

# RENEWED FOCUS ON COMPENSATION TO ADDRESS MISCONDUCT RISK

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The Financial Stability Board (**FSB**) [released](#) on 23 November 2018 its [recommendations](#) on the types of data regulators should be collecting from financial institutions (**FIs**) regarding compensation tools, as part of its [workplan](#) to address misconduct risk in FIs. This data is intended to help regulators monitor the effectiveness of FIs' compensation structures in addressing misconduct risk and assessing whether additional measures are required.

The recommendations signal a renewed focus by regulators on the role of employee compensation in driving prudent risk-taking behaviours and business practices. FIs should proactively consider whether they collect such data and are able to respond to any requests from regulators, as well as whether their compensation structures would stand up to scrutiny.

## 1. PURPOSE AND CONTEXT OF THE RECOMMENDATIONS

The recommendations follow the FSB's release in April 2018 of tools for use by FIs and regulators to strengthen governance frameworks to mitigate misconduct risk (see our bulletin [here](#)) and form part of the FSB's ongoing work on misconduct risk. While the recommendations are not binding on national regulators, we anticipate that they will prompt regulators to sharpen their focus on the compensation tools being used by FIs, as well as the data gathered by supervisory teams regarding the use of these tools.

The recommendations are intended to help FIs and regulators understand whether governance and risk management processes at FIs:

**appropriately consider conduct issues** when designing their compensation and incentive systems, including in the setting of goals for individuals, ex ante performance measurement mechanisms and ex post compensation adjustments;

**support the effective use of compensation tools** in combination with other performance management tools to help promote good conduct or to remedy misconduct;

**promote wider risk management goals** consistent with the firm's overall strategy and risk tolerance; and

**support the effective identification of emerging misconduct risks** and appropriate review of incentive systems and compensation decisions in response to conduct incidents to ensure that incentives, risk and reward are appropriately aligned.

## 2. DETAILS OF THE RECOMMENDATIONS

The recommendations identify a set of core data which the FSB considers to be the minimum set of information which should be available to regulators (**Core Data**), and which the FSB suggests that regulators receive updates on at least annually.

The FSB has categorised the recommendations into "Part A" recommendations, which address compensation frameworks, and "Part B" recommendations, which focus on compensation actions undertaken in response to misconduct.

### PART A RECOMMENDATIONS

The FSB recommends that regulators collect the following Core Data from FIs:

- a. **details of the employees** who are the subject of compensation tools to help mitigate or address misconduct risk as well as how **material risk takers (MRTs)** in relation to misconduct risk are identified;
- b. **information on how FIs determine, monitor and review** their use of compensation

and performance management frameworks to support effective risk management, including details of:

- i. the internal misconduct categories used for compensation purposes;
  - ii. policies and procedures for assessing and applying compensation tools in misconduct cases, particularly in relation to determining individual accountability; and
  - iii. positive incentives and policies used by the FI to promote good conduct;
- b. **information on the design of performance arrangements and performance measures**, including:

- i. the design of compensation arrangements for MRTs;
  - ii. key financial and non-financial monitoring metrics, performance objectives and bonus pool measures and adjustments including data used and the weighting apportioned to it; and
  - iii. how compensation is adjusted where misconduct issues arise; and
- b. **which compensation adjustment tools are available**, including “in year” adjustments and ex post adjustments through malus or clawback arrangements. Where malus and clawback arrangements are used, the FSB has indicated that regulators should also review the wording of malus and clawback clauses.

Additional information on compensation design including deferral and retention policies, vesting criteria, the use of cash and non-cash incentives as well as the ways in which performance, risk and compensation are linked may also be collected from FIs.

## **PART B RECOMMENDATIONS**

The FSB recommends that regulators gather the following Core Data from FIs in respect of compensation actions taken in response to misconduct:

- a. **data on misconduct incidents under examination by the FI**, including outstanding cases and new cases that have occurred in the current year, and relevant measures taken including compensation adjustments as applicable. The FSB has suggested that the data retrieved by regulators should include:
  - i. type of misconduct and when it first occurred;
  - ii. an assessment of the severity of the misconduct;
  - iii. the number and category of staff involved (ie, their rank and function);
  - iv. the root cause of the misconduct event and the remedial actions taken; and
  - v. details of the size of compensation adjustments relative to total variable remuneration; and
- b. **a list of all compensation adjustments**, including in year, malus (reduction) and clawback adjustments to compensation, as well as the rationale for the adjustments, including separate evidence of compensation adjustments for misconduct.

### **3. IMPLICATIONS OF THE RECOMMENDATIONS**

The message from the recommendations is clear: regulators will be scrutinising FIs' use of compensation tools to address misconduct by the collection of detailed data on compensation design and outcomes. Implicit in this message is the assumption that FIs are already using compensation tools to help control and mitigate misconduct risk and are reviewing and monitoring these tools to ensure they continue to be effective.

While a significant number of FIs across Asia already use compensation tools to help mitigate misconduct risk and drive prudent risk-taking behaviours, this has not to date been driven by Asian regulators but instead has largely been driven by regulatory developments elsewhere in the world. Additionally, where Asian regulators have imposed prescriptive requirements in this area, these requirements have typically been aimed at ensuring that compensation is used to discourage excessive risk-taking generally, rather than mitigating misconduct risk in particular.

For example, in Hong Kong, while the Securities and Futures Commission (**SFC**) has endorsed the FSB's *Principles for Sound Compensation Practices* and encouraged their adoption by SFC supervised entities, the SFC has not mandated the use of these principles. Further, although the Hong Kong Monetary Authority (**HKMA**) has indicated that it expects banks' incentive systems to take into account an individual's adherence (or the lack thereof) to culture and behavioural standards, the HKMA guidance is not prescriptive.

In Singapore, the Monetary Authority of Singapore (**MAS**) has similarly limited their guidance in this area to:

issuing [guidelines on best practices for corporate governance](#) for certain Singapore-incorporated FIs which encourage the use of performance-based remuneration aligned with the risk profile of the FI (including deferred compensation); and

[requiring](#) Singapore incorporated banks to publicly disclose certain information regarding their remuneration policies, including the way in which banks take their current and future risks into consideration in setting remuneration.

In our experience, FIs subject to more prescriptive compensation requirements elsewhere in the world in relation to compensation (such as the *EU Capital Requirements Directive IV* and the Australian Banking Executive Accountability Regime) are more likely to already use compensation tools in relation to misconduct risk. The absence of prescriptive guidance from Hong Kong and Singapore regulators in this area suggests that FIs across the region will be at different stages in their adoption of compensation tools to help control misconduct risk.

However, there are signs that regulators' attitudes to the role of compensation in managing conduct risk are changing across the region. As part of the MAS' recently issued consultation on its proposed *Guidelines on Individual Accountability and Conduct* (see our bulletin on the guidelines [here](#)), the MAS has indicated that it expects FIs to, as part of complying with the guidelines:

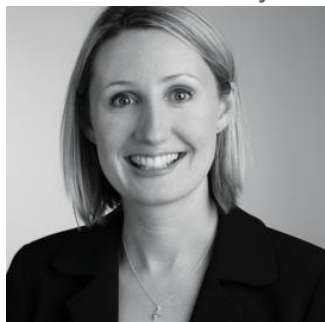
set the compensation of employees in material risk functions in a way which encourages them to act consistently with desired conduct outcomes; and

have, as part of its broader conduct framework, an incentive structure which considers risk and control objectives in compensation decisions.

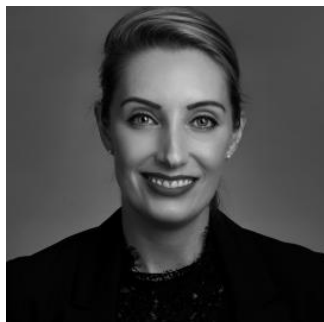
What this is likely to mean – particularly if other regulators across Asia follow the MAS’ example in imposing more prescriptive requirements in this area – is the increasing focus in this region of compensation tools as a key tool to control misconduct risk. FIs should review and monitor their compensation systems in anticipation of requests from regulators for data about the effectiveness of such systems.

## KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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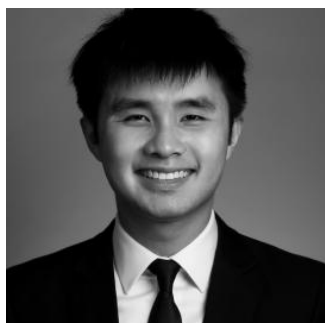
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