SBP's Comments on the Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices

General Comments

The guidance is quite comprehensive and proposes recommendations for addressing the misconduct through risk based adjustment of compensation. To further enhance its efficacy, it may be beneficial to add an annexure providing some sector specific examples, showing how the non-compliance with the proposed recommendations will affect the financial institutions.

Query wise response.

Question 1: Should the Guidance be more specific with regard to the respective roles of the board or that of senior managers with regard to compensation and misconduct?

Response: The guidance needs to be a bit more specific with regard to the roles of the Board of Director and senior managers with regard to compensation and misconduct. Particularly, proposed recommendation '1' of the Supplementary Guidance (SG) places the responsibility for oversight of the compensation system on the Board. It would useful if the board may conduct their activities through dedicated board sub-committee like remuneration/ compensation committee of the Board. On the other hand, senior management is responsible for ensuring effective implementation As such, management of banks/ financial institutions (FIs) may establish a management committee for ensuring the availability of the compensation system designed to promote ethical behavior and compliance with laws, regulations, and internal conduct standards.

Question 2: The Guidance suggests that qualitative, non-financial assessments should have a direct impact on compensation and that they are important in determining how to align compensation with risk. Would additional guidance be helpful? Please provide data if your firm uses such provisions including the types of metrics used, and a discussion of any challenges you face in their use.

Response: The qualitative, non-financial assessments have important role in the alignment of compensation with risk. Given that qualitative, non-financial assessment is a very subjective exercise and involves a lot of judgment, additional guidance would be of great help in aligning compensation with risk. Particularly, qualitative factor become more important for business lines/ units that do not generate profit and require assessment based on performance against non-financial objectives.

Question 3: The Guidance identifies three tools most commonly used to address misconduct: in-year adjustment (adjustment to the current year's variable compensation before it is awarded); malus (reduction of deferred compensation before it has vested or fully transferred); and claw back, which permits recovery of variable compensation that has already been paid and vested. Given the particular characteristics of misconduct risk, do you believe that all three tools need to be available to a firm to establish appropriate incentives to deter misconduct?

Response: As the compensation is paid before the final outcome of an activity is known, some form of risk adjustment measures is necessary to deter misconduct. Further, remuneration adjustment required (to be made) varies from situation to situation, which entails a menu of adjustment options to reduce the incentive for excessive risk taking. In this regard, the three tools stated above would facilitate banks/ firms in establishing appropriate incentives for affecting the payoffs to address the misconduct. However, it is usually challenging to apply ex post adjustment like claw back for recovery of

remuneration already availed particularly by executives or Board members. So, guidance needs to insist on having some sort of legal or regulatory framework in place for effective application of adjustment options like claw back. As the "claw back" requirements have gained prominence post-GFC, the guidance may also add an annexure providing some examples of how various jurisdictions have devised and implemented the "claw back" requirements as part of their laws and/ or regulations so as to facilitate other jurisdictions in putting in place such requirements.

Question 4: The Guidance suggests minimum scenarios where adjustment of compensation should occur. Are there additional circumstances in which adjustments to compensation should be expected? What are the advantages and disadvantages of suggesting such minimum conditions? In particular, is there evidence from past use of such tools that might be instructive in how to formulate such scenarios?

Response: Since these are guidelines (rather than standards to be strictly implemented), additional circumstances (to adjust compensation) may be suggested. The additional circumstances such as: cartelization of the bank's executives; manipulation of financial markets (for instance the manipulation of LIBOR rates); mis-selling of financial products to customers (Bancasurance); and insider trading, may guide firms as to whether a specific circumstance may entail compensation adjustment.

Question 5: How much variable compensation should be placed at risk of adjustment in order to effectively impact incentives for excessive risk-taking or other inappropriate conduct?

Response: As a basic principle, the variable compensation subjected to risk adjustment should be higher for executives, senior level employees, and formally identified Material Risk Takers (MRTs) and Material Risk Controllers (MRCs), and lower for other categories of employees. Particularly for beginner to middle level employees a limited/ small amount of variable compensation needs to be placed at risk of adjustment. This is important from the perspective that there is a need to balance the effective impact of incentives for inappropriate conduct with that of keeping employees motivated and/ or maintain creativity/ initiative within an organization. Among the various variable pay options, it would be useful to defer the stock bonuses for longer periods and cash bonuses for relatively shorter periods. In terms of extent, it may be reasonable if two-thirds (2/3) of the variable compensation of the executive/MRT/MRC is deferred while for other employees one-third (1/3) of the compensation is deferred.

It would be relevant to highlight that fail-safes should also be placed along with tools to address misconduct (by variable compensation adjustments) to ensure that such tools are only used to address misconduct and not used to settle scores or for other personal reasons. As such guidance needs to provide for this aspect as well.

Question 6: Does the Guidance adequately cover compensation incentives that may be relevant to addressing misconduct risk in all sectors of the financial industry? Are there additional specific provisions that should be considered to better address misconduct risks in particular financial sectors? Are there specific provisions in the guidance that may not be relevant to a particular financial sector?

Response: The guidance seems to cover broad recommendations for the financial sector. The proposed supplementary guidance is a good attempt to use compensation as a first line of defense to address misconduct risk. For effective implementation, the guidance may emphasize on banks/ firm to make the recommendations part of their code of conduct and arrange employees' awareness programs for effectively cascading the recommendation down the line and limiting/ minimizing the misconduct incidents. While sector specific guidance is preferable, however, this guidance adequately covers key areas for addressing the misconduct risk. To further enhance its efficacy it may be useful to add some sector specific examples for enhancing application of various compensation incentives identified in the supplementary guidance.