FSB 2015 Workshop on Compensation Practices

London, 14 April 2015

The FSB organised on 14 April 2015 the third workshop on compensation practices to share experiences and lessons on the implementation of the FSB *Principles* and *Standards* for Sound Compensation Practices (P&S) by financial institutions. The workshop focused on three main areas: the governance of risk adjustment processes; the alignment of compensation and risk from the perspective of the risk management function; and compensation and conduct issues. Officials from the FSB Compensation Monitoring Contact Group and fifteen senior executives responsible for remuneration and risk management at global systemically important banks participated in the workshop, which built on the findings and recommendations of the April 2014 workshop and progress report.[1]

This summary reflects regulators' understanding of the main points raised in the discussion at the workshop. It does not necessarily represent the views of authorities nor consensus views expressed by financial institutions at the workshop. Workshop findings will be included in the next progress report on compensation practices, which will be published in advance of the G20 Summit in November 2015.

The FSB welcomes any feedback on topics discussed at the workshop and summarised in this note. Comments should be sent to fsb@bis.org **by 10 July 2015**.

1. Key takeaways

1.1 Effective governance of compensation starts with the right 'tone at the top', and with the risk management function playing a key role

The role of banks' boards in compensation systems has expanded, and governance processes increasingly integrate at the board level relevant input from the risk management and other control functions: human resources (HR), risk, finance and audit committees work together with compensation committees to ensure compensation systems attain multiple objectives, including prudent risk-taking. The risk management function performs today an expanded role, and the quality of risk information provided to boards has improved. Industry participants share the view that the resources and stature of such functions have increased in recent years; one participant noted that the stature was bolstered by their role in compensation

[1] The conclusions of the April 2014 workshop were that: progress continues to be made in embedding risk management in firms' compensation practices, particularly in the governance of such practices and the integration of risk and control functions in compensation decision making; that operational challenges remain in some areas (e.g. selecting metrics to assess risk-aligned performance; educating Board members about compensation-related risk factors; determining the extent of discretion that should be applied in implementing compensation policies across the firm; and that adapting to different regulatory approaches and increasing complexity is a primary challenge and cause of concern for firms.

decision-making: “It is well-known that compliance and risk are consulted for each and every candidate considered for promotion. A number of people actually fail on that score.”

Participants also noted the challenge of building governance practices and compensation policies that will remain effective when the memory of the crisis fades, and there is a natural shift toward increased risk taking. Boards are increasingly focused on creating a culture that is attractive to people in the longer term, and on adapting the system of incentives to the type of organisation that they want to achieve. At the same time, increased external transparency and better communication will contribute to greater awareness and better understanding of the high level objectives of sound compensation policies.

1.2 Continuing progress is apparent in aligning compensation with risk

Risk alignment is now routinely considered in the design and governance of compensation systems. Control functions play a central role in design and operation of incentive compensation, and have begun to build out frameworks to help validate the effectiveness of risk adjustment mechanisms. Better indicators for risk alignment are now in use and initial experiences are available of back testing and other mechanisms to assess effective functioning of the risk measures. Risk objectives and regular “risk reviews” are now commonplace and there is more awareness among bank staff of the role of risk in determining compensation. Notwithstanding this progress, more work is needed to ensure the effective alignment of compensation and risk in terms of influencing staff behaviour throughout the firm.

1.3 Boards are increasingly focusing on conduct issues

Bank boards have increasingly focused on conduct issues, consistent with their fiduciary responsibility. Board members are asking whether risk takers understand what the firm expects of them (e.g. long term economic success of firm, reputation, client relations), what conduct issues should impact compensation, and where and how to draw the lines in terms of which individuals should be held accountable and what the right impact on compensation should be. Industry participants emphasized that conduct remains a “collective” issue that affects “the business unit, individual and supervisor.”

The boards’ focus is not only on appropriate compensation policies for staff with low adherence to values, but also on how to adjust compensation to encourage positive behaviour. One participant noted: “there is a role for story telling within the organisation for minor incidents and misbehaviour”. At the same time, credible deterrence remains a challenge. Individuals’ behaviour and conduct issues are typically addressed on a case-by-case basis, and compensation systems appear not to be sufficiently developed to effectively address conduct issues on an ex ante basis. One participant noted “ex ante adjustments for conduct issues would be the holy grail”; another observed that at some point conduct is no longer about compensation: “It’s dismissal, sanction and prosecution.” Industry participants agreed that addressing misconduct goes much beyond compensation, and that such issues could be better dealt with by improving the culture, risk awareness and individual responsibility at firms. Moreover, where serious misconduct is found to have taken place, employees will often be dismissed rather than be subject to malus or clawback. At worst, such misconduct should lead to prosecution which is, and should remain, outside the scope of what compensation systems can realistically achieve.

2. Selected topics

2.1 Governance of ex-ante and ex-post risk adjustment processes

The session focused on the governance framework surrounding ex ante and ex post risk adjustment processes, including the respective roles played by HR, compliance and risk management functions, as well as remuneration committees and boards of directors.

Participants noted continued strengthening of governance processes involving remuneration decisions. There is now a much more explicit consideration of risk metrics in adjusting compensation, including at the level of bonus pools. The focus on risk-adjusted compensation has expanded beyond senior executives to cover all material risk takers (MRTs). The risk function is more involved and the process has become more structured (often including compliance and other control functions), and Board Remuneration Committees (Remco) are interacting more frequently with Risk Committees. Industry participants noted that the Risk Committee has significant input on compensation issues. More than one bank highlighted joint Remco and the Risk Committee meetings and the fact that the Chief Risk Officer (CRO) is now a permanent member of the Remco. One participant observed that the identification of MRTs is now a joint responsibility of the Remco and Risk Committees.

This higher level of attention to risk has contributed to increased awareness among staff that risk management now has significant input into compensation decisions. This facilitates better understanding by bank employees of the drivers of compensation and their link to the values and culture of the firm, thereby inducing changes in behaviour. One participant noted that the overall objective is to "increase both risk awareness and the feeling of personal responsibility across the organization", and there is still work to be done. Another participant observed that "the basis for defining performance has changed. Compensation is adjusted for risk at the very beginning of the process, when defining the bonus pool." Several participants voiced the view that banks "now have a more sophisticated view on how people are making money… in some cases in the past we were paying for illusory financial performance". The time horizon has also changed, with consideration increasingly given to rewarding people for profits over a longer time period, given expected timing of the realisation of risk. Boards are increasingly focused on these objectives, and have correspondingly empowered risk management functions to cooperate with human resources functions with respect to the design and operation of compensation systems.

With compliance and conduct considerations attracting more attention, banks have shifted the focus on modalities to reward good behaviour and not just reign in bad behaviour. One participant mentioned that introduction of a new compensation system that eliminated formulaic incentive compensation plans initially resulted in turnover within the relevant business lines but that it ultimately led to "better behaviour, better sales quality, and more earnings than in the past". Some participants highlighted that maintaining the attractiveness of the sector particularly for junior staff is increasingly becoming a challenge given broader reputation issues and restrictions on pay packages. One participant also mentioned the difficulty of hiring staff in control functions (e.g. information technology and cybersecurity) given the competition for talent outside the sector and the fact that talent in these functions can obtain pay packages from firms in other sectors that are not constrained by deferral and ex post adjustment requirements.

Participants also discussed regulatory developments in some jurisdictions that have influenced the structure of compensation packages. Most comments focused on the European Union (as discussed in the 2014 Progress Report), with many banks expressing concern that the levers to align risk and influence behaviour might have diminished with the introduction of a maximum ratio between fixed and variable compensation under CRD IV/CRR.[2] One European bank noted that the cap also minimizes flexibility to deal with downturns. One non-European bank noted that its global compensation policy needs to be adjusted for Europe, but also across European markets given differences in national rules. Differing national requirements also led to compensation frameworks not being widely understood by employees. Another European bank noted the challenges of maintaining a consistent global group policy that applies EU rules in non-EU jurisdictions, particularly in Asia. A non-European bank added that this was beginning to impact the local pay structures in financial centres in Asia, with an increased fixed remuneration and changes in the competition for talent between European and non-European banks in those jurisdictions.

2.2 Aligning compensation and risk from the perspective of the risk management function

The session covered practices seen as most effective for aligning compensation and risk, how these practices have changed over the past five years, and the use of risk indicators to monitor the effects of compensation design on incentives structures. Participants also discussed how compensation practices are increasingly embedded in broader risk management frameworks. One participant noted that "history had overweighed the 'what' in compensation over the past few years, but organizations are now increasingly focused on the 'how'. Compensation is more effectively aligned with risk from the outset". Another bank reported the process underway to explicitly link the way in which the risk appetite framework is cascaded down to business units and individuals, which is then used to assess performance and determine pay. Such a process needs to permeate the entire organisation, so it can only be mainstreamed over time. Several participants noted that risk management and other control functions are critical to developing and analysing various types of risk indicators Other structured processes for surveillance and monitoring of compensation systems, such as back testing, formal risk reviews and better documented performance reviews were also highlighted.

Several participants observed that impacting the behaviour and approaches of business managers remains the ultimate challenge, since they are the ones driving a firm's performance. In order to enhance awareness and influence behaviour at the business line management level, one bank has incorporated remuneration as one of the factors in its business strategy stress testing program, while another bank has increased training programs and introduced a self-assessment for managers on performance reviews. Several participants underlined the importance of having "360-degree reviews" that involve all relevant units and control functions in the process and consider culture, compliance and risk in an integrated manner for both compensation and promotion decisions. Others pointed to increased training for managers of MRTs and on objective setting, and increased monitoring of processes to validate how targets are set and evaluated and how the associated performance translates into compensation decisions. Whilst managers had traditionally been viewed as resisting negative feedback of their staff, improvements had been observed when managers had been more closely involved in the formulation of risk management objectives.

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2 CRD IV is the European directive enacting Basel III, which came into effect on 1 January 2014 and includes specific requirements on compensation structures.

Other challenges were also identified. One participant cautioned about the extent to which the risk management function can be involved in HR issues given limited resources. Another observed that hardwired links to risk metrics can be a double-edged sword, in that different risk measures can send different signals and incentivise different behaviours, creating a tension between measurement and design issues. For example, using the cost of capital as a factor in the compensation formula is not straightforward given the range of possible standards (e.g. Basel III advanced approaches or other regulatory capital standards, economic capital, leverage ratio, liquidity pricing etc.), all of which produce different costs of capital and any of which can be binding. Indicators of performance also differ by business line and may be more difficult to quantify in some businesses, e.g. operational risk metrics. Finally, indicators that measure issues such as customer satisfaction can be misleading, in that "a customer can be very satisfied but for the wrong reason". One bank reported that it has been experimenting with back-testing to verify that newly introduced measures have not changed incentives in an unintended way, and to ensure that business line managers are not "gaming the system".

Participants discussed types of indicators that could effectively show whether compensation and risk are well aligned. These may include: the dispersion of bonuses paid out around a mean; the percentage of variable compensation and the amount of compensation at risk, including through discretionary components; and the balance between forms of compensation that align with the interests of shareholders versus those that are more aligned with creditors of the firm. A few participants noted that there could be a greater role for a combination of instruments in order to structure a system that effectively aligns incentives with different stakeholders. Another participant added that debt instruments have been underutilised and that they should be explored further, particularly in view of the introduction of an international standard on Total Loss Absorbing Capacity (TLAC) for G-SIBs. One bank indicated it was not a question of whether debt should be used, but how much.

In terms of public disclosure and communication, a few participants mentioned the need to reach out to shareholders and other stakeholders (e.g. proxy firms) in order to better explain their remuneration policies. One participant noted that the increasing complexity of compensation policies makes it difficult to present them in a way that is clear and easy for investors to understand, or in a way that is comparable across institutions.

2.3 Compensation and conduct

The session explored the application of ex-post risk adjustment through malus, clawback and other mechanisms that can help mitigate conduct risk, such as the spectrum of performance management mechanisms (including compensation and promotion) used to ensure appropriate consequences when misconduct issues arise.

As discussed in previous workshops, participants confirmed that malus is being applied more broadly and frequently than before. By contrast, clawbacks remain rare and are considered a measure of last resort that may accompany an employee's dismissal. Participants confirmed that the threat of clawback can be a powerful deterrent, but highlighted concerns about legal enforceability given the difficult issues they raise (labour law, tax complications, changes in the value of awards since vesting etc.). They also noted that while deterrence is a valid objective, the use of these mechanisms should be subject to appropriate due process. Participants confirmed that the typical escalation process in the case of infractions begins with bonus and promotion decisions before resorting to the use of malus, clawbacks and termination for cause (which almost always implies the loss of all unvested deferred components). Real time controls (e.g. monitoring of risk limits being breached) have become more commonplace at firms. Views, however, differed on whether to apply malus as soon as a sanctionable action takes place (in order to create a more direct link between the event and the sanction), or instead to apply malus at the end of the year in order to obtain more information, apply the malus more consistently across the firm, and deliver a stronger message.

Participants discussed other ways to deter misconduct and agreed that, while compensation is a powerful tool if enough pay is at risk, dealing with conduct goes beyond compensation and that compensation is not necessarily the appropriate route for dealing with all instances. Effective misconduct risk management is increasingly driven by the promotion of principles, risk awareness and need for individual responsibility at firms (supported by a strong 'tone from the top' in organisations). It was added that external pressures (notably financial and reputational risk) had played a greater role than simply adherence to regulatory rules and standards, hence the need to achieve the right balance between quantitative measurements and the design of effective principles and governance, with no 'one size fits all' approach.

Several banks commented on "early warning indicators" for potential conduct problems including: assessing disproportionately high profits in specific business lines; tracking unusual revenue patterns and erratic margin calls; monitoring of phone and e-mail communications for consistency with ethics and risk guidelines; operational risk indicators; 360 degree reviews; and monitoring of events at other firms to ensure similar vulnerabilities do not occur within the institution. However, assessing behaviour involves a degree of trial and error, not least due to the limitations of indicators. One bank commented that whilst customer satisfaction was easily assessed, achieving appropriate long-term customer outcomes was hard to quantify.

Industry participants identified a number of factors that would help change culture and address misconduct risks, including: a clear 'tone from the top' about the firm's system of values that weighs the 'how' equally to the 'what' and is backed up by tangible actions, including frequent meetings with business heads to convey the message; embedding behavioural aspects in performance assessments and rewarding good behaviour; hiring and promotion decisions; training on conduct and ethics; dealing with minor incidents before they grow ("broken windows"); and communicating widely and effectively within the firm ("storytelling") about the type of behaviours that would be subject to compensation adjustments to raise awareness. One participant noted the importance of "mindshare" by the Board and senior management around conduct matters as reflected and operationalized in regular meetings where misconduct is assessed, noting "the impact of that process throughout the organization is incredibly consequential. Everyone knows this happens, just like they know a compliance problem will affect promotion potential. It also avoids gamesmanship in the promotion system." A few banks also indicated that they have created regional review/disciplinary committees to increase consistency of approach, minimise the incidence of exceptions, ensure greater awareness among middle management, and act on training and promotion levers.