FSB FINANCIAL STABILITY BOARD

23 November 2018

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

## Overview of responses to the consultation

On 7 May 2018, the FSB published a consultative document on *Recommendations for consistent national reporting of data on the use of compensation tools to address misconduct risk* ("Recommendations").[1] The FSB received 11 responses[2] from associations representing supervisors, banks, a research foundation, trade associations and a trade union.

This note summarises the main points from the responses, including to the specific questions set out in the consultation and provides an overview of the response to those comments, including changes made to the Recommendations.

Generally, most respondents voiced support for efforts to promote good conduct, improve culture and reduce the incidence of misconduct at financial institutions. Among other issues raised, commenters offered suggestions for further tailoring the scope of the Recommendations, expressed concerns over privacy and confidentiality of the data collected, and highlighted some of the technological challenges associated with collection and analysis of data.

In reviewing the comments, FSB members have concluded that some of the concerns raised may be the result of a lack of clarity in the Recommendations themselves. The following clarifications are aimed at elucidating some of the issues raised across various comment letters:

- The Recommendations refer to compensation "tools" to address potential misconduct risk, which are both ex ante mechanisms (design of variable compensation that ensures appropriate incentives and controls) and ex post risk adjustment mechanisms that would be utilised when accountability for adverse outcomes is established.
- The Recommendations will be implemented by national/regional authorities, who will determine the scope, nature, and timing of any resulting reporting. The suggested items for consideration will be tailored by national/regional authorities 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 national/regional authorities and reporting protocols will reflect national law, including

[1] FSB, *on Recommendations for consistent national reporting of data on the use of compensation tools to address misconduct risk,* May 2018 (http://www.fsb.org/2018/05/recommendations-for-consistent-national-reporting-of-data-on-the-use-of-compensation-tools-to-address-misconduct-risk/)

[2] http://www.fsb.org/2018/07/public-responses-to-consultation-on-recommendations-for-consistent-national-reporting-of-data-on-the-use-of-compensation-tools-to-address-misconduct-risk/

privacy and confidentiality provisions applicable to supervisory dialogues. The Recommendations do not include additional public disclosure provisions.

- The Recommendations do not contemplate a "uniform data collection framework" nor a one-size-fits all standard for use of compensation tools. They are not based on the assumption that compensation tools should be used to address every misconduct risk, nor that regulators require the use of specific tools in specific circumstances, nor that compensation should be used alone to address misconduct, when it is clearly part of a wider toolkit. They recommend collection of information on how firms actually use tools, not only the framework and processes that govern their use. While other risk management and governance tools complement the effects of compensation tools in managing risk-taking behaviour, collection of information on the use of compensation tools is important given the history of misconduct that has occurred.
- The Recommendations are aimed at "significant" financial institutions, as defined for purposes of the FSB's progress report on implementation of compensation standards.[3] National authorities may, at their own discretion, consider applying the Recommendations more broadly.
- Effective risk adjustment relies on effective identification of risk and strong corporate governance including development of policies and procedures that result in effective balance of risk and reward. Effective risk management and strong corporate governance are key concepts for effective compensation frameworks. In order to assess whether variable compensation is appropriately risk adjusted, supervisors must be confident that firms are effectively identifying, analysing, tracking, and considering risk events. Collecting supporting data is a critical step in identifying, preventing and mitigating misconduct risk, including through the use of compensation tools. The absence of effective policies and procedures for risk adjustment processes, for example, would not be consistent with jurisdictions' expectations. Likewise, effective analysis considers not only how such events occur (in order to ensure accountability and address identified control gaps) but also whether they are likely to occur in other areas of operations. An important part of that analysis focuses on effective compensation design and ex post adjustments which help appropriately balance risk and reward and take into account compliance performance and ethical and responsible behaviour.
- Supervisors recognise that many significant firms have already made improvements to data collection and analysis related to compensation practices. Important changes have occurred in firms' management of compensation and conduct risk in recent years, including growing emphasis on incentivising positive behaviour rather than simply preventing negative behaviour.
- These Recommendations highlights better practices. Banks and their supervisors can and should engage in dialogue on the ways in which a particular institution addresses misconduct through a mix of its governance, controls, risk management, and compensation approaches that are tailored to the institution's unique circumstances.

[3] FSB, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Fifth progress report,* July 2017 (http://www.fsb.org/2017/07/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards-fifth-progress-report/)

That dialogue, as part of the normal supervisory relationship, has proven to be a productive tool in addressing misconduct. The Recommendations gather information on how financial institutions internally define misconduct (which has a significant impact on the scope of information collected) and on how it is effectively managed. Evidence that misconduct risk is being effectively managed is critical to supervisory reporting processes, however the Recommendations do not propose any compensation provisions that are globally applicable to a wide universe of employees. The Recommendations are consistent with allowing institutions to tailor their information collection in a way that results in effective identification, prevention and mitigation of misconduct risk as well as consideration of this risk in compensation design and decisions.

- Finally, since many jurisdictions already collect this information supervisors are aware of the implementation challenges that range from technological (collection of information across multiple source platforms) to potential conflicts with cultural norms or local laws (data privacy and employee protections). The Recommendations assume that data collection, as in all supervised areas, would be an iterative process. As firms embrace technology in other areas of operations, so too should their risk management of incentive compensation practices evolve.

The name of the publication has changed from *Recommendations for consistent national reporting of data on the use of compensation tools to address misconduct risk* to *Recommendations for national supervisors: Reporting on the use of compensation tools to address potential misconduct risk* so that the purpose and the preventative nature of the Recommendations is clearer.

**Summary of responses to consultation questions**

**Question 1: Is the proposed "Data Set" sufficient to help (a) supervisors and (b) firms to monitor the effectiveness of the use of compensation tools to address misconduct?**

One respondent set out broad concerns about the need to more effectively define the link between compensation policies and risks to financial stability and noted that an international approach is not necessary given the development of local regulatory frameworks. The Recommendations build on developments across a number of jurisdictions and are aimed at significant financial institutions. Compensation practices of significant financial institutions are a priority monitoring area for the FSB.

Three of the responses from trade associations set out concerns about the recommendations being overly prescriptive and wanting to see more of a principles-based approach to the gathering of data. They also suggested that the scope of the data collection should be limited to material risks takers (MRTs) and should focus on those issues that could cause a risk to financial stability. Jurisdictions will consider the Recommendations in a manner consistent with their existing supervisory processes on compensation, including their regime for identification of the population within scope. In particular, the identification of MRTs should consider all risks taken by employees, including adequate consideration of conduct risk. The Recommendations do not impose a definition of misconduct upon firms, in recognition that there is no one-size-fits-all approach. While some factors ought to be considered by all firms, e.g., whether a law has been violated, setting forth a standard in this area could result in an overly prescriptive model.

Two trade associations and one firm noted that they broadly thought the data set out in the Core Data Set is appropriate and that recommendations should be limited to that set of information. Meanwhile one respondent believed there was a need for more information to be included in the Core Date Set and for additional emphasis on "pervasive types of misconduct" such as inappropriate advice and mis-selling. Because the Recommendations are expected to be further tailored by jurisdictions, the FSB has retained both the core and additional information as options for supervisors to consider.

Some respondents raised concerns about the treatment of data that is provided to supervisors and legal issues about sharing information. Others emphasised issues related to privacy. It is envisaged that information collected would be subject to national laws concerning the protection of supervisory data. Since many supervisors are already gathering at least some of the information covered by the Data Set it is not envisaged that there will be data privacy issues.[4]

One respondent noted that they would like to see more guidance provided on defining MRTs. The FSB does not set out specific definitions for MRTs but in previous compensation progress reports has set out details on the definitions that FSB jurisdictions use for MRTs.

**Question 2: If not, which additional data/information should be collected?**

The majority of respondents did not see the need for additional information to be set out in the Recommendations, although supervisors are free to tailor the collection of additional information to take account of local circumstances.

Three respondents suggested the need for more information with one suggesting the collection of data on the frequency of misconduct incidents and another suggesting that supervisors collect information on involvement and consultation with employee representatives at the company when developing frameworks. It is expected given the types of information already contained in the Recommendations that supervisors would have some insight into the frequency of misconduct incidents.

One respondent set out the need to consider the extent to which non-monetary performance measurement systems can lead to misconduct. While the Recommendations are focused on compensation and misconduct the FSB has made clear in previous publications that it does not consider that compensation is the only factor that may drive misconduct.

One commenter noted that effective aggregation of data and use of such data in benchmarking would not be feasible. Another suggested that jurisdictions consider developing standardised reporting templates for the collection of actual compensation data. The FSB does not intend to develop a standardised reporting template or conduct a benchmarking exercise but does encourage authorities to establish clear expectations on data gathering and reporting on the use of compensation tools to address misconduct risk, and encourages firms to benchmark their misconduct frameworks against better practice.

[4] Several commenters also raised privacy concerns in their response to Question 3.

**Question 3: Are there any impediments to (a) firms and (b) supervisors in (i) gathering or (ii) using the Data Set?**

One respondent said that differences between compensation in different jurisdictions would make it difficult to implement the collection of the data. Another raised concerns that the envisaged monitoring and metrics would not match underlying compensation programmes. Several commenters set out concerns about privacy and/or the extent to which the disclosure of data would present legal and confidentiality issues with one highlighting particular concerns about reporting highlighted in section B of the data set.[5] Another noted that supervisors should work collaboratively with firms to develop the most efficient means to collect and learn from relevant data. The Recommendations were developed to be in line with existing reporting practices and are consistent with better practice in this area. Given that local practice varies, the discussion of burden is an appropriate topic for firms to raise with local supervisors.

One trade association would like to see examples of misconduct provided in order to define and collect data. As set out in A.2 of the Core Data Set, there is an expectation that firms define what they consider to be misconduct. The FSB does not intend to provide a more detailed description of misconduct or to impose a prescriptive definition.

One commenter noted that "the required submission of a uniform data set", could inappropriately usurp the role of the board and management. The collection of supervisory data in no way inhibits the role that must be played by boards and senior management to ensure effective compensation policies and practices are in place. The Recommendations are not intended to be a uniform data set, but rather to be tailored by jurisdiction. Well targeted data collection is critical to effective oversight by the board and management, and is a key element in managing risk at all large complex institutions. The types of data that firms choose to send to boards are a decision for individual firms. While the data may be further tailored, it would presumably reflect at least at a high level many of the categories of information that are highlighted in the Recommendations including data on compensation, incentives and the disciplinary process.

Two commenters noted the Recommendations could result in significant regulatory burden, suggesting that they should apply only to significant institutions and that supervisors should carefully consider proportionality and the risk profile of the company before requiring the full Data Set to be provided. The same commenter noted that supervisors should carefully consider the frequency at which data should be collected. The Recommendations are aimed at institutions considered significant for the purposes of the Principles and Standards. Data would only be collected where local legal requirements permit such collection by supervisors, which in many jurisdictions is the subject of specific legislation. Any data collected would remain with national/regional supervisory authorities. 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 misconduct risk.

[5] FSB views on privacy concerns are included in the response to comments received as part of Question 1.

**Question 4: Are there any elements in the "Data Set" that may not be relevant to a particular financial sector?**

One respondent set out examples of where they believed it might be difficult for financial institutions to meet specific requirements set out in the Recommendations. In common with a number of other responses they set out a view that the scope of the data requirements should be limited to MRTs. The revised Recommendations make clear that the scope of application for the Recommendations should reflect existing national processes, including those related to the identification of MRTs and that the supervisory reporting should cover those individuals considered in scope by the firm's compensation framework as conduct considerations are applied.

A response from a supervisory body suggested that certain of the Recommendations may not be as relevant to the sector they regulate given the low level of misconduct incidents related to compensation. However, most who offered comments on this question agreed that the information was relevant across sectors, with one noting that differentiating across sectors opened a "potentially disastrous loophole".

A number of respondents set out the need for the Recommendations to ensure proportionality, to focus on those individuals or those firms that pose the greatest risks. This is consistent with the FSB's broader approach on compensation in which the Principles and Standards were designed to apply to large complex firms as defined by national authorities.

One respondent queried whether firms should have policies that set out how compensation tools should be used. FSB members expect that compensation policies should set out clear expectations on the use of compensation tools and when they could be triggered. The FSB's *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices*,[6] in particular Recommendation 7, sets out expectations on the need for compensation policies to be consistent, fair and transparent.

One respondent asked whether scorecards should be expected to include adjustments for misconduct events. There is not a set expectation on this point, however where misconduct occurs there is an expectation that an adjustment is considered.

One respondent flagged that there could be overlap in the requirements between Recommendations A.2-4. The FSB does not believe there is an overlap in these Recommendations however in cases of overlap, information would be collected only once.

With regard to recommendation B.1.1 one respondent set out concerns about the extent to which it is possible to identify "near misses". As a result of feedback part of this Recommendation has been removed. However, FSB members believe that compensation decisions should consider not only the consequences of actions when they crystallise, but also how successfully (or not) the institution worked to identify and prevent similar risks from occurring in other areas of operation. At the FSB's compensation workshop with firms in December 2017 banks

[6] FSB, *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices*, March 2018 (http://www.fsb.org/2018/03/supplementary-guidance-to-the-fsb-principles-and-standards-on-sound-compensation-practices-2/)

emphasised the importance of root cause analysis and lessons learned "read across" to identify similar vulnerabilities in other areas of operations.[7]

One respondent suggested that Recommendation B.1.2 goes beyond the FSB's remit. This recommendation seeks to back test whether compensation policies have been effectively implemented and therefore is an important mechanism for supervisors to consider the robust implementation of compensation policies and the practice at firms. The FSB's work on the effectiveness of compensation policies and practices is focused not only on the effectiveness of compensation design (and the appropriateness of incentives delivered), but also the effectiveness of risk adjustment practices. Monitoring and validation of compensation outcomes is a core expectation in some FSB members' supervisory guidance. Past FSB roundtables have explored this issue and members believe it is a better practice. As a result this recommendation has not changed.

In the case of B.1.5 one respondent suggested that the data collected by the Data Set should only include procedures related to mapping and identifying patterns of misconduct and not the outcomes of this work. Supervisors are interested in how effectively banks are identifying and tracking misconduct, therefore this Recommendation is not only restricted to the content of policies and procedures.

**Question 5: Are there any additional elements that should instead be considered for a particular financial sector?**

Two responses from associations of supervisors suggested that the collection of more information should be considered for specific financial sectors. The Recommendations were developed to encourage collection of information on all types of misconduct and are sufficiently general to apply across financial sectors; therefore, the FSB has not added any more sector specific data into the Recommendations. Where pervasive misconduct occurs it should be promptly addressed, including with appropriate compensation actions. These Recommendations were developed as part of the FSB's misconduct workplan which looks to address risks of misconduct which have the "potential to significantly harm consumers, undermine trust in financial institutions and markets and create systemic risks".[8]

**Question 6: What elements of the Data Set are not already utilised by firms in their own monitoring of compensation and misconduct risk management practices?**

One commenter underscored that a single financial institution may employ multiple monitoring methodologies and evaluation practices to reflect the unique aspects of a particular business unit or differences between employees working in different regions, noting that here is no single way to monitor compensation tools and no single set of analytic metrics that would support their judgments. The FSB recognises that practice in this area continues to evolve and supports those efforts. The implementation of the Recommendations should reflect underlying

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

[8] 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/)

differences in compensation regimes and jurisdictions can be expected to tailor their reporting accordingly.

One trade association noted that in its jurisdiction few firms currently undertake checks when a misconduct incident has occurred in order to audit compensation adjustments. One response set out concerns that the Recommendations are not proportionate and therefore could lead to resources at firms being inappropriately channelled to collecting data that is not relevant. One association of supervisors noted that given limited frequency of misconduct in the sector and the differences in business models of insurers versus banks, insurers are not as likely to have formal processes in place to identify specific misconduct categories, set formal definitions and track/report on misconduct. One respondent suggested that the Recommendations should focus on high severity issues. Recommendation B.1 asks for a breakdown of incidents according to their severity. This will allow supervisors to take a risk-based approach and focus on those that are most severe. Additionally, Recommendation B.1.2 has been changed to reflect a more limited scope in that it only applies to "major" misconduct incidents.

**Question 7: What types of information have been most useful to firms in their monitoring and assessments of potential misconduct, and when assessing the effectiveness of compensation tools?**

A trade association noted that the information provided in the data set is useful to firms. Meanwhile, another response from trade associations made the point that the Recommendations could be used as a basis for data collection requirements developed at the national level. This is the intention of the Recommendations which are not meant to be a detailed set of requirements but rather a set of basic data that will help supervisors and firms better understand the links between misconduct and compensation and evaluate the effectiveness of their efforts in this area.

A response from a research foundation suggested that a range of other data sources could be collected as part of the Recommendations. The FSB encourages jurisdictions to consider supplementing the data in the Recommendations to take account of local circumstances. The Recommendations themselves have not been expanded to incorporate these additional information sets.

One respondent noted that they are not able to assess the effectiveness of compensation tools (i.e. to attribute actions or behaviours to them) however they do monitor how compensation tools are being used. The FSB understands that practices in this area are evolving and continues to work with members to identify better practice.

One respondent noted that customer feedback, surveys, internal and external audits, investment analysts, press reports and especially dialogue are useful tools in monitoring and assessments of potential misconduct. The FSB agrees that these are important sources of information however the Recommendations are intended to be principles based so these are not specifically referenced in the suggested data.

**Question 8: What are the most important changes that have occurred in firms' management of compensation and conduct risk in recent years? Do the current**

**Recommendations focus enough on these developments that may help to better achieve alignment of risk and reward?**

A number of respondents noted the extent to which in recent years firms have sought to ensure compensation policies are consistent with long-term risk alignment, particularly with the use of compensation tools. This is a trend that has been reflected in conclusions from the FSB's progress reports on implementation of the Principles and Standards.

One respondent noted a risk that the Recommendations are overly focused on misconduct and that a focus on alignment with risk management should not be lost. The FSB agrees that, as set out in the Principles and Standards, it is important for long-term risk alignment to be considered in the design and execution of compensation arrangements and policies. While the Recommendations focus on misconduct, since this is the remaining element of the FSB's misconduct workplan, this is just a subset of the FSB's focus on the importance of risk alignment in compensation policies.

**Question 9: How do firms monitor and validate the use of compensation tools when misconduct occurs to ensure an appropriate balance between risk and reward? What analytics support firms' judgments in these areas?**

One response from trade associations stated that compensation policies have been tailored to individuals and specific financial institutions and therefore a common approach is not possible. Two other respondents set out the steps firms are taking to ensure an appropriate balance between risk and reward. The practice of monitoring and validating compensation outcomes, which allows firms to consider the effectiveness of compensation tools in balancing risk and reward is considered a better practice. FSB members have observed that there is no single model in this area, and encourage continued innovation and development of practice.