FSB FINANCIAL STABILITY BOARD

9 August 2021

FSB Workshop on Compensation Practices 2021
18 – 19 May 2021

Summary of Discussion

On 18 and 19 May 2021, the Financial Stability Board (FSB) hosted a virtual industry workshop as a part of its assessment of the effectiveness of the implementation of the FSB's *Principles for Sound Compensation Practices* [1] and their *Implementation Standards* [2] (Principles and Standards). The workshop sought to gather information on key compensation issues and challenges for the effective alignment of risk and compensation, with an additional focus on the impact of the pandemic on firms' compensation practices.

Executives responsible for managing compensation processes at nine internationally active banks, insurance firms and asset management firms, and representatives from an industry association, a law firm and a prudential supervisory authority, together with officials from the FSB Compensation Monitoring Contact Group (CMCG), joined the workshop.[3]

The four workshop sessions covered:

1. *Non-financial criteria and measures, behaviours and firm culture* – Participants identified trends in the use of non-financial criteria, potential differences across sectors and how these criteria affect and are affected by firm culture.

2. *Effective alignment of risk and compensation* – Participants identified effective practices for alignment between risk and compensation and how practices may vary across sectors.

3. *Legal and regulatory issues* – The discussion focused on the most significant legal and regulatory impediments to the use of compensation tools, such as malus and clawback and possible steps to address these. The session also explored firms' use of severance pay.

4. *COVID-19 and compensation* – Participants discussed compensation-related actions firms and supervisors have taken in relation to COVID-19.

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1 FSB (2009a), *Principles for Sound Compensation Practices*, April.

2 FSB (2009b), *Implementation Standards for the FSB Principles for Sound Compensation Practices*, September.

3 Some other officials from FSB member jurisdictions also attended the workshop.

The CMCG is responsible for monitoring and reporting on national implementation of the Principles and Standards. Given the good progress on implementation of the Principles and Standards across the FSB membership[4], the CMCG is increasingly focused on identifying effective practices and enhancements to compensation frameworks.

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 therefore does not represent an assessment of activities across a large number of firms but rather a summary of issues discussed by participants. It does not necessarily represent the views of authorities or firms at the workshop.

Main points of discussion

1. Non-financial criteria and measures

1.1. Recent trends

Over the past five years, firms across all three sectors (banking, insurance and asset management) have increasingly incorporated non-financial criteria into the determination of variable remuneration for staff. As a result, they make up a larger share of measures than previously. Firms' focus on risk management has been the main driver of a wider use of non-financial metrics. However, most recently the increase has been also driven by increased importance placed on firm's culture and societal expectations rather than by regulation. Firms increasingly align remuneration with long-term goals like sustainable profits and respond to the change in external environment.

Workshop participants reported that they take into account environmental, social and governance (ESG), reputational and diversity-related factors in order to set and allocate the compensation pool. Such criteria also apply when assessing individual performance and are often reflected on balanced scorecards. More specifically, some of the key performance indicators (KPIs) that have been recently added by firms include: sustainability performance, employee well-being, customer protection, employee engagement, diversity and inclusion, and human capital management.

Some firms have formed conduct committees which review and discuss conduct behaviours and potential breaches. Moreover, some firms publicly disclose such metrics (e.g. pay equality, diversity) and their impact on compensation.

1.2. Discretion versus a more formulaic approach

Several firms noted that increased use of non-financial measures requires a certain level of discretion in the way that they are applied. One firm noted that this discretionary approach

[4] FSB (2019), *Implementing the FSB Principles for sound compensation Practices and their Implementation Standards: Sixth progress report*, June.

enables them to appropriately integrate risk into the compensation decision compared to a more formulaic or rigidly structured approach. Stakeholders, especially more sophisticated investors, seem to appreciate and welcome this approach. However, firms also noted that such criteria are sometimes less objective as they cannot be as easily quantified as financial measures. Thus there is a risk that they could be potentially engineered such that variable remuneration reaches a desired level. Due to this potential concern, several panellists agreed that the effective use of non-financial measures requires robust governance arrangements on the use of discretion.

1.3. Future use of non-financial criteria

Firms expect the use of non-financial criteria such as reputation, diversity and inclusion, and ESG factors to be even more widespread over the next five years and continue to reinforce the firm culture. While this is generally viewed as positive, firms also cautioned that the increased use of such non-financial metrics should not dwarf other equally or even more important performance metrics and that an appropriate balance between non-financial and financial metrics is needed.

2. Alignment of risk and compensation

2.1. Determinants of CEO remuneration

CEOs play an important role in leading the risk alignment of firms and forming the firm’s culture. The criteria applied when setting the CEO's salary demonstrates what really matters to the firm. Sending out the right message is crucial for retaining the right talent in a competitive recruitment market and supporting the firm’s long-term growth. Therefore the panel explored how CEO compensation was determined across various firms. Some metrics for determining CEO bonuses include the return on risk-weighted capital, total shareholder returns, cost of capital and leadership assessments from the board.

One panellist noted that reliance on more variable compensation, particularly for the C-suite such as CEO and CFO, could lead to better risk alignment. Another panellist reported that its remuneration committee closely examines the remuneration of the CEO and of the firm’s top 20 earners, including those that are not part of senior management.

Several firms reported differentiating between long- and short-term performance (e.g. by considering long-term credit cost and cost of capital), which allows them to identify longer-term trends. This longer-term horizon is sought in order to avoid excessive volatility in variable remuneration. These metrics are then combined with a balanced scorecard that aims to ensure a long-term perspective. This particular compensation structure does not encourage short-term high-risk high-reward bets and attracts candidates with a prudent risk-taking approach, thus functioning as a self-selection process. While such an approach reduces the procyclicality of CEO salary and promotes more stability, firms noted that it was challenging to implement and remain competitive with other firms that may have a shorter-term outlook. Some firms also noted their use of deferred compensation to align behaviours to their firm’s culture. One panellist said that at their firm, 90% of variable compensation was deferred.

2.2. Unintended consequences of regulating variable compensation

Several firms expressed concern over the trend in some countries of fixed remuneration rising faster than the variable component, a development that they considered could impair the effectiveness of deferral as a tool and make alignment of compensation and behaviour more challenging. This may be an unintended consequence of the strengthening of the regulatory framework on variable compensation as well as efforts to avoid high variable compensation that conjures negative publicity (whereas high fixed remuneration goes relatively unnoticed). At the same time, in light of the competitive recruitment landscape, firms are facing pressure from potential CEOs and senior executives for higher fixed compensation compared to what they were earning previously.

One firm mentioned that in their jurisdiction, the majority of employees do not receive variable compensation, while several firms in different jurisdictions noted that variable pay was low relative to fixed pay. While this eliminates the incentive to take undue risk in pursuit of variable compensation, it also makes it challenging to align performance and pay in the event that there is gross misconduct. Other firms said that this was less of an issue for their firm as they use other tools to sanction misconduct and unacceptable behaviour. At the other end of the spectrum, variable pay is high in other jurisdictions.

2.3. Employee evaluation

Most firms use a mix of financial and non-financial KPIs, with each component receiving a certain weight. Some firms have also introduced 360° review processes[5] to measure areas that are more difficult to capture through KPIs but are better observed by other colleagues (e.g. collaboration, risk awareness).

Some firms have also established new databases that track misconduct incidents. These data are ultimately linked to compensation decisions, allowing human resources to link specific incidents to employees. This is also intended to signal the focus on acceptable behaviour to the whole firm.

2.4. The role of internal control functions

Even small and potentially less risky firms have relatively complex remuneration policies. Firms highlighted the critical role of internal control functions in governance and remuneration. Because of the increasing complexity of the balanced scorecard, the role of internal control functions to review and ensure consistency of remuneration decisions is critical for demonstrating strong remuneration practices, which in turn reduces the likelihood of bad behaviour.

In addition, firms noted that at the level of board committees, there exists a mechanism to ensure close collaboration between risk and remuneration committees. For example, through an overlap

5 A 360° review is a performance evaluation tool that solicits feedback for an employee from all directions—their managers, co-workers and direct reports.

of membership between the committees and requiring endorsement by the risk committee before the risk report is submitted to the remuneration committee.

2.5. The role of culture in risk alignment and behaviour

Firms acknowledged that remuneration is one of the most influential drivers of risk alignment; however the overall corporate culture plays an important role in addressing various kinds of misconduct. Firms also commented that beyond annual performance reviews, it is important for firms and management to communicate the objectives and values of the firm both internally and externally on a continuous basis, as well as incorporating them in the hiring of new staff and recognising/rewarding employees throughout the year.

One firm cautioned that there should be zero tolerance for failure to uphold the firm's values and culture and that this principle should not be compromised for senior management or key financial contributors. They noted that poor performance is usually easy to observe (e.g. how you treat colleagues in a stressed situation) and that it is important to be transparent by providing concrete examples of acceptable and unacceptable behaviour. Firms also stressed the importance of culture emanating from the top.

Several firms commented on the societal role that some financial service firms play in different countries. In India for example, banks are highly respected as they contribute to the development of the local economy and society and banking is considered one of the most prestigious occupations. The firm believes that this perception attracts candidates that want to serve this cause.

3. Legal and regulatory issues

3.1. Obstacles in the use of clawback/malus

Although clawback policies have been adopted in some firms and jurisdictions, there are few examples of its use in practice. There is generally no widespread use of clawbacks, due to both legal and practical reasons.

Legal obstacles in applying clawback are very common as sometimes labour law makes its application impossible or less effective. Firms reported that clawback is particularly difficult to enforce as it is either forbidden by local laws or not judicially enforceable in many cases. Therefore as an alternative, many firms extend deferral periods and treat this as a de-facto clawback. One firm explained that they embed a de-facto clawback in severance packages, whereby a percentage of severance is held back for a few years in the event an issue surfaces after the employee's departure. In some jurisdictions, deferred salary is considered unconditional by law (i.e. cannot be waived), which makes holding back of salaries impossible.

In determining the optimal length of deferral, firms try to balance the need to make it long enough to prevent insufficient risk alignment with the need to keep it sufficiently short so that the amount of payout is not excessively discounted by the recipient. As banks increasingly rely on non-banking talent (e.g. IT), they have to compete with other industries, including technology firms, that are not subject to the same regulations.

Another cost that firms consider before applying clawback is the question that would arise regarding their own management ability and effectiveness of internal controls. For example, the need to apply clawback may be seen as a failure of a firm's risk management in being able to detect the error or breach in advance. Firms may be concerned over damaging their reputation and this in turn may have an adverse impact on recruitment and talent retention. On the other hand, there may be egregious situations where it is important to send the signal that the firm will apply all measures at hand, including clawback.

3.2. Regulatory issues regarding severance pay

At the 2019 workshop, some firms raised the point that severance pay may not be subject to effective risk alignment or be covered by compensation tools (malus and clawback). In addition, severance pay does not have consistent treatment across jurisdictions. For jurisdictions where severance pay is not considered variable remuneration, it may not necessarily be subject to ex-ante or ex-post adjustments. Therefore, the CMCG was interested in exploring how firms use severance pay.

Panellists highlighted that the lack of common definition or treatment for severance pay creates many obstacles. In some cases, regional versus local regulations provide conflicting accounts. For example, in the EU, severance pay is regarded as variable remuneration, but in some EU member countries, local law considers it fixed remuneration. Moreover, severance payments are often mandatory under labour law, which makes it challenging to apply the principle of "no reward for failure". Severance pay is also very high in some jurisdictions (e.g. Belgium).

One firm reported that in some jurisdictions where firing and rehiring is flexible, there are instances where firms offer severance pay to employees and rehire them shortly after. This may be considered circumvention of regulation/the spirit of severance payment, and therefore, to prevent such circumvention, firms noted the importance of robust governance processes and internal controls. One firm noted that they do not allow rehiring of people within a year or two of leaving and that all rehires must be vetted centrally by a senior human resources director.

4. COVID-19 and compensation

4.1. Functioning of the existing remuneration framework

The COVID-19 pandemic has tested how remuneration frameworks operate in practice. For example, firms needed to consider, under their governance mechanism, how to apply their policies and procedures, including the use of discretion, in response to current and future risks. Most remuneration frameworks were sufficiently flexible to respond to the prolonged pandemic. Although some firms introduced some temporary measures, there was no need for an overhaul of their frameworks. Regulators found their policies and guidance provided them with the necessary prudential tools, such as restriction on the increase of compensation, and halting dividend payouts and share buybacks, as well as other supervisory actions to protect the safety and soundness of firms.

While the main performance criteria were kept in place, some firms introduced measures aimed at supporting the firms' resilience. For example, some added new capital conservation factors to their criteria while others added factors to cover customer satisfaction during this challenging period. A few firms included the ability of senior management to continue to meet strategic objectives, including alignment with core values. Participating firms noted that overall, the workforce seems to have acknowledged these unprecedented circumstances and accepted these measures and restrictions. Meanwhile, the official sector participant noted that in its jurisdiction, during the pandemic many firms under its supervision increased their use of non-financial criteria such as operational resilience, health and safety of employees and customers, transparency in communications, and overall pandemic response.

4.2. Wider consideration including talent retention and impact on society

The COVID-19 pandemic has also been a real test for management regarding attracting and retaining talent amid an environment where variable compensation was and may continue to be impacted. Some firms reduced variable remuneration for senior management and executive directors significantly or even in some cases down to zero. This was seen as a necessary signal to society and stakeholders as well as to the entire staff in the organisation. This provided an opportunity for firms to rethink, refresh and embed company purpose, while other firms used this as an opportunity to rethink how to retain talent. Firms demonstrated wider commitment to their workforce, focusing on the overall wellbeing of staff and their families, and aiming to preserve jobs and boost morale through positive feedback.

Some regulators saw better alignment of values and more incorporation of ESG metrics in the firms they supervise. One authority observed changes, such as better alignment of firms' compensation plans to their values and the creation of programmes to encourage employees to work in the best interest of customers. This was driven by both external pressure and the adoption of ESG metrics in its strategy and objectives. Finally, one firm mentioned that it implemented more transparent disclosures during the pandemic.