FSB FINANCIAL STABILITY BOARD

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FSB compensation workshop 2019: Key takeaways

Basel, 13 November 2019

On 13 November 2019, the Financial Stability Board (FSB) hosted a workshop in Basel for banks, insurance and asset management firms to discuss their experiences in implementing the FSB's *Principles for Sound Compensation Practices*[1] and their *Implementation Standards*[2] (Principles and Standards). The objective was to gather information on key compensation issues and challenges to help inform the FSB's assessment of the effectiveness of the implementation of the Principles and Standards.

The four workshop sessions covered:

1. *Assessing the effectiveness of compensation policies* – the discussion considered the steps firms are taking to assess the effectiveness of compensation policies and practices they have established and implemented.
2. *Use of data by firms as part of compensation practices* – participants considered how firms use data to implement compensation policies and practices.
3. *Regulatory and legal issues* – the discussion focused on the extent to which legal barriers and conflicts between elements of the Principles and Standards and regulatory frameworks exist, and possible steps to address these.
4. *Developments on compensation and risk alignment research* – participants discussed academic research and empirical evidence on the effectiveness of compensation and risk alignment.

Executives responsible for managing compensation processes at 19 large, internationally active banks, insurance and asset management firms, and representatives from trade associations and academia, together with officials from the FSB Compensation Monitoring Contact Group (CMCG), participated in the workshop. The CMCG is responsible for monitoring and reporting on national implementation of the Principles and Standards. The CMCG's work is increasingly focused on assessing the effectiveness of the Principles and Standards.

This summary reflects the understanding of CMCG members who attended the workshop of the main points raised in the discussion, which was conducted under the Chatham House rule. It does not therefore represent an assessment of activities across a large number of firms but rather a summary of issues discussed. It also does not necessarily represent the views of authorities nor consensus views expressed by firms at the workshop.

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[1] FSB, *Principles for Sound Compensation Practices*, April 2009 (http://www.fsb.org/2009/04/principles-for-soundcompensation-practices-2/)

[2] 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/)

Key takeaways

Six themes emerged as key takeaways from the discussion at the workshop:

1. ***Effectiveness***

Firms advised that the Principles and Standards are being embedded in the culture of their organisations. Some firms reported metrics they use to consider the effectiveness of compensation policies and schemes including the monitoring of customer satisfaction, or operational losses to the extent they can be an indicator for underlying risks within a business. Generally, firms are at an early stage of developing frameworks to assess the effectiveness of their compensation policies and practices.

Firms noted the importance of effective communication with employees as an important factor in driving behavioural and cultural change. One firm noted the benefits of employees seeing that compensation policies are being implemented.

2. ***Risk alignment***

Effective risk alignment is at the heart of efforts by regulators to reform compensation structures. All firms reported that they take steps to align compensation with risk. They also noted that, given the earlier regulation for banks in this area, banks are often more advanced on this work than firms in other parts of the financial sector.

Some firms noted that investors can in some cases have a shorter-term outlook, meaning their interests may not always be aligned with long-term interests set out in compensation rules.

Firms expressed the view that efforts to prevent and address instances of misconduct mean that non-financial metrics play an increasingly important role in compensation schemes. They provided examples of a range of changes, including the removal of sales targets, increased qualitative assessments of culture, and measures to align compensation with firm culture and values.

Firms also reported on the difficulty of choosing appropriate metrics against which to measure non-financial outcomes. They noted that the increased integration of social, economic and governance (ESG) factors into compensation, which have been added to align with firm values, also present challenges in terms of measurement.

A number of firms raised the importance of positive compensation adjustments and the extent to which they can be a powerful mechanism for promoting and incentivising positive behaviour by staff, moving away from a "culture of fear".

3. ***Data use***

A number of firms reported improvements in systems and processes for gathering and analysing compensation data. Some firms noted that this allowed them to consolidate data into a single dashboard that managers use to make compensation decisions, and integrate financial and non-financial metrics.

Firms reporting on these developments commented on the extent to which these developments provided line managers with an increased ability to make effective decisions and how this increased accountability for, and objectivity of, decision-making.

Some firms reported undertaking more effective analysis of compensation data using new tools. Some noted that new systems allow for real-time analysis of data during compensation rounds, which can be used to make more effective compensation decisions. Previously, analysis was limited to an ex post review of decisions taken during compensation rounds. However, firms noted that such systems can often be complicated and expensive to implement, and are not always an investment priority for firms. Some firms reported that they are trying to assess how they can use the data to identify correlations that may allow for a more forward-looking approach.

A number of firms noted the importance of not being overwhelmed by data, given that hundreds of data points can feed into each individual bonus decision. Firms indicated that they are trying to find ways to present detailed information to senior management and boards in a manner which is concise and useful for decision-making.

Academic research shows that directors' personal stock portfolios have in some cases reached such high values that they could undermine the effectiveness of a firm's compensation scheme as those directors may not be influenced by their annual bonuses. However, in banks there appears to be a correlation between directors holding (and not frequently selling) shares and bank profitability. In order to align directors' remuneration with the long-term interests of the firm, academic work suggests restrictions on equity for a longer period than their tenure should be considered.

4. *Governance*

Firms highlighted the central role control functions play in compensation processes. For instance, risk and compliance functions input to individual compensation decisions. Additionally, at some firms, internal audit functions provide ex post challenge to compensation policies and schemes.

Generally, firms reported that, given the earlier passage of legislation and regulation on bank compensation, banks are at a more advanced stage than other firms in terms of embedding compensation decisions in their governance processes. However, most firms reported a greater focus on these issues at board level and the increased importance of firms' compensation policies and practices in particular for non-executive directors.

Firms referenced the importance of balancing consistent processes and governance with the ability to apply discretion on compensation decisions within a clear framework.

Firms noted that, while there has been greater harmonisation of compensation regimes in recent years, important differences (e.g. deferral requirements, bonus cap, disclosure regimes) still exist, and these continue to present practical difficulties in terms of designing and implementing consistent compensation policies across international groups.

5. *Compensation tools*

Reflecting the results set out in the CMCG's sixth compensation progress report,[3] firms noted that the use of malus and clawback is limited because of both complexity and, in some jurisdictions, legal challenges. In-year adjustment is the ex post adjustment tool used most

[3] FSB, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Sixth progress report,* June 2019 (https://www.fsb.org/2019/06/implementing-the-fsb-principles-for-sound-compensation-practices-and-their-implementation-standards-sixth-progress-report/)

frequently. Firms reported an extremely limited use of clawback given the legal risks associated with its application. Even in jurisdictions where clawback is not precluded by, for example, employment legislation, firms still hesitate to apply it as it remains a relatively untested tool. Additionally, it can be difficult to find lawyers with the requisite knowledge of clawback to provide legal advice in some jurisdictions.

This limited use of clawback even extends to firms that have seen significant incidents of misconduct. Firms reported that recent changes to employment law or regulations in France and Germany have helped to address some of the legal difficulties although application of clawback remains infrequent. That said, similar measures are being implemented outside the financial sector and therefore further legal developments may now be expected in some jurisdictions.

Firms noted that where malus or clawback is applied this is likely to have a significant negative impact on the career progression of the employee, and may make it less likely that they will be hired by another firm. Therefore, in order to ensure decisions are fair and employees have appropriate opportunities to make representations, the process involves considerable governance, which can take time and be resource-intensive.

Some firms noted the extent to which severance payments have become a focus since they may not provide effective risk alignment.

Participants discussed new analysis on the time typically taken to identify events where operational risks have crystallised, in particular misconduct. Firms discussed the extent to which this may be a factor that needs to be considered in terms of length of deferral.

6. *Competition for talent*

Firms noted the increased hiring challenges they face for three reasons: (i) they increasingly need to hire from other sectors where compensation structures are different; (ii) the extent to which financial services firms are no longer considered employers of choice; and (iii) the extent to which factors other than compensation now influence the decisions of prospective employees. On the latter point, firms noted that prospective employees, particularly of younger generations, are increasingly focused on factors such on ESG, purpose and culture, whereas previously there was a greater focus on compensation. Firms are seeking to respond to these trends in order to attract talent.

Firms report that they are increasingly looking to recruit for roles which require digital and cyber experience. However, they face difficulties recruiting from other sectors as compensation, which is largely not regulated in these sectors, is structured very differently given regulatory requirements, for financial firms. Some firms noted the extent to which prospective employees from other sectors discount deferred compensation and focus instead on the cash element, which can lead to upward pressure on fixed and/or total compensation. However, most firms stated that at least for some prospective employees, compensation is a less significant driver than the factors above, perhaps reflecting the negative reputational impact on the industry as a result of the last financial crisis.

Some firms reported that as regulation has evolved, there appears to be an increasingly level playing field within financial services, although some firms reported continued inconsistencies. In particular, firms reported difficulties transferring employees internally between jurisdictions due to compensation policies differing because of statutory and regulatory divergence.