Recommendations for national supervisors:

Reporting on the use of compensation tools to address potential misconduct risk

23 November 2018

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Foreword on *Recommendations for national supervisors: Reporting*[1] *on the use of compensation tools to address potential misconduct risk*[2]

The FSB agreed a workplan in May 2015 to address misconduct risk through a combination of measures. The workplan focused on (i) examining whether reforms to incentives, for instance to governance and compensation structures, are having sufficient effect on reducing misconduct risk and whether additional measures are needed; (ii) examining whether steps are needed to improve global standards of conduct in the fixed income, commodities and currency (FICC) markets; and (iii) coordinating reforms to major financial benchmarks.[3] The work comprises measures for effective governance and compensation frameworks. In the area of compensation,[4] the FSB issued *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices* ("Supplementary Guidance to P&S") regarding the use of compensation tools to address misconduct risk in significant financial institutions (i.e. financial institutions that national supervisory authorities consider significant for the purposes of the P&S).

Firms and supervisors have expressed interest in further development of data gathering, data analysis and reporting practices.[5] FSB work on measures to address misconduct risk supports broader efforts to improve supervisory consideration of compensation practices. In this vein, this document represents the view of the FSB on the types of data that can support improved monitoring by national (or jurisdictional)[6] supervisory authorities,

[1] Use of the term "reporting" in this document refers broadly to information made available to the firm's national supervisors as part of the broader supervisory dialogue and not to public disclosure. The data gathered by the national supervisory authority would remain with the supervisor and would be considered in established processes for monitoring the use of compensation tools.

[2] For the purposes of this document, misconduct would be defined by individual firms and/or national supervisors but is generally understood to be "conduct that falls short of expected standards, including legal, professional, internal conduct and ethical standards" (please see also footnote 9).

[3] The last recent FSB progress report on the misconduct workplan was published in July 2017 (http://www.fsb.org/wp-content/uploads/Misconduct-progress-report-July-2017.pdf).

[4] See *FSF Principles for Sound Compensation Practices*, April 2009 ("P&S") and *FSB Principles for Sound Compensation Practices - Implementation standards*, September 2009 ("Implementation Standards for P&S") (http://www.fsb.org/what-we-do/policy-development/building-resilience-of-financial-institutions/compensation/). FSB, *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices*, 2018 (http://www.fsb.org/2018/03/supplementary-guidance-to-the-fsb-principles-and-standards-on-sound-compensation-practices-2/). The supplementary guidance has been developed in the form of recommendations on better practices at financial institutions considered significant for the purposes of the P&S. The guidance does not establish additional principles or standards beyond those already set out in the P&S.

[5] As reported in past progress reports, several jurisdictions collect information routinely from significant institutions as part of the supervisory process, covering for example, risk-taking, risk outcomes, compensation structures, use of compensation tools and conduct risk. Other jurisdictions gather information on an ad hoc basis, if at all. In addition, in some jurisdictions there are substantial public disclosure requirements related to compensation. For example, Pillar 3 standards from the BCBS cover information on the use of compensation tools. At the firm level, data gathering processes differ across individual firms, financial sectors and jurisdictions. Whereas some firms have developed sophisticated monitoring and reporting mechanisms, other firms are only at the beginning of this process. See FSB, *Stocktake of efforts to strengthen governance frameworks to mitigate misconduct risks*, May 2017 (http://www.fsb.org/wp-content/uploads/WGGF-Phase-1-report-and-recommendations-for-Phase-2.pdf).

[6] Throughout the document the terms regulator, supervisor, supervisory authority, national supervisory authority and jurisdictional supervisory authority, in singular or plural, are used interchangeably, and therefore they should be understood as referring to the competent authority, as the context may require. This would apply in cases where the competent authority

within the scope of applicable legislative and regulatory frameworks, on the use of compensation tools to address misconduct risk in significant financial institutions.

The Recommendations are directed to the relevant national supervisory authorities for firms in all financial sectors. They build on national supervisory work and existing international efforts and, in particular for the banking sector, take into consideration the Basel Committee on Banking Supervision (BCBS) Pillar 3 disclosures framework, which includes disclosures on compensation.[7]

The Data Set represents data that is already collected in a number of jurisdictions. Many significant firms are already sharing at least some of this information with supervisors whether through one-off supervisory examinations or regular reporting. It is important to note that the Recommendations are directed to national/regional authorities for further consideration. Each authority in implementing the Recommendations will determine the scope, nature, and timing of any resulting reporting. The suggested reporting items will be tailored by the national/regional authority to fit the circumstances of its individual jurisdiction and existing practice. The FSB will not collect the data indicated in these Recommendations. The reported data will remain with the national authority and reporting protocols will reflect national law, including privacy and confidentiality provisions applicable to supervisory dialogues. The Recommendations do not include additional public disclosure provisions.

The Recommendations are aimed at "significant" financial institutions, as defined for purposes of the FSB's progress report on implementation of compensation standards. National/regional authorities may, at their own discretion, consider applying the Recommendations more broadly.

The Recommendations complement other documents prepared for the FSB's workplan on measures to address misconduct risk, and in particular the toolkit for firms and supervisors for strengthening governance frameworks to mitigate misconduct risk.[8]

is not the national authority, for example in the case of the European Central Bank that, in cooperation with national competent authorities (NCAs), through the Single Supervisory Mechanism (SSM), is responsible for supervising Significant Institutions established in the participating EU Member States, as defined by Articles 4 and 6 (4) of the SSM Regulation of the European Central Bank (ECB).

[7] See for example BCBS, Pillar 3 disclosure requirements (part 13), March 2017 (https://www.bis.org/bcbs/publ/d400.htm). The requirements provide for banks and banking organisations to disclose qualitative and quantitative information on their remuneration policies. Quantitative disclosure templates are meant to provide information on a bank's fixed and variable remuneration awarded during the financial year, details of any special payments made, and information on a bank's total outstanding deferred and retained remuneration, respectively. The disclosure requirements should be published annually, with the first disclosures due in a bank's Pillar 3 report at its financial year-end 2017.

[8] See FSB, *Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors*, April 2018 (http://www.fsb.org/2018/04/strengthening-governance-frameworks-to-mitigate-misconduct-risk-a-toolkit-for-firms-and-supervisors/)

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Recommendations for national supervisors: Reporting on the use of compensation tools to address potential misconduct risk[9]

1. Introduction

Collecting appropriate data and evaluating it on a regular basis can provide both firms and supervisors with important insights into the effectiveness of compensation programmes and potential areas of weakness. These Recommendations are meant to represent better practices and are directed to national supervisory authorities from all financial sectors for further consideration as part of their oversight of compensation practices in significant financial institutions.[10] The Recommendations draw on the experience of supervisors who are members of the FSB and are designed to support more effective engagement with firms, improved monitoring practices and informed assessments of the role played by compensation in supporting prudent risk-taking behaviours and business practices.

Where guidance, for example on public disclosure, exists, the Recommendations lever on such guidance to avoid overlaps and recognise the synergies in information production, while recognising that information collected for supervisory purposes might need to be more detailed or specific than that prepared for public disclosure.

The Recommendations are not intended to be prescriptive but instead suggest certain categories of data that may enhance supervisory dialogue with firms.[11] Although decisions on the scope of data gathering, the types of data and the frequency of collection are for national supervisory authorities to make, these recommendations on the types of data should be helpful to better understand the conduct risk management framework and the use of compensation tools to prevent and remediate potential misconduct risk. The Recommendations must be viewed in light of existing national laws and regulations and in a manner consistent with the supervisory powers individual regulators have been granted.

The Recommendations further a number of important FSB objectives, including development of comparative baselines, promoting accountability and identifying areas of weakness or emerging risks that could usefully be addressed through compensation and performance management processes. The use of compensation and performance management mechanisms should not only address misconduct - preventatively and when it occurs - but should also help to promote good conduct, for example by helping support firm-led efforts to prevent misconduct, ensure products are suitable for clients, and safeguard market and firm integrity.

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[9] Throughout this document, the term “misconduct risk” is kept for consistency with the terminology used in the FSB work on measures to address “misconduct risk” (see http://www.fsb.org/2017/07/reducing-misconduct-risks-in-the-financial-sector-progress-report-to-g20-leaders/). It is however noted that many firms prefer the use of the term “conduct risk” as conduct programmes extend well beyond efforts to address misconduct, and increasingly exhibit, for example, measures aimed at promoting positive conduct as well as remediating inappropriate conduct.

[10] The P&S note: “The FSF Principles for Sound Compensation Practices are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms”. The Supplementary Guidance to P&S note: “Significant financial institutions” are those that national supervisory authorities consider significant for the purposes of the P&S.

[11] The P&S use the term “financial institutions” and “firms” interchangeably. Both terms are used in these Recommendations interchangeably and they should be understood, as the context may require, as referring to different types of institutions or firms in the broad financial sector.

Supervisory reviews should lever on existing firm-driven analyses and internal monitoring and testing. For this reason, the FSB encourages both firms and supervisors to develop a structured approach to data gathering, reporting and analysis.

The data set ("Data Set") is designed to help firms and supervisors answer a number of important questions. These include whether governance and risk management processes surrounding compensation:

- appropriately include conduct considerations in the design of their compensation and incentive systems, including the setting of individual goals, ex ante performance measurement mechanisms and ex post compensation adjustments;
- support the effective use of compensation tools in combination with other performance management tools to help promote good conduct or to remediate misconduct;
- promote wider risk management goals, including for conduct issues, consistent with the firm's strategy and risk tolerance; and
- support 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.

The Recommendations do not establish new principles or standards beyond those already established in the P&S, nor are they designed to be "one size fits all".

2. Misconduct and Compensation

In recent years, supervisors and firms have directed significant attention to improving compensation and risk adjustment practices.[12] They have focused more intensively on the impact compensation and related performance management mechanisms can have on incentives, the risks they may create, and their implications for the long-term health of financial institutions.[13]

These tools can play an important role in addressing misconduct by providing both ex ante incentives for good conduct and ex post adjustment mechanisms that support appropriate accountability when misconduct occurs.[14]

As set out in the P&S,[15] firms should regularly review whether the design and implementation of incentive compensation programmes deliver appropriate risk-taking incentives, and any identified deficiencies should be corrected. Well-targeted data gathering and analysis supports a number of processes used by firms to identify, prevent, mitigate and remediate misconduct,

[12] Effective risk adjustment relies on appropriate identification of risk and strong corporate governance including development of policies and procedures that result in effective balance of risk and reward.

[13] See for example: FSB, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Fifth progress report,* July 2017 (www.fsb.org/wp-content/uploads/P040717-6.pdf).

[14] FSB, *Measures to reduce misconduct risk: Second Progress Report*, September 2016 (www.fsb.org/wp-content/uploads/Measures-to-reduce-misconduct-risk-Second-Progress-Report.pdf)

[15] See P&S, Principle 2 and related commentary.

including internal monitoring and back-testing of incentive compensation awards and pay-outs.[16]

While the Recommendations provide a tool for possible use by national supervisory authorities, firms are expected to develop supporting processes, including structured approaches to data gathering.

The FSB acknowledges the challenges inherent in gathering data, including, among others, those related to: coordination between group activities and local entities; integration of data from various sources (such as legal, finance, audit and human resources databases which may be retained on separate systems), and aggregating them in meaningful pools; data privacy issues; and data integrity issues. Indeed, a major challenge within firms is how to meaningfully integrate and ensure the exchange of information on a horizontal level between the different control and support functions (human resources, compliance, legal, risk), and also among different group entities. Further, these processes are often multi-year in nature and this will influence the cycle and timing of related data gathering and data analysis.

For this reason, it is important for firms to engage in a regular review of their data collection and aggregation processes and related management information systems. Work already undertaken by some firms in this area is encouraging and provides a path to better practices. At a workshop held by the FSB with industry participants in December 2017 one bank noted that "the collection and use of data to support analysis of the link between compensation and misconduct risk is key to reducing the opportunities for misconduct while strengthening the ability to contain the associated risks".[17]

An internal structured data collection strengthens firms' ability to establish, implement and monitor risk prevention and mitigation strategies, and assist a more effective use of compensation as an incentive device within a firm's risk governance and risk management frameworks. Internal data should be sufficiently granular to support rigorous internal monitoring and analysis.[18] A structured data collection by firms should also assist back-testing and thereby support refinements to compensation policies and misconduct risk management systems. Internal data collection should also support more effective disclosure as required by the P&S (e.g. to shareholders, regulators and other stakeholders).

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[16] As noted in the FSB's fifth progress report on the implementation of the P&S, although firms have made progress in these areas, significant work remains to be done. (See: http://www.fsb.org/wp-content/uploads/P040717-6.pdf)

[17] FSB, *FSB Workshop on the Link between Compensation and Conduct Data collection and analysis*, May 2018 (www.fsb.org/2018/05/fsb-workshop-on-the-link-between-compensation-and-conduct-data-collection-and-analysis/)

[18] Sufficient data and strong analytical capacity should be in place within the firm to adequately monitor, with involvement of control functions, the effectiveness of incentive compensation arrangements, carry out robust misconduct root cause and pattern analysis, including identification of outliers and key trends, and determine the firm's overall exposure to misconduct risk and the effectiveness of the management of this risk.

3. Objectives of the Recommendations

These Recommendations are intended to support supervisors in their dialogue with firms, and to foster the development of better practice. They are also aimed at better supporting the implementation of the P&S as well as the Supplementary Guidance to the P&S.[19]

A framework is proposed for data gathering and reporting as a tool for supervisors to monitor and analyse the effectiveness of compensation frameworks in addressing misconduct risk.

To achieve this goal, it is recommended that, consistent with legal and regulatory frameworks, supervisors collect a set of descriptive information, both qualitative and quantitative, on the firm's compensation system and its use as part of the misconduct risk management framework. Broadly, the information collected should help supervisors to understand and review:

- **The importance of conduct within the firm's incentive compensation framework and the role of compensation policy in establishing a sound risk and conduct culture.** Data recommendations in this respect include information on the:
  - Incentive system's main characteristics and functioning (e.g. setting individual targets/performance criteria, assessing incentives provided, performance and determining compensation).[20]
  - Procedures in place to manage misconduct risk. For a comprehensive analysis and understanding of the risks that compensation adjustments should reflect, supervisors should understand the firm's conduct management framework and the role played by compensation and performance management practices within that framework.[21]
  - Metrics or other indicators used to identify and measure misconduct risk for compensation purposes.[22]

- **The use of compensation tools in practice and their role in ensuring accountability when misconduct occurs.** Data gathering in this area includes information on:
  - Compensation adjustments made during the previous year and supporting documentation.[23]

[19] Relevant references to the P&S and the Supplementary Guidance to P&S are noted for context in footnotes to the Data Set.

[20] The data reporting should help supervisors to review the progress made by firms in integrating effective conduct standards into their compensation and control frameworks; for example, whether non-financial performance measures are appropriately designed and incorporated in performance plans and effectively impact compensation awards.

[21] This would include information on how misconduct is identified as well as on the governance and decision-making processes used to assess individual and collective responsibility when misconduct occurs, and to decide the impact on compensation. In this regard, information on events that have occurred would support supervisory consideration of how compensation adjustments are being used and in which circumstances.

[22] Some observed practices across firms show that indicators are often limited to compliance with laws and regulations, rather than also incorporating values and standards of conduct including fair treatment of customers or preservation of market integrity.

[23] This would include, for example: i) adjustments at bonus pool and individual levels; ii) in-year adjustment or ex post adjustment in terms of malus or clawback.

- Information on the firm's investigation of significant misconduct, and the actions taken in response.[24] This information would help the relevant supervisor understand the circumstances under which compensation adjustments were made and/or when other tools were considered more appropriate, and the relevance attached to compensation measures vis-à-vis other tools available for ensuring accountability when misconduct occurs.[25]

4. Scope

The Recommendations are aimed at supervision of significant financial institutions. Authorities should establish clear expectations on data gathering and reporting on the use of compensation tools to address misconduct risk.

Jurisdictions will consider the Recommendations in a manner consistent with their existing supervisory processes on compensation, including their regime for identifying the population in scope. In particular, the identification of material risk takers should consider all risks taken by employees, including adequate consideration of conduct risk. Based on the Recommendations, supervisory reporting should cover those individuals considered in scope by the firm's compensation framework as conduct considerations are applied.[26]

Recommendations

The Data Set covers compensation frameworks as well as their actual implementation:

Part A: Compensation frameworks to address misconduct risk and their governance

Part B: Compensation actions taken in the event of misconduct

The Recommendations identify a core set of data ("Core Data") for the effective supervision of compensation practices that are considered particularly important for supervisory monitoring. This represents the minimum set of information that should ideally be available to supervisors.

The FSB recommends that the Core Data be reviewed periodically through ongoing supervisory activity and integrated into supervisory frameworks, within the scope of a jurisdiction's applicable laws and regulatory frameworks.

To complement the Core Data, the Recommendations also identify additional information that can provide further insight on compensation and misconduct risk, and may be useful in particular in case of supervisory deep dives or horizontal reviews on compensation and conduct.

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[24] The Recommendations include information on: incident identification; the root cause of such events and the ways in which firms use related lessons learned to identify and prevent similar failures in other areas of operations; the roles and responsibilities of those involved in decision making; and internal management information reports.

[25] Compensation is one of the available tools to address misconduct risk. In certain instances the use of other performance management tools such as disciplinary sanctions, dismissal, deferment in career progression, mandatory training etc., may be appropriate depending on the severity of the misconduct.

[26] This does not necessarily mean that all MRTs should receive the same treatment.

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DATA SET

The following box describes the Core Data and additional information for the purpose of the Recommendations.

The Core Data are highlighted in bold; the additional information is not bolded.

It is recommended that supervisors carry out an initial, comprehensive data gathering of the Core Data indicated in parts A and B for significant financial institutions, and then receive updates no less frequently than on a yearly basis.[27] Since frameworks, policies and procedures do not change frequently, at least not in a material way, the updates on the information in part A related to the firms' policies and procedures generally should include only material changes or new elements that have become relevant.

The information in part B on concrete compensation actions taken in response to misconduct generally should be updated annually.

A. COMPENSATION FRAMEWORKS TO ADDRESS MISCONDUCT RISK AND THEIR GOVERNANCE

A.1. Population in scope for the application of compensation tools to mitigate/address misconduct risk and, if available, a description of the criteria/methods used to identify material risk takers (MRTs) in relation to misconduct risk.[28]

A.2. Processes for determining, monitoring and reviewing the firm's use of compensation and broader performance management frameworks where relevant in supporting effective risk management including of misconduct risk. This should include a description of the role of key bodies, processes and functions involved in misconduct risk management, such as:[29]

- **A description of the internal definition of misconduct categories used for compensation purposes, including whether misconduct categories are used consistently among different business units or legal entities; and**
- **A description of the firm's policies and decision-making procedures for assessing and deciding on the use of compensation tools in case of misconduct, specifically for assessing and determining individual responsibility and the appropriate impact on compensation in case of**

[27] For banking organisations some of these data, and in particular the additional information to the Core Data Set A might already be collected by firms for the purposes of Pillar 3 disclosure. National supervisory authorities should assess the extent of any potential synergies among the two exercises.

[28] Firms should consider whether the current population identified through their MRT process should be reviewed to reflect the incidence and potential for misconduct in other areas of their workforce.

[29] Supplementary Guidance to P&S (recommendations 1-4).

misconduct incidents; including information on the bodies and functions involved and the information gathered in support of the process.

- **General information on positive incentives and policies utilised by the firm to promote good conduct.**

A.3. Design of performance arrangements and performance measures, such as:

- **Information on the design of compensation arrangements for MRTs and how that design takes into account conduct-related considerations;[30]**
- **A description of the key financial and non-financial monitoring metrics, performance objectives and/or bonus pool measures and adjustments (where applicable performance score cards and dashboards) used to link compensation and conduct (both positive and negative) for MRTs,[31] the data used and its sources; the triggers and their respective weighting if any; and**
- **The incorporation of misconduct considerations in the compensation adjustment process, (e.g. the percentage of compensation at risk for misconduct issues).[32]**

A.4. Compensation adjustment tools available (in year adjustments; and ex post adjustments through malus or clawback), including wording of the malus and clawback clauses.

Additional information on the firm's compensation policies and procedures

Compensation Governance[33]

A.1.1. Documentation supporting review of the compensation policy, including action items, responsible parties and progress against those items, to address any gaps raised (e.g. outputs of monitoring and back-testing processes).

Description of the firm's compensation system: [34]

A.1.2. Most important design characteristics of the compensation system, including:[35]

- the key risks taken into account in the compensation process;
- the ways in which the firm links compensation with performance and adjusts compensation for key risks during a performance measurement period (performance and risk metrics used to adjust compensation where appropriate through in-year adjustment, malus or clawback);

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[30] P&S (Principles 1-2); and Supplementary Guidance to P&S (recommendations 1 and 5).

[31] P&S (Principle 4); and Supplementary Guidance to P&S (recommendations 1, 5 and 7).

[32] P&S (Principles 5-6); Supplementary Guidance to P&S (recommendations 5, 6 and 7).

[33] P&S (Principles 1-2).

[34] See, for example, information covered under the BCBS standards on Pillar 3 disclosure requirements (part 13), March 2017 (https://www.bis.org/bcbs/publ/d400.htm).

[35] Supplementary Guidance to P&S (recommendations 5, 6 and 7).

- the deferral and retention policy[36] and vesting criteria; and
- balance between cash and non-cash instruments such as shares.

Additional information on the firm's misconduct risk management framework

A.2.1 A description of how conduct objectives feed into the firm's Risk Appetite Framework and are cascaded down to legal entities/business units.

A.2.2 A description of the types of measures and policies for dealing with misconduct events.

A.2.3 A description of internal processes and supporting information for assessing and determining individual responsibility in case of misconduct. The additional reporting could include: aggravating and mitigating circumstances considered in the decision; disclosure within the firm of the incident and of the outcome of the procedure; information sources (e.g. whistleblowing/alert systems; customer complaints; legal disputes; internal audits; self-denunciation; other); internal reporting mechanisms and escalation procedures.

A.2.4 The firm's code of conduct and other relevant internal guidelines in place to specify expected good conduct.

A.2.5 A description of how compensation is used in combination with other tools within the performance management framework in relation to misconduct (e.g. hiring, performance review, promotion, succession planning and talent development strategies).

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B. COMPENSATION ACTIONS TAKEN IN THE EVENT OF MISCONDUCT[37]

B.1. Data on misconduct incidents under examination by the firm (including outstanding cases and new cases that have occurred in the current year) and relevant measures taken, including compensation adjustments as applicable.[38] **This includes:**

- **category/type of misconduct incident and year of its first manifestation;**
- **severity assessment of the misconduct event (from significant event to lower level infractions);**
- **number of employees and category of staff involved by rank and function;**[39]
- **root cause of the misconduct event and remedial actions taken; and**

[36] For instance, information on percentage of deferral, total time horizon, time horizon of vesting, persons in scope.

[37] Supplementary Guidance to P&S (recommendation 8).

[38] Misconduct cases may take some time before they come to the light, and the inquiry by the firms into the events and the follow up actions may also take some time to be decided. The data gathering should take this timing issue into account.

[39] Supplementary Guidance to P&S (recommendations 5 and 6).

- **details on the size of compensation adjustments relative to total variable remuneration.**

B.2. A listing of all compensation adjustments (in-year, malus, clawback) with the rationale for the adjustments, including separate evidence of compensation adjustment for misconduct.

Additional information

B.1.1 A record of major incidents, and their potential estimated or actual impact in terms of financial losses or capital implications. A description of what is considered a major incident that is internally escalated.

B.1.2 Data on major misconduct incidents for which no compensation adjustment or performance management measures were made (for which there was a determination in the previous financial year that misconduct occurred), including a rationale for not taking any action.

B.1.3 Management information reported to (a) senior management and (b) the board on misconduct.

B.1.4 A copy of relevant independent investigation reports and thematic conduct reviews or audits.

B.1.5 Internal analysis conducted by the firm in mapping misconduct, identifying patterns of misconduct and determining the root causes of misconduct.