

FSF Principles for Sound Compensation Practices

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Introduction¹

Compensation practices at large financial institutions are one factor among many that contributed to the financial crisis that began in 2007. High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms. These perverse incentives amplified the excessive risk-taking that severely threatened the global financial system and left firms with fewer resources to absorb losses as risks materialised. The lack of attention to risk also contributed to the large, in some cases extreme absolute level of compensation in the industry.

These deficiencies call for official action to ensure that compensation practices in the financial industry are sound. While national authorities may continue to consider short-term measures to constrain compensation at institutions that receive government assistance, it is essential that steps also be taken immediately to make compensation systems as a whole sound going forward.

To date, most governing bodies (henceforth “board of directors”) of financial firms have viewed compensation systems as being largely unrelated to risk management and risk governance. This must change. While voluntary action is desirable, it is unlikely to effectively and durably deliver change given competitive pressures and first-mover disadvantage. The global supervisory and regulatory infrastructure is an appropriate vehicle for making sound compensation practices widespread.

The FSF Principles for Sound Compensation Practices are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms. They will be implemented by firms and will be reinforced through supervisory examination and intervention at the national level. Authorities, working through the FSF, will ensure coordination and consistency of approaches across jurisdictions.

The Principles are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. They are *not* intended to prescribe particular designs or levels of individual compensation. One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm. However, any compensation system must work in concert with other management tools in pursuit of prudent risk taking.

¹ In April 2008, the Financial Stability Forum (FSF) recommended that “regulators and supervisors work with market participants to mitigate the risks arising from remuneration policies.” The FSF formed a Compensation Workstream Group in late 2008 with a mandate to draft sound practice principles for large financial institutions.

I. Principles

The FSF Principles for Sound Compensation Practices aim to ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation. The benefits of sound compensation practices will be achieved only if there is determined and coordinated action by national regulators, facilitated if necessary by suitable legislative powers and supported by national governments.

1. Effective governance of compensation

The board of directors of major financial firms should exercise good stewardship of their firms' compensation practices and ensure that compensation works in harmony with other practices to implement balanced risk postures. The Principles need to become ingrained over time into the culture of the entire organisation.

1. **The firm's board of directors must actively oversee the compensation system's design and operation.** The compensation system should not be primarily controlled by the chief executive officer and management team. Relevant board members and employees must have independence and expertise in risk management and compensation.
2. **The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.** The compensation system should include controls. The practical operation of the system should be regularly reviewed for compliance with design policies and procedures. Compensation outcomes, risk measurements, and risk outcomes should be regularly reviewed for consistency with intentions.
3. **Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.** Effective independence and appropriate authority of such staff are necessary to preserve the integrity of financial and risk management's influence on incentive compensation.

2. Effective alignment of compensation with prudent risk taking

An employee's compensation should take account of the risks that the employee takes on behalf of the firm. Compensation should take into consideration prospective risks and risk outcomes that are already realised.

4. **Compensation must be adjusted for all types of risk.** Two employees who generate the same short-run profit but take different amounts of risk on behalf of their firm should not be treated the same by the compensation system. In general, both quantitative measures and human judgment should play a role in determining risk adjustments. Risk adjustments should account for all types of risk, including difficult-to-measure risks such as liquidity risk, reputation risk and cost of capital.

5. **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.
6. **Compensation payout schedules must be sensitive to the time horizon of risks.** Profits and losses of different activities of a financial firm are realized over different periods of time. Variable compensation payments should be deferred accordingly. Payments should not be finalized over short periods where risks are realized over long periods. Management should question payouts for income that cannot be realized or whose likelihood of realisation remains uncertain at the time of payout.
7. **The mix of cash, equity and other forms of compensation must be consistent with risk alignment.** The mix will vary depending on the employee's position and role. The firm should be able to explain the rationale for its mix.

3. Effective supervisory oversight and engagement by stakeholders

Firms should demonstrate to the satisfaction of their regulators and other stakeholders that their compensation policies are sound. As with other aspects of risk management and governance, supervisors should take rigorous action when deficiencies are discovered.

8. **Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.** Supervisors should include compensation practices in their risk assessment of firms, and firms should work constructively with supervisors to ensure their practices conform with the Principles. Regulations and supervisory practices will naturally differ across jurisdictions and potentially among authorities within a country. Nevertheless, all supervisors should strive for effective review and intervention. National authorities, working through the FSF, will ensure even application across domestic financial institutions and jurisdictions.
9. **Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.** Stakeholders need to be able to evaluate the quality of support for the firm's strategy and risk posture. Appropriate disclosure related to risk management and other control systems will enable a firm's counterparties to make informed decisions about their business relations with the firm. Supervisors should have access to all information they need to evaluate the conformance of practice to the Principles.

II. Commentary on the principles

This section sets out why changes in compensation policies are needed and why the issues are important for supervisory authorities. It discusses the Principles in more detail and further sets out further comment on the Principles.

Change is necessary

During the course of its work, the Workstream Group reviewed relevant reports and analyses by other bodies and experts, engaged in discussions with experts from the financial industry, the public sector and academia, and investigated industry practice by conducting a global survey of practice at major financial firms. It also reviewed the results of surveys commissioned by others.²

Multiple surveys find that over 80 percent of market participants believe that compensation practices played a role in promoting the accumulation of risks that led to the current crisis. Experts agree. Few if any observers and respondents believe that compensation was the sole cause of the crisis, nor do they believe that changes limited to compensation practice will be enough to limit the chance of future systemic crises. However, absent such changes, other reforms are likely to be less effective.

Market participants are pessimistic about the effectiveness of change unless it is industry-wide and global. Major financial institutions compete for talent in a global labour market. Some firms have already moved to change their practices and may temporarily feel safe in doing so because of the impact of the crisis on the labour market. However, in the longer run, such firms will be forced to conform to broad industry practice by labour market pressures. Moreover, firms have many competing priorities. Changing compensation practice will be challenging, time-consuming, and will involve material costs. Therefore, in the absence of sustained external pressure, firms may fail to carry through on originally good intentions. Although some market participants are wary of regulatory pressure, many believe that a widespread change in practice can be achieved only with the help of supervisory and regulatory agencies, which should coordinate at the global level.

Compensation is an incentive system, not simply a market wage

Major financial institutions are too large to be managed solely by the direct knowledge and action of senior executives. Consequently, systems, such as accounting systems, budgets, position limits, capital allocations, risk management and control systems and, importantly, compensation systems are designed to encourage employees to accomplish the goals set by senior management and the firm's governing bodies. Systems inform senior management and the firm's governing bodies ("board of directors") of the position and activities of the organisation. They help management set employee incentives in order to steer the organisation in pursuit of profit and other goals while staying within the risk appetite set by

² See, for instance, the FSF report on *Enhancing Market and Institutional Resilience* (April 2008), the IIF report on *Principles of Conduct and Best Practice Recommendations* (July 2008), the G30 report on *Financial Reform. A Framework for Financial Stability* (January 2009) and various initiatives at the national level.

the board of directors. Labour market pressures influence compensation systems, but the systems also influence how the market for financial talent operates.

Too little attention to links between compensation and risk

As a practical matter, most financial institutions have viewed compensation systems as being unrelated to risk management and risk governance. Compensation systems have been designed to incentivise employees to work hard in pursuit of profit and to attract and retain talented employees. Risk management systems have been designed to inform senior management about risk postures and to be an element of risk controls.

In principle, if risk management and control systems were strong and highly effective, the risk-taking incentives provided by compensation systems would not matter because risk would stay within the firm's appetite. In practice, all risk management and control systems have limitations and, as the current crisis has shown, they can fail to properly control risks. The incentives provided by compensation can be extremely powerful. Without attention to the risk implications of the compensation system, risk management and control systems can be overwhelmed, evaded, or captured by risk-takers.

Until recently, financial supervisory and regulatory authorities also have not focused on the implications for risk of compensation systems. Front-line supervisory personnel have long understood that compensation based solely on revenue or volume can lead to unbalanced risk postures. However, supervisory strategy has focused on risk control systems. A few decades ago this was a workable approach for most financial institutions. Most risk was in the traditional loan book and most firms were able to control front-line incentives towards excessive risk by having strong and separate credit underwriting and monitoring departments. In recent years, however, risk has become more multidimensional and complex and the array of means of taking risk has grown large. A simple one-dimensional balance between front-line and risk management personnel is no longer sufficient. Greater balance within the compensation system itself will reduce the burden on risk management systems and increase the likelihood that they are effective.

Such balance is not inconsistent with pursuit of profit and need not require a change in the firm's strategy or goals. Indeed, the current crisis has revealed that many firms took actions that were inconsistent with their own goals and internally determined risk appetite.³ Priority must be given to the link between risk and compensation.

³ In principle, there is a danger that compensation systems could become too inflexible or oversensitive to risk. In practice, a swing towards excessive risk-sensitivity is unlikely. Boards of directors are well aware of the need for effective incentives, and senior supervisory and regulatory agencies around the world are well aware of the need for the financial industry to remain dynamic and profitable. Thus, implementation of the Principles is unlikely to lead to compensation systems that are imbalanced in the sense of placing too much weight on risk.

Principles 1–3: Effective governance of compensation**Rationale**

Effective governance is a necessary precondition for compensation systems to be sound, though other practices are required as well. Financial firms that adopt a view that the compensation system interacts materially with other aspects of risk governance are likely to comply with the other principles as well. In contrast, firms that are not attentive to the governance of compensation may in reaction to supervisory pressure adopt policies and procedures that appear to be in compliance, but substance is likely to be lacking.

To date, most boards of directors have viewed compensation systems as being largely unrelated to risk management and risk governance. Compensation committees of boards have been attentive to the compensation of the most senior executives. Decisions about the compensation of all other employees have been delegated to the firm’s senior management. Often, formal responsibility for design and operation of the firm’s compensation system has been the duty of human resources departments. However, such departments tend to have little real power. Variable compensation (“bonus”) has been substantially influenced by the results of negotiations between senior management and the heads of business units and by the levels of compensation offered by competitors. Risk typically was not among the primary influences on the outcomes of such negotiations.

More about the governance principles

The firm’s board of directors should be responsible for the compensation system’s design and operation. Boards must pay serious, sustained attention to the design *and* to the operation of compensation practices for the whole firm, not just the most senior executives.⁴ Complete delegation of compensation system operation to senior executives is risky because they are subject to many pressures, especially during economic booms. Without sustained board attention, the operation of well-designed compensation systems may change in ways that are inconsistent with the spirit of the system design.

To achieve effective governance of compensation systems, substantial expertise on the part of the most-involved board members will be required. Such individuals must be independent, non-executive directors. Because sensitivity of compensation to risk will be essential, the most-involved board members will find themselves mediating disputes about details of risk measurement. They must have enough risk-measurement expertise to grasp the essence of the problems. They must also have enough sense of the history of risk realizations to mediate disputes about how compensation should change during periods of high losses.⁵

Activities that are conceptually similar to those already used for accounting and risk management systems are likely to be helpful in supporting good governance of compensation

⁴ Non-executive directors hold particular responsibility for ensuring that executive incentive compensation arrangements are sound. For financial institutions with dual boards, the Supervisory Board must take responsibility for all compensation arrangements, not just senior executive compensation arrangements.

⁵ Boards may wish to obtain independent audits of the adequacy of risk management systems and controls as well as of compensation system operation. However, such audits are not a substitute for the presence of some board members who themselves have expertise.

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systems. At lower levels of the organization, ***the compensation system should be monitored and reviewed to ensure that it operates as intended.*** A good design is not sufficient – the system must also function well. It cannot do so without controls, just as an accounting system is unreliable without controls.

Each firm should conduct regular reviews that identify material deviations of compensation outcomes from the intent of its compensation system. Such reviews should detect not only departures from rules, but also unreasonable or undesirable outcomes that flow from unavoidable system weaknesses, such as imprecise risk measures. It is important that such reviews touch all levels of the organisation. Large numbers of lower-level employees with inappropriate incentives can take actions that are individually insignificant but that, taken together, can harm the firm.

Staff engaged in financial and risk control should be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm. Moreover, compensation of back-office and risk-control employees should not be influenced by personnel in front-line business areas. Such employees must play a continuing role in the operation of the compensation system. For example, risk measures and risk judgments play a key role in risk-adjustment of compensation, as does the long-term accuracy of measures of profit-and-loss. Back-office and risk control employees play a key role in ensuring the integrity of such measures. If their own compensation is importantly affected by short-term measures, their independence will be compromised. If their compensation is too low, the quality of such employees may be insufficient to their tasks and their authority may be undermined.

As a practical matter, the compensation system often includes its own accounting system for profit-and-loss (so called “management P&L”), with rules for the treatment of revenue and expense that differ across business units and that depart from accounting standards for financial statements. Performance goals and hurdles are often set in terms of this parallel accounting system’s measures. Because the measures influence compensation, three aspects of the quality of the measures deserve particular attention from governing bodies to ensure that compensation is not distorted: The inclusion of all costs, the quality and independence of valuations, and avoiding giving current-year credit for expected future-year revenue. For some activities, such as spot foreign exchange trading involving no end-of-day positions, risks are intraday and marginal daily cash profit is directly measurable using independently obtained market prices. However, overhead costs are hard to allocate, especially the value of the firm’s creditworthiness and use of liquidity resources. It may also be the case that a business strategy generating measurable daily results possesses embedded risks that only emerge every few years, under unusual stress conditions. For many other activities, profit is difficult to measure and firms rely upon a mark-to-model process for valuation. Exotic products and positions are an example. Some of these impose a long tail of risk on the firm in the form of model assumptions which cannot be validated and whose failure only becomes apparent in future years. Market prices may not exist and employees managing the business may influence the models that provide mark-to-model valuations. Moreover, the expected future revenues of model valued products are sometimes present-valued irrespective of the likelihood of receipt and considered as profit for the current year when employee performance is evaluated. The result is strong incentives to transact these products in order to

maximize current year compensation while the residual risks are borne by shareholders in future years.

Measures produced for financial statements have their own drawbacks, and senior management must be able to engineer features of the performance measurement accounting system to encourage some kinds of activity and discourage others. Thus, bespoke performance measurement systems should not be eliminated. But governing bodies must ensure that controls and adjustments are such that compensation is appropriately related to economic profit and risk.

Principles 4-7: Effective alignment of compensation with prudent risk taking

Rationale

Two complementary approaches exist for aligning compensation with risk-taking incentives. One, the focus of Principle 4, adjusts for risk that the employee or business unit imposes on the firm but that is not yet realized. Imagine two employees whose activity generates the same short-run profit for the firm. One is a trader who ends each day with no positions and thus who exposes the firm to losses only during the trading day. Another is an originator of long-term, on-balance-sheet assets that provide substantial fees at origination but that expose the firm to substantial risk of loss over the life of the asset. Many compensation systems would tend to reward the two employees similarly, other things being equal, because there would be no “risk charge” applied to the short-term profits generated by the second employee.

Though the need for risk adjustment may seem obvious, material risk-adjustment of variable compensation grants was not widespread in the industry through 2008.⁶

The focus of the second approach and of Principles 5, 6 and 7 are practices that make compensation appropriately sensitive to risk outcomes. Such sensitivity also is not yet widespread. These Principles complement the risk adjustment approach because available risk measures, both quantitative and judgmental, have limitations. Sole reliance on them is likely to leave loopholes that would encourage taking poorly measured risk. If compensation is sensitive to outcomes, exploiting the loopholes becomes less attractive. However, bad outcomes of some risk positions are infrequent but large, so a purely outcome-based system would encourage the taking of tail risks, especially by employees with a relatively short expected remaining tenure of employment.

⁶ At least in some jurisdictions, major banks moved towards risk-adjustment of compensation in the mid-1990s. The reasons why such efforts were abandoned are not entirely clear, but one commonly cited reason is the limitations of risk measures. In large complex organizations, implementation of risk adjusted compensation is likely to involve some use of quantitative risk measures, but such measures are often not comparable across products and business units and are known to have other weaknesses. Each business unit criticizes not only the risk measures applied to its activities but also those applied in other units, making it difficult to achieve consensus about how to move forward with implementation of risk measures in compensation systems. Putting a good face on such internal debates, perhaps the perfect became the enemy of the good.

A compensation system that employs both approaches is more robust but still imperfect if it is purely mechanical. For example, many tail risks are hard to measure, so both risk adjustment and outcome-based approaches may fail to fully align compensation with the risk. Governing bodies must use intuition and common sense in looking for compensation outcomes that are not sensitive enough to risk. Boards and executive management should also be sensitive to the danger signal inherent in businesses where it is very difficult to develop appropriately risk-aligned compensation. If the firm cannot assess the employee's performance in a business, the firm is probably unable to fully assess this business's risks, and may wish to limit its exposure to the business.

More about the risk alignment principles

Perhaps the greatest barriers to progress towards the principle that *compensation must be adjusted for risk* are:

- Determining and implementing the proper mix of executive judgment and quantitative risk measures. Though quantitative risk measures have limitations, this does not imply that quantitative measures should not be used nor that risk cannot be judged.⁷ Well-governed firms make risk decisions at multiple levels and budget risk-taking across business units. Quantitative risk measures provide support for such decisions but substantial amounts of judgment are used as well. Just as judgment is required in managing the firm's risk posture, significant amounts of judgment will be an element of any system for risk-adjusting compensation. Perhaps because risk adjustment has been uncommon, the nature of best practice in combining judgment and quantitative measures in risk-adjusting compensation has not yet become clear.
- The difficulty of incorporating types of risk for which measurement is at early stages, such as liquidity or reputation risk. This difficulty is not a reason to ignore such risks.
- The difficulty of safeguarding the fairness of risk adjustments.
- The danger that quantitative measures will be distorted by self-interested employees trying to unduly influence the measurement process.

One of the greatest challenges to achieving sound compensation practice, for both financial firms and supervisors, is that the particulars of the way towards risk-adjusted compensation are not always clear, and yet the details of how compensation is earned are essential to sound practice. Over the medium term, the industry must experiment. Two visions of possible ways forward emerged from discussions with experts and market participants.

One vision is of a system that relies almost entirely upon judgment: Although the overall firm-wide amount of the bonus pool in a given year might be driven largely by firm-wide profit, senior executives would allocate the pool to business units or even individual employees quite far down in the organisational structure. In doing so, the executives might make themselves aware of quantitative measures of risk, but decisions would not be driven by such measures in any mechanical or reproducible way. The strength of the approach is that

⁷ For example, even for a single type of risk, such as credit risk, several types of measures that cannot be mechanically aggregated may be needed to assess the risk of a position. And for some important risks, such as those associated with liquidity or reputation, existing quantitative measures are crude at best.

it cannot be gamed by influencing quantitative measures and the risk adjustments are likely to be fairly good if the overall risk management system of the firm is good. The weaknesses of the approach are that it places a large operational burden on senior executives and that it lacks objectivity and transparency and is therefore difficult to audit. There is also the likelihood that a considerable proportion of internal management and senior staff time will be devoted to securing good outcomes for individuals and teams via internal political processes.

A second approach would make somewhat heavier use of quantitative measures in allocating the firm-wide variable pay pool to business units. For example, economic capital allocations might be used, with judgmental adjustments for known weaknesses of the allocations. Managers of the business units would then use substantial judgment in risk-adjusting the variable pay of individuals, producing written descriptions of their rationale. A strength of this approach is that it is more transparent and auditable and it uses the knowledge of mid-level managers. Weaknesses include the possibility that business units will try to influence economic capital measures to their own advantage and that, over time, the firm will underweight risks that the economic capital system captures poorly.

The two visions are only examples. Firms are likely to differ in the approaches they use and ways forward will emerge that are not yet apparent. The fact that the ways forward are not yet well understood is not a rationale for inaction.

Any robust compensation system is likely to take advantage of the signals arising from the firm's risk management infrastructure. Poor business unit results for internal audit, compliance, or risk management, for example, should reduce payments to the staff and managers of that business unit.

Risk adjustment of variable pay for the most senior executives presents a special challenge. They are responsible for the entire firm's risk posture and performance. However, quantitative risk measures of firm-wide risk are especially difficult to produce and to deconstruct into the contribution of each member of the executive team. Thus, the compensation committee of the board of directors, which should determine the compensation of senior executives, must use judgment in adjusting for risk. They should pay particular attention to the quality of operation of the firm's risk management and risk-adjusted compensation systems, as well as other determinants of risk.

Three principles focus on making compensation sensitive to risk outcomes: ***compensation outcomes must be symmetric with risk outcomes; compensation payout schedules must be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.*** They are motivated by the fact that, as a practical matter, the industry's efforts to achieve such sensitivity have not been effective in containing risk-taking incentives.

Theoretical treatments of how to motivate employees to act in the interests of the firm's shareholders emphasise various forms of stock-based compensation. Many financial firms paid a significant portion of total compensation in stock or similar instruments, with the stock-based portion typically greater the higher the level of the employee. Vesting and other restrictions required employees to hold some newly granted stock for significant periods of time. Although stock ownership exposed employees to losses in event of poor firm performance, many market participants and experts believe that this was not sufficient to offset risk-taking incentives. Three reasons are commonly cited. First, performance targets

and other features of compensation systems encourage employees to focus on “getting the stock.” Downside risk that might be realized later is not as relevant to an employee who receives only a small grant of stock. Second, below the level of the executive suite, most employees view the performance of the firm as a whole as being almost independent of their own actions. Actions by other employees or business units are seen as determining the firm’s fate. Similarly, stock performance might be driven by various exogenous factors. Thus, employees heavily discount the value of the stock and act to bring the cash component of bonus up. Third, many market participants view equity prices as being over-sensitive to short-term performance of the firm on both the upside and the downside and view shareholders as having a focus on short-term results. Psychologically, this pushed employees toward a focus on short-term performance.

Thus, when implementing the principle that *the mix of cash, equity and other forms of compensation should be consistent with risk alignment*, it is not obvious that more equity and less cash always increases the employee’s incentive to align risk with the firm’s appetite. The mix is likely to differ across employees and to involve a smaller cash component the more senior the employee. Some evidence implies that traditionally structured options, which are out-of-the-money when granted, are inferior to ordinary equity because the asymmetric payoff properties of options offer incentives to take too much risk.⁸ However, options that are in-the-money when granted might have different properties in that they would be similar to ordinary equity in terms of upside payout but, like a clawback, would reduce compensation in event of poor firm performance. The goal should be a mix of cash, ordinary equity, and appropriately structured options that generates a closer match between executive incentives and the long term stewardship of the firm than in the past.

Variable compensation for senior executives is probably more risk-aligned when a relatively small fraction is paid in cash and most is deferred. Compensation for more junior and transactionally oriented staff should also rely upon appropriate deferral, but a larger share could prudently be paid in cash once the relevant validation period is cleared.

Recent practice has not been consistent with the principle that *compensation outcomes must be symmetric with risk outcomes* because the bonus component of compensation has been much more variable upward in response to good performance than downward in response to poor performance, especially poor firm-wide performance. In years of losses by the firm as a whole, most employees’ bonuses at most firms have continued at a significant portion of boom-year levels. In other words, the size of firms’ bonus pools showed much more inertia than did economic performance. Firms justified this mainly by arguments that employees need incentives to work effectively even in bad years, that many employees and business units perform well even in bad years for the firm, and that employees will move to another firm if bonuses fall far below recent levels. Individual employees and business units receive small or no bonus only if their performance is poor relative to competitors or if their line of business generates very large losses.

⁸ See for instance Chen, Steiner and Whyte (2006), *Does stock option-based executive compensation induce risk-taking? An analysis of the banking industry*, Journal of Banking and Finance 30; Sanders and Hambrick (2007), *Swinging for the fences: the effects of CEO stock options on company risk taking and performance*, Academy of Management Journal 50; and Jensen and Murphy (2004), *Remuneration: where we’ve been, how we got to here, what are the problems, and how to fix them*, ECGI working paper.

It might appear that such practice simply implies part of the bonus is more like a fixed salary, so that the variable component of compensation is smaller than it appears, perhaps reducing incentives to take risk. However, the effect on incentives is more perverse. Because weak relative performance may be punished, and taking more risk, especially tail risk, is a way to boost short-run performance, the asymmetry of bonus practice encourages taking of excessive risk.⁹ It also reduces the incentive to draw attention to excessive risk taking by others, since the sensitivity of the employee's compensation to losses caused by others is reduced. Moreover, during booms, bonus amounts ratchet up each year as a result of both benign conditions and increased risk-taking, unlike fixed salaries.

The obvious ways forward are to make bonus grants much more sensitive to poor performance of the firm or business unit, or to make grants a smaller portion of total compensation. Such changes might have a price in terms of specific business unit incentives to work hard or employee retention, so the size of such changes is not clear, but some change is required.¹⁰

Recent practice has also been inconsistent with the principle that *compensation payout schedules must be sensitive to the time horizon of risks*. In addition to making *new* bonus grants sensitive to risk outcomes, which is the focus of the symmetry principle, grants from any given year should typically be sensitive to risk outcomes over a multi-year horizon. Otherwise employees will have an incentive to expose the firm to risks that are unlikely to be realized for some time, especially in cases where risk adjustments are known to the employee to be inadequate.

One way to align time horizons is to place a portion, and in some cases up to the entirety, of any given year's bonus grant, both cash and equity, into the equivalent of an escrow account. All or part of the grant is reversed if the firm as a whole performs poorly or if the exposures the employee caused the firm to assume in the year for which the bonus was granted perform poorly (a "clawback"). Departure of the employee from the firm should not trigger early payout (hence, for example, many past "golden parachute" arrangements did not conform to this principle).

Commonly used vesting provisions for stock grants do not achieve the same result because the employee forfeits unvested stock only upon leaving the firm. Thus, long-term risks imposed on the firm by employee actions are reflected in compensation only through declines in the value of stock or by dismissing the employee.

Design features of systems that make payouts sensitive to the time horizon of risk include the relative weight given to firm and employee performance, the time horizon of payout, and the rate of clawback per unit of poor performance. Both the horizon and the rate are likely to

⁹ Risk adjustment may reduce the perversity of the incentives, but only if the tail risks the employee or business unit takes are measured well.

¹⁰ Maintaining bonus payments from current revenue is not necessarily the only way to provide incentives. One possibility would be to grant bonuses in the form of claims on future-year bonus pools, with the claims exposed to clawbacks as described below. In the event a firm with losses recovers and its franchise proves valuable, such claims would eventually convert into wealth for the employee. This is only an example – there may be other ways to achieve similar ends.

differ for firm and employee performance and to differ across employees because different employees expose the firm to risks of different duration.

Unlike bonus grants, considerations of legal enforceability may require that clawback systems be driven by observable and verifiable measures of risk outcomes. Moreover, such provisions have not been common practice and in some jurisdictions may be legally difficult to implement. An exception is violations of policy by the employee, such as violations of risk management or control policies, fraud, or other malfeasance. Such employee actions are grounds for dismissal-for-cause in most jurisdictions and thus should be a basis for clawbacks.

“Golden handshake” payments that reimburse unvested compensation foregone at the employee’s predecessor firm are a difficult problem. If employees are routinely compensated by a new employer for accumulated unvested bonuses, or for vested bonuses still subject to clawback, in a manner that removes the employee’s exposure to risks imposed on the old employer, the incentive effects of the Principles will be reduced.¹¹ Similarly, multi-year guaranteed bonuses are not in line with the principle.

Similarly, “golden parachute” arrangements that generate large payouts to terminated staff that are not sensitive to performance or risk are prudentially unsound. Such arrangements create a “heads I win, tails I still win” approach to risk, which encourages more risk taking than would likely be preferred by the firm’s shareholders or creditors.

Principles 8–9: Effective supervisory oversight and engagement by stakeholders

Rationale

As noted previously, supervisory oversight is not only required for collective action to occur, but is likely to be required in the long run to offset countervailing pressures. Such oversight will be ineffective if it becomes routine or inattentive.

Similarly, governance is more likely to be effective if the firm’s stakeholders, particularly shareholders, are engaged with compensation. In order for them to be engaged, they must be informed. They can only be informed if the firm discloses relevant information. Giving shareholders an explicit voice may also be helpful.¹²

Some countries require disclosure of the level of compensation paid to top executives. However, disclosure of remuneration policies and structures, particularly as they affect other levels of an organization, has generally been poor. In the future, all the stakeholders of financial firms, including supervisors, shareholders, and (where firms are systematically

¹¹ One possible approach might involve giving the new employee deferred compensation in the form of deferred shares in the new firm, on terms similar to those that would have applied at the old firm. Such a practice would have to be widely adopted to be effective. Or sign on bonuses might only cover vested bonuses at the previous employer that are not at risk.

¹² For example, each year shareholders might vote on a nonbinding resolution to approve compensation. In cases where the resolution is not approved, the firm would be expected to consult, make material changes, and provide explanations why proposed compensation is aligned with shareholders’ interests.

important) governments, will expect to receive more information about compensation policies and to increase their engagement with them.

More about the supervisory oversight and stakeholder engagement principles

Supervisory review of compensation practices should be rigorous and sustained and deficiencies should be addressed promptly with supervisory action. Supervisory assessments of a firm's compensation policies against sound practice should be included in the supervisor's overall assessment of a firm's soundness. Any shortcomings in compensation arrangements should be brought to the attention of the firm's management and board. Often such communications have more impact if delivered by very senior supervisors.

When a supervisor discovers any practice which appears to be contributing to material weakness in a firm's soundness, direct intervention may be necessary to remedy the situation. Particularly when the totality of a firm's compensation practices are less than sound, supervisors should first exercise suasion on the affected firm, and in the absence of necessary improvement should consider escalation to firmer intervention, which may include increased capital requirements.

National supervisory authorities must move cooperatively towards implementation of the Principles. Two avenues of cooperation are likely to be necessary. First, all would benefit from a better understanding of the range of current practice and from work that reveals ways toward improvement. Such understanding can only be achieved by reviews and other work that cuts across borders. Second, regulations and supervisory practices must be such that their impact is consistent across nations. Achieving this is not mechanical because legal constraints, supervisory infrastructure, and other aspects differ across nations. Thus, supervisors must work together to develop guidance and procedures to achieve common impact, not only in the early, developmental stage, but also in the long run, and consistent with other supervisory matters.

Supervisors should be alert for regulatory arbitrage activity within as well as across borders. For example, a shift of exposures or activity to a unit using risk measures or compensation practices that are less well-suited than those in the former unit should trigger supervisory attention.

Apart from supervisors, other stakeholders such as shareholders, counterparties, depositors, auditors and analysts also have an interest in the firm's compensation policy in order to independently assess the firm's continued financial health and stability.

Hence, *firms should disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.* The shape of sound disclosure is likely to change over time and to remain fluid for some years because practice is likely to evolve. Nonetheless, the necessary information should cover all the elements of the Principles and extend well beyond the details of the compensation of a handful of senior executives. Among the relevant information is the general design philosophy of the system and the manner of its implementation, a sufficiently detailed description of the manner of risk adjustment and of how compensation is related to actual performance over time, information about compensation outcomes for employees at different levels or in different units sufficient to allow stakeholders to evaluate whether the system operates as designed, and summaries of results of internal and external audits.

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