

ECONOMICS, POLITICS AND THE INTERNATIONAL PRINCIPLES FOR SOUND COMPENSATION PRACTICES

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“Financial and Banking Regulation: A Post-Crisis New Deal?”

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➤ **I. Introduction. Main Issues**

II. Theories and Policies

III. The Rise of International Standards

IV. Implementing International Standards in Europe

V. Conclusions

Main Issues

- Was executive compensation at banks predominantly short-term oriented before the crisis?

2 Viewpoints

- Politicians
 - Academics
-
- The role of regulation in bank compensation arrangements / structures
 - General policy
 - Detailed pay structure
 - Recommending
 - Mandating

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Corporate Governance of Banks

- Banks are Special
 - Banks are more leveraged than other firms
 - Mismatch between liquid liabilities and illiquid assets
 - Deposit insurance which generates moral hazard
 - Facile asset substitution
 - Opaqueness
- Therefore bankers are more prone to risk taking
- Prudential regulation and supervision reduce excessive risk taking

Governance and the Financial Crisis

- Beltratti & Stulz (2009)
 - No evidence that banks with better governance performed better
 - In fact... banks with more pro-shareholder boards performed worse
- Adams (2009)
 - TARP banks had worse governance
 - TARP banks had more independent boards, greater incentives for CEOs (than non-TARP banks)
- Results
 - Corporate governance was not a main determinant of the crisis
 - However, “good governance” may need reforms

Executive Pay and the Financial Crisis

- Fahlenbrach & Stulz (2010)
 - US CEOs had substantial wealth invested in their banks – focus on the long-term
 - No evidence that banks with better executive-shareholder interests alignment had higher returns
- Cheng, Hong & Scheinkman (2010)
 - “Yesterday’s heroes” were the largest risk-takers and also high-compensation firms
 - Short-term investors pushed for short-term incentives

Executive Pay and the Financial Crisis

- Bebchuk, Cohen and Spamann (2010)
 - Executive performance-based pay based on short-term gains rather than aligning with sustainable shareholder value (Bear Stearns and Lehman case studies)
- Results
 - No clear proof that short-term incentives led to excessive risks
 - Bankers also motivated by non-monetary incentives
 - No clear support for regulating bankers' pay

Proposals Optimal Structure of Pay

- Banks to take into account the interests of creditors, to avoid excessive risk taking
 - Tie CEO compensation to a measure of firm's riskiness, e.g. to CDS spread, to maximize the whole value of the firm, i.e. equity & debt (Bolton, Mehran and Shapiro, 2010)
 - Tie executive pay to the aggregate value of a basket of securities (common shares, preferred shares, bonds) issued by the bank (Bebchuk and Spamann, 2010)
 - A significant portion of stock-related compensation in the form of convertible equity-based pay (Gordon, 2010)
 - Supporting some type of regulation
 - However, nature of regulatory intervention is unclear

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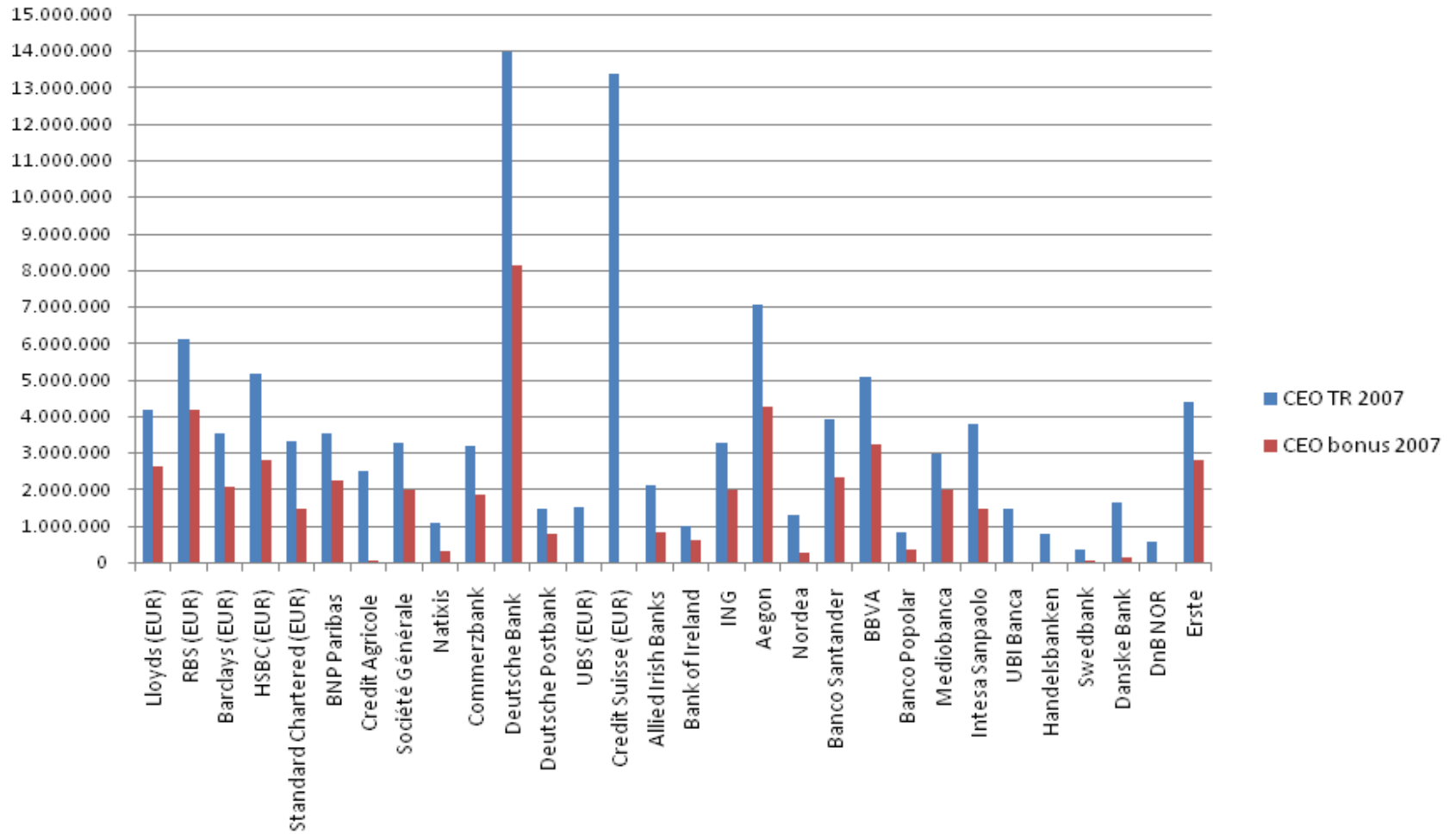
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Government Rescues Conditions

- Government intervention schemes imposed adjustments in remuneration policies
 - UK: RBS and Lloyds cases – FSA Code on Remuneration Practices
 - France: major 6 banks – AFEP-MEDEF Recommendations
 - Switzerland: UBS – Credit Suisse “race to the top” – UBS’ “pioneering approach to executive compensation practices”
- Approach extended to all banks

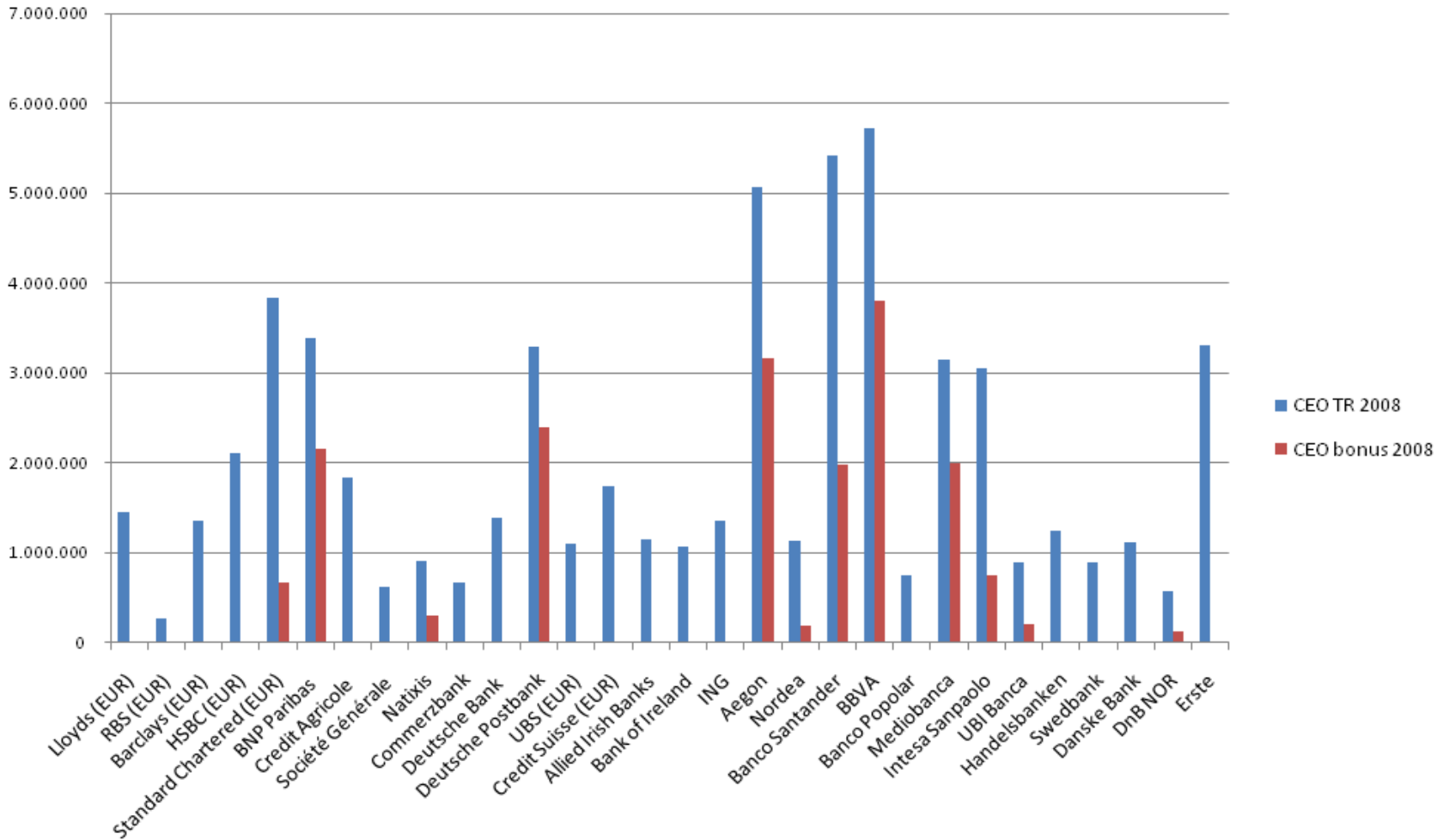
2007 CEO cash compensation



Source: University of Genoa; research done on 30 European banks providing individual numerical disclosure in all 3 years: 2007, 2008, 2009

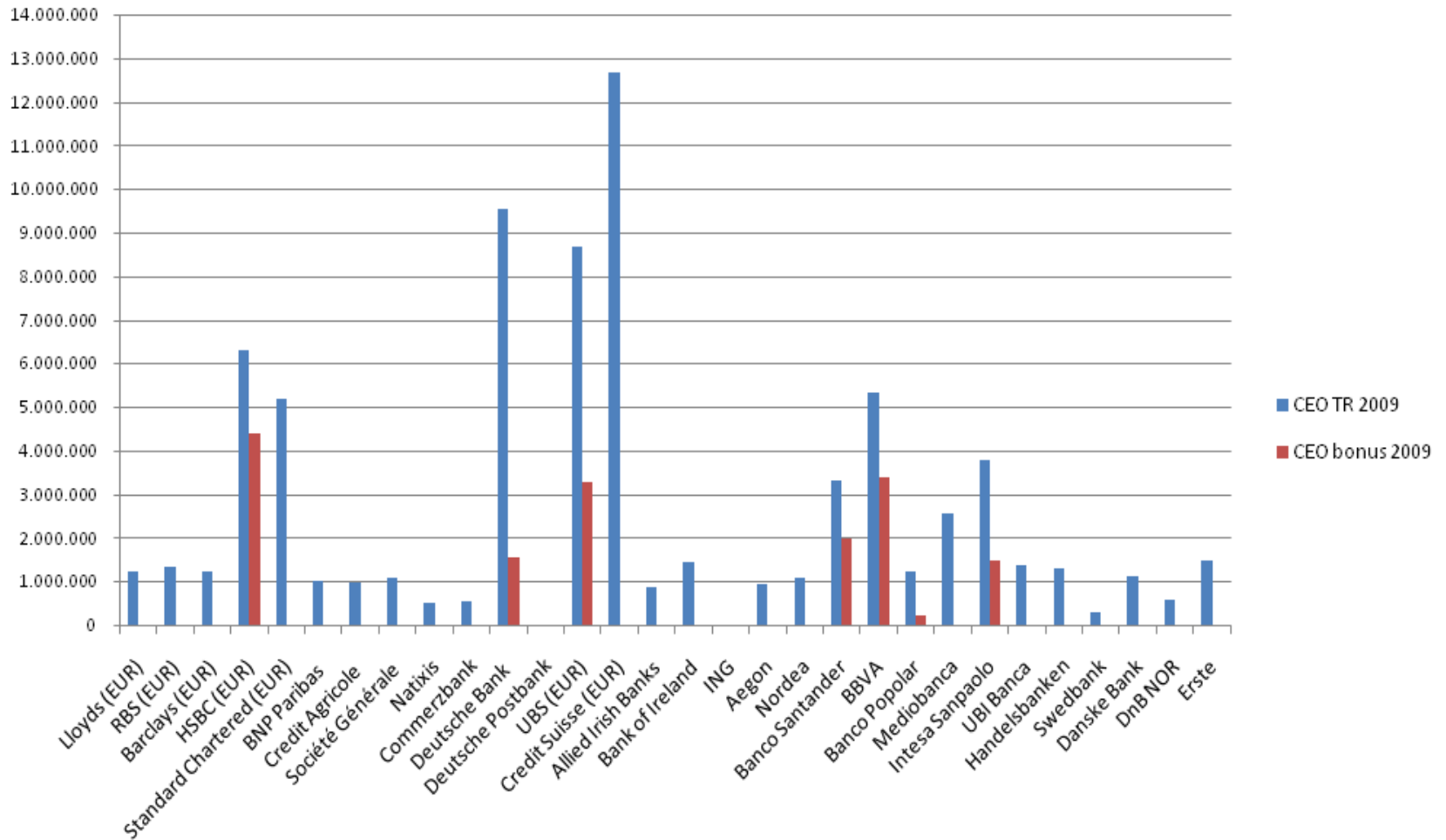
Note: Credit Suisse's TR includes bonuses, as reported by the bank.

2008 CEO cash compensation



Source: University of Genoa; research done on 30 European banks providing individual numerical disclosure in all 3 years: 2007, 2008, 2009

2009 CEO cash compensation



Source: University of Genoa; research done on 30 European banks providing individual numerical disclosure in all 3 years: 2007, 2008, 2009

Post-crisis: no major differences between ailing and non-ailing banks

NON_AILING (17 banks)	2007	2009	2007	2009
Remuneration policy: year change		11		64.71%
LTIP (share-linked)	12	12	70.59%	70.59%
Deferment Yes / No	8	11	47.06%	64.71%
Share Vesting period (min)	5	6	29.41%	35.29%
Malus / clawback	1	6	5.88%	35.29%
AILING (23 banks)	2007	2009	2007	2009
Remuneration policy: year change		15		65.22%
LTIP (share-linked)	23	21	100.00%	91.30%
Deferment Yes / No	8	15	34.78%	65.22%
Share Vesting period (min)	11	13	47.83%	56.52%
Malus / clawback	2	11	8.70%	47.83%

Source: University of Genoa; research done on 40 European banks' Remuneration policies from remuneration reports 2007 & 2009

International Principles & Standards

- Addressed to “significant financial institutions”

- **Remuneration Governance**
 - BoD to monitor and review compensation systems
 - BoD to engage control functions (i.e. HR, finance, risk management, compliance)
 - Remuneration Committee
 - Oversees design and implementation of remuneration policy
 - Competent and independent judgment
 - Remuneration Committee working closely with Risk Committee

International Principles & Standards

- **Remuneration Structure**

- Compensation must be adjusted for all types of risks (i.e. liquidity, reputation, capital)
- Compensation outcomes symmetric with risk outcomes
- Malus & clawback applicable to both cash incentives and share-based payments
- Deferral of variable compensation
 - A “substantial proportion” (40% - 60%), increasing with the level of seniority and responsibility (>60%)
 - Deferral period not less than 3 years
- Guaranteed bonuses are inconsistent with sound risk management and pay-for-performance
- Severance packages to be re-examined and maintained if aligned with long-term value creation

International Principles & Standards

- **Disclosure**
 - Benefits not only shareholders, but other stakeholders (creditors and employees)
 - Increased transparency through new reporting items
 - Deferral
 - Share-based incentives policy
 - Criteria for risk adjustment
- **Supervision**
 - Effective supervisory oversight
 - “Prompt remedial action”
 - Escalation to firmer intervention, e.g. increased capital requirements

International Principles & Standards

Our Assessment

- Principles reflect already existing best practice
 - Limits of short-term incentive effects
 - Alignment of incentives with sustainable shareholder value
- Novelty: emphasis on the alignment of compensation with prudent risk taking
- Flexibility – pay structures reflect differences in firms' risk policies
- Principles should not be taken as too prescriptive, as not intended to prescribe particular pay design / levels
- However some rigidity in apportioning equity-based pay
 - Substantial stock-based compensation could exacerbate incentive alignment problems (“Fuld problem”)

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Pre-Crisis Approach

- 2001-2003 period (across sectors) (Ferrarini and Moloney, 2004)
 - Less sophisticated regulation in block-holding companies
 - Closer attention to pay-setting in dispersed ownership companies
- 2004-2005 Recommendations (mainly disclosure) (Ferrarini et al., 2009)
 - No major differences in disclosure practices between banks & non-banks
 - Focus on core disclosure requirements
 - Less attention to detailed requirements
 - Differences across Member States

Post-Crisis Approach

- 2009 Recommendations
 - Rec. on the remuneration of directors of listed companies
 - Rec. on remuneration policies in the financial sector
- CRD III (amending existing CRD)
- CEBS Consultation Paper on Remuneration Policies and Practices (Oct. 2010)

CRD III and CEBS Principles

Aim to increase compliance with the FSB Principles & Standards

- **Main principle** (Art. 22 CRD)

“The remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the credit institution”

- Introduce more rigidity in pay structures

- However some flexibility is provided (**Principle of proportionality**)

(4° Considerandum CRD) “Principles should recognize that credit institutions and investment firms may apply the provisions in different ways according to size, internal organization and the nature, scope and complexity of their activities [...]”

CRD III and CEBS Principles

- **Supervisory powers** (Art. 54 CRD)

"Member States shall ensure that, for the purposes of the first paragraph, their respective competent authorities have the power to impose financial and non-financial penalties or measures."

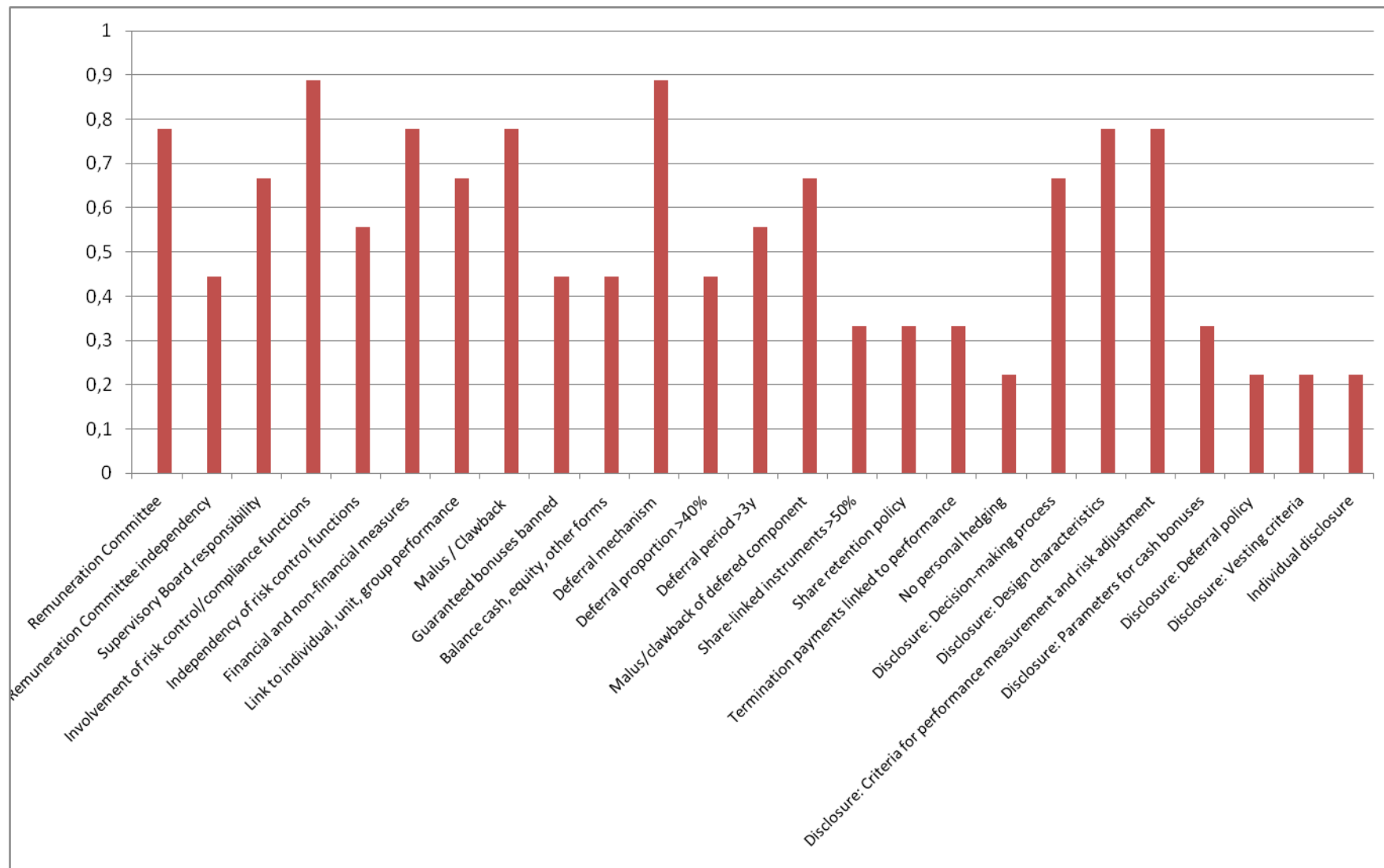
- Qualitative measures

- Firms to reduce risks by introducing changes to their pay structures or “freezing” variable pay that is inconsistent with effective risk management

- Quantitative measures

- Requirements to hold additional funds

Implementation of International Principles & Standards in Member States – Financial Authorities Regulations (2008-2010)

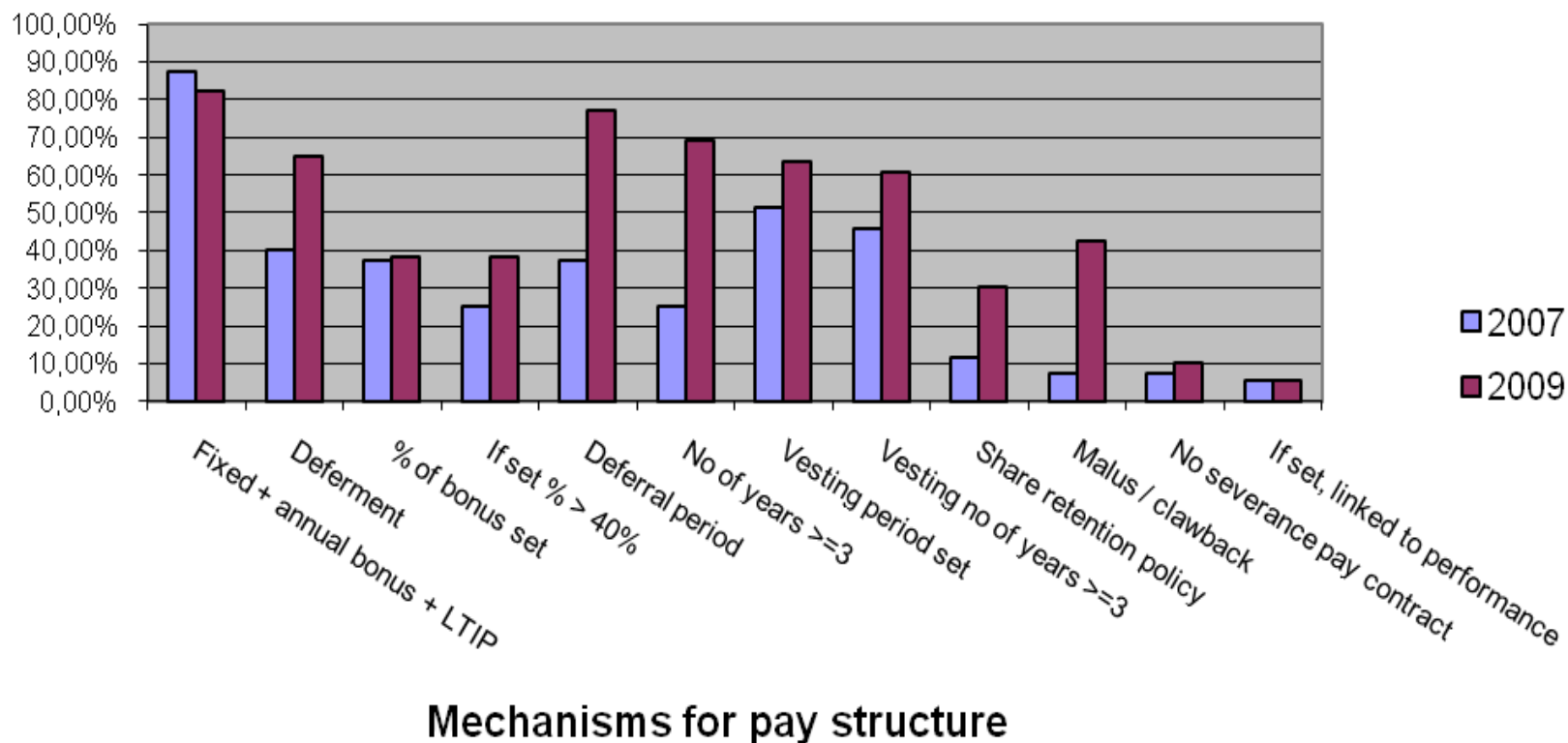


Implementation of International Principles & Standards in Practice (40 European banks 2007 and 2009)

Pay structure	2007 (no of banks)	2009 (no of banks)	2007 (%)	2009 (%)
Fixed + annual bonus + LTIP	35	33	87.50%	82.50%
Deferment	16	26	40.00%	65.00%
% of bonus set	6	10	37.50%	38.46%
If set % > 40%	4	10	25.00%	38.46%
Deferral period	6	20	37.50%	76.92%
No of years >=3	4	18	25.00%	69.23%
Vesting period set	18	21	51.43%	63.64%
Vesting no of years >=3	16	20	45.71%	60.61%
Share retention policy	4	10	11.40%	30.30%
Malus / clawback	3	17	7.50%	42.50%
No severance pay contract	3	4	7.50%	10.00%
If set, linked to performance	2	2	5.41%	5.56%

Implementation of International Principles & Standards in Practice (40 European banks 2007 and 2009)

2007-2009



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The Case for Regulating Bankers' Pay

- ✓ Regulatory intervention should be limited in scope
- Drawbacks detailed regulation
 - Hamper the flexibility of compensation arrangements
 - Regulators may not be professionally qualified for designing and monitoring pay
 - Boards losing key governance function such as setting executive pay
 - Problems in attracting and keeping managerial talent

The Case for Regulating Bankers' Pay

- Proposals
 - Setting executive pay is a matter for boards
 - Role of regulators
 - Supervise via prudential regulation (e.g. imposing capital requirements for banks with aggressive pay policies)
 - Establish requirements for governance of compensation, including disclosure
 - Suggest structures which would undermine excessive risk taking (soft approach)

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