Measures to reduce misconduct risk

Second Progress Report

1 September 2016

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Measures to reduce misconduct risk

Second progress report

Executive Summary

In May 2015 the FSB agreed a workplan on measures to reduce misconduct risk,[1] covering: (1) examining whether reforms to incentives, for instance to governance and compensation structures, are having sufficient effect on reducing misconduct; (2) examining whether steps are needed to improve global standards of conduct in the fixed income, commodities and currency (FICC) markets; and (3) coordinating reforms to major financial benchmarks.[2] Collectively, these efforts aim to strengthen the resilience of the financial system by raising expectations for, as well as awareness of, good practice standards of behaviour and conduct across markets and market participants.

Ethical conduct, and compliance with both the letter and spirit of applicable laws and regulations, is critical to public trust and confidence in the financial system. Misconduct is also relevant to prudential oversight as it can potentially affect the safety and soundness of a particular financial institution and result in financial and reputational costs to that firm.[3] Particularly severe patterns of misconduct can damage the efficient functioning of financial markets and may raise prudential concerns about broader risk management, governance and compensation practices. Furthermore, the erosion of trust in financial institutions and markets may pose even more far-reaching challenges for the financial system.[4]

This report describes the progress made since the previous progress report in November 2015 across the various streams of work, focusing on recent work relating to incentives and to FICC markets.

The future actions planned for these workstreams are as follows (and listed in tabular form in Annex I):

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[1] See FSB, *Measures to reduce misconduct risk: progress report*, November 2015 (http://www.fsb.org/wp-content/uploads/Misconduct-risk-progress-report.pdf).

[2] The original FSB workplan on misconduct also included examining the extent of potential withdrawal from correspondent banking and possible steps to address this issue. The FSB has established a Correspondent Banking Coordination Group to take forward the four-point action plan on correspondent banking published in November 2015 (http://www.fsb.org/wp-content/uploads/Correspondent-banking-report-to-G20-Summit.pdf). As this work has broader financial inclusion goals, it is now being taken forward separately from the misconduct workplan, with its own progress reports to be published in August and December 2016.

[3] The ECB recently estimated that cumulative legal costs (including damages, fines, settlements and litigation costs) at a sample of 26 global banks headquartered in the United States, the United Kingdom, Switzerland and the euro area have reached almost USD 275 bn between 2008 and mid-2016. In the case of European banks, provisions for legal costs amounted to USD 160 bn in between 2008 and 2015, equal to almost half of their net income over the period (https://www.ecb.europa.eu/pub/pdf/other/sfcfinancialstabilityreview201605.en.pdf).

[4] See for example Dudley W.C. *Enhancing Financial Stability by Improving Culture in the Financial Services Industry*, October 2014 (http://www.bis.org/review/r141021c.htm).

1. The role of incentives in reducing misconduct

- ***Guidance regarding the application of the FSB Compensation Principles and Standards[5] to misconduct risk.*** The FSB, in collaboration with standard-setting bodies, will develop by end-2017 supplementary guidance in the form of recommendations on better practice, which would supplement the Principles and Standards with respect to the link between compensation and conduct. These recommendations could include details on the use and application of compensation tools including malus and clawback, as well as ex ante compensation tools, and views on ways to address any limitations and constraints to their effective use. The guidance will be subject to public consultation.
- ***Improved monitoring and reporting on the use of compensation tools.*** The FSB, in collaboration with standard setting bodies, will develop by end-2017 recommendations for consistent national reporting and data collection on the use of compensation tools to address misconduct risk in significant institutions. Recommendations will take into account the need to work within existing national law and could include recommendations on the frequency with which supervisors should collect such data, and recommendations for reporting on the types of tools deployed (both ex ante and ex post), the reasons for their use and the variable compensation affected by the tool. The recommendations will be subject to public consultation.
- The FSB, through its newly-formed Working Group on Governance Frameworks (WGGF), will conduct a stocktake of various efforts underway by international bodies, national authorities, industry associations and firms to strengthen governance frameworks to address misconduct risk, and report its findings in March 2017.

2. Improving global standards of conduct in FICC markets

- The International Organization of Securities Commissions (IOSCO) Board Level Market Conduct Task Force will by end-January 2017 publish a detailed regulatory toolkit for wholesale market conduct regulation, aggregating relevant tools that market regulators use in practice.
- The Foreign Exchange Working Group[6] will by May 2017 finalise the FX Global Code and the proposals to ensure greater adherence.

3. Reforming major benchmarks

- The IOSCO Financial Benchmarks Task Force will finalise guidance for benchmark administrators on the content of their statements of compliance with the Principles for Financial Benchmarks by end-2016.

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[5] See FSB, *Principles for Sound Compensation Practices*, April 2009 (http://www.fsb.org/2009/04/principles-for-sound-compensation-practices-2/) and FSB, *Implementation Standards for the FSB principles for Sound Compensation Practices*, September 2009 (http://www.fsb.org/2009/09/principles-for-sound-compensation-practices-implementation-standards/).

[6] The Foreign Exchange Working Group was established in July 2015 to facilitate the creation of the Global Code and to promote its adoption. It operates under the auspices of the Bank for International Settlements' Markets Committee, which is composed of senior officials responsible for market operations in 21 central banks representing the 15 largest currency areas. It is chaired by Guy Debelle (Reserve Bank of Australia).

- The IOSCO Financial Benchmarks Task Force will conduct a follow-up review of WM/Reuters 4 pm London Closing Spot Rate by end-2016.
- The FSB will monitor progress in implementing the workplan on reform of major interest rate benchmarks and issue a final report by end-2017.

4. Next progress report to G20 Leaders

- The FSB will issue a progress report, including drawing together recommendations to reduce misconduct risk in the financial sector, ahead of the July 2017 G20 Summit.

1. The role of incentives in reducing misconduct

1.1 Compensation structures

Compensation tools play an important role in reducing misconduct risk by providing both ex ante incentives and performance assessment mechanisms that can help to promote good behaviour and ex post adjustment mechanisms that ensure appropriate accountability when misconduct occurs. As outlined in previous progress reports on the implementation of the FSB Principles and Standards,[7] banks have generally made good progress in the area of compensation, including strengthening the links between compensation and conduct. In its 2015 progress report on compensation practices,[8] the FSB found that existing deferral and variable compensation provisions, if appropriately calibrated and applied rigorously, should enable firms to more effectively prevent or deter misconduct, but that more analysis was needed to specifically assess whether tools such as malus and clawback are sufficiently developed and effectively used to deter misconduct.

In 2016 the FSB Compensation Monitoring Contact Group (CMCG) collected further information through a targeted survey (especially directed to bank and bank holding companies that the respective supervisors consider significant for the purposes of the Principles and Standards) and a roundtable discussion with representatives of a sample of those financial institutions to discuss developments and better practices in the use of compensation tools for addressing misconduct risk.[9] The CMCG work on compensation and conduct has focused on a representative set of banks and bank holding companies that are considered by the respective supervisors as significant for the purposes of the Principles and Standards, including for the cross-border nature of their activities. For a number of FSB members, including some of the largest jurisdictions, surveys were sent to holding companies, or parent organisations, and responses describe enterprise-wide practices (including activities other than exclusively

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[7] See the FSB Compensation Monitoring page (http://www.fsb.org/what-we-do/policy-development/building-resilience-of-financial-institutions/compensation/monitoring/).

[8] See FSB, *Fourth progress report on compensation practices*, November 2015 (http://www.fsb.org/2015/11/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards/).

[9] See *FSB Round Table on Compensation Tools to Address Misconduct in Banks*, July 2016 (http://www.fsb.org/2016/07/fsb-round-table-on-compensation-tools-to-address-misconduct-in-banks/).

banking operations).[10] For simplicity the institutions that were involved in the survey or roundtable are referred to in this section of the report and in Annex II as "institutions" or "financial institutions".

The use of ex post mechanisms such as malus[11] (to adjust the unvested portion of employees' variable compensation) and clawback (to recover the vested and already paid portion of variable compensation in the event of adverse risk outcomes) were a particular focus of discussion. Annex II provides more detail on the findings from the stocktake on the use of compensation tools to address misconduct risk. The main findings regarding practices observed are summarised below:[12]

Jurisdictions have taken different approaches in setting expectations around the use of variable compensation, deferral and ex post adjustment mechanisms (including malus and clawback) to reduce misconduct risk. This may be due to the fact that the Principles and Standards do not explicitly address misconduct risk and more generally do not imply a "one-size-fits-all" approach. Differences in markets, business models and legal systems drive differences in the specific approaches to the integration of conduct and compensation. The structure of compensation arrangements also varies across jurisdictions, with significant variation in the proportion of variable pay, amounts actually at risk, the length of deferral, and the choice of compensation tools.

For financial institutions surveyed in markets where compensation includes significant amounts of variable pay, the availability of mechanisms such as malus and clawback help to align compensation with the likely tail of business risk providing a direct, individualised means of imposing accountability and enforcing appropriate standards of conduct. By contrast, in other jurisdictions, supervisors report that the institutions surveyed tend to rely less on adjustment of variable compensation as a tool for influencing incentives for misconduct because of differences in business models, among other factors. They take the view that commitment to good conduct is embedded in the employment arrangement, and dismissal and other performance management tools are more effectively employed to reduce misconduct risk. Differences related to legal and procedural safeguards also influence the use of these tools. While malus is a viable option in most jurisdictions surveyed, the availability of clawback is more limited, and legal hurdles surrounding its use are high.

Despite jurisdictional differences, there is broad agreement among those surveyed and supervisors on the importance of compensation tools as one element of the toolkit for reducing misconduct risk. Considerations relating to conduct should have a role in defining business goals as well as in assessing and rewarding employee performance. At the same time, these institutions and supervisors recognise the potential limitations of the use of ex post

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[10] Some of the descriptions in this report about these financial institutions may not be applicable to smaller regional and national banks. The stocktake conducted by the CMCG in 2016 did not include activities of institutions outside banking groups.

[11] Some FSB jurisdictions use the term "forfeiture" when referring to ex post adjustment of unvested remuneration. For the purposes of the discussion in this document, the description of prevailing practice reflects the operation of both malus and forfeiture mechanisms in FSB member jurisdictions.

[12] The FSB assessment of information collected through the stock-take represents a best effort by supervisors to characterise, at a high level, what are generally quite complex underlying legal and regulatory regimes and compensation practices at the group of banking institutions surveyed. The extent to which the practices described reflect those of any single financial institution, or financial institutions in any single jurisdiction, varies.

compensation tools and are therefore focused on ensuring that variable compensation is deferred for an appropriate period of time and that meaningful amounts of variable compensation remain at risk. Financial institutions with significant cross-border operations in multiple jurisdictions tailor their approach where possible to reflect local requirements while striving for as much consistency across jurisdictions as possible. The development of internal policies; coordination with other institutions through industry-led initiatives; and discussions with supervisors have influenced the development of malus and clawback practice. Many related policies and practices are currently being "road tested" as institutions develop differentiated solutions suited to their particular businesses and markets of operation.

The effectiveness of compensation frameworks in reducing misconduct risk should not be considered in isolation. Supervisors and the financial institutions surveyed report that the effectiveness of ex post compensation tools depends critically on the context in which they operate, and in particular on the support provided by related governance, risk and wider performance management policies and practices. Ex post tools aimed at recovering compensation already awarded, provide a credible threat for addressing the consequences of misconduct but institutions and supervisors emphasise that a number of other factors also contribute to effective management of conduct risk, including leadership ("tone from the top and middle"), clear lines of accountability, training and promotion practices and the effective integration of conduct goals into business strategies and performance assessments. Many participants at the roundtable and in responding to the stocktake reported that progress is being made in all these areas.

Financial institutions and supervisors have signalled the importance of shifting the supervisory focus to positive measures aimed at building a culture of good conduct. For the link between compensation and conduct to be meaningful, the focus must be therefore on the full career cycle, from hiring to promotion to potential dismissal. The institutions surveyed emphasised the importance of setting conditions for and motivating good conduct as part of the employee's longer-term relationship with the employer, where professional development and reward should reflect a shared commitment to long-term values. This is particularly the case where there is a risk that other drivers, such as short-term profitability goals, may pull away from conduct goals.

The changes in culture – attitudes, policies, processes – that are underway will take time to embed. Changes triggered by regulatory requirements and supervisory guidance related to compensation and conduct over the last few years have been significant. Indeed, many participants at the industry roundtable said that compensation reforms needed time to be fully embedded and that additional regulation would not be desirable before existing reforms have been fully implemented. They noted the need for a number of performance cycles over which to incorporate and judge the effectiveness of recently implemented reforms. Both institutions and regulators are of the view that it may be too early to obtain a meaningful measure of the effectiveness of compensation policies and practices in managing conduct risk. They note, however, that there is an ongoing dialogue among jurisdictions as well as among supervisors and regulated institutions on these issues, and further enhancements to this dialogue could benefit from increased sharing of better practice. An enhanced dialogue may also facilitate consistency in approaches, a goal particularly important for global institutions.

Consistent metrics for monitoring and assessment will need to be developed. The institutions surveyed have developed different definitions of misconduct and the indicators and data for monitoring the use and effectiveness of these tools have only begun to be developed. Regulatory and supervisory requirements as to what needs to be monitored and reported in the area of conduct risk management and compensation also vary significantly across jurisdictions. Consistent metrics that take into account different approaches to implementing the link between compensation and conduct in significant banks operating in various jurisdictions may be useful to facilitate comparative assessments of the effectiveness of compensation among the broader spectrum of tools to manage misconduct risk.

Recommendations and next steps

To facilitate the use of compensation tools to address misconduct risk, the FSB will conduct additional work in the two areas described below. The FSB will also continue to promote the sharing of lessons learned and aggregate-level information on use of compensation tools to address misconduct risk, including through hosting industry-supervisory forums and through its ongoing monitoring and reporting on the effects of compensation-related reforms.

Such work by the FSB and standard setting bodies will also continue to explore compensation practices in other financial sectors to better assess and ensure recommendations concerning misconduct risk apply also to financial sectors beyond banking.

Guidance regarding the application of the Principles and Standards to misconduct risk.

While the Principles and Standards suggest that risk adjustment should consider all types of risk (including reputational risk), they do not include explicit discussion of misconduct issues and how compensation could be structured or adjusted to reflect those issues. Whilst recognising that differences exist across countries, identification of better practices linking compensation and conduct could encourage greater consistency across FSB jurisdictions in the development of compensation practices and use of compensation tools to more effectively address misconduct risk and foster more effective compensation policies.

The FSB, in collaboration with standard-setting bodies, will develop by end-2017 supplementary guidance in the form of recommendations on better practice, which would supplement the Principles and Standards with respect to the link between compensation and conduct. Recommendations will take into account the need to work within existing national law and could include details on the use and application of compensation tools including malus and clawback, as well as ex ante compensation tools, and offer views on ways to address any limitations and constraints to their effective use. The guidance will be subject to public consultation.

Once the guidance is developed, and in order to foster more effective policies and further promote a "level playing field" for financial institutions operating in multiple jurisdictions, authorities could be asked to establish clear expectations with respect to adoption of the better practice outlined in the guidance.

Improved monitoring and reporting on the use of compensation tools and additional emphasis on ex ante tools.

Misconduct risk can potentially affect the safety and soundness of financial institutions. If related risks are to be effectively monitored it is necessary that financial institutions develop mechanisms of tracking data to detect trends on misconduct and the use of compensation tools in relation to misconduct. It is also important that supervisors have access to consistent data on the use of compensation tools in addressing misconduct risk. Responses from the institutions surveyed and supervisors indicate significant variation in the current scope and timing of monitoring and reporting requirements related to misconduct events and the application of compensation tools. This impacts the completeness, consistency and comparability of the information available to supervisors across jurisdictions and in some cases across financial institutions within the same jurisdiction. Greater data availability and back testing on the use of compensation tools would enable financial institutions and supervisors to have meaningful conversation on the effectiveness of compensation tools, including for addressing misconduct risk.

From an ex ante perspective, compensation can be an important driver of behaviours that are better aligned with company values and consistent with the long-term stability of financial institutions. The role of compensation can be significantly strengthened by further development of ex ante tools such as incorporation of conduct-related performance objectives in the annual assessment process. In fact, goal setting is critical to drive good behaviour in the broader context of performance management and to better ensure the effectiveness of compensation policies in promoting good conduct and deterring misconduct. This is also consistent with increased emphasis on encouragement of positive behaviours. Objectives that reflect the importance of integrity, compliance, effective risk management and broader firm values should be part of performance plans. Performance goals should reflect both financial and non-financial criteria. The inclusion of non-financial goals in performance assessment emphasises the importance that management places on appropriate conduct and helps clarify related expectations for employees, while reducing the potential for "conflicting signals" that may occur when financial drivers of compensation (such as revenue or profit) clash with non-financial objectives (such as effective risk management). Supervisors are encouraged to maintain a continuous dialogue with financial institutions on the need for a full set of tools to reduce misconduct risk with a focus on promoting good behaviours, including via the effective use of ex ante compensation tools.

The FSB, in collaboration with standard setting bodies, will develop by end-2017 recommendations for consistent national reporting and data collection on the use of compensation tools to address misconduct risk in significant institutions. This could include recommendations on the frequency with which supervisors should collect such data, and recommendations for reporting on the types of tools deployed (both ex ante and ex post), the reasons for their use and the variable compensation affected by the tool. The recommendations will be subject to public consultation.

An interim report on progress in developing these recommendations will be published ahead of the 2017 G20 Summit.

1.2 Governance frameworks

The FSB established the WGGF in May 2016 to exchange good practices on the use of governance frameworks to address misconduct risk at firms with a view to deciding whether the development of additional guidance or a supervisory toolkit is necessary. This follows up on an action point in the November 2015 *Measures to Reduce Misconduct Risk Progress*

Report. To launch this effort, the WGGF held a two-day meeting in June 2016. The first day provided an opportunity for national authorities to exchange information about supervisory practices in assessing governance frameworks, strengthening individual accountability and non-financial incentives, and enforcement powers. On the second day, the WGGF engaged with industry participants (e.g. directors, chief risk officers, business line leaders, compliance) to explore efforts underway at banks and bank holding companies, insurers and asset managers to address conduct and culture issues. More details of the roundtable discussion can be found in Annex III.

Some of the views expressed by attendees at the industry roundtable include:

- All financial institutions believe that a high standard of conduct – broadly defined – is key to the long-term viability of the firm.
- All financial institutions have made progress and can make further progress in governance arrangements.
- There is movement toward the first line of defence (i.e. lines of business or the risk-takers themselves) owning culture and conduct risk, and this evolution is welcomed.
- Financial institutions have a number of initiatives underway but there is no track record as this work is at an early stage, particularly the development of culture metrics.
- Division of labour between financial institutions and regulators is clearer – financial institutions need to own conduct/culture and if authorities owned this, then it would fail as it would become a compliance exercise.
- Driving culture change needs a rounded view of compensation and performance management; it is not just about compensation but also promotion, prestige and validation. It is important to put these non-compensation mechanisms into practice. I
- Financial institutions are wary of prescriptive details on culture/conduct that would hinder the ability of financial institutions to take their own approach.
- On enforcement, participants thought that ex post enforcement actions against financial institutions were important but enforcement actions against individuals could be a more effective deterrent; a rogue trader would be impacted by the fear of jail.
- Some participants noted that efforts to increase individual accountability had achieved early positive effects.
- In wholesale markets, there is a tendency for market participants to write their own codes of conduct and standards.
- Industry participants have a desire to address "the rolling bad apples" – employees dismissed due to misconduct who surface at another financial institution.

The discussions highlighted a broad range of practices by both industry and national authorities that could be used to strengthen governance frameworks .to address misconduct risk. The WGGF will take stock of efforts underway on governance frameworks to address misconduct risk. The concept of "governance frameworks" is relatively broad and could encompass, for example, the structure and responsibilities of the board of directors, individual accountability, internal controls, compliance and audit, culture, as well as financial and non-financial incentives.[13] Thus, one of the goals of the stocktake is to review how "misconduct," "governance frameworks," and other related concepts have been defined by international bodies, national authorities, industry associations and firms, and the scope of work that they have undertaken to address those areas. The WGGF will gather information and will seek to avoid overlap with existing workstreams with the aim of presenting a comprehensive landscape on governance frameworks and misconduct risk and identifying potential gaps.

The stocktaking exercise would include:

1. *International bodies:* International bodies are devoting considerable efforts to addressing a broad range of misconduct issues across a variety of financial institutions. There are a number of international initiatives that are focused on bringing together information on particular aspects of these varying initiatives.
2. *National authorities*: Supervisory and regulatory approaches to addressing culture and misconduct risk vary across jurisdictions (e.g. regulation, supervisory guidance, enforcement powers) as well as the types of misconduct being considered. The WGGF will continue to collect information on supervisory approaches to assessing the effectiveness of governance frameworks to mitigate misconduct, the use of non-financial incentives, and how enforcement powers act as a deterrent for future misconduct. In addition, the WGGF's stocktake will include efforts to strengthen individual accountability and a culture of responsibility, to analyse root causes for misconduct and the use of enforcement measures, as well as efforts to deter "rolling bad apples".
3. *Industry association*s: Various financial industry associations have issued policy documents setting forth practices for good behaviour and competence. The stocktake should help to provide national authorities with a view of how these efforts interact with their own supervisory initiatives.
4. *Firms:* Firms have the primary responsibility for monitoring, identifying, and addressing culture and misconduct, and have made some progress since the global financial crisis. Taking stock of financial sector firms' efforts will provide national authorities with the advantage of seeing the range of practices and efforts currently underway.

Complementing the stocktake will be a literature review of root cause analyses of misconduct at firms and of how non-financial sector firms ensure that good conduct and responsible behaviour are embedded within the organisation. Based on the findings from the stocktake and literature review, the WGGF will be able to identify what the second phase of work might entail, including whether the development of a supervisory toolkit or guidance is needed to give further impetus to efforts underway to address misconduct risk in the financial sector.

[13] While compensation practices and financial incentives could be encompassed by the concept of "governance frameworks," these topics were covered by the CMCG in this year's survey and will therefore not be a part of the WGGF stocktaking efforts.

2. Improving standards of market practice

2.1 Wholesale markets

As part of the broader international effort to reduce the risk of misconduct in wholesale markets, the IOSCO Board established a Market Conduct Task Force with the following objectives:

- to raise a broader awareness, including among financial institutions and individuals, about the tools and approaches IOSCO members use to regulate conduct in wholesale markets; and
- to present examples of market conduct tools and approaches, including innovative and impactful approaches, to assist IOSCO members.

IOSCO will publish a final report of the Task Force that will include a detailed regulatory toolkit for wholesale market conduct regulation aggregating relevant tools that market regulators use in practice. The toolkit will provide examples of the various tools used by market regulators and will describe tools relevant to a wide variety of areas of conduct regulation, including the following:

- *Conduct expectations*, such as prohibitions on manipulative or fraudulent conduct;
- *Individual-level obligations,* such as licensing and conduct requirements;
- *Firm-level obligations,* such as duties owed by financial institutions to clients;
- *Regulatory supervision*, such as examination, inspection practices and market and trade surveillance; and
- *Enforcement*, such as approaches to bringing civil, criminal enforcement and administrative actions.

The work already completed by the Task Force includes a mapping exercise of past IOSCO work on conduct issues in wholesale markets and a survey of IOSCO members on the tools and approaches that they currently use to regulate this sector. The work has demonstrated that IOSCO has published principles and standards covering market conduct, both generally and specifically with respect of wholesale markets. IOSCO members generally also have relevant market conduct frameworks, incorporating a broad range of tools (both supervisory and enforcement) to address misconduct in wholesale markets.

IOSCO intends to complete the final report, including the regulatory toolkit, by the end of January 2017.

2.2 Foreign exchange markets

To promote the integrity and effective functioning of foreign exchange markets, in May 2016 the FX Working Group released the first phase of the Global Code of Conduct for the Foreign Exchange Market (Global Code) and principles for adherence to the new standards.[14]

The Global Code is intended to apply to a broad range of market participants, including financial institutions; central banks (except where this would inhibit the discharge of their legal

[14] See BIS, *FX Global Code: May 2016 Update*, May 2016 (https://www.bis.org/mktc/fxwg/gc_may16.pdf).

duties or policy functions); quasi-sovereigns and supranationals; asset managers, including sovereign wealth funds, hedge funds, pension funds, and insurance companies; corporate treasury departments, brokers and trading/affirmation, and settlement platforms.

The Global Code covers issues such as ethics; professional standards; conflicts of interest; governance; handling confidential information; communications; execution and client order handling; pre-hedging; market disruption; mark-ups; risk management and compliance; confirmation and settlement and account reconciliation.

The complete Global Code and the adherence mechanisms will be released in May 2017, which will include principles related to electronic trading (including algorithmic operators and users), trading venues, brokers and prime brokerage.

3. Reforming financial benchmarks

3.1 Interest rate benchmarks

The Official Sector Steering Group (OSSG) is monitoring progress in implementing the FSB's recommendations set out in its July 2014 report *Reforming Major Interest Rate Benchmarks*.[15] The 2014 report made recommendations for enhancing existing benchmarks for key interbank offered rates (IBORs) in the unsecured lending markets, and to promote the development and adoption of nearly risk-free benchmark rates (RFRs) where appropriate.

A first progress report was published in July 2015, followed by a further progress report in July 2016.[16] The 2016 progress report found that the IBOR administrators have continued to take important steps towards implementing the FSB's recommendations to strengthen the existing benchmarks through adapting their methodology to underpin the rates with transaction data to the extent possible.

- The administrators for the three major interest reference rates – EURIBOR, LIBOR and TIBOR – have all released papers laying out plans to evolve their rates, consulting and engaging with their stakeholders to improve the methodologies and increase the scope of transactions involved in setting the rates, with some of those administrators commencing feasibility studies on receiving the raw data and centralising the calculation.
- Reflecting the systemic importance of the IBORs, authorities in all three jurisdictions have now taken action to regulate their IBOR administrators. Similar to steps already taken in Japan and the United Kingdom to regulate the TIBOR and LIBOR administrators, the Belgian government is in the process of establishing a national regime for the supervision of the administrator of EURIBOR. Also in June, the EU Benchmarks Regulation was published, introducing a regulatory framework for benchmarks across the

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15 See FSB, *Reforming Major Interest Rate Benchmarks*, July 2014 (http://www.fsb.org/2016/07/reforming-major-interest-rate-benchmarks-3).

16 See FSB, *Progress in Reforming Major Interest Rate Benchmarks: Interim report on implementation of July 2014 FSB recommendations*, July 2015 (http://www.fsb.org/wp-content/uploads/OSSG-interest-rate-benchmarks-progress-report-July-2015.pdf); and FSB, *Reforming Major Interest Rate Benchmarks: Progress report on implementation of July 2014 FSB recommendations*, July 2016 (http://www.fsb.org/wp-content/uploads/Progress-in-Reforming-Major-Interest-Rate-Benchmarks.pdf).

EU.[17] The European Securities and Markets Authority (ESMA) will develop draft regulatory technical standards and implementing technical standards on a large number of topics, and also provide the European Commission with technical advice on possible delegated acts.[18]

- OSSG member authorities, benchmark administrators and market participants from other jurisdictions, including Australia, Canada, Hong Kong, Mexico, Singapore and South Africa, have continued to take steps to improve the existing interbank rates in their own jurisdictions.

The report also found that OSSG members have made good progress in identifying potential RFRs. It is important that RFRs are identified because the volume of transactions in the IBORs underlying markets are low and at risk of declining further.

However, while substantial progress has been made, the reforms of the IBORs have not been completed. The 2016 report found that administrators should now focus on transition and decide how to anchor rates in transactions and objective market data as far as practicable.

- The reforms proposed by the administrator of LIBOR will be implemented progressively during 2016.
- Likewise, reforms to EURIBOR and TIBOR are still ongoing. Due to the synergies with other infrastructure projects and the need to verify the reliability of the data, as well as to enhance transparency in the reform process, the implementation timeline for EURIBOR now foresees a reformed EURIBOR in H1 2017. The TIBOR administrator has been accelerating its internal discussions and preparations to finalise its reforms, taking into account the comments collected through its second consultation process as well as other issues that are relevant to recent financial market conditions.

Similarly, more progress remains to be achieved in identifying RFRs and promoting their use where appropriate. Where groups have been set up to identify a single alternative and to promote its use, the final choice has yet to be made and transition planning is still in preliminary stages. In some currency areas, there are no plans to promote a transition to RFRs, as authorities have concluded that the identification of robust RFRs should be sufficient. However, for those currencies that intend to more actively promote the use of RFRs as an alternative to LIBOR for some purposes, the 2014 report noted, “shifting a material proportion of derivative transactions to a risk-free rate would reduce the incentive to manipulate rates that include bank credit risk and would reduce the risks to bank safety and soundness and to overall financial stability.” Due to the importance of this work and how market participants would benefit from improved benchmarks and more choice within markets, it is paramount that momentum is maintained to achieve the FSB’s recommendations regarding RFRs.

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[17] See Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.171.01.0001.01.ENG&toc=OJ:L:2016:171:TOC).

[18] See https://www.esma.europa.eu/policy-rules/benchmarks.

The OSSG will continue to monitor progress in reforms to interest rate benchmarks, and will prepare a final report for publication in 2017.

3.2 IOSCO work on benchmarks

IOSCO has undertaken a number of projects with respect to benchmarks reform which are aimed primarily at assessing the degree of implementation of the Principles for Financial Benchmarks[19] by benchmark administrators operating in IOSCO jurisdictions. In February 2016, IOSCO published its second review to assess the implementation of the Principles by the administrators of EURIBOR, LIBOR and TIBOR.[20] The second review, which aimed to assess the three administrators' progress in addressing the recommended remediation work from the first review, found that all three administrators had been proactively engaged in addressing the issues raised by the first review.[21] Because the majority of the recommendations from the first review have been implemented or are subject to ongoing work related to the evolution of the benchmarks, IOSCO did not recommend a follow-up review. Nevertheless, it stated that relevant national authorities should monitor the progress made by the three administrators to implement the recommendations in this report.

In addition to the second IBOR review, IOSCO was also asked by the FSB to conduct an assessment of the implementation of the Principles by the administrator of the WM/Reuters 4 pm London Closing Spot Rate (FX Review). The report was published in September 2014 as part of the FSB's Report on FX Benchmarks which presented recommendations to reform the major FX benchmarks.[22]

In addition to the Second IBOR Review and FX Review, when the Principles were first published in 2013 IOSCO committed to a general review of compliance by a broad population of benchmark administrators. This review, which was published in February 2015, was a high-level assessment charting the extent to which the Principles have been implemented by a broadly representative sample of administrators across different asset classes and geographies.[23] The review found that most administrators had taken steps to implement some or all of the Principles, with many reporting ongoing work.

The IOSCO Benchmarks Task Force is now focusing on two final projects:

- ***Guidance for administrators on the Principles*** – Following the broad review of implementation of the Principles, IOSCO determined that administrators might benefit from further guidance on the content of the statements of compliance that administrators

[19] See IOSCO, *Principles for Financial Benchmarks Final Report*, July 2013 (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf).

[20] See IOSCO, *Second Review of the Implementation of IOSCO's Principles for Financial Benchmarks by Administrators of EURIBOR, LIBOR and TIBOR*, February 2016 (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD526.pdf).

[21] The first review found that reforms introduced by the administrators had raised the overall oversight, governance, transparency and accountability of the three administrators and their respective benchmarks, while further work was still needed on the benchmarks' methodology and design. See IOSCO, *Review of the Implementation of IOSCO's Principles for Financial Benchmarks by Administrators of Euribor, Libor and Tibor*, July 2014 (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD444.pdf).

[22] See IOSCO, *Review of the Implementation of IOSCO's Principles for Financial Benchmarks by WM in respect of the WM/Reuters 4.p.m Closing Spot Rate*, September 2014 (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD451.pdf).

[23] See IOSCO, *Review of the Implementation of IOSCO's Principles for Financial Benchmarks*, February 2015 (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD474.pdf).

are expected to publish. Following an information gathering exercise to identify the scope of the project, IOSCO is developing the guidance. This will allow for greater transparency for market participants and improved consistency across all benchmarks administrators. The final guidance is expected by end-2016.

- ***Follow up review of WM/Reuters 4 pm London Closing Spot Rate –*** A second review is underway which will assess the progress made in implementing the Principles since the last review. The benchmark has recently transitioned to a new administrator (Thomson Reuters), and it is this new administrator which will be participating in the review. IOSCO is aiming for publication of the final report by end-2016.

Annex I: Misconduct risk workplan action items and timetable

Action item	Date completed, or to be completed, by	Responsible Body
I. Progress report on measures to reduce misconduct risk		
FSB to issue a progress report, including drawing together recommendations to reduce misconduct risk in the financial sector.	Mid-2017	FSB
II. The role of incentives		
1. Compensation structures		
FSB to develop supplementary guidance to the Principles and Standards in the form of recommendations on better practice on compensation and conduct.	End-2017	FSB
FSB to develop recommendations for consistent national reporting and collection of data on the use of compensation tools to address misconduct risk.	End-2017	FSB
2. Governance frameworks		
FSB to take stock of efforts underway by international bodies, national authorities, industry associations and firms.	March 2017	FSB
III. Improving global standards of conduct in FICC markets		
FX Working Group to finalise the FX Code and the proposals to ensure greater adherence.	May 2017	BIS
IOSCO to publish a detailed regulatory toolkit for wholesale market conduct regulation aggregating relevant tools that market regulators use in practice.	January 2017	IOSCO
IV. Reforming major benchmarks		
FSB to monitor progress in implementing the workplan on interest rate benchmarks and issue final report.	End-2017	FSB

Action item	Date completed, or to be completed, by	Responsible Body
IOSCO to finalise guidance for benchmark administrators on the content of the statements of compliance that administrators are expected to publish.	End-2016	IOSCO
IOSCO to conduct follow up review of WM/Reuters 4 pm London Closing Spot Rate.	End–2016	IOSCO

Annex II: Examining the effectiveness of compensation tools in addressing misconduct risks – key findings

Building on its 2015 progress report on compensation practices,[24] the FSB collected further information on the link between compensation and conduct issues through a supervisory and financial industry questionnaire, bilateral interviews with selected bank and bank holding companies, and an industry roundtable. The stocktaking focused on details of existing rules or guidance on compensation policies and tools for addressing misconduct risk, on current supervisory practice in this area, and industry practice and recent developments. The key messages from the industry roundtable held earlier this year have been published on the FSB website.[25]

1. Misconduct, risk culture and compensation

Compensation policies and practices play an important role in building a sound risk culture as they can help incentivise prudent risk-taking while also holding individuals accountable for inappropriate behaviour.[26] The FSB Principles and Standards for Sound Compensation Practices clearly affirm the importance of compensation systems in promoting an appropriate alignment of employees' interests and performance with long-term value creation and the time horizons of risk.

Among other things, the Principles and Standards are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. Although the Principles and Standards do not specifically address the issue of misconduct or provide guidance on the operation of compensation tools in the event of misconduct, Principle 4, about the effective alignment of compensation with risk, stipulates that "compensation must be adjusted for all types of risk. […] Risk adjustments should account for all types of risk, including difficult-to-measure risks such as liquidity risk, reputation risk and cost of capital."

Principle 5 then stipulates that "compensation outcomes must be symmetric with risk outcomes. […] Compensation systems should link the size of the bonus pool to the overall performance of the firm. Employees' incentive payments should be linked to the contribution of the individual and business to such performance. Bonuses should diminish or disappear in the event of poor firm, divisional or business unit performance."

Finally, Standard 5 specifies that "subdued or negative financial performance of the firm should generally lead to a considerable contraction of the firm's total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements."

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24 See FSB, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards*, November 2015 (http://www.fsb.org/2015/11/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards/).

25 The summary can be found at http://www.fsb.org/what-we-do/policy-development/building-resilience-of-financial-institutions/compensation/monitoring/

26 "Risk culture" within an institution reflects an institution's norms, attitudes and standards of behaviour as they relate to risk awareness, risk-taking and risk management. See FSB, Guidance on Supervisory Interaction with Financial Institutions on Risk Culture, April 2014 (http://www.fsb.org/2014/04/140407/).

Key tools in the compensation toolkit for addressing misconduct are deferral, in-year adjustment, malus and clawbacks (ex post compensation tools). *Deferral* occurs where the payment of a proportion of variable compensation is delayed for a period after the date of award. *Malus* refers to the cancellation or reduction of unvested variable compensation and *clawback* is the recovery or recoupment of variable compensation that has already been paid. *In-year adjustments* refer to discretion to adjust variable compensation downwards (at either pool or individual level) as part of the annual performance evaluation process in a given year, to address risks that materialise during the performance period (even if those risks originated in previous periods), often on the basis of failure to meet performance targets or conduct-related objectives.

2. Regulatory approaches to the link between compensation and conduct

Although the 2015 Progress Report noted that almost all FSB jurisdictions have fully implemented the Principles and Standards for bank holding companies, in practice regulatory and supervisory approaches to linking misconduct and compensation, and in particular the use of compensation tools such as malus and clawback to adjust compensation in the event of misconduct, differ quite significantly across jurisdictions. In particular, there is considerable variation among jurisdictions with respect to the (i) role of variable pay in broader compensation structures, (ii) the nature of deferral, and (iii) the development and actual use of compensation tools to address misconduct risk.

For instance, in some jurisdictions a significant portion of compensation is delivered in the form of variable pay (Australia, Canada, China, EU countries,[27] Hong Kong, Singapore, Switzerland, US), and ex post compensation adjustment tools are more routinely included in compensation arrangements and more frequently applied. In other jurisdictions variable pay is not as relevant/common. Jurisdictions such as India, Japan, Turkey note that, in general, the business model is relatively simpler and less variable compensation tends to be used (in favour of fixed or non-performance-based pay); they believe other aspects of the employee value proposition are more relevant to incentives (for example, tenure with the firm). These countries have less developed mechanisms for ex post compensation adjustment.

Differences may also be due to different regulatory or supervisory approaches adopted in the implementation of the Principles and Standards. A number of jurisdictions provide for minimum deferral periods longer than the minimum three years indicated by the Principles and Standards (e.g. EU countries in compliance minimum requirements set in the European regulatory framework[28]). Others provide limited discretion in this area. In EU jurisdictions there are ceilings on the proportion of variable compensation that can be paid (EU bonus cap). A study conducted in the EU by the European Banking Authority concludes, however, that even the levels of variable compensation permissible under the bonus cap can easily accommodate a much higher use of compensation tools such as malus and clawback. [29]

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[27] There are, however, notable differences between the EU member states.

[28] The Capital Requirements Directive IV requires a deferral over a period which is not less than three to five years and is appropriately aligned with the nature of the business, its risks and the activities of the member of staff in question.

[29] See, European Banking Authority: *Report on Benchmarking of Remuneration Practices at union level and data on High Earners. Data as of end 2014.* https://www.eba.europa.eu/documents/10180/1359456/EBA+Op-2016-05++%28Report+on+Benchmarking+of+Remuneration+and+High+Earners+2014%29.pdf. In 2014, the ex post risk adjustment applied in the EU accounted for 0.49% of the total outstanding deferred variable remuneration.

On the other hand, these factors have implications for the amount of variable compensation actually "at risk" of adjustment through use of malus and clawback. At the industry roundtable some participants noted that restrictions in amounts at risk may limit the effectiveness of variable compensation as a tool to incentivise better behaviour. It was also noted that inconsistency in deferral periods results in further inconsistency in the ability to apply these tools.

Finally, some jurisdictions explicitly require the use of malus and clawback, while in other jurisdictions the application in particular of clawback is not permissible under local law (for instance because of conflicts with labour law).

3. Current practices in the use of compensation to address misconduct risk

As noted in previous progress reports on compensation, institutions that are considered significant by respective authorities for the purposes of the Principles and Standards have made good progress and changed their compensation practices post-crisis with an emphasis on enhanced deferral, delayed vesting and the possibility of more robust malus and clawback in a broader set of circumstances. The results of the survey as well as evidence gathered at the industry roundtable also indicate that surveyed institutions are generally strengthening the links between compensation and conduct. At least in the largest markets, survey results indicate that the use, and granularity, of risk and conduct objectives have evolved significantly over the past three years, and practices relating to risk management processes (internal controls, surveillance and testing) and governance (policies and procedures, documentation and formal reviews) continue to improve.

Surveyed institutions recognise that compensation and conduct are directly linked, and are increasingly looking to actively manage conduct via compensation tools both ex ante (by including explicit conduct targets and encouragement of positive behaviour) and ex post (ensuring appropriate consequences for poor behaviour). Ex ante risk adjustment measures, robust internal controls, and certainty of consequences help to establish a clear and transparent incident/impact/consequence pattern and convey an effective message that drives desired behaviours. Most institutions believe that better managing the drivers of behaviour will not only reduce the occurrence of misconduct events, but will also enhance the way business is done.

In terms of prevention, the institutions surveyed monitor activity and implement controls aimed at deterring misconduct and have moved to strengthen surrounding governance processes, including articulation of clear roles and responsibilities for the management of conduct risk. Enhancements have been made to key control mechanisms, early warning systems and quality assurance processes. Strengthening the focus on ex ante determinants of misconduct and on indicators and frameworks for monitoring conduct-related performance and risks will help better align compensation with misconduct risks ex ante and more accurately adjust it when misconduct related events occur. Survey responses generally indicate that boards and senior management appear to be taking this issue seriously, with significant developments in terms of involvement of the board and senior and line management in compensation decisions ("tone at the top" but also "tone in the middle"). Increased participation of control functions in compensation design and decisions, including identification and remediation of misconduct events, is also apparent. The involvement of each of these functions sends a visible signal on the importance of good conduct and helps better integrate compensation, risk and conduct policies and support related decision making. In jurisdictions such as the US and UK, many of the surveyed institutions' formal risk and/or conduct review panels include representatives of key control functions and are further informed by data-driven findings (internal audit, regulatory or third party reviews, monitoring of operational losses, and limit excesses) that help to inform performance assessments and risk-adjustment of compensation awards.

Better management information systems and increased use of data and control function judgments are also part of the answer. Recognition of patterns is also key. In particular, good internal record-keeping and reporting, including documentation of the circumstances and decisions emanating from all review processes, is essential to assessing the fairness and effectiveness of misconduct risk management processes. Responses to the stocktake indicated that surveyed institutions vary in the extent to which they track such activity, for example whether they compile statistics across all subsidiaries or only within certain lines of business. Financial institutions participating in the roundtable noted that while there has been progress in the development and use of misconduct data, this is a relatively new area and therefore further improvements can be expected.

In terms of performance management, surveyed institutions use a wide variety of tools to reflect and align pay to reduce misconduct risk. Performance-based compensation frameworks reflect financial and non-financial objectives that include assessments of risk management and compliance, as well as other behaviours and conduct (e.g. a balanced scorecard approach that considers both the 'what' of financial objectives and the 'how' of values and behaviours). Most surveyed institutions report strengthening the importance of risk and conduct-related objectives in performance and award decision-making (e.g. introducing mandatory conduct, compliance, or other non-financial performance objectives), and requiring line managers to take these into account in assessing whether an employee's behaviour is consistent with the firm's conduct and ethical standards. A large number of institutions participating in the roundtable held the view that incentives should also include recognition of positive targets and behaviours, which may be more effective than negative reinforcement in motivating and sustaining good conduct (for example, through explicit recognition of employees who have demonstrated exemplary risk management practices).

The institutions surveyed also recognise that consideration of financial and non-financial objectives may lead to different views on performance and report some difficulty in resolving clashes between competing performance drivers. Mixed messages and conflicting signals can arise when expectations reflected in codes of conduct and ethics are exposed to budget and other financial pressures. At the roundtable, surveyed institutions emphasised the importance of the signals given by senior and middle management of where to place the balance between performance, customer and counterparty interests as well as of adhering to expected values. Alignment between metrics used for performance assessment and operating activities is essential for effective communication to employees.

4. Evidence and challenges on the use of ex post compensation tools

Based on responses to the FSB survey, the ex post compensation tools that are most actively used in cases of misconduct include:

- *In-year bonus adjustments* – Bonus reductions (or risk-adjusting annual pay based on performance against ex ante risk and performance objectives) appears to be the most frequently applied tool particularly when less serious misconduct occurs. In-year adjustments are considered to be much easier to apply, and may adjust compensation for events that originated in a previous time period.

- *Malus* – The use of malus is not infrequent in a number of jurisdictions, although some banks noted that malus is used only when in-year adjustments do not suffice. The decision to implement malus may be influenced by the seriousness of the misconduct. Malus generally operates on all compensation considered to be "at risk".[30] Some of the institutions surveyed tie use of malus to compensation from specific periods of time in which inappropriate risk-taking or conduct occurred, but the majority consider any deferred compensation to be potentially at risk of malus, regardless of whether it is linked to the year in which misconduct occurred. Typically dismissal is accompanied by malus (loss of any unvested remuneration).
- *Clawback* – Some of the institutions surveyed reported including contractual clawback provisions that are generally meant to be invoked for the most egregious cases.

Compensation tools may also be used in combination with one another. For example, if insufficient in-year adjustments can be made, some institutions apply both in-year and malus to the same adverse outcome.

The institutions surveyed highlighted that enforcement of malus and/or clawback mechanisms raises legal challenges. Clawback in particular raises a series of enforcement challenges, even in jurisdictions where its use is legal, because of the legal safeguards relating to paid and vested compensation. Uncertainties regarding enforceability lead de facto to an operational hierarchy under which in-year adjustments are used first, then malus adjustments to upcoming payments or unvested deferred amounts, and only for the most serious cases of misconduct is clawback invoked.

Effective communication surrounding use and application of these tools is seen as essential to ensure individual employees understand how and under what circumstances the tools can potentially impact compensation and thus are critical to ensuring the desired deterrent effect. However, privacy considerations generally preclude communication about the specific circumstances in which such tools are used and most of the institutions surveyed thus rely in practice on more generic case studies or hypothetical examples to illustrate the potential for use of such tools.

Limitations on the use of ex post compensation adjustment tools may impact their effectiveness to address misconduct risk. Such limitations may stem from the legal issues, such as conflicts with local law (primarily labour), tax and accounting regimes, or the possibility of legal challenge or rights of appeal that may result in reversal of institutions' sanctions as a result of judicial or arbitration decisions. Moreover, there are few publicly available precedents relating enforcement actions, and confidentiality and privacy concerns may limit the amount of information available on actual use and outcomes (including the results of legal challenges).

Other operational constraints also exist. One main issue raised by institutions participating in the roundtable and in response to the stocktake is the issue of limited degree of consistency

[30] Compensation "at risk" generally refers to all unvested compensation, whether awarded in the current year or past.

across jurisdictions which may impact the ability to operate global policies. Many financial institutions that operate globally prefer to have globally consistent policies on compensation generally, and on malus and clawback specifically, but given that the ability to enforce such clauses may vary according to national law, malus and clawback clauses are tailored where possible to reflect legal requirements in specific regions of the world. These differences often make it difficult for globally active firms to treat employees operating in different jurisdictions consistently, even when those employees perform the same job function.

Some of the institutions surveyed pointed to the fact that employees "discount" the value of compensation which is subject to malus and clawback, which may limit the ability of these clauses to provide the desired incentive effect. Others noted that malus and clawback are backward-looking tools and that low amounts of pay may actually be at risk as a result of either limited deferral or amounts of variable compensation for some employee populations. In addition, for egregious misconduct, ex post adjustment to compensation may be "too little, too late". Firms noted that other people management tools can then be used for remediation of misconduct. These include: denial of promotion or demotion; limitations on internal transfers and behavioural corrections through performance management discussions. In a number of jurisdictions dismissal is a common approach for handling misconduct issues and may be used before resorting to compensation tools or when misconduct is committed by employees whose pay is not required to be deferred (e.g. more junior staff, or those not identified as material risk takers).

The practice of bonus buyouts (or "make whole" agreements) represents a specific challenge in that it can weaken the link between compensation and conduct by allowing employees to circumvent the application of malus for misconduct events that subsequently come to light after an employee has left.

Notwithstanding the challenges in the use of compensation tools, including limitations on enforceability, supervisors and the financial institutions surveyed consider that malus and clawback are important compensation tools, because they serve as a credible threat and help to ensure that the consequences of misconduct are clear and meaningful, including through direct impacts on compensation.

Financial institutions that participated in the stocktake and roundtable pointed to a number of practices which have helped to make implementation and enforcement of malus and clawback more certain and highlighted a number of strategies for responding to associated challenges. Some examples cited include: (1) more focus on the use of malus, longer deferral periods and different vesting schedules to compensate for difficulties in applying clawback;[31] (2) use of rights of set-off which provide the right to reduce or cancel any unvested deferred compensation equal to the amount recoverable under clawback in cases where clawback recovery is still pending; (3) choice of venue or choice of law provisions that make enforcement more likely;[32]

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[31] In some cases, for example, banks partially offset lack of clawback tools by cliff rather than pro rata vesting deferred compensation.

[32] For example, many of the US firms that were surveyed specify arbitration as the venue for disputes and New York law as the applicable law, as both historically have resulted in a lower likelihood of reversal. In particular, some banks have had success enforcing clawback of compensation in New York under the "faithless servant" doctrine which allows for recovery of all compensation paid (even "wages") after disloyal acts.

(4) coordination with local counsel worldwide and use of regional malus and clawback provisions which reflect local constraints to enforcement of global award terms; (5) ensuring that employees knowingly agree to all award terms and conditions. [33]

5. Beyond compensation

It is important to note that while the institutions surveyed believe that well-designed compensation structures and programmes play a key role in sensitising employees to the importance of conduct and deterring misconduct, compensation incentives by themselves are not sufficient. Financial institutions surveyed reported that addressing misconduct risk goes beyond compensation tools, focusing on longer-term management and development of people, talent and performance and deploying other governance tools such as hiring, promotion, mobility and training. Participating institutions also pointed to the importance of "communication, transparency, consistency and reinforcement" for behaviours that reinforce firm values.

[33] Some financial institutions, such as those in the UK, require attestations/acceptance by employees of the specific terms and conditions (including forfeiture) of any award of shares. Others, including some in the US, document such conditions in all award agreements in order to make enforcement more likely.

Annex III: High-level summary of June industry roundtable on governance frameworks

1. Remarks from Elizabeth Corley, Vice Chair at Allianz Global Investors and Acting Chair of the UK FMSB

Elizabeth Corley provided an overview of the FICC Markets Standards Board (FMSB) and its efforts to define and sustain good practice standards for wholesale FICC markets. These efforts are intended to raise standards of good behaviour, competence and awareness, thereby contributing to the fairness and effectiveness of these markets. To this end, the FMSB would issue its first standards for conduct in FICC markets in June[34] and, while initially applicable in the UK, it is hoped that they will be adopted globally over time. Rhetorically though, she questioned whether it is possible to have global convergence. She also expressed the view that regulation and supervision are, in the end, more powerful than standards.

Turning to implementation and how the standards can be brought to traders, **Ms Corley** said that the heads of business lines, as the first line of defence (LoD), should be primarily responsible and that this can be augmented with case study training. Later in the session, a number of participants agreed that case studies could contribute significantly to the understanding of the standards. One problem however, is that medium-sized and smaller financial institutions often do not have sufficient budgets for training in this area or the development of case studies.

Contrasting standards with compliance, **Ms Corley** noted that there is a significant difference between a compliance manual and what a trader knows is good practice. She also wondered if there is a universally agreed-upon understanding of "comply or explain". Expanding this point, Ms Corley mentioned the issue of fairness and recognised that it is a challenge to move from a mindset of win-lose to one of fairness and ethics.

Ms Corley then commented on so-called "rolling bad apples" (employees dismissed due to misconduct at one firm who are then hired by another firm), an issue that was the subject of considerable discussion throughout the day. She began by stating that frequently, when a firm has an employee that should be terminated, because the time, cost and legal risk involved with building a case to fire the individual is so great, the firm frequently "exits" the employee under mutually agreeable terms. Exacerbating the problem, for fear of litigation risk, the firm frequently will not be particularly transparent with respect to the reason for departure of the employee when providing references to a prospective employer.

Ms Corley thought that it would be very helpful if regulators would pursue solutions to the "rolling bad apple" problem. She and other industry representatives thought that perhaps one solution is a central registry maintained by the official sector. Members of the Working Group on Governance Frameworks (WGGF) pointed to the challenges of establishing and maintaining a global registry. There is also the question of determining what is good and what is bad, and

[34] See FMSB, *Reference Price Transactions standard for the Fixed Income markets*, June 2016 (http://www.femr-mpp.co.uk/wp-content/uploads/2016/06/16-06-FMSB_ReferencePriceTransactions_FIMarkets_TransparencyDraft.pdf).

perhaps most importantly, data and personal privacy laws, as well as other legal issues, make the idea of a global registry difficult.

Concluding this session, the **Chair** of the roundtable (Jeremy Rudin, Chair of the WGGF)) said that the industry clearly sees a need to respond to the misconduct problem by developing standards. If the industry does not take action, the official sector will attempt to regulate this, and he was of the opinion that this is not the desired outcome. More broadly, he said that the challenge with any standard is implementation.

2. The 'three lines of defence'

Three industry representatives opened this discussion from the perspectives of the first LoD within financial institutions (the owners and managers of risk), second LoD (compliance) and from a leader responsible for developing a governance framework for assessing culture. (The third line of defence is internal audit.)

The first speaker described how the first LoD identifies and addresses conduct risk at his firm, which started in 2014 in response to several regulatory orders. Thus far, over 200 action plans have been developed and a market conduct risk committee has been established. As part of this, the firm has identified 12 market conduct risk areas (including those that affect both markets and employees) and within those risk areas, 32 types of conduct risk. He noted that although the trading floor is the first LoD, the supervisor of the trading floor is the first line of the first LoD. He discussed how the role of supervisors of trading floors has been strengthened – supervisors are not only held accountable for setting the appropriate tone but also to collect random samples of emails for evidence of misconduct. He noted that conduct risk is considered a subset of compliance risk and the firm is in the process of developing a set of metrics to assess change, but this has been the biggest challenge. The firm has come up with 9 metrics, including the development of an issues tracker which focuses on the issue and not the employee. The tracker will monitor how many new issues get on the tracker and how many are escalated to compliance.

The next speaker discussed her role in the second LoD and her company's efforts to strengthen the compliance function, which now reports directly to the Board. The compliance function works in the interest of employees, clients and shareholders to promote adherence to rules, supervisory requirements and principles of good conduct. Conduct risk is managed by the firm's Corporate Commercialisation Governance Framework, which has at its heart the premise that customer service, processes, products and services must be simple, personal and fair. Meanwhile, risk management is performed by identifying and measuring conduct risks via indicators that enable the firm to assess each risk by country and legal entity. She also noted that her firm's remuneration policy, which is currently under review, places limits on fixed and variable remuneration and emphasises client interests over personal interests. She concluded her remarks by stressing that the various lines of defence should not be independent or remain silent; lines of defence operating in silos are not an effective solution.

And finally, the last speaker spoke about the need to regain trust, and noted that it is about leadership; financial institutions must lead by example. Noting that there had been considerable discussion of the various lines of defence in previous sessions, he said that the key is to bring the discussion down to the "ground level", to every employee. Related to this, he asked how incentives should be properly structured. He then detailed a framework for conduct, including questions and steps such as: (1) how are conduct risks identified; (2) what risk controls are in place: (3) how are staff made to feel responsible for conduct risk; (4) is the right environment in place to encourage staff to speak up (whistle-blowing); (5) how to properly balance incentives and rewards; (6) accountability must go both up and down the organisation; and (7) what oversight does the board have over conduct and how do conduct events impact strategy.

A discussion then ensued about the interaction between the first and second LoD. In the past, the compliance function (part of the second LoD) was responsible for training, but now, it is the first LoD that delivers training on conduct. One member asked whether the compliance function can understand the business mindset. Conversely, do business leaders in the first LoD have the ability to understand conduct risk given that they have not worked in the second LoD? Ensuring knowledge of the business activities and functions, as well as having a thorough understanding of conduct risk is a significant challenge for financial institutions. To this end, participants discussed the benefits and challenges (e.g. compensation) of having first LoD staff members working in the second LoD and vice versa.

Participants also discussed reputational risk and its interaction with conduct risk. They asked how reputation risk should be defined and whether there are parameters for reputation risk appetite. One participant said that reputation risk should be owned by the first LoD. Another participant shared the view that reputation risk starts with values; is the firm willing to say “no”, for example, to certain types of lending or activities because they are inconsistent with its values? Meanwhile, one member opined that reputation risk is part of conduct risk, and includes events in the grey area between illegal and unethical practices.

One participant said that financial institutions need to better align lessons learnt with future strategies. He thought that the official sector could play a useful role in this area. Referring to the proper environment within a firm, one member said that while it is important to learn from mistakes, in order for this to happen, financial institutions must create an environment where employees feel safe to speak up. One participant said that there is a “trust deficit” in the financial sector and that financial institutions must do better to create an environment that encourages engagement and, in turn, builds trust. Another participant noted that the challenge is to translate values into behaviours that encourage transparency. One possibility, he thought, is to move people across the three lines at early stages in their career.

3. Assessing the effectiveness of governance frameworks

Three industry representatives – from banking, asset management and insurance – were asked to share their views on how they assess the effectiveness of governance frameworks.

The first speaker provided her views on why governance matters, and how to embed ethics and culture in governance and its challenges. She noted that while the industry has made good progress addressing misconduct, more time is needed to see how the changes will impact governance structures. Moreover, governance structures are not static, they always need updating. As a starting point, she suggested that if the strategy of the organisation is appropriate, only then can the governance structure be properly considered. In this regard, she stressed that effective communication is essential; who delivers the messages within the firm and with what frequency? She also mentioned the need to link rewards with performance in a holistic manner (i.e. holistic performance). Finally, she shared the view that documenting lessons learnt is important. There must be a backward-looking analysis of issues in order to understand the sources and causes of problems. From that, financial institutions can take steps to prevent similar occurrences in their institution.

The second speaker stressed the fiduciary responsibility of asset managers, noting that they are responsible for other peoples' money and the decisions and actions of the firm may affect their lives. Returning to earlier points about zero tolerance for misconduct risk, he said that reducing risk is expensive, so reducing it to zero is not only very expensive, but also does not result in a firm that is able to properly serve its clients. That said, financial institutions wished to maintain a posture of zero tolerance for misconduct risk even though misconduct cannot be completely eliminated. In terms of culture, he thought that it was important for participants to understand that within a single firm there may be many different sub-cultures; as a consequence, ensuring consistency across the firm is very challenging. Finally, he felt that regulation of markets needs greater convergence. For a global firm such as his, it is very difficult to operate in different markets each with their own rules.

The last speaker spoke about the issue of enforcement, noting that while it is a deterrent for future events, it is unlikely to bring about a change in culture when enforcement is taken against a firm (for which a trader may not care and thus his/her behaviour might not be affected) and enforcement against individuals, which would sharpen the trader's mindset. In terms of authority and the appointment of senior officials within a firm, preapproval gives the supervisor immense power, but in fact, supervisors should not be determining ideal candidates, this is the responsibility of the firm. Stepping back and speaking about governance frameworks more broadly, he said that it is not possible to identify a single, ideal governance framework. Perhaps elements of a framework can be identified as effective, but a single prescriptive framework for all financial institutions does not exist. Within the governance framework, he mentioned that financial institutions must improve their ability to articulate how individuals should discharge their roles and responsibilities. Finally, he added to the voice of others from the industry that it would be useful for regulators to share experiences and lessons with financial institutions.

Participants discussed the challenges for developing data points or metrics to measure performance and conduct, but noted it was important to start somewhere even if not perfect. One participant underscored that regulators need to recognise that addressing conduct and culture is a multi-year task and noted that supervisors could help financial institutions by (i) not regulating culture/conduct as each financial institution's culture differs and (ii) ensure firms have effective whistleblowing policies. He noted the importance of moving the dialogue forward by not focusing on past mistakes but rather the changes underway at financial institutions. Another participant highlighted the need to examine root causes for culture/misconduct, that is, collect the facts and understand why you missed it and correct for it. Finally, participants generally agreed that it would be good to increase the level of responsibility for conduct among individuals, particularly for the first LoD, but a few opined that it may encourage an avoidance of risk.

4. Concluding remarks with the private sector

The **Chair** listed a number of key takeaways from the discussion with the private sector, including:

- A high standard of conduct is key to the success of the firm.
- Progress in improving conduct can be made through stronger governance frameworks.
- Financial institutions – not supervisors – must "own" conduct.
- Although it is difficult to establish precisely what is "good behaviour", it is the responsibility of financial institutions to do so.
- There is a need to have a more "rounded" view on tools to address misconduct risk, including alignment of compensation with performance management, recognition of positive behaviour, and promotion and development opportunities.
- Financial institutions' initiatives in addressing misconduct risk are recent. There is not much of a track record yet, making it difficult to evidence what success looks like.
- Financial institutions are embracing the need for training to address conduct risk via case studies.
- It is difficult to measure "success" when implementing cultural change.
- There is no appetite among firms for setting an ex ante tolerance for misconduct risk in the way that a financial institution might have a tolerance for, say, operational risk.
- Ex post enforcement on individuals by supervisors can lead to improvements in culture within financial institutions.
- Financial institutions are of the view that supervisors can play a role in helping firms to avoid hiring someone who has been dismissed elsewhere for misconduct.
- Heard of several examples of how the first line of defence is taking ownership of and steps to address conduct risk.
- Sharing of market practices is useful, but financial institutions are wary of prescriptive, detailed requirements that impede upon their individual firm's culture.
- Financial institutions must create a safe environment for employees to speak up.