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FSB Issues Report on Climate-Related Compensation Practices

The Report Reviews Financial Institutions' Practices of Incorporating Climate-Related Metrics into Their Compensation Frameworks and Identifies Implementation Challenges

SUMMARY

On April 20, 2023, the Financial Stability Board released a report on *Climate-related Financial Risk Factors in Compensation Frameworks*. The report, which was prepared based on a 2022 survey conducted in FSB member jurisdictions across the banking, insurance, and asset management sectors, provides insights on how financial institutions incorporate climate-related metrics into their compensation frameworks and identifies related implementation challenges. Recognizing that this is an area that is in the early stages of development and implementation and is expected to continue to evolve, the report suggests that financial regulators can facilitate the process by sharing regulatory and industry practices with each other and with the industry.

DISCUSSION

The report observes that financial institutions are increasingly adopting climate-related metrics in their compensation frameworks in recent years. This trend may be driven by regulatory and supervisory requirements and guidance as well as international initiatives. Based on the 2022 survey noted above, many FSB member jurisdictions have already adopted or plan to adopt regulatory and supervisory frameworks for incorporating climate-related financial risks into compensation frameworks across the banking, insurance, and asset management sectors. The report also notes that international bodies, such as the Task Force on Climate-related Financial Disclosures (TCFD) and the International Sustainability Standards Board (ISSB), recognize that linking climate-related objectives with compensation can be a way to incentivize and drive progress for climate-related strategic goals.

A. CLIMATE-RELATED COMPENSATION PRACTICES

The report identifies the following climate-related compensation practices and trends:

- Climate-related metrics tend to be included in the non-financial measures, often as part of an ESG category that incorporates broader ESG factors, to determine compensation, rather than the financial measures.
- Examples of climate-related metrics include:
    - reduction of carbon footprint (e.g., greenhouse gas emissions reduction, achievement of 100% renewable energy use, and climate policy introduction);
    - provision of sustainable finance products (e.g., volume and amount of sustainable business, ESG investments, and revenues from ESG financing);
    - accountability-type measures (e.g., ESG and climate-related initiatives, leadership on climate issues, and training on corporate sustainability); and
    - external ESG metrics (e.g., ESG ratings and indices).
- There currently appears to be less focus on climate-related risk management metrics in compensation frameworks, possibly because climate-related financial risks tend to be included within overall risk measures and linked to a broad range of risk factors and may affect financial key performance indicators without being explicitly included.
- Where included in compensation frameworks, climate-related metrics are generally applicable at individual and/or collective levels for executives and senior management (e.g., CEO, CFO, CRO and Chief Sustainability/Climate Officer, and certain business heads with climate-related responsibilities).
- Climate-related metrics are incorporated primarily in short-term incentive plans and to a lesser degree in long-term incentive plans. Short-term incentive plans often break down tiered goals on climate-related metrics to single-year milestones.
- At present, the impact of climate-related metrics on total compensation outcomes is relatively modest, due to their small weights or their being used only as an overall adjuster or modifier.
- The board is generally empowered to exercise its discretion to adjust the climate-related metrics and/or their weight, which could influence compensation outcomes.
- Geographic differences are more significant than sectoral differences with respect to progress in adopting climate-related compensation practices among financial institutions (e.g., inclusion of climate-related metrics in compensation frameworks are generally more common in Europe).

B. COMMON IMPLEMENTATION CHALLENGES

The report identifies the following common challenges in incorporating climate-related metrics into compensation frameworks:

- Gaps in data availability (including disclosure and transparency), reliability, and analysis (including measurement and methodology) make it difficult to incorporate reliable quantitative metrics into compensation frameworks and track performance against climate-related targets.
- It is challenging to develop objectively quantifiable and measurable climate-related metrics that are relevant to and aligned with financial institutions' climate strategies and acceptable to all stakeholders.

- There may be an inherent timing misalignment between a relatively short performance evaluation period of compensation frameworks (e.g., annually) and a relatively long period for achieving climate-related results.
- It is challenging to use climate-related compensation practices to incentivize employees across the organization, including at more junior levels.
- Uncertainty on climate risk, including potential changes in regulatory expectations and government policies related to climate risk, may result in gaps or inconsistencies in the way financial institutions incorporate climate-related metrics into their compensation frameworks.

IMPLICATIONS

Although the report does not provide any specific guidance, expectations, or recommendations for how financial institutions should incorporate climate-related metrics into their compensation frameworks, the report provides insights that may facilitate financial institutions' benchmarking of their own compensation practices against those of their peers. As the report acknowledges, climate-related compensation practices remain a nascent and rapidly evolving area. Financial institutions should continue to monitor developments in this area, both with respect to regulatory requirements and supervisory guidance as well as market practices, in their relevant jurisdictions and sectors.

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