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Make risk management part of your remuneration plan

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Providing generous bonuses to managers of financial organizations for achieving the desired short-term results was among the main factors contributing to the 2007 financial meltdown. At the time, most boards of directors considered remuneration policies (known also as compensation policies) as being unrelated to risk management. Moreover, boards were focusing only on the remuneration of the senior executives of their organizations.

Following the financial crisis, however, the remuneration-related regulatory requirements and best practices applicable to financial services organizations (many of them once thought of as "too big to fail") have become increasingly demanding, aiming for effective governance of remuneration policies, the alignment of those policies to risk management, and increased engagement of stakeholders.

Developing an effective remuneration policy

Organizations should have in place a transparent remuneration policy—it should be disclosed to all personnel of the organization, with sufficient details on the personnel performance appraisal process and the link between the appraisal and possible variable remuneration (i.e., bonus schemes). Moreover, many jurisdictions around the globe require disclosing periodically to the public the governance processes relating to the development of the remuneration policy, the composition and mandate of the bodies that played a significant role in its development, the roles of the internal control functions, the basic characteristics of the remuneration policy, and aggregated remuneration data. Such information would likely be posted on the organization's website.

An organization's remuneration policy should include, among others, the performance objectives for the organization, business units, and staff; the structure of remuneration; the performance assessment criteria; risk-adjustment measures for the variable part of the remuneration; the award, deferral, and payout structure of variable remuneration; and malus and clawback provisions.

These malus and clawback provisions apply usually to employees that can have a material impact on the risk profile of the organization, and these provisions set the conditions based on which the organization has the right to reduce or request back part or all of the deferred part of variable remuneration. Having long deferral periods and clawback mechanisms in place provide greater assurance that adverse performance outcomes can be reflected in the variable remuneration.

The remuneration policy should also set a framework for employees selling products/services directly to clients or other persons acting on behalf of the organization (e.g., agents promoting products/services, receiving orders from clients, providing advice in respect to products/services offered by the organization), ensuring that it does not provide incentives for excessive risk-taking or misrepresenting products and services.

Remuneration consists of two parts:

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1. A fixed part, which is nondiscretionary, stable over a period of time, linked to the specific role and responsibilities of the employee, and does not depend on performance.
2. A variable part (i.e., the part of the remuneration that does not meet the above conditions).

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