FSB FINANCIAL STABILITY BOARD

# Climate-related Financial Risk Factors in Compensation Frameworks

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# Executive summary

The impact of climate change on the financial system is becoming a strategic priority for financial institutions and regulators. In turn, financial institutions are increasingly adopting climate-related metrics in compensation frameworks and many jurisdictions have incorporated or plan to incorporate rules or guidance in regulatory and supervisory frameworks. In addition, many jurisdictions are monitoring the incorporation of climate-related risks into the compensation frameworks across banking, insurance and asset management. These initiatives are, however, at the early stages of development and implementation, and come with a range of challenges.

Climate-related metrics tend to be included in the non-financial measure of financial institutions' balanced scorecards rather than as a financial measure. They are often part of an environmental, social and governance (ESG) category that incorporates broader ESG factors such as diversity and inclusion, while there are separate climate-specific categories in some cases.

Climate-related metrics incorporated in compensation frameworks include the reduction of carbon footprint, provision of sustainable finance and products, and accountability type measures such as leadership in the climate-related area. Some financial institutions also use external-based metrics, such as ratings and indices, to benchmark themselves against their peers.

Where they are included in compensation frameworks, climate-related metrics are generally applicable at individual and/or collective level for executives and senior management only. The climate-related metrics are incorporated primarily in the short-term incentive plan and to a lesser degree in the long-term incentive plan.

The impact of climate-related metrics on total compensation outcomes is relatively modest at present, partly because their weights are still small or they are used only as an overall adjuster or modifier. However, some financial institutions report that they are increasing the weights for climate-related metrics and moving them to a main component instead of as a modifier.

Geographical differences are more prominent than sectoral differences in explaining progress in adopting climate-related metrics in compensation frameworks among financial institutions, reflecting the different stages of development in climate initiatives in general among financial institutions as well as stakeholder expectations such as shareholders, investors and customers.

Financial institutions identified a number of important challenges when including climate-related metrics in compensation frameworks. For instance, gaps in the availability and reliability of data make it difficult to apply consistent metrics and monitor them in performance evaluation and compensation determination. Another common challenge is developing meaningful metrics that are relevant to and aligned with financial institutions' strategies and that are also objectively quantifiable and measurable. Climate-related goals will take time to achieve and so there may be an inherent misalignment between a relatively short performance evaluation period of compensation frameworks and a relatively long period for materialisation of climate-related results.

To overcome these challenges financial institutions are regularly reviewing and adapting metrics to link them more closely with their strategies and businesses. Time misalignment challenges could be overcome by effectively setting short-term milestones to reward short-term progress against long-term climate goals.

Incorporation of climate-related metrics into compensation frameworks is expected to evolve further, in line with climate change becoming more prominent as a strategic priority for financial institutions, their regulators and other stakeholders. Continuous revision and adaptation of metrics by financial institutions, in response to a fast-changing environment, is needed to ensure effective alignment of compensation with prudent risk taking. Financial regulators can facilitate this process by helping share regulatory and industry practices with each other and with industry.

# Introduction

The Compensation Monitoring Contact Group (CMCG), composed of global supervisors from Financial Stability Board (FSB) member jurisdictions, is tasked with the monitoring and reporting on the progress of national implementation of the FSB's Principles for Sound Compensation Practices and Implementation Standards (Principles and Standards).[1] The CMCG published its latest Progress Report in November 2021.[2] The report observed an emerging trend that financial institutions are increasingly using non-financial measures, including environmental, social and governance (ESG) aspects, to drive accountability for delivering outcomes. Against the backdrop of this finding, the CMCG decided to examine this emerging trend in 2022, focusing specifically on climate-related financial risk factors in compensation frameworks.

A growing number of financial institutions have adopted strategic goals that include ESG factors and are increasingly using non-financial measures related to ESG in performance measurement to determine variable compensation. However, the means by which the strategic goal is translated to the compensation framework is developing. This report reviews compensation practices around a climate-related theme and how the stated goal of financial institutions as it related to climate-related financial risks is incorporated into the compensation framework.

Climate-related financial risk factors in compensation frameworks are still an emerging theme. Therefore, this report does not aim to present and compare practices across jurisdictions, but rather to identify challenges and to provide an early insight in a fast-moving field to assist ongoing initiatives of regulators and financial institutions.

In recent years, the main focus for regulated financial institutions in the climate-related field has been on risk management and disclosure. However, international bodies recognise that the link with compensation frameworks can be a way to incentivise and drive progress for strategic goals as reflected in the following documents:

- The Status Report from the Task Force on Climate-related Financial Disclosures (TCFD) states that "*remuneration policies are important incentives for achieving an organization's goals and objectives and may provide insight on an organization's governance, oversight, and accountability for managing climate-related issues*" and presented some examples of relevant disclosure.[3]

- The Exposure Draft on Sustainability-related Disclosures by the International Sustainability Standards Board (ISSB) states that "*an entity shall disclose how the body and its committees oversee the setting of targets related to significant climate-related risks and opportunities, and monitor progress towards them, including whether and how related performance metrics are included in remuneration policies*" and that "*an entity shall disclose information relevant to the cross-industry metric categories of remuneration: (i) the percentage of executive management remuneration recognised in*

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

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

[3] TCFD (2021), *2021 Status Report: Task Force on Climate-related Financial Disclosures*, October.

*the current period that is linked to climate-related considerations; and (ii) a description of how climate-related considerations are factored into executive remuneration*".[4]

- The Application Paper on the Supervision of Climate-related Risks in the Insurance Sector by the International Association of Insurance Supervisors (IAIS) states that "*the alignment of remuneration with prudent risk-taking should take into consideration climate-related risks, as appropriate, since risk adjustments should account for all risk types relevant to the insurer*" and that "*remuneration can be used as one of several incentives to integrate climate-related risks in the risk management system*".[5]

- The Principles for the effective management and supervision of climate-related financial risks by the Basel Committee on Banking Supervision (BCBS) notes that "*the board and senior management should consider whether the incorporation of material climate-related financial risks into the bank's overall business strategy and risk management frameworks may warrant changes to its compensation policies, taking into account that these should be in line with the business and risk strategy, objectives, values and long-term interests of the bank*".[6]

The findings in the report are based on questionnaire responses from FSB member jurisdictions across the banking, insurance and asset management sectors.[7] The survey was conducted during April-June 2022 and, as a general principle, covered the period 2020-2021 for current practices and 2022-2023 for future developments. Each jurisdiction was asked to select approximately three large financial institutions per sector to obtain meaningful insights, although the number varied depending on the structure of the jurisdiction's financial sectors.[8] The report also incorporates insights from an industry workshop (Workshop) held in September 2022. The Workshop provided an opportunity to exchange information and views on key issues and challenges in implementing climate-related financial risk factors in compensation frameworks. It was attended by senior executives in the relevant areas (e.g. compensation, reward, performance and human resources) of major banks, insurance companies and asset management firms, as well as consultants and academics. The findings from questionnaire responses and the Workshop were largely consistent and the latter often provided further insights and rationale, including holistic cross-jurisdictional and cross-sectoral views. Information shared below does not necessarily represent the views of regulators/authorities nor should it be understood to be consensus views expressed by financial institutions.

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4 ISSB (2022), *Exposure Draft and comment letters: General Sustainability-related Disclosures*, March.

5 IAIS (2021), *Application Paper on the Supervision of Climate-related Risks in the Insurance Sector*, May.

6 BCBS (2022), *Principles for the effective management and supervision of climate-related financial risks*, June.

7 The number of responses received was 19, 22 and 20 for the banking, insurance and asset management sectors respectively. The European Central Bank (ECB) provided a uniform response on the banking sector for five EU jurisdictions (France, Germany, Italy, Netherlands and Spain), although Netherlands also submitted an individual response. Canada and the US submitted responses for the banking and insurance sectors only. For Australia, the asset management sector includes registrable superannuation entities. China did not submit responses. Russia did not participate in the questionnaire.

8 The method to obtain information was left to the decision of each jurisdiction. For example, authorities may seek direct inputs from the selected financial institutions and/or provide insights based on their engagement with those financial institutions or existing supervisory knowledge.

# 1. Regulatory and supervisory developments

Many jurisdictions have regulatory and supervisory frameworks for incorporating climate-related financial risks into compensation frameworks across the sectors (see Box 1). In the survey, 11 out of 19 responding jurisdictions (approximately 60%) reported that they have regulatory and supervisory frameworks in place for banks to incorporate climate-related financial risks into compensation frameworks. Similarly, 10 out of 22 responding jurisdictions (approximately 45%) have done so for insurance companies, and 9 out of 20 responding jurisdictions (approximately 45%) for asset management firms. Several jurisdictions that currently have not introduced regulatory and supervisory provisions/expectations across sectors indicated that they are planning to do so. A few other jurisdictions noted that they take a different approach (e.g. through supervisory dialogues).

In the banking and insurance sectors, most jurisdictions rely either on guidance or a combination of guidance and mandatory rules with the split around 50/50. In contrast, the asset management sector exhibits more cases of mandatory rules only.

Whether to explicitly incorporate climate-related financial risks into compensation frameworks may depend on the circumstances of each jurisdiction. In some jurisdictions, the reference to climate-related financial risks is only given implicitly by provisions/expectations referring to the use of non-financial measures when determining variable remuneration. Climate-related financial risks could be a part of broad consideration to manage all relevant risks in a principles-based approach.

Among the jurisdictions that have a regulatory and supervisory framework for incorporating climate-related financial risks into compensation frameworks, approximately half of respondents are monitoring the incorporation of those risks into compensation frameworks across the sectors. Among the jurisdictions that do not have an explicit framework, one authority decided to extend the scope of already planned onsite reviews to incorporate climate-related financial risks in compensation practices in response to the CMCG's work.

**Box 1: Examples of regulatory and supervisory frameworks and monitoring activities**

**Brazil**[9]

The Central Bank of Brazil (BCB) issued in October 2022 supervisory expectations stating that banks should maintain compensation policies that consider climate risks in the incentive structure. The BCB examines the adequacy of the compensation structure and considers climate-related financial risks as one of the relevant risks. Starting in 2023, banks must start publishing on their websites a report called the "Social, Environmental and Climate Risk and Opportunity Report" where they should describe the criteria used by the Board to ensure that these risks are considered in the compensation policy approval and review processes.

**Canada**[10]

The Office of the Superintendent of Financial Institutions (OSFI) issued in March 2023 a Climate Risk Management Guideline applicable to federally regulated financial institutions (FRFIs), including banks

9 BCB (2022), *Guide to Supervisory Practices*, October; BCB (2021) *BCB Resolution No. 139*, September; and BCB (2021), *BCB Normative Instruction No. 153*, September.

10 OSFI (2023), *Climate Risk Management Guideline*, March.

and insurance companies. It states that senior management has overall accountability for the FRFI's climate risk management and that the FRFI should take into account climate-related risks in senior management compensation, as appropriate.

**European Union (EU)**[11]

The European Central Bank (ECB) issued in November 2020 a guide on climate-related and environmental risks, which provide the supervisory expectations on compensation policies in relation with ESG risks. Supervisory actions or monitoring of ESG related aspects and risks are embedded in the on-going supervision as performed by the Joint Supervisory Teams.

The European Insurance and Occupational Pensions Authority (EIOPA) has published in April 2020 an opinion on the supervision of remuneration principles in the insurance and reinsurance sector which states that ESG criteria should be taken into account in the assessment of an individual's performance.

**Italy**[12]

The Bank of Italy issued in April 2022 specific supervisory expectations for climate-related and environmental risks according to which remuneration policies and practices should foster behaviour consistent with the approach adopted to climate-related and environmental risk. To encourage behaviour consistent with this approach, the expectation states that the variable remuneration of the intermediaries that have set objectives in this area is anchored to the achievement of those objectives.

The 2022 Supervisory Review and Evaluation Process (SREP) includes a specific analysis to verify the respect of the EU rules and of the expectations for asset management firms.

Consob Issuers Regulation provides, under Article 84-*quater*, para. 2-*bis*, that the remuneration policy "*Indicates how it contributes to the company strategy, the pursuit of the interests in the long term and the company sustainability, and is conceived keeping into account the compensation and the work conditions of the company employees* (…)". This provision is meant to implement Article 123-*ter* of the Italian Consolidated Law on Finance, which, in paragraph 3-*bis* provides for listed companies that "*The remuneration policy shall contribute to corporate strategy, the pursuit of long-term interests and the company's sustainability and shall explain the way in which it makes this contribution*".

IVASS is in the process of issuing a measure updating current insurance regulations by incorporating EU provisions on sustainable finance. Specifically, the updates require that insurers' remuneration policies contain information and targets on the integration of sustainability risks into the risk management system.

**Singapore**[13]

The Monetary Authority of Singapore (MAS) issued guidelines on individual accountability and conduct in September 2020 (effective September 2021), guidelines on environment risk management in December 2020 (effective June 2022) and information papers on environmental risk management in May 2022. These documents collectively set out MAS' expectations for financial institutions to address environmental and climate-related risks that they may be exposed to, and to integrate and embed climate and environmental risk considerations in their existing processes (such as through incentive structures) to facilitate implementation of strategic plans and targets. In 2021, MAS conducted thematic reviews on select financial institutions' environmental risk management practices, to take stock of their progress in implementing MAS' guidelines. In 2023, MAS plans to engage a broader group of financial

[11] ECB (2020), *Guide on climate-related and environmental risks for banks*, November; and EIOPA (2020) *Opinion on the supervision of remuneration principles in the insurance and reinsurance sector*, April.

[12] BdI (2022), *Supervisory expectations on climate and environmental risks*, April; and IVASS (2022), *Consultation Paper no.9/2022 concerning draft amendments on sustainable finance to IVASS Regulations no. 24/2016, 38/2018, 40/2018 and 45/2020*, October.

[13] MAS (2020), *Guidelines on Individual Accountability and Conduct*, September; MAS (2020) *Guidelines on Environmental Risk Management for Banks*, December; and MAS (2022), *Information Papers on Environmental Risk Management*, May.

institutions on their implementation progress, including the incorporation of environmental and climate-related risk factors to their compensation frameworks.

**United Kingdom (UK)**[14]

The Prudential Regulation Authority (PRA) sets broad expectations in respect of the monitoring, governance and risk management of climate-related financial risks in a Supervisory Statement and also issued supplementary guidance that linked these expectations to remuneration for banks and insurance companies. Supervision of climate-related financial risks has been incorporated into the core supervisory approach for all areas of supervision, with the assessment of a financial institution's management of climate-related financial risks included in all relevant elements of the supervisory cycle. The PRA will pay particular attention to how financial institutions quantify climate-related risks and incorporate those risks into business strategies, decision-making, and risk-taking, keeping a number of supervisory tools under review for use when progress is deemed insufficient.

# 2. Metrics in compensation frameworks

## 2.1. Strategy and external commitments

Climate change has become a strategic priority for many financial institutions. Strategy and external commitments often flow from international and/or industry initiatives (e.g. Net Zero Initiatives[15], Paris Agreement[16], United Nations Environment Programme Finance Initiative (UNEPFI)[17], United Nations Sustainable Development Goals (SDGs)[18], Glasgow Financial Alliance for Net Zero (GFANZ)[19], Net-Zero Banking Alliance (NZBA)[20], Net-Zero Insurance Alliance (NZIA)[21], Net Zero Asset Managers initiative (NZAM)[22] and Science Based Targets initiatives (SBTi)[23]), while some more jurisdiction/firm-specific examples are also observed.

Many financial institutions publicly disclose and make external commitments on climate-related strategies, for example, in annual reports or sustainability/climate reports, which are generally in line with recommendations of the TCFD or Sustainability Accounting Standards Board (SASB). Workshop participants noted that there has been increasing disclosure on financial institutions' compensation frameworks and outcomes, including the link of climate-related financial risks and compensation, through their annual reports and sustainability/climate reports.

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14 PRA (2019), *Supervisory Statement: Enhancing banks' and insurers' approaches to managing the financial risks from climate change*, April; and PRA (2020) *Dear CEO letter*, July.

15 See here.

16 See here.

17 See here.

18 See here.

19 See here.

20 See here.

21 See here.

22 See here.

23 See here.

## 2.2. Metrics

Financial institutions are increasingly linking climate-related metrics in compensation frameworks to their strategies and external commitments. This also applies to many financial institutions that are based in jurisdictions where authorities have not set a regulatory and supervisory framework for incorporating climate-related financial risks into compensation frameworks. This suggests that initiatives are driven in response to international initiatives rather than (or in addition to) local regulatory and supervisory developments. Internationally active financial institutions (e.g. in Europe) that incorporate climate-related metrics and targets across the organisation, including the branches/subsidiaries, may also have helped this trend.

However, the inclusion of climate-related metrics is still at an early, evolutionary stage. The inclusion in compensation frameworks has generally only been observed in recent years. Those that have included such metrics are regularly reviewing and adapting them, usually on an annual basis. The main focus at present is on compensation for executive and senior management.

Climate-related metrics tend to be included in the non-financial measure of the balanced scorecard to determine compensation outcomes, rather than as a financial measure.[24] They are often part of an ESG category that incorporates broader ESG factors such as diversity and inclusion, while there are separate climate-specific categories in some cases. Financial vulnerabilities due to climate change, which are considered in risk management, have not yet been fully embedded into the compensation framework. This may be a potential area for stronger supervisory focus in considering a meaningful incentive and link in compensation frameworks.

Below are some observations (also see Table 1) based on the financial institutions that incorporate climate-related metrics in their compensation frameworks:

- Some financial institutions include reductions to their own carbon footprint as metrics in compensation frameworks. Quantitative metrics used by financial institutions tend to be focused on Greenhouse Gas (GHG) emissions from their own operations (Scope 1) or indirect GHG emissions from purchased energy (Scope 2) as they are able to measure progress against these more effectively. For instance, carbon reduction related to Scope 1 or 2 is a more prevalent measure across all sectors. Relatively more cases on decarbonisation within their portfolios (Scope 3) were reported in the insurance sector (as asset owner). Qualitative metrics such as climate policy introduction and engagement were also reported.

- Some financial institutions use sustainable finance and products as business-related issues in compensation frameworks. Each sector has quantitative metrics suitable for its own business, for example, the growth of sustainable finance business for banks and investment/funds for insurance companies (as asset owner) and asset management firms. Qualitative metrics such as integration of ESG considerations into the decision-making process were also reported.

[24] There is no common taxonomy to classify such metric into financial and non-financial measures, which creates some differences across financial institutions and jurisdictions.

- Some financial institutions also include measures on climate-related leadership, training, innovation and disclosure that align accountability with progress against these measures. These broadly align with and support the financial institutions' strategy and external commitments.

- Currently, there seems to be less focus on risk management metrics relating to climate change in compensation frameworks (see Box 2 for some examples). The focus seems to be on the process of risk management and compliance rather than the impact of quantitative measures. This may be because quantification frameworks and methodologies (e.g. scenario analysis) in risk management are not yet well established and because climate-related financial risks tend to be included within overall risk measures and linked to a broad range of risk factors. In addition, there is a possibility that risk materialisation (e.g. losses from climate disasters) could affect financial Key Performance Indicators (KPIs) and consequently compensation even if they are not explicitly included.

- Some financial institutions use external-based metrics such as ESG ratings and indices to benchmark themselves against their peers. Indicators used include their position in the Dow Jones Sustainability Index (DJSI) or performance within ESG rating providers such as Morgan Stanley Capital International (MSCI) and Carbon Disclosure Project (CDP), or a combination of more than one ratings provider. Some financial institutions were seen to review the differences between the rating policies of the ESG rating providers and their own management policies from time to time and revise their compensation framework as necessary.

**Table 1: Examples of climate-related metrics in compensation frameworks**

| Category | Metrics |
|---|---|
| Reduction of carbon footprint (both own operations and indirectly by means of lending/investing) | (Outcome/Performance)<br>• Progress on Net Zero policy<br>• GHG emissions reduction (Scope 1 and 2)<br>• GHG emissions reduction (Scope 3) (e.g. for corporate bonds and equities portfolio and real estate portfolio in insurance sector), including metrics on carbon-intensive sectors<br>• Status of CO2 fixation (e.g. through mangrove plantations)<br>• Achievement of 100% renewable energy use<br>(Policy/Procedures)<br>• Imposition of lending policy restrictions for carbon-intensive business<br>• Engagement with portfolio companies and insurance underwriters |
| Provision of sustainable finance and products | (Outcome/Performance)<br>• Volume and amount of sustainable business and climate conscious business (e.g. green asset origination for each business line)<br>• Development and marketing of products and services (e.g. ESG investment, launch of insurance products and ESG funds)<br>• Revenues from ESG financing<br>• Performance of investment portfolio performance where broader ESG factors is integrated into investment decision making<br>(Policy/Procedures)<br>• Integration of ESG consideration into investment process |
| Accountability | • Training on corporate sustainability<br>• ESG, sustainability and climate change-related initiatives<br>• Proposition and innovation in ESG space<br>• Leadership on climate issues<br>• Capacity to promote and project ESG knowledge internally and externally<br>• Vendor sustainability programme expansion<br>• Organisation of climate-related events<br>• Annual quantitative target on disbursement of funding for climate actions Environmental accountability<br>• Disclosure on climate-related strategy and achievement of outcomes |
| Risk management | • Compliance with ESG policy<br>• Risk KPIs related to climate change risk |
| External-based ESG metrics | • Ratings by ESG rating providers (e.g. MSCI, CDP)<br>• Index by ESG vendors (e.g. DJSI) |

Workshop participants highlighted that shareholders and investors generally prefer quantifiable, measurable and therefore auditable metrics, but noted that it is challenging to develop such climate-related metrics that are also meaningful to the strategy and business outcomes. They also confirmed that metrics are constantly reviewed. A participant noted a fundamental measurement problem on how to link the strategy with the impact on the portfolio (e.g. what global Net Zero means to the portfolio of a particular financial institution). One additional challenge highlighted is on measurement over the intended time horizon. For example, if the evaluation is for a single year, metrics should not be excessively impacted by market movements and, if the evaluation is for the long term, metrics should reflect longer trends.

There were varied views regarding how extensive/targeted the metrics should be. One view was that metrics should not be distilled to overly simplified specific measures and should be reflective of overall factors in a holistic manner, rather than hard targets set on a few limited specific measures. Another view was to keep the scorecard targeted with a few key metrics linked to the strategy rather than overload the scorecard with too many metrics which could lead to the metrics getting diluted. Participants also noted that shareholders generally prefer a simple scorecard.

Some participants noted that their firm uses external ESG ratings. Others that do not use them expressed caution that as financial institutions are at different stages of their journey and not targeting the same objectives, a financial institution's relative position against peers does not always give a precise reflection of progress given different starting points. Instead, they felt that the core strategy is something which executives should be held accountable for and actual target relevant to the core strategy should be achieved instead of relative positions.

**Box 2: Examples of risk management focus in compensation frameworks**

**An insurance company in Asia and Oceania**

There are quantitative and qualitative climate-related metrics, such as climate change, sustainable finance and carbon reduction. The insurance company ensures that financial implications of financed emission targets are embedded into the financial resources plan and business management information reporting for ongoing performance measurement.

**An insurance company in Europe**

An insurance company's Remuneration Committee considers a risk underpin. This requires Board level executives to meet risk KPIs including those related to climate risk (e.g. natural catastrophe management). The risk underpin enables the Board to dynamically respond to risks from climate change in compensation outcomes.

# 3. Link with compensation outcome

## 3.1. Development of framework and actual application

The use of climate-related metrics in KPIs and its link with performance evaluation and compensation outcomes is mixed (see Box 3 for some examples). The survey and the Workshop suggest that this is still at an embryonic stage. In addition, for the financial institutions that appear to have made this link, the impact on total compensation outcomes is relatively modest at present.

Many financial institutions that have introduced climate-related considerations into their compensation frameworks are regularly adapting their climate strategies, metrics, and targets to reflect the latest regulatory requirements and to monitor their evolution. To date, such metrics have been met or exceeded in most cases, resulting in a lack of evidence on the use of compensation risk adjustment tools in respect of climate. For some financial institutions, the inclusion of climate-related metrics in the factors to influence compensation outcomes has only been introduced in the last 1-2 years, so the outcomes are yet to reflect these measures or are still being monitored. Therefore, there is currently limited information on the influence of climate-related metrics in compensation outcomes. Actual application examples on how the metrics impact on compensation outcomes will be accumulated over time. However, there is an expectation that compensation outcomes will be commensurate with performance and risk outcomes of climate-related metrics in future.

The cross-sectoral difference is not significant. Rather, geographical differences appear to play a larger role, reflecting the different stages of development in general climate or ESG initiatives. It was reported that domestic financial institutions in some jurisdictions are still in an exploratory stage for the inclusion of climate factors in the compensation frameworks, while the branches/subsidiaries of internationally active financial institutions (e.g. in Europe) have already incorporated climate-related metrics and targets in their strategy and their compensation frameworks. One Workshop participant also observed that differences are mainly due to regional factors, rather than sectoral ones, with inclusion of climate-related factors in compensation frameworks more common in Europe. However, this is not always the case, for example, where the authority applies the requirement/expectations across all financial institutions, both local ones and branches/subsidiaries of foreign owned financial institutions.

## 3.2. Performance evaluation and compensation outcomes

Bonus pools are generally designed to reflect collective achievement and accountability of a financial institution's strategy. Financial institutions are progressively considering how to incorporate climate-related metrics at a collective level, rather than only at an individual level (see Box 3 for some examples). In some jurisdictions climate-related metrics in bonus pool setting is a recent introduction, and yet to be reflected in actual outcomes. Where financial institutions have more established climate-related metrics in bonus pool setting, the impact on pool outcomes tended to be part of broader considerations in meeting overall strategy and risk expectations.

Where climate-related KPIs are included in balanced scorecards, it is more common as part of a broader category (e.g. the non-financial risks or the ESG category) than as a specific climate category. Some cases were reported where financial institutions use such factors as an overall adjuster or modifier. The two approaches are not necessarily mutually exclusive. Some cases were reported where the weights for climate-related KPIs have recently been (or will be) increased, or where the factors have been (or will be) moved to a main component rather than using only as a modifier.

It appears that climate-related KPIs are incorporated primarily in the short-term incentive (STI) plan and to a lesser degree in the long-term incentive (LTI) plan. Similar to bonus pool setting, this could be either as part of a broader suite of measures (e.g. ESG, sustainability) or specifically for climate. The STI plans often break down tiered goals on climate-related metrics to single year milestones and the compensation is estimated based on the achievements in each year. The challenge highlighted in LTI plans is to set and evaluate clear structural objectives, even though it may appear to be more logical and consistent with the long-term nature of climate-related financial risks.

The Board is generally empowered to apply its discretion to adjust the metrics/KPIs and/or the weight, which ultimately could influence compensation outcomes. The Board is expected to regularly review compensation frameworks to ensure they are operating as intended, design measures aligned with climate-related financial risks, and ensure alignment between compensations outcomes and climate risk/measures.

Some Workshop participants noted the lack of consistency around the metrics used as financial institutions use metrics that are relevant to their business. They noted that there is a danger of financial institutions “cherry-picking” climate-related metrics which they would achieve or deliver anyway. There is also a risk that financial institutions reward for intention instead of impact. This may lead to higher levels of compensation payments without achieving progress against the original strategy on climate. One participant noted that their firm engages in dialogue with stakeholders to fill this gap and to assist its own initiatives.

Some participants highlighted a potential issue in incentives when multi-year targets run concurrently. If the targets/metrics are still evolving, the targets/measures agreed for a current year multi-year bonus may be different in subsequent years while the old targets/measures are still running. Therefore, some participants suggested it may practically make sense to consider them in the STI plan, while recognising that short-term milestones can be set to reward short-term progress against long-term climate goals. The challenge of internal reporting, which could take place shorter than an annual cycle, was also raised.

From a risk perspective, there is clearly a timing difference between a decision of climate-related strategy/target and the materialisation of profitability and risk. The fact that climate-related financial risks emerge over time allows for the application of compensation tools such as deferral and malus. Though applying clawback may face legal barriers and may be limited to serious fraud or misbehaviour cases. Some participants noted that climate litigation risk is low and does not currently play a large part in their consideration of compensation.

A participant noted that, from an economics viewpoint, there will inevitably arise a trade-off as long as the externality of long-term climate-related financial risks is not perfectly internalised into relatively short-term business decision-making. Therefore, it should not be expected that compensation alone can solve this dilemma. However, involvement of second and third lines of defence (risk management and control functions) as well as a discretionary approach would bring a risk aspect into compensation outcomes.

Participants noted that to the extent climate-related goals and metrics are considered as non-financial measures, there is a chance that they could lead to higher compensation payments without corresponding overall financial measures results, which may raise concerns among stakeholders. Some participants noted that the balance between financial and non-financial performance is always a challenge but that, as long as a portion of compensation is based on non-financial metrics that are not directly related to financial and profitability results, investors may be accustomed to such situations.

Participants noted that discretion and oversight by the Board, supported by various sub-committees responsible for different aspects, could play an important role in calibrating such trade-offs by taking into account overall stakeholder expectations. They also considered that discretion is especially important to ensure a holistic assessment for a long-term goal. From a regulatory perspective, however, excessive discretion might lead to inaccurate results and some guidance in the appropriate use of discretion may be needed.

**Box 3: Examples of evolving practices**

**Bank 1 in Europe**

In setting the group performance award pool funding, the bank reflects ESG through an assessment of progress made toward targets linked to strategic focus areas of planet, people and partnerships. This assessment is included in the qualitative, risk, regulatory and sustainability assessment as part of the pool determination process. The performance award pool is adjusted in case the non-financial targets including climate-related targets are not met.

**Bank 2 in Europe**

Balanced scorecard carries a 30% weighting on ESG-related metrics that appear under three broad non-financial categories called risk and control, values and culture, and sustainability, although such metrics only reflect the non-financial side and the percentage is not the contribution to the overall scorecard.

**A bank in Middle East and Africa**

Given the importance of ESG, non-financial metrics at one bank increased in weighting from 10% to 20% in both the STI and LTI scorecards in 2021.

**Bank 3 in Europe**

The climate-related risk KPIs work as modifier of the variable remuneration calculated on the basis of other KPIs. In 2021, climate-related risk KPIs were met at 80% for three roles: Chief Executive Officer (CEO), Chief Risk Officer (CRO) and Chief Financial Officer (CFO). Accordingly, they each received 80% of the maximum climate-related variable compensation (i.e. 7.5% of total variable compensation) had their climate-related risk target been fully met.

**An insurance company in Europe**

In 2021, an insurance company introduced a climate measure (reduction in carbon intensity of shareholders' assets) with 5% weight in its LTI plan. In 2022, the weight was increased to 7.5%. Being long-term, the plans are yet to be performance-tested, but there is a tangible outcome and incentive for the firm and LTI plan participants to work toward these long-term climate-related measures. Furthermore, the progressive uplift in weighting demonstrates increasing focus and importance the firm places on climate-related measures in achieving its long-term strategic goals.

**An asset management firm in Americas**

The "ESG and Organizational Strength" goals are collectively weighted 25%. One of four subsets of these goals is "Corporate Sustainability" objectives where achievements such as corporate climate disclosures, vendor sustainability program expansion, and corporate emissions are considered.

**An asset management firm in Europe**

The firm's LTI plan is at risk if the Compensation Committee considers that insufficient progress has been made against ESG targets. Additionally, for many senior roles, there was a level of deferral in place for long-term or short-term compensation outcomes, meaning the Board may consider not only in-year adjustment but also malus when applying any risk adjustment to compensation.

## 3.3. Impact on compensation by role

Where included in compensation frameworks, climate-related metrics are generally applicable at individual and/or collective level for executives and senior management. The CEO is commonly responsible for defining, implementing and monitoring the climate-related strategy and external commitments. This is closely followed by the CFO, CRO and Chief Sustainable/Climate officer (or equivalent). In some cases, the CEO and Board members are collectively responsible. These observations are similar across all sectors.

Some business heads were also reported to have climate-related responsibilities. Cited roles include heads of retail banking, business banking, institutional banking, project finance, investment, portfolio management, business development, environment, sustainability & corporate social responsibility (CSR) and customer/membership relations. The business heads are responsible for executing on their particular mandate, including any relevant climate-strategy related KPIs, and their compensation is impacted by the performance in that field.

It is difficult to ascertain how climate-related KPIs are, or will be, integrated to the compensation framework for all staff. In a few limited cases, the climate-related targets and their impact on the valuation of the bonus pool at group level are further cascaded down to business lines to be taken in conjunction with individual performance.

Workshop participants generally agreed that climate-related metrics are mainly applicable for the Board where these metrics are directly derived from the long-term goal linked to strategy and, to a slightly lesser extent, senior executives. Participants pointed out that including a mandatory goal for all employees should be avoided as it could become a tick-box and compliance exercise. To ensure it remains relevant, they suggested it should be tailored and meaningful to the function and role. In some cases, cascading down to business line or individual level is relatively easier for those supporting particular initiatives (e.g. transition finance) as there are specific goals for relevant business lines and individuals.

In addition, some participants noted that the CEO can use compensation as a way of signalling changes in priority within the organisation as well as to external stakeholders. They also noted that, beyond direct incentivisation, compensation could also be used as a cultural reinforcer and positive messages as part of a broader programme to integrate climate/ESG within the organisation.

# 4. Challenges and future focus

Several common challenges emerged across all three sectors. These are possibly due to the emerging and fast developing nature of climate-related financial risks globally, and were more or less universal across jurisdictions and financial institutions.

- **Data**: The greatest issue is the gap or challenge of data availability (including disclosure and transparency), reliability and analysis (including measurement and methodology). Financial institutions indicated that the lack of reliable data makes it difficult to implement climate risk strategies, to take climate risk decisions as well as to conduct climate risk analysis. Since some methods and metrics (e.g. Scope 3 emission) cannot be fully controlled and relied upon, financial institutions noted it is difficult to apply reliable quantitative metrics into the compensation framework. This also makes it difficult to track climate-related metrics in performance scorecards as well as implement an adequate compensation framework and apply risk-based compensation adjustments.[25]

- **KPIs**: Another frequently cited issue is how to set relevant and meaningful KPIs, which are typically an input into determining compensation outcomes. Financial institutions indicated that it is difficult to develop objectively measurable KPIs that are acceptable to all stakeholders. From a risk perspective, climate-related KPIs are often classified by financial institutions as non-financial measures with little focus on potential financial vulnerability. It is a challenge to find an appropriate balance between financial and non-financial measures to manage stakeholder expectations. If metrics are included to cover all aspects of climate or more widely ESG, there is a risk that these schemes lose their efficacy. The challenge is to choose a few meaningful metrics from a wide range of possible metrics. In addition, KPIs related to climate risk are in their infancy, lack sophistication and are being continuously refined or rejected. As a result, targets can be frequently revised which may lead to irrelevant/outdated metrics.

- **Misalignment of timing**: Another common theme is the misalignment between the performance evaluation period and the achievement of climate/ESG-related results. For example, climate-related metrics (e.g. amount of Greenhouse Gases) are not estimated in real time, which limits immediate feedback and a response strategy. The challenge is the setting of short-term climate goals on an annual basis as is required in a compensation framework, while the external commitments tend to have much longer timeframes and progress is non-linear. Compensation frameworks that are not aligned with prudent risk management (e.g. incentivise short-term profits or revenues) have downside risks.

- **Incentivisation across the organisation**: The approach to cascade targets to senior and junior levels was commonly identified as a challenge. There is some difficulty in incorporating climate and sustainability aspects as part of the daily operations of a financial institution. There are low levels of awareness of climate/sustainability risks, which is limiting the offering of climate/sustainability solutions especially in emerging markets. While a compensation framework is only one incentivisation tool, there may be a need to promote education and awareness programmes at all levels of an organisation on the importance of implementing strategies aligned to climate change and its alignment with the compensation framework.

Finally, financial institutions noted that uncertainties on climate risk, including how regulatory expectations and government policy will change, makes risk management more difficult. This uncertainty has resulted in gaps or inconsistencies in the way financial institutions have implemented external commitments to climate-related financial risk into their compensation frameworks. Accordingly, the need for more detailed guidance for a standardised methodology and common reference data for benchmarking on climate-related risks in relation to the compensation framework was highlighted. These tools could enable financial institutions to map

[25] Disclosure by investee companies may improve by regulations (e.g. EU's Corporate Sustainability Reporting Directive, which starts to apply in 2024).

meaningful action plans for target tracking and embedding in their performance evaluation and compensation as well as to facilitate comparison and reporting. Several Workshop participants called for regulators to take a leading role in this area. While this report does not provide any specific guidance or expectations, the challenges identified and insights gained may assist the journey of financial institutions as well as regulators.