemented by non-financial measures to mitigate procyclicality and support the firm's sustainable growth. Chief Risk Officer (CRO) compensation is based more on functional role objectives such as risk management and compliance metrics. It is important that firms' metrics and criteria and their application drive the right behaviours on the part of those individuals.

The effective use of performance measurement mechanisms and risk adjustment tools in determining compensation is ultimately underpinned by robust governance. Effective governance is becoming more important as the increasing application of non-financial measures requires the appropriate use of discretion and judgement by the Board and internal control functions.

Experience during the COVID-19 pandemic

Throughout the COVID-19 pandemic, firms and supervisory authorities have worked to better understand and test firms' compensation frameworks. Most of the existing compensation frameworks, including the associated governance mechanisms, demonstrated sufficient flexibility to adapt to the evolving economic landscape.

Supervisory authorities found that they are equipped with the necessary prudential tools, such as restricting variable remuneration and limiting dividend payouts and share buybacks, to protect the safety and soundness of firms. In most jurisdictions, banking authorities 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.

Introduction

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 for Sound Compensation Practices* [1] and their *Implementation Standards* [2] (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. More than ten years on since the crisis and the publication of the Principles and Standards, the previous compensation progress report[3] observed steady progress in their implementation in the banking sector. However, it also highlighted the need for further progress in the insurance and asset management sectors and the need to focus on the effectiveness that is still being tested across the sectors. Against this backdrop, this progress report focuses on effectiveness – both effective compensation practices and the effective implementation of the Principles and Standards.

The analysis and conclusions presented in this progress report leverage input from FSB member jurisdictions[4] provided by means of a questionnaire that focuses on the period 2020-2021, including the period immediately after the COVID-19 pandemic outbreak. It was designed to cover the practices of the largest financial institutions in all three sectors.[5] It also incorporates insights from an industry workshop held on 18 and 19 May 2021 (May 2021 industry workshop) which was attended by executives of internationally active banks, insurance and asset management firms, and representatives from an industry association and a law firm.[6] Furthermore, it includes some of the latest regulatory developments up to the publication of this report, as appropriate.

1. Regulatory and supervisory framework

1.1. Regulatory and supervisory responsibilities

In most jurisdictions, regulatory and/or supervisory responsibility regarding firms' compensation is established by law. These responsibilities on compensation are laid out explicitly in many cases but, even without explicit reference to compensation, they are covered implicitly under a

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1 FSB (2009a), *Principles for Sound Compensation Practices*, April.

2 FSB (2009b), *Implementation Standards for the FSB Principles for Sound Compensation Practices*, September.

3 FSB (2019), *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Sixth progress report*, June.

4 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 (Turkey), 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.

5 The scope of the questionnaire was per jurisdiction, a maximum of the top five banks considered significant for the purpose of the Principles and Standards; the top three insurance firms by either total gross written premiums for general insurers or total liabilities for life insurers; and the top three asset management firms as measured by assets under management.

6 The summary of the workshop is available here.

broad mandate on the safety and soundness of the financial sector. In addition to enforceable standards, several authorities have issued additional guidance via supervisory circulars or guidelines, either regarding governance in general or on compensation specifically, to establish their views on sound practice.

During the COVID-19 pandemic, regulators found that their policies and guidance provided them with the necessary prudential tools, such as halting dividend payouts and share buybacks, as well as other supervisory actions, to protect the safety and soundness of firms. In general, a majority of jurisdictions have powers to issue directions and guidance to conserve capital including but not limited to dividend restrictions, limiting share buyback and restrictions on variable remuneration payouts. In most jurisdictions, banking authorities have powers to direct firms to hold back and/or limit bonuses especially in cases where there are concerns about capital conservation and/or to increase deferral periods. This is much less prevalent in the asset management and insurance sectors, as such supervisory powers exist in only approximately half of the jurisdictions. Notwithstanding a lack of legal power, regulators may take necessary measures to achieve similar outcomes in the form of recommendations and supervisory expectations.

1.2. Regulatory and supervisory approaches

Compensation practices are assessed as part of regular supervision in most jurisdictions, and inform the overall supervisory assessment. They feed into the supervisory rating of risk management on an ongoing basis and/or periodically (e.g. annually for significant firms but less frequently or on a risk-based basis for smaller firms). A review of compensation practices often forms part of a broader risk culture review.

- In Canada, recent supervisory work included gaining insights into the alignment of performance management and compensation with behaviour and culture. Supervisors gain insight into non-financial measures used to assess performance as part of ongoing reviews and/or monitoring of firms.

- The ECB assesses whether the compensation policies and practices include adequate ex ante risk alignment mechanisms (e.g. whether the KPIs are linked to risk control and conduct) and whether the compensation policies and practices are aligning individuals' behaviours with the risk appetite of the bank by means of ex post risk and performance adjustments (malus and clawback).

- In the UK, the Financial Conduct Authority (FCA) embeds its assessment of compensation into the broader assessment of the firm's culture to better understand the drivers of culture and the possible risks that could arise.

Supervisors use a broad range of practices to assess firms' compensation practices. A number of jurisdictions report that compensation practices are assessed through off-site reviews (typically involving a review of public disclosures and ad hoc information requests) and risk-based compensation reviews conducted by specialist teams or external consultants. In some cases, supervisors require firms to provide annual compensation reports, or to participate in industry-wide risk culture surveys that include questions on how compensation is perceived to influence behaviour. Common practices also include conducting periodic or risk-based on-site inspections.[7] These off-site reviews and on-site inspections often include dialogue (interviews and meetings) with representatives of firms' Boards, senior management and internal control functions.

In Singapore, as part of ongoing supervision, thematic reviews of compensation practices were conducted during on-site inspections of significant banks and insurers. The scope of such reviews included an assessment of how KPIs, both financial and non-financial, are aligned with prudent risk-taking and ethical behaviour. In the UK, reviews are completed annually utilising self-assessment forms for significant firms (in the case of banks and investment firms, less frequently in the case of insurers) with a wide set of information collected.

Many jurisdictions acquire information from firms to gain a more comprehensive understanding of the effective alignment of compensation practices and the use of non-financial measures. Information is collected on compensation and performance evaluation frameworks, management scorecards, performance appraisals, risk appetite statements and communications to staff related to compensation approaches. Minutes of the Board and Compensation Committee meetings and reports from internal and external auditors are also obtained. The European Banking Authority (EBA) collects quantitative compensation benchmarking data and data on high earners from banks and regularly publishes reports using this data. In Hong Kong, reports of independent remuneration review are obtained from banks. Supervisors in China and Italy (for insurers) ask for a specific compensation report different from disclosed information.

Some jurisdictions report that they do not regularly collect data on compensation. In some cases, supervisors instead review publicly disclosed information. For instance, mandatory banking disclosure requirements in India require disclosure of qualitative and quantitative compensation practices including disclosure on accounting for current and future risks in the compensation process, linkage of performance with compensation, and deferral and vesting policies/practices of the bank. In the insurance sector of India, no public disclosures are mandated but the insurance regulator collects and reviews information through other channels.

Box 1: Examples of effective supervisory practices

Self-assessment exercise and thematic review in Australia[8]

In 2018, the Australian Prudential Regulation Authority (APRA) wrote to the boards of 36 banks, insurers and registrable superannuation entities (RSEs) asking them to conduct a self-assessment on governance, culture and accountability and provide that assessment to APRA. From these self-assessments, APRA conducted over 60 supervisory engagements with boards and senior managers and reviewed a number of supporting documents. APRA identified common themes and provided specific observations to entities on the depth, challenge and insight from the self-assessments. Insights have informed supervisory action plans for these entities and targeted prudential engagements are underway.

Additionally, an APRA thematic review of Remuneration Practices at Large Financial Institutions, published in 2018, examined how remuneration frameworks and policies were translating into remuneration outcomes for senior executives. APRA's review analysed the remuneration process and

7 For many jurisdictions, on-site inspections were temporarily suspended in response to COVID-19 restrictions.

8 For further information, please see APRA (2019), *Self-assessments of governance, accountability and culture*, May, APRA (2019), *Transforming governance, culture, remuneration and accountability: APRA's approach*, November, and APRA (2018), *Remuneration practices at large financial institutions*, April.

outcomes of approximately 280 senior roles (800 data points) across the sample over the three-year period. Overall, the review found that remuneration frameworks and practices across the sample did not consistently and effectively meet APRA's objective of sufficiently encouraging behaviour that supports risk management frameworks and entities' long-term financial soundness.

The findings from these reviews have informed APRA's development of *Prudential Standard CPS 511 Remuneration*.[9]

Thematic inspections in Singapore[10]

In Singapore, the Monetary Authority of Singapore (MAS) conducted a thematic on-site inspection of compensation practices for several banks in 2018, covering in particular the incentive structures of front office staff in the private banking, global markets and corporate banking businesses. The review focused on the governance of, and frameworks and policies for, performance evaluation, remuneration and consequence management, and whether these were aligned with the FSB Principles and Standards. The inspection included: a review of the frameworks, policies and procedures; interviews and discussions with management and staff; process walk-throughs; and review of samples of staff performance appraisals and disciplinary cases. The MAS held industry roundtables and townhalls in 2019 to share the observations from the review and exchange views with the industry. This was followed by a 2019 information paper on the desired outcomes relating to incentive structures and good practices observed from the review. The MAS also issued another information paper in 2020 on private banking sales and advisory practices following thematic inspections of selected private banks in 2018 and 2019.

A thematic inspection of compensation practices for significant insurers was also performed in 2018. The scope of the review included governance of remuneration structure and indicators used in performance evaluation. The desired outcomes and good practices identified in MAS' 2019 information paper are also relevant and applicable to insurance companies. Industry dialogues and townhalls have similarly been conducted with all licensed insurers to share about the good practices and desired outcomes as set out in the information paper.

Periodic data collection in the UK[11]

In the UK, the Prudential Regulation Authority (PRA) and FCA conduct annual reviews of the compensation arrangements of significant banks and investment firms. The reviews are based on detailed self-assessment forms, so-called Remuneration Policy Statements (RPS), which collect information on both policies and their application to material risk takers (individual and collective data). These, together with document analysis and interviews with board members and senior management, are used to assess compliance with the compensation requirements, compare firms' practices, and assess rules' effectiveness. The UK authorities analyse cross-firm and key issue trends and communicate these outcomes to firms directly through a letter to the Chair of the Remuneration Committee. These letters are also made public as the messages are useful for a wider group of firms.

9 Prudential Standard CPS 511 Remuneration (CPS 511) will be effective from 1 January 2023 for banks classified as significant financial institutions (SFIs), 1 July 2023 for insurers and RSEs classified as SFIs and 1 January 2024 for all other entities. For this report, Australian practices considered current prudential requirements and CPS 511. CPS 511 further reinforces Australia's approach to the implementation of the FSB Principles and Standards. Please see here for CPS 511.

10 For further information on the outcome from the review and supervisory expectations, please see MAS (2019), *Incentive Structures in the Banking Industry – Fostering Sound Behaviour and Conduct*, March and MAS (2020), *Private Banking Sales and Advisory Practices*, February.

11 For further information on the UK supervisory approach on compensation and the results of the FSB peer review, please see FSB (2021), *Peer Review of the United Kingdom*, April. The letters can be found in the 'More information and guidance' section of the remuneration code page.

2. Governance mechanisms

2.1. Board and the Committees

Robust governance, including Board[12] oversight, appropriate involvement of independent internal control functions and the appropriate use of discretion, are fundamental to the effectiveness of compensation practices. In most jurisdictions and across sectors, the role of the Board involves overseeing the implementation of compensation policies, including the risk adjustment of compensation, leveraging the support of the Compensation and Risk Committees. However, setting up of specific committees is not mandatory in all jurisdictions.

The roles of the Board and the Board committees differ in terms of involvement and allocation of responsibilities. It ranges from the case where the Compensation Committee is primarily entrusted with an oversight role of the compensation risk-alignment to having powers delegated from the Board in matters concerning compensation adjustment. The Board, on proposal of the Compensation Committee or CEO where appropriate, reviews and approves the compensation policy and validates the annual variable compensation for material risk takers (MRTs) as well as the CEO, and the heads of key internal control functions.

The Compensation and Risk Committees play a supporting and advisory role to the Board. The Compensation Committee is responsible for the setting up and monitoring of the general compensation framework while the Risk Committee provides input to align the compensation system to the relevant institution's risk. Other committees may also be involved. Practices of interaction and cooperation among the committees include:

- **Joint sessions of the Compensation and Risk Committees**: Both committees interact by engaging in the design of the risk and compensation frameworks. The Compensation Committee obtains input or receives periodic reports from the Risk Committee, including reports to inform compensation adjustments. The Risk Committee reviews the alignment of compensation plans with the risk management objectives and recommends approval of indicators and metrics included in the bonus pool.

- **Shared membership**: There is a regulatory requirement for the Compensation Committee to share one member with the Risk Committee to bring a deeper understanding of key business and risk issues. The Chair and members of the Compensation Committee may also sit on other committees, such as the Risk Committee, though this is not necessarily a legal or regulatory requirement.

- **Through CRO evaluation**[13]: Even if the Risk Committee does not have any direct oversight of the incentives and compensation process, it is still directly involved in the CRO's KPIs setting, performance evaluation and compensation package approval.

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[12] There are different governance structures across jurisdictions. For example, Germany has a 2-tier-structure, where the "Management Board" is supervised by a "Supervisory Board" which is primarily responsible for overseeing the "Management Board" and its activities. In addition, names and mandates of committees vary among jurisdictions and firms.

[13] This also applies to MRTs.

- **Through CRO report**: The Risk Committee reviews the CRO reports on material risk events which form the basis of decisions around collective and individual variable remuneration adjustments and often include consideration of exposure to current and future risks, reflecting a downward adjustment, taking into account the firm's risk profile and the cost of capital. The Risk Committee chair and/or the CRO has a further opportunity to input into the Compensation Committee's decisions on adjustments.

Box 2: Examples of proactive involvement of the Board

A bank in the US

The Board is expected to receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organisation's incentive compensation arrangements may be promoting imprudent risk-taking. Furthermore, the Board is expected to consider periodically obtaining and reviewing simulation analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes, and the amount of risk taken.

An insurer in Canada

A committee of the Board reviews the grant value and outstanding value of all salary, bonus and long-term incentive awards over the past five years for each member of the executive team. The committee also reviews stress-testing analysis of the potential value of outstanding equity awards for executive team members over a range of future share prices.

The committee has the discretion to lower or zero out incentive awards to individuals or groups, if they conclude results were achieved by taking risks outside of approved risk-appetite limits.

An asset manager in Russia

The Board approves any payment of severance compensation where an employment contract with an employee is terminated and the proposed payment exceeds five times the monthly salary of the employee. The Board is also directly involved in the conclusion of collective agreements.

2.2. Internal control functions

The involvement of the internal control functions (e.g. compliance, risk management and internal audit) that are independent of the revenue generating business units in the review of the compensation policies and their implementation varies across jurisdictions and sectors. Practices include:

- The internal control functions provide input to the relevant Board committees, in particular the Compensation and Risk Committees. They provide input to the quantitative and qualitative criteria used for the ex ante risk adjustments that align variable remuneration with the risk appetite framework.

- The internal control functions review and advise on the risk events of individuals that could trigger clawback or malus. They also observe the behaviour of the individual staff members and provide feedback for the purpose of setting the individual and collective bonus pools.

- The internal control functions are involved in defining KPIs. With a growing importance of non-financial measures, internal control functions' role in interweaving the holistic view of the firm and the risks is pivotal for ensuring strong compensation practices.

Box 3: Examples of internal control functions involvement

A bank in Europe supervised by the SSM

The bank's control functions provide input to its key committees. They are, in the context of the tasks and responsibilities assigned to them, involved in the design, application and monitoring of the bank's remuneration systems and in the review of identification of MRTs at group level and legal entity level.

They also contribute to the determination of the total amount of variable remuneration and to the assessment of the MRTs' behaviour, conduct, business-related risks, performance criteria and granting of remuneration, including severance and ex post risk adjustments.

In particular, the audit function provides an independent and objective assurance on the adequacy of the design, operating effectiveness and efficiency of the risk management system and the internal controls systems through recurring audit procedures on the remuneration system and its constant reporting to maintain a robust governance structure.

With regards to malus and clawback specifically, the control functions have an obligation to provide information and advice to the appropriate local and group decision-making bodies on relevant malus and clawback potential triggering events to enable decision-making.

Annual audit controls and linking detected violations to salaries and bonuses in an asset manager in China

The audit departments of asset managers in scope conduct audits every year to detect potential irregularities. If these special audits, accompanied by daily supervision and inspection of sensitive behaviour, detect violations, corresponding penalties are applied. The consequences of such accountability violations will be linked to employee salaries and bonuses.

3. Effective use of metrics/criteria and compensation tools

3.1. Measurement of performance and variable compensation setting

Across jurisdictions and sectors, firms set the overall variable compensation pool by using a wide range of metrics and criteria. Those used especially for senior management may be classified into two broad categories: financial and non-financial measures. However, there is no common taxonomy to classify such metrics and criteria into financial and non-financial categories, which creates some differences across firms and jurisdictions. Irrespective of the classification, better practice is for firms to adopt a holistic approach to selecting measures used to incentivise staff and, in doing so, ensuring that compensation is adjusted for all types of risk.

Financial metrics

This type is the most common metric used across sectors and jurisdictions to set the size of the bonus pool. More specifically, the size of the bonus pool depends on the company's yearly financial performance that is determined through profit and income-related metrics, such as income before tax, net profit, earnings per share (EPS) and total shareholders return (TSR). The insurance industry also uses some indicators specific to this sector, such as premiums, while asset managers also use fund performance, including ranking.

Risk-adjusted metrics can be positioned as subsets of financial metrics in that they are financial metrics more closely related to risk and/or they are performance metrics adjusted for risk. The industry uses several risk-adjusted metrics to account for different types of risk, such as credit, liquidity, market and operational. Common risk metrics include: profit measures adjusted for prudential valuation, economic value added, (risk-adjusted) returns on risk-weighted assets, (risk-adjusted) return on capital ((RA)ROC) and (risk-adjusted) return of equity ((RA)ROE). Some risk/performance management metrics such as non-performing loans (NPLs) and revenue volatility, and key regulatory indicators such as Common Equity Tier 1 (CET1) and liquidity ratios also are types of financial metrics.[14]

Non-financial metrics

Many jurisdictions report that firms also account for non-financial types of risks and objectives. Although there are no common definitions, there are some commonalities in what constitutes non-financial measures, with some variances observed in the specific definitions used between jurisdictions. These include measures that: i) are not financial (e.g. measures related to profit, revenue, sales); ii) support prudent risk management (e.g. risk appetite metrics, such as operational incidents, and other risk-related metrics, such as anti-money laundering (AML) and know-your-customers (KYC)); or iii) promote broader ESG objectives (e.g. measures related to climate change or diversity and inclusion).[15] Non-financial measures can be both quantitative and qualitative, and so are not necessarily non-quantifiable.

Table 1: Examples of non-financial measures

Types	Examples
Risk appetite	Strategic, reputational, operational (including legal), insurance risk related measures
Risk management	Control effectiveness, conduct, regulatory and audit findings, risk culture survey results, customer satisfaction/complaints, execution of risk remediation programs
ESG	Climate and environmental sustainability, diversity and inclusion, talent management, leadership, cooperation and teamwork

Box 4: Effective practices of non-financial measures

Better practice observed is for firms to use non-financial measures that are most relevant to their strategy and risk profile. Non-financial measures should align employee incentives with the firm's purpose and reflect the time horizon of risk. Non-financial measures may be based on quantitative or qualitative criteria, or a combination of both. Purely discretionary measures often do not provide clarity to employees on what the firm values. Better practice is to use measures, where available, that are quantifiable and not purely discretionary.

Non-financial measures may be at an individual level and/or firm level. Firm-level non-financial measures often reflect collective risks. Individual non-financial measures should align to the firm's risk profile and reflect the individual's role and responsibilities, including consideration of span of control.

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[14] Some of these risk-adjusted and risk management metrics could be classified as non-financial metrics or fall between financial and non-financial metrics.

[15] Some of these metrics could be classified as financial metrics or fall between financial and non-financial metrics.

3.2. Growing importance of non-financial measures

Non-financial measures now drive a larger proportion of variable compensation than they did previously. Firms across all three sectors have increasingly incorporated non-financial measures into the determination of variable compensation for staff. Various industry representatives at the May 2021 industry workshop indicated that the KPIs used in their employees' compensation scorecard increasingly include non-financial metrics, even where not required by the relevant regulations. Firms' focus on risk management has been the main driver of a wider use of non-financial metrics. Recently, firms have started to place more importance on firms' culture and societal expectations and therefore have increasingly incorporated ESG metrics, with any regulatory requirements setting a minimum standard.

A firm's selection of non-financial measures is critical in articulating, shaping and promoting incentives for employees that are aligned with the firm's purpose and reinforce the desired risk culture. When selecting non-financial measures, better practice is for a firm to take a holistic view of the composition of financial and non-financial measures and, where possible, select measures that are reliable and can be independently verified. This increases the importance of effective design, supervision and disclosure of these criteria.

To implement effective non-financial measures in the design of a firm's compensation practices, supervisors have observed that leaders within a firm play an important role in strengthening the link between non-financial measures and compensation. Leaders can advocate the importance of non-financial measures, while taking care not to do so at the detriment of other equally important criteria and measures, particularly with respect to a firm's financial resilience.

Box 5: Example of recent legislation related to sustainability in the EU

Against the backdrop of increasing efforts to promote sustainable development and reduce the risks and impacts of climate change, the EU has introduced various policy frameworks and measures. In November 2019, the EU adopted regulation on sustainability-related disclosures in the financial services sector. The regulation covers asset managers and financial advisers, and seeks to achieve more transparency regarding the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information.

The regulation requires asset managers and financial advisers to publish and disclose their policies on the integration of sustainability risks and adverse sustainability impacts. In addition, specifically in relation to remuneration, the regulation requires financial market participants and financial advisers to include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks, and to publish that information on their websites.

3.3. Recent observations on non-financial measures in regulatory and supervisory frameworks

3.3.1. Regulatory requirements or supervisory guidance

Many jurisdictions have implemented regulatory requirements or issued supervisory guidance on the use of non-financial measures for compensation practices. Regulatory requirements or supervisory guidance are in place in over 75% of jurisdictions for banks, and approximately 60% of jurisdictions for insurers and asset managers. Some jurisdictions have issued non-binding guidance on the use of non-financial measures for compensation practices. Guidance often establishes an authority's view on sound practice. Although it may lead to inconsistent implementation across firms, non-binding guidance provides firms with flexibility to adopt non-financial measures in a manner that is best suited to aligning compensation practices with their business model and objectives.

Table 2: Regulatory requirements or supervisory guidance on non-financial measures

	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
Banks		x		x	x	x	x	x	x	x	x			x	x	x	x	x	x	x	x	x	x	x
Insurers		x		x	x	x	x	x	x		x				x			x	x	x	x	x	x	
Asset Managers		x		x	x	x	x			x	x			x	x			x	x	x	x		x	*

* No information was provided.

The application of non-financial measures, through either regulatory requirements or supervisory guidance, is often proportionate to a firm's size or risk profile. For example, some jurisdictions apply requirements to the largest and/or the most significant firms reflective of the Principles and Standards. Jurisdictions use a variety of methodologies to identify such firms, including asset thresholds for banking and insurance and funds under management for asset managers. Such an approach minimises regulatory burden on smaller firms and provides them with information about better practice to inform the design of compensation practices.

Both within and across sectors, the majority of authorities outline regulatory requirements or supervisory guidance to give consideration to both financial and non-financial measures when assessing individual performance in determining compensation. Additionally, some jurisdictions have more prescriptive requirements related to non-financial measures, for example by requiring a balance or appropriate mix of financial and non-financial measures, or by requiring material weight or due weight to be given to non-financial measures.

For instance, Australia has conducted further work to strengthen the use of non-financial measures in compensation design through implementing a requirement for firms classified as significant financial institutions to give material weight to non-financial measures where remuneration is performance related. The UK authorities require variable remuneration, which includes both short-term and long-term incentive arrangements, to be based on a balance of both financial and non-financial metrics.

Box 6: Example of non-financial measures requirement in the Netherlands

In the Netherlands, the Financial Supervision Act prescribes that the remuneration policy of banks, investment firms and insurers, among others, shall include the criteria and performance on which the variable remuneration is based, including the performance of a natural person working under its responsibility, the business unit and the company. In assessing the performance, both financial and non-financial criteria shall be used. At least 50% of the variable remuneration shall be based on non-financial criteria.

The explanatory memorandum to the Financial Supervision Act provides as examples of non-financial criteria the degree to which the following goals are achieved: strategic goals, customer satisfaction, compliance with risk management policies, compliance with internal and external rules, leadership, management skills, cooperation with other persons and business units, creativity, motivation, sustainability and social awareness. Negative results with respect to non-financial criteria, in particular concerning unethical or non-compliant behaviour, cancel out positive results with respect to financial criteria.

3.3.2. Requirements on disclosure of non-financial measures

Principle 9 of the Principles and Standards specifies that firms should be expected to disclose clear, comprehensive and timely information about their compensation practices to inform constructive engagement by all stakeholders. Public disclosure enables stakeholders to evaluate the effectiveness of a firm's alignment of compensation policies, including their use of non-financial measures, with their objectives. Meaningful public disclosure should sufficiently explain how non-financial measures has influenced compensation outcomes, and how this relates to the performance and financial resilience of the firm.

Regulatory requirements on disclosure of non-financial measures are in place in over two-thirds of jurisdictions for banks and approximately half of jurisdictions for insurers and asset managers. Where jurisdictions have public disclosure requirements for non-financial measures, the requirements typically relate to both quantitative and qualitative information. Notably, disclosure requirements are more developed in the banking industry. The Basel Committee on Banking Supervision (BCBS) Pillar 3 disclosure requirements provide a framework for disclosure of compensation policies and practices, where large banks are expected to disclose quantitative and qualitative information about their compensation practices. In addition to Pillar 3 disclosure requirements, many large banks and other firms disclose non-financial measures through firm-specific annual external publications. For example, Swiss regulation requires disclosure of compensation design and assessment criteria, including non-financial measures.

Table 3: Regulatory requirements or supervisory guidance on disclosure of non-financial measures

	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
Banks		x	x	x		x	x	x	x		x	x	x	x	x		x	x	x	x	x		x	x
Insurers		x		x			x				x	x	x		x			x	x		x		x	x
Asset Managers		x		x		x	x						x		x		x		x	x	x		x	x

Even without the existence of regulatory requirements, an increasing number of firms are disclosing more information in relation to non-financial measures, to respond to higher expectations from stakeholders by enhancing transparency on how compensation practices are promoting sound risk management and long-term objectives. For example, many jurisdictions have observed increasing stakeholder interest in ESG issues and diversity and inclusion, and how these objectives are addressed by the design of compensation arrangements.

3.4. Alignment of risk and compensation

To ensure alignment of compensation with long-term value creation and the time horizon of risk, an appropriate balance between financial and non-financial measures is necessary to account for both short-term and long-term firm performance objectives and risks holistically.

These measures are best supported by a mix of instruments (e.g. cash and shares) to pay compensation, and are subject to in-year ex ante adjustment and deferral arrangements complemented by ex post adjustment tools (e.g. malus or clawback provisions). Additionally, financial and non-financial gateways and/or modifiers that reduce variable compensation in case of underperformance, the breach of risk management and misconduct strengthen the link between compensation and effective alignment with risk outcomes.

Box 7: Examples of alignment of risk and compensation

India's new regulation in asset management sector[16]

In India, to align the interest of the key employees of asset management companies with the unitholders of mutual fund schemes, the Securities and Exchange Board of India (SEBI) introduced in July 2021 the regime where minimum 20% of compensation of the key employees should be paid in the form of units of the mutual fund scheme(s) in which they have a role/oversight. Such units will be locked in for a minimum period of three years or tenure of the scheme, and be subject to clawback in the event of violation of code of conduct, fraud and gross negligence.

Review of asset managers' compensation policies, including risk alignment, in France

Asset managers' compensation policies are subject to requirements under the Alternative Investment Fund Managers Directive (AIFMD) and Undertakings for Collective Investment in Transferable Securities Directive (UCITS V Directive) (Directives 2011/61/EU and 2014/91/EU, respectively), supplemented by the European Securities and Markets Authority (ESMA) guidelines and AMF guidance. They are reviewed by the Autorité des Marchés Financiers (AMF) during the initial firm authorisation process and must be reviewed annually by the firm's internal audit function. Major changes in the asset manager's practices are also submitted to the AMF. Regulation requires the existence of a "Risk Takers Classification Policy" and application of deferred variable remuneration. An additional requirement is to link part of the variable compensation to the fund performance and avoid any excessive risk-taking practices via a malus mechanism.

While the AMF cannot take ownership of asset manager compensation decisions, it can reject a firm's compensation policy (e.g. if it fails to meet deferral requirements). In addition, the AMF has an injunction power to force a regulated actor to do (or not do) something if they do not comply with applicable regulation (i.e. there is an actual or potential threat of not meeting applicable capital requirements). However, this power has thus far not been used on compensation-related matters.

Ex ante risk adjustment process in a bank in Europe supervised by the SSM

The total amount of variable remuneration for any given performance year is initially determined at group level, taking into account the bank's affordability parameters, and then allocated to divisions and infrastructure functions based on their performance in support of achieving the bank's strategic objectives.

As a first step, the bank assesses the profitability, solvency and liquidity position in line with its risk appetite framework, including a holistic review against the bank's multi-year strategic plan, to determine what the bank "can" award in line with regulatory requirements (i.e. group affordability).

In the next step, the bank assesses group and divisional risk-adjusted performance, i.e. what the bank "should" award in order to provide an appropriate compensation for contributions to the bank's success.

In a final step, the bank compares and aligns the determined variable remuneration levels to the accrual to ensure the bank remains safe and sound and can return to or maintain its profitability over the coming years. For example, if what should be awarded exceeds what can be awarded, the remuneration could be adjusted downward. In addition, if the profitability is expected to decline and/or solvency/liquidity position is expected to deteriorate in the next years, the remuneration in the current year may not be as large as the current year's result alone could imply.

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[16] For further information, please see SEBI (2021), *Alignment of interest of Key Employees of Asset Management Companies (AMCs) with the Unitholders of the Mutual Fund Schemes*, April.

3.5. Promotion of sound culture and positive behaviours

Firms often use compensation arrangements to promote their desired culture by incentivising positive behaviours and, where appropriate, reducing compensation to respond proportionately to poor behaviour and misconduct. Firms also use them to establish and promote appropriate risk culture and governance. A balanced scorecard that includes financial and non-financial measures is a common tool used by firms to promote a sound culture that is aligned with the firm's values, strategic objectives and risk appetite. Some firms have also introduced 360º review processes[17] to measure areas that are more difficult to capture through KPIs but are better observed by other colleagues (e.g. collaboration, risk awareness).

The FSB *Recommendations for national supervisors: Reporting on the use of compensation tools to address potential misconduct risk*[18] focused on the effective identification of emerging misconduct risks and appropriate review of incentive systems and compensation decisions in response to conduct incidents to ensure alignment of incentives, risk and reward. Increasingly, firms are using non-financial measures to not only discourage misconduct but also reinforce firms' core values and culture, thereby encouraging positive behaviours like leadership, innovation and creativity. Such use of non-financial measures can set cultural expectations by responding to positive behaviours through compensation uplift and downward adjustment of compensation for misconduct.

Across jurisdictions, stakeholders of firms are expecting higher levels of transparency to explain how compensation is supporting drivers of long-term value creation, such as sound firm culture that is aligned with a firm's values. Effective practice is for firms to demonstrate publicly, often through quantitative and qualitative disclosure, how selected financial and non-financial measures drive value. It is equally important to ensure transparency internally within the firm. Clear internal communication to staff in relation to the respective metrics would enable staff to understand the expectations towards them.

Box 8: Example of promotion of sound culture

Customer-oriented business conduct in Japan

The Japan Financial Services Agency (FSA Japan) established "Principles for Customer-Oriented Business Conduct" in 2017 (revised in 2021). These principles, which are not regulations but adopt a "comply or explain" approach, have been widely accepted by asset managers.

One of these principles asks financial service providers to develop frameworks for motivating employees appropriately, including remuneration and performance evaluation systems designed to encourage conduct such as actions to pursue customers' best interests, fair treatment of customers, and appropriate management of conflict of interest.

Based on these principles, compensation policies are publicly disclosed on asset managers' websites. For example, some asset managers set their KPIs taking into account an appropriate balance between short and mid-to-long term incentives. The objective is to design compensation frameworks based on comprehensive assessments such as contribution to mid-to-long term performance.

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[17] A 360º review is a performance evaluation tool that solicits feedback for an employee from all directions (their managers, co-workers and direct reports).

[18] FSB (2018), *Recommendations for national supervisors: Reporting on the use of compensation tools to address potential misconduct risk*, November.

3.6. Closer focus on CEO/CRO compensation

3.6.1. CEO compensation

A blend of financial and non-financial measures commonly determines CEOs' compensation. Some firms across the three sectors adopt a formulaic approach, allocating explicit weights to each financial target (e.g. a specific percentage of the CEO bonus is determined by a certain metric), as well as establishing an overall balance between financial and non-financial metrics. Typically, in a formulaic approach, discretion may still be applied in establishing the final variable compensation. Other firms do not assign explicit weights and may rely more on the professional judgement and discretion of the Compensation Committee.

It should be noted that firms and jurisdictions often have diverging interpretations of what constitutes financial or non-financial measures (see Section 3.1). Certain categories of performance indicators, such as operational strategic objectives, can be identified as either financial or non-financial. For example, customer related strategic targets, such as net promoter score[19], have been identified as either financial or non-financial in different jurisdictions. In the asset management sector, compensation of CEOs is also generally assessed based on their ability to execute the asset managers' strategies, for example: broadening of distribution channels; enhancing investment capabilities; and retaining customers.

For the cases where a formulaic approach has been disclosed, financial metrics have a predominant impact on the CEO's variable compensation in most cases (i.e. their relative weight is higher than non-financial measures). Financial and non-financial metrics are evenly balanced in fewer cases (i.e. each weight with 50%). In instances where non-financial metrics had a higher relative weight than financial metrics, this was typically where non-financial metrics included risk-related metrics (such as anti-money laundering risk management or risk culture).

Among the adopted financial measures, in most cases the non-risk-adjusted metrics determine the majority of CEOs' pay. The most common non-risk-adjusted metrics include financial performance metrics (e.g. revenues, ROE, net profit, underwriting margins, net premium growth, fund performance, EPS and TSR) and other firm-specific strategic targets (e.g. market share and cost/efficiency metrics). Risk metrics or risk-adjusted metrics (e.g. risk adjusted return on capital (RAROC), risk-weighted assets reduction, return on risk capital, asset quality, and risk appetite breaches) were present but not used as often or as extensively as non-risk-adjusted financial metrics. A focus on non-risk-adjusted performance criteria could undermine an effective alignment of compensation and risk-taking.

When minimum underpinning financial measures (or gateways) are used in incentive structures, they determine whether any variable compensation is payable to the CEO and tend to be linked to prudential requirements. In a few cases firms reported a direct link between the CEO's compensation and capital planning (e.g. in relation to results of Internal Capital Adequacy Assessment Process), capital adequacy, or other metrics influencing capital adequacy (e.g. risk-weighted assets).

[19] Net promoter score typically measures customers' experience and satisfaction through survey questions with rating scales.

In order to align individual interests and a firm's long-term financial performance, a common approach is for firms to adopt a long-term horizon in setting the objectives of the CEO and judging the CEO's performance. Firms are increasingly applying financial and non-financial performance measures over longer time horizons to strengthen alignment with risk. CEOs are compensated by a mix of instruments and cash, deferred over a number of years. Practices have been evolving from stock options and common stock to more widespread use of stock units that mimic the financial performance of common stocks but have different rights, such as cash-settled restricted stock units (CRSUs)[20] and restricted stock units (RSUs)[21]. Convertible debt (and similar instruments) is not commonly used.

Another approach is to adjust annual performance using longer-term risk adjustments. These are backward looking over more than one year and linked to cost of funding. This method applies limits (floor and ceiling) as well as countercyclical adjustments to the payout ratio of the CEO to reduce volatility of variable compensation and the procyclicality of the CEO's total compensation. It tends to ensure that fluctuations in the CEO's total compensation are not extreme, with the adjustments for risk and balanced scorecard (including non-financial metrics) ensuring that less profitable years are not followed by excessive rewards.

3.6.2. CRO compensation

CROs in most jurisdictions are compensated using an approach that is consistent with Principle 3 of the Principles and Standards, which expects staff engaged in financial and risk control to be compensated in a manner that is independent of the business areas they oversee, and commensurate with their key role in the firm.

Firms tend to use different composition and performance evaluation metrics for the CRO than those used for the CEO. To align the incentives to the responsibilities and desired behaviours, variable compensation of CROs is commonly based on functional role objectives such as risk management and compliance metrics. KPIs for the CRO also fall into commonly used categories: regulatory; corporate governance or leadership; customer satisfaction; employee or talent management; and business culture or strategy. As with the CEO, some firms take a formulaic approach to CRO compensation while others do not assign explicit weights and may rely more on judgement for compensation decisions.

Non-financial metrics used for the CRO include (but are not limited to): monitoring and adherence to specific risk limits; internal and external audit results; internal risk control; compliance with regulatory requirements; operational resiliency; articulation of key risks; and enabling proper understanding by management about firm risk. Across all sectors, there was increasing emphasis on promoting the firm's risk culture. In addition, some jurisdictions reported handling of innovation related risk, IT/digital operations and climate and green investing related metrics.

Financial metrics, especially profitability (e.g. revenues, ROE, net profit), make up a smaller share of measures (typically less than 50% of the overall assessment) for the CRO in

[20] Track stock price over the determined vesting period.

[21] Vest based on future achievement on specific profitability metric. Most firms had a three to four-year vesting period.

comparison to the CEO. Some differences are observed between sectors. In the banking and insurance sectors, almost all jurisdictions reported the use of profitability metrics, including risk-adjusted metrics. In contrast, in the asset management sector, only some jurisdictions reported that their firms used profitability metrics. The most commonly used profitability metrics are ROE, return on tangible equity (ROTE), and return on average tangible common shareholders' equity (ROTCE). Others include profit before tax, net profit, return on assets, EPS growth, revenue, adjusted profit and loss (P&L), and improvement on ROE. For the banking sector some jurisdictions have firms that use metrics related to credit performance (e.g. NPL ratios). For the insurance sector, some jurisdictions noted that firms measure and use market share.

In some jurisdictions, cost-related metrics are used to evaluate the CRO's performance. Such metrics can come with inherent risk. While less common, these metrics are often focused on cost savings and cost efficiency, possibly resulting in under investment in financial and risk control functions. An overt focus on cost could encourage behaviour that runs counter to strong risk management practices, so these firms must also balance their variable compensation plans with risk-centred metrics.

3.7. Experience during the COVID-19 pandemic

The COVID-19 pandemic has tested how compensation frameworks operate under times of stress in the financial markets. Firms have applied their policies and procedures, including the use of discretion, under their governance mechanisms in response to current and future risks. Most compensation frameworks have been sufficiently flexible to respond to the prolonged pandemic, although firms continue to monitor and assess the effects of COVID-19. Compensation policies and effective governance already in place could deal with economic uncertainty, and poor performance was generally reflected in financial or non-financial measures. Although some firms introduced some temporary measures, several firms surveyed by the CMCG and invited to the May 2021 industry workshop said that there was no need for an overhaul of their compensation frameworks as they have proved effective.

Nevertheless, firms took some actions to respond to greater economic uncertainty and changes in the external environment.[22] The most common were cancellation or reduction of bonus pools or individual bonus distributions.[23] In some cases, a progressive approach was taken based on seniority (i.e. a higher level of reduction for more senior roles). Senior management in some firms voluntarily accepted pay cuts/cancellation of variable remuneration. Some firms took alternative actions, such as longer deferral periods or modification of the payment instruments.

Examples of modifications to compensation schemes include:

- Increasing the weight of controls over sales (a bank)

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[22] Some firms noted public perception was also one of considerations.

[23] In some cases, these measures were taken in response to regulatory restrictions and/or expectations on compensation. For example, authorities asked banks to suspend cash bonuses for senior staff and MRTs in South Africa and the UK, and asked banks and insurers to limit cash bonuses for executives in Australian. Authorities in Brazil and Canada requested suspension of increase in compensation and those in Russia and the EU communicated supervisory expectation that the deferred portion and the length of deferral of compensation be increased.

- Assessing management performance based on maintaining operations and ensuring employee and customer resilience and wellbeing (a bank)

To alleviate the impact of COVID-19, some firms:

- Created a separate instrument to prevent talent leakage because long-term incentive (LTI) vesting conditions were not met and could possibly not be met later (a bank)
- Amended certain long-term financial targets to reflect the economic impact of the pandemic (a bank)
- Provided COVID-19 related remuneration support (an asset manager)

These responses by firms have highlighted the importance of flexibility in compensation structures to account for disruptive events. Changes to compensation schemes may be ongoing.

4. Legal and regulatory challenges to the effective use of compensation tools

Compensation tools provide employers with a way of delaying compensation (deferral), and adjusting or claiming back pay that has been awarded, vested and/or paid out (e.g. in-year adjustments, malus, clawback).[24] In addition to being used to align compensation with risk, such tools can also play an important role in mitigating and addressing misconduct risk. In 2018, the FSB published supplementary guidance on the use of compensation tools to address misconduct.[25] While these tools are embedded in firms' compensation regimes, legal and regulatory challenges hinder their effective use, particularly clawback.

This report also considers severance payments, which is an area of increasing interest in terms of its potential to be used to circumvent the alignment of risk and compensation, particularly as severance packages paid to MRTs can be quite material in some jurisdictions.[26]

4.1. Malus

Besides in-year adjustment, malus is the most commonly used compensation adjustment tool to adjust downwards unvested variable remuneration during the period where compensation is deferred. While all jurisdictions have regulatory requirements or supervisory guidance on the use of deferral in the banking sector, not every jurisdiction sets minimum deferral periods – for example, Canada, Mexico and the US have principles-based guidance, which allows firms to set their own deferral lengths according to the nature of risks.

In contrast, the use of deferral by insurers and asset managers is not as widespread. This may be explained by the lack of regulation or guidance in many jurisdictions for these sectors.

[24] The exact definition may vary between jurisdictions.

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

[26] Some jurisdictions require firms to make severance payments when making employees redundant. These legally required severance payments (redundancy packages, in particular as part of redundancy programmes) are not in the scope of this report.

Regulatory requirements or supervisory guidance for minimum deferral periods are set in over half of jurisdictions for the insurance sector and approximately one third of jurisdictions for the asset management sector.

The minimum deferral period is generally three years in all sectors, but several jurisdictions impose a longer deferral period. In the EU, the Capital Requirements Directive V (CRD 5) has increased the minimum deferral time for banks to at least four years, and for members of the management body and senior managers of significant banks, five years. In the UK, prudential regulations require firms to defer at least 40% of the variable remuneration award for at least four years, rising to five or seven years for individuals with certain senior management functions.

Many significant banks have longer deferral periods due to their group or individual firm compensation policies, even in jurisdictions without prescriptive rules. In determining the optimal length of deferral, firms try to balance variable remuneration needing to be deferred for a sufficient period to allow for risk alignment, while avoiding the perception that the payout is discounted and remaining competitive to attract talent.

Further progress on the regulation or supervisory guidance of deferral periods for the asset management and insurance sectors would pave the way for a wider application of this essential tool.

Table 4: Minimum deferral period

	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
Banks	3	+	3	-	3	+	+	3	3	3	+	3	3	-	+	3	3	3	-	+	+	-	+	-
Insurers	-	+	-	-	3	3	3	3	3	3	3	-	3	-	3	-	-	3	-	3	+	-	3	-
Asset Managers	-	+	-	-	3	3	+	-	-	-	+	-	3	-	+	-	-	-	-	3	+	-	+	-

3 = 3 years; + = more than 3 years; - = not applicable

4.2. Clawback

4.2.1. Approach to clawback – Difference among sectors and jurisdictions

Clawback is an important risk alignment tool. Although its use and benefits are largely untested, there is some data and information available on the application of clawback. The incidence and applicability of clawback varies more across jurisdictions than between sectors within the same jurisdiction, as the limitations associated with clawback imposed by labour legislation or contractual obligations typically apply across all sectors within a jurisdiction.

Many jurisdictions, including those with contractual and/or legal impediments to the use of clawback, have issued supervisory guidance on the application of clawback. France and Spain have created special provisions/laws that would allow for clawback to be implemented in spite of general labour laws. Australia released a new prudential standard in August 2021 to progressively implement clawback requirements for all three sectors at large/significant institutions for individuals in key roles (including the CEO, senior managers and highly-paid MRTs). Challenges both in attempting to issue supervisory guidance and in the use of clawback persist in several jurisdictions.

Table 5: Regulatory requirement or supervisory guidance on the application of clawback

	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
Banks		x		x	x	x	x	x	x	x	x	x	x		x		x	x		x		x	x	x
Insurers		x		x	x	x		x	x	x	x	x	x		x			x						x
Asset Managers		x		x	x	x	x		x		x		x	x	x					x			x	*

* No information was provided.

4.2.2. Potential legal barriers and practical difficulties

Across sectors and jurisdictions, the enforcement of clawback provisions continues to be met with challenges, the most significant of which is labour legislation overriding the use of clawback. In addition, there is a jurisdiction where clawback, even though allowed, may only be made applicable to financial institutions under resolution and even then only under court order.

Approximately half of the jurisdictions stated that despite having no legal challenges, there were practical challenges to applying clawback. These include:

- Difficulty in proving individual accountability/culpability and in determining the scope and quantum of the clawback;
- Difficulty in recovering the amount from the individual (more so, if the individual is no longer employed with the firm, or if, in case of equity awards, they have been transferred onwards by the employee);
- Difficulty in determining an appropriate period of applicability of clawback (i.e. perpetual clawback is not practically feasible and difficult to enforce);
- Possibility of legal challenge and the lack of legal precedent;
- The cost of legal action being higher than the amount due for recovery;
- Challenges in accounting/taxation/social security treatment of reversals;
- Significant variation in the legal standards for enforceability of clawback (especially for firms operating in multiple jurisdictions);
- Older contracts not providing provision for clawback, thus making enforceability difficult; and
- Reputational risk, both arising from possible legal challenge and associated media coverage, as well as from the perception regarding failure of a firm’s risk management in being able to detect the error or breach in advance.

Firms considered the adverse impact of their reputation on recruitment and talent retention. Firms noted, however, that they would be more likely to apply all measures including clawback in egregious situations to send the signal to relevant parties that firms take action for serious conduct events.

Given the multiple challenges faced when enforcing clawback, firms tend to prefer to use malus and in-year adjustments as risk-alignment measures as these are perceived to be both easier to implement as well as less likely to be legally contested. Therefore, as an alternative to clawback, some firms have extended deferral periods and treated malus as de-facto clawback. Another example is to embed a de-facto clawback in severance packages, whereby a percentage of severance is held back for a few years in the event an issue surfaces after the employee's departure.

4.2.3. Examples of application of clawback

Across all jurisdictions, there are few examples of the use of clawback. Among the three sectors, application of clawback is observed relatively more in the banking sector, possibly due to the Principles and Standards and/or relevant national legislation and regulation being more prevalent and better embedded. Several jurisdictions reported examples of successful application of clawback:

- In India, clawback was successfully applied in the case of a CEO of a bank on account of significant divergence in disclosure relating to asset quality and governance.
- In Korea and the UK, clawback has been applied successfully in a few cases in the banking sector. The UK has also seen significant legal decisions supporting the use of clawback in non-banking contexts.[27]
- In the EU, in one case, employees were still employed by the bank and the bank was able to claw back 100% of the bonus. In another case the matter was followed by arbitration and the bank was able to claw back 50% of the bonus plus legal costs.
- Mexico reported that some banks apply clawback only on remuneration contractually covered, while other remuneration is established in accordance with local labour law regulations.

Instead of applying clawback, employers may choose to make informal arrangements. There are several instances where individuals voluntarily returned variable remuneration on the basis that the individuals will not be identified publicly.

Inclusion of clawback terms in an employment contract generally seems to lead to better enforceability of clawback. In more than half the jurisdictions across all sectors, firms generally include a clawback clause in contracts or in their compensation policy. However, this is a relatively recent phenomenon, and may give rise to an uneven playing field where it cannot be retroactively included/implemented in older contracts.

27 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67. This case established in English law that contractual clauses that are subject to challenge as penalty clauses do not need to be justified on the basis of being a genuine pre-estimate of loss. Rather, they can be justified on the basis of a wider legitimate interest. This is helpful in the case of clawback clauses imposed by a regulatory or investor requirement, which seek to advance legitimate goals.

4.2.4. Regulation and industry practices that facilitate the application of clawback

The application of clawback becomes more effective when it is underpinned by legal provisions that explicitly allow for clawback and supervisory guidance for effective enforceability. In some jurisdictions, corporate governance codes apply to listed entities and mention malus and clawback as best practice on remuneration. The inclusion of a clawback clause in employment contracts minimises the risk of legal challenge. Moreover, the existence of a clawback mechanism, even when not deployed, may serve as an effective deterrent against bad behaviour.

As case law develops and precedents are set, firms will develop a better understanding of the enforceability of clawback and what areas or weaknesses need to be strengthened in contracts or in terms of variable remuneration. Thus, clawback continues to be an evolving practice and further developments may lead to more consistent enforceability, although it may take time if firms avoid bringing these cases to court and supervisors are not able to require firms to apply clawback.

Box 9: Examples of regulations to facilitate the application of clawback

Italy

For the banking sector, the Banca d'Italia Circular 285/2013 – implementing the CRD IV, as amended by Directive 2019/878/EU, and the EBA Guidelines – explicitly envisages that variable remuneration is subject to ex post risk adjustments (malus and clawback) and may be reduced to zero depending on the performance and individual behaviours.

For the asset management sector, the relevant regulation –the Banca d'Italia Regulation of 5 December 2019 – allows the application of ex post adjustments to variable remuneration in the form of malus and clawback leading to the reduction down to zero, considering the level of achievement of performance objectives and individual behaviours.

For the insurance sector, Istituto per la Vigilanza sulle Assicurazioni (IVASS) regulation 38/2018 – implementing Delegated Regulation 2015/35/EU – provides rules on the measurement of performance, malus and clawback, a retention period on compensation by financial instruments and termination payments – with particular reference to the effectiveness of provisions relating to the clawback clauses (though legal challenges could still exist). Further detailed expectations on the proportionality principle concerning remuneration are included in the IVASS Letter to the market of 5 July 2018.

EU

In the insurance sector, the European Insurance and Occupational Pensions Authority (EIOPA) has published guidelines which state that malus and clawback clauses should be introduced among the adjustments to variable remuneration, including, for example, in the event that an entity or a business unit does not meet its objectives, or an entity fails to comply with the Solvency Capital Requirement, among others.[28] A similar type of approach applies to the banking sector based on the CRD and the EBA Guidelines.

[28] EIOPA (2020), Opinion on the supervision of remuneration principles in the insurance and reinsurance sector, April.

4.3. Severance payments

The definition of severance payments and their treatment differ across jurisdictions. Notwithstanding this limitation, severance payments are regulated by labour legislation in over half of jurisdictions. Supervisory authorities may issue regulations or supervisory guidance on the prudential treatment and/or disclosure of severance payments.

In the banking sector in approximately half of the jurisdictions, severance payments are considered variable remuneration and thus generally subject to ex ante and ex post adjustments so that they do not reward failure/misconduct and discourage excessive risk-taking. The number of jurisdictions applying these kinds of adjustments to severance payments is lower in the insurance and asset management sectors. This means that within the same jurisdiction, severance payments are often treated differently across the sectors. The differences within jurisdictions can be partly attributed to different supervisory authorities regulating different sectors. For example:

- In the EU asset management sector, the AIFMD sets out that payments related to the early termination of a contract should be related to performance achieved over time and be designed in a way that does not reward failure. The UCITS V Directive contains a provision equivalent to the AIFMD provision. The ESMA has provided further guidance on sound compensation practices for UCITS and alternative investment fund managers, which includes guidance on risk alignment. In the EU banking and insurance sectors, severance payments are considered variable remuneration (with some exceptions), and are generally subject to ex ante/ex post adjustments.

- Japan, Mexico, Saudi Arabia and the US take different approaches among banking and insurance sectors when applying ex ante and ex post adjustments.

- In South Africa, the asset management sector has different regulations, whereas severance payments are treated the same way in banking and insurance.

The relationship between severance payments and non-compete clauses[29] generally depends on the individual agreement between the employer and the employee. Severance payments are often linked to a non-compete clause. In these cases, the firm is required, even in the case of an employee’s poor performance or malfeasance (for instance, when the employee has contributed to negative financial performance or is guilty of a material compliance breach), to make a severance payment unless it is stated otherwise in the individual employment contract. Severance payments in these cases have a different legal status and are protected by labour law to protect the firm from competition. Such payment is not considered an award for the work done by the employee and therefore cannot be adjusted through, for example, malus and clawback. In some cases, however, severance payments may be subject to adjustment if this is included in the employee’s contract.

[29] A non-compete clause prohibits an employee from working for a competitor in a certain geographical area for a certain amount of time after leaving the company. The breach of non-compete clauses may result in penalties and litigations (e.g. seeking injunction and/or damages). However, as a practical matter, it may be challenging to successfully enforce the repayment of the severance payment as the breach generally occurs after the severance payment has been made.

Compensation as a result of non-compete clauses is considered to be a severance payment in some jurisdictions. Thus, in order to take a consistent approach within a group, some firms seem to consider all severance payments as fixed remuneration, based on the premise that at least part of the compensation could have this nature (if it corresponds to a non-compete clause).

As is shown above, there is a disparity of regimes in the absence of regulation and supervisory guidance with the treatment left to individual contracts.[30] This could result in obstacles against its consistent use at significant institutions either cross-sectoral or cross-border application within the group.

In addition, the issue of "re-hiring" was raised during the May 2021 industry workshop. Severance payments could be offered to employees who are then rehired by the same firm shortly after. This would negate the purpose of severance payments and circumvent otherwise applicable deferral rules. To avoid such circumvention of regulation on severance payments, it would be crucial to strengthen the internal governance and controls within financial institutions.

30 There are references to lack of uniform treatment in documents from various fields, for instance, in OECD tax or social policy-related documents (please see OECD manual and OECD database).

Annex: Implementation of the Principles and Standards

Progress in the adoption of the Principles and Standards in the insurance and asset management sectors has not been significant since the last progress report.[31] While a number of jurisdictions have adopted the Principles and Standards in the insurance and asset management sectors, implementation seems to be moving slower than in the banking sector.

Table 6: Implementation of the Principles and Standards for significant insurers

	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
Principle 1	R	R	X	S	R	R	R	S	R	S	R	S	R	X	R	S	NA	R	R	R	R	S	R	S
Principle 2	R	R	X	S	R	R	R	S	R	S	R	S	R	X	R	S	NA	R	R	R	R	S	R	S
Principle 3	R	R	X	S	R	R	R	S	R	NA	R	S	R	X	R	S	NA	R	R	R	R	S	S	R
Principle 4	R	R	X	S	R	R	R	S	R	NA	R	S	R	X	R	S	NA	R	NA	R	R	NA	R	S
Principle 5	R	R	X	S	R	R	R	S	R	R	R	S	R	X	R	S	NA	R	NA	R	R	NA	S	S
Principle 6	R	R	X	S	R	R	R	S	R	NA	R	S	R	X	R	S	NA	R	R	R	R	NA	S	S
Principle 7	X	S	X	S	R	R	R	S	R	NA	R	S	R	X	R	S	NA	R	S	R	R	NA	R	S
Principle 8	NA	S	X	S	R	R	R	S	R	S	S	S	R	R	S	NA	NA	S	S	R	R	NA	S	S
Principle 9	NA	R	X	S	R	R	R	S	R	R	R	S	R	R	R	S	NA	S	NA	R	R	S	S	R

Table 7: Implementation of the Principles and Standards for significant asset managers

	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
Principle 1	NA	R	X	S	R	R	R	NA	R	R	R	NA	R	S	R	S	NA	S	S	R	R	S	R	0
Principle 2	NA	R	X	S	R	R	R	NA	R	R	R	NA	R	S	R	S	NA	S	R	R	R	S	R	0
Principle 3	NA	R	X	S	R	R	R	NA	R	R	R	NA	R	R	R	S	NA	S	R	R	R	S	R	0
Principle 4	NA	R	X	S	R	R	R	NA	R	R	R	NA	R	S	R	S	NA	S	R	R	R	NA	R	0
Principle 5	NA	R	X	S	R	R	R	NA	R	R	R	NA	R	S	R	S	NA	S	S	R	R	NA	R	0
Principle 6	NA	R	X	S	R	R	R	NA	R	NA	R	NA	R	S	R	S	NA	S	S	R	R	NA	R	0
Principle 7	NA	S	X	S	R	R	R	NA	R	NA	R	NA	R	S	R	S	NA	S	S	R	R	NA	R	0
Principle 8	NA	S	X	S	R	R	S	NA	R	S	S	NA	R	S	S	NA	NA	S	R	R	R	NA	R	0
Principle 9	NA	R	X	S	R	R	R	NA	R	R	R	NA	R	S	R	S	NA	S	S	R	R	S	R	0

(Table 6 and 7)

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); X = not addressed; NA = not relevant; 0 = no information provided.

* AR (Table 6): The status changed from 0 since the last report. For Principle 1-6, Corporate Governance Principles and Recommendations Resolution (Resolution 1119/18) was issued for insurance and reinsurance entities. Principle 7 is not reflected in the resolution while Principle 8 and 9 are not applicable.

* AU (Table 7): Applicable to registrable superannuation entities (RSEs).

* CA (Table 7): Responses for the March 2021 questionnaire were received from the top three asset managers in Canada that are business segments of insurance companies under OSFI's purview. Asset managers are not directly regulated by OSFI and the column was marked "NA" in the previous report.

* CN (Table 7): The status changed from NA to R based on self-reporting (however, supporting information is not provided).

* IN (Table 7): The status changed from X to R. Companies' Act and SEBI Circulars are applicable.

Source: Based on self-reporting

[31] In light of the progress in the banking sector, the implementation status for banks has not been updated.