vigeo rating

SUSTAINABILITY FOCUS

SEPTEMBER 2013

Toward a more balanced banking remuneration in EU: will reputation and regulation do the job?

Abstract

In the last decades income inequality has grown substantially in most developed countries, and it has been made even larger by the financial crisis. According to a recent OECD report, income inequality has increased more between 2008 and 2010 than in the previous 12 years[1], especially in those nations most hit by growing unemployment rates. In this general context, it is not surprising that the remuneration of executives, especially of bankers, is increasingly attracting the attention of the public opinion and of investors. Some investors - concerned about the dramatic increase of executive pays compared to the modest (if not totally absent) rise of employees' wages - have introduced in their voting policy maximum ratio between the remuneration of CEOs and the minimum salary of employees. At the same time, as made self-evident by the financial crisis sparked in 2008, unreasonable annual bonuses can also represent a misguided incentive for excessive risk-taking, especially in the financial sectors. In Europe, in order to limit the short-termism of the compensation policies of bankers, in 2010 the Committee of European Banking Supervisors (CEBS, now EBA) issued the Guidelines on remuneration policies and practices. However, as also showed by European Banking Authority (EBA), these guidelines have been implemented unevenly amongst Member States and, in general, with a 'soft' interpretation of their provisions. Amongst other results, Vigeo's 2013 review of the European Diversified Banking sector confirmed this tendency. In the future, stricter legislative developments (including the EU bonus cap) and the increased reputational risks associated with this issue will force banks to adopt more socially acceptable and long-term performance-driven compensation policies.

Introduction

The 2008 financial crisis has drawn the attention on the need to rethink the incentive schemes for bankers, but after five years the compensation of many executives is still considered well above a social acceptable level by a large part of the society. The state of intolerance of investors and public opinion on this issue has resulted, during the 2012, in what has been named "shareholders spring": the remuneration packages of giants such as UBS, Credit Suisse and Barclays have been approved only by a "limited support" of shareholder votes. According to the results of Vigeo's 2013 review of 28 largest European banks, only 19 banks gave shareholders the opportunity to express an opinion on executive remuneration through a non-binding vote at the Annual General Meeting, of which only 8 had their remuneration packages approved by more than 90% of shareholder votes.

Also in 2013 the compensation of bankers remains a hot topic: there is an increasing unwillingness of shareholders to compensate the failures of their managers, especially in a continuous period of financial and economic turmoil, caused by the financial sector itself. In addition, there is a mounting public awareness on the large income inequalities of our society, in which executive compensation plays both a symbolic and tangible role if compared with the flat, if not decreasing, average real wages of employees and the large unemployment rates. After all - according to a report published by the European Banking Authority (EBA) on 15 July 2013[2] – Europe has still 3,175 bank staff who earned at least one million Euro of total remuneration in 2011, with more than 2,400 based in UK. This edition of Vigeo's Sustainability Focus will provide an insight into the main stakeholder concerns and business risks related to executive remuneration in European large banks.

Business risks related to executive remuneration

A well-structured executive compensation plan is an essential element of good corporate governance: it represents the set of economic incentives necessary to overcome - or at least mitigate - the principal-agent problems between management and shareholders. Theorically a sound remuneration policy is considered as a key driver for the **operational efficiency** of a company and it must be designed in coherence with its business strategy, objectives, values and long-term interests. In banks, given their key role in financing the real economy, the remuneration structure has even a more important function: it must prevent the interests of executives to put the collective interest at risk, for instance through an eccessive risk-taking.

Indeed, an unsound remuneration structure is also increasingly associated with risks in terms of **reputation,** particularly precious for the banking sector as its businesses is mainly based on the trust of financial markets. In fact, the degree of transparency and the justification of executive pay are nowadays issues under scrutiny by investors and public opinion; this can influence in a relevant way the public perception of a company, eroding or reinforcing its corporate reputation. The reputational effect of executive remuneration is amplified by the "say on pay" principle - whereby shareholders have the right to vote on the compensation of their executives – which is becoming a common practice in many countries (for instance, US introduced it in 2010 while Italy did it in 2011). A future shift toward a binding - and not only consultative - shareholder vote may even increase the reputational risks related to executive remuneration[3].

Nevertheless, an unbalanced remuneration structure can also increase a bank's exposure to other important risk classes. In particular, in terms of **human capital**, an appealing variable remuneration plan is essential for attracting, retaining and motivating executives to fulfill at the best their duties. At the same time, a high level of transparency on the rules guiding the allocation of bonuses is crucial to preserve the social cohesion and motivation of workforce: employees' motivation can be negatively impacted by remuneration that reward executives' failures.

Banks are slow in complying with new regulations

One of the key lessons provided by the financial crisis is that the remuneration structures of bankers must be designed to control risks and to limit the bankers' pursuit of high bonuses through excessive risk taking[4]. Has this lesson been learned? Apparently yes: at the end of 2010 the Committee of European Banking Supervisors (CEBS) introduced the Guidelines on remuneration policies and practices[5]. These Guidelines came into force in most European countries on 1 January 2011 with the EU Capital Requirement Directive, **CRD III**. These Guidelines introduced relevant remuneration requirements for all employees and specific stricter requirements applicable to the so called "**Material Risk Takers**" (also referred as "Identified Staff", or Code Staff in the UK), i.e. staff whose actions have a material impact on the risk exposure of the firm (see Focus box).

However, the practical implementation of this legislative framework was slow and difficult, as demonstrated by the survey on the implementation of the CEBS' guidelines published by EBA in April 2012[6]. Although the EBA found some improvements in terms of governance of remuneration, it also observed a generalized tendency of European institution to identify a **very low number of material risk takers**. This tendency was confirmed by the latest Vigeo's review of the European Banking Sector: only 6 banks appeared to include individual traders, trading desk and credit officers in their "identified staff" and to review their remuneration through the risk management function, as prescribed by the EBA's guidelines, in addition to the human resources function.

Focus Box: Material Risk Takers: who are they?

The CEBS 2010 Guidelines require financial institutions to identify the staff members whose remuneration is subject to specific stricter requirements. This group of employees, named "identified staff", includes executives, senior managers and independent control functions and "other risk takers", such as staff members whose professional activities – either individually or collectively, as members of a group – can exert influence on the institution's risk profile (such as individual traders, specific trading desks and credit officers).

This definition is actually very general and it is not surprising that financial institutions have applied it quite loosely. In fact, the EBA's 2012 survey revealed that the numbers of identified staff vary considerably between member states, but in general it is very low. The banking authority expressed genuine concerns about this finding, since an heterogeneous and insufficient application of the remuneration guidelines could lead to serious **regulatory arbitrage** and **competitive disadvantages**.

In light of these results, on 21 May 2013 the EBA issued a consultation paper[7] proposing a clearer definition of "Identified Staff" under the CRD IV remuneration requirements (including a cap to annual bonus). The identification process proposed by the EBA is based on a mix of internal criteria, regulatory qualitative and quantitative criteria (e.g. variable remuneration exceeds 75 % of the fixed component of remuneration and EUR 75,000), with an employee identified as "Identified Staff" if he/she met at least one of these three criteria.

The EBA also observed that for the "identified staff" the requirements in terms of risk alignment of remuneration remain largely unapplied. According to the 2010 Guidelines, a substantial portion of the variable remuneration component of "identified staff" should be **deferred over an appropriate period of time**, which is not less than three up to five years. These proportions should increase significantly along with the level of seniority and/or responsibility. In its 2013 review, Vigeo found that 76.9% of large banks comply with the basic recommendations of the Guidelines for its executives (at least 60% of variable remuneration deferred over a minimum period of three years), but only 5 banks (18.5%) introduced longer deferral periods.

In order to ensure that the variable compensation is aligned with the long-term interests of the company, **long-term incentives** should also be adopted. On this issue, in Vigeo 2013's review 11 banks (39.3%) were not transparent on the allocation of long-term incentives or they did not have in place any incentive plan based on multi-year performance period.

Best Practices

Identification and monitoring of Material Risk Takers:	
Nordea	To identify risk takers at Nordea Markets, analysis is based on hierarchical structures as well as individual risk mandates, taking into account the size and complexity of Nordea's operations. Within lending activities, managers of a number of business areas as well as all employees in the Group Credit organisation have been defined as risk takers. When identifying risk takers within control functions, Nordea has followed the principle of including all employees in the relevant units irrespective of the individual person's capacity to influence risks. Members of Group and divisional credit committees have also been defined as risk takers. Nordea identified 1533 "risk takers" in 2012 (out of around 31,500 employees). In addition to this, Nordea's risk analysis includes risks related to governance, structure of remuneration schemes, goal setting and measurement of results, as well as fraud and reputation.
Risk alignment of Remuneration:	
Credit Suisse	According to the 2012 Remuneration Policy, STI awards are granted in the form of performance share awards, which are deferred over three years and subject to clawback conditions. LTI awards are granted in the form of cash awards after a three-year performance period, and vest in three tranches, one on each of the third, fourth and fifth anniversaries of the date of grant. All deferred awards for 2012 contained a general malus provision. For 2012, the incentive compensation was granted in the proportion of 10%/50%/40% for the unrestricted cash, STI award and LTI award, respectively, corresponding to a deferral rate of 90% for Executive Board members, which is the maximum deferral rate applied to employees Group wide (was 80% in 2011).

Also the dimension of bonuses can influence the risk profile of banks. Excessively high bonuses can incentivize excessive risk taking decisions by individual employees and, for this reason, the 2010 CEBS Guidelines recommended *"an appropriately balanced ratio of variable to fixed remuneration"*. However, only few Member States introduced maximum ratios (e.g. the Netherlands), while most legislations left the individual institutions to set an internal rules. This soft legislative approach has not proven fully adequate: in 2012 the EBA observed that variable remuneration of European banks considerably exceed fixed remuneration for all Identified Staff[8]. According to EBA data on high earners in EU banks published in July 2013, in 2011 the average bonus of UK bankers - although significantly reduced with comparison to 2010 – was still around 3.46 times their fixed salary.

On the basis of this considerations, the EU is currently moving toward the introduction of more stringent rules. In April 2013 – in the context of the Capital Requirements Directive 4 (CRD IV) - the European Parliament approved rules to limit bankers' bonuses to 100% of annual salary, or twice the annual salary with an explicit approval of shareholders[9]. From 2014 this bonus cap will apply globally for the senior management and top traders of European banks, while for non-EU banks the cap will only apply in Europe. The scope of this bonus cap may be substantially increased by the proposal made by EBA in May 2013 to widen the definition of "material risk takers" to include anyone earning more than 500,000 euros.

Remuneration plans : what targets ?

In addition to the structure and dimension of bonuses, the soundness of a remuneration package also depends on the nature of the performance conditions taken into account. In particular, in its Guidelines the CEBS stressed the importance of having remuneration plans incorporating explicit parameters that take into consideration the risks and performance of the business unit and the institution[10], such as return on risk-adjusted capital (RORAC) or economic profit. These indicators – contrary to more traditional operating efficiency (profits, revenues, or volume metrics) or market measures indicators (share price and total shareholder's return) - incorporate explicit adjustments for risk and thus are more adequate measures of the long-term effects of the performances of staff members.

The outcome of EBA's survey showed that the use of risk-adjusted performance parameters for setting bonus pools is increasing, but much more experience has still to be gained on the credibility of these parameters and their simultaneous internal use for risk management purposes outside remuneration, so that they can really become embedded in the organisation's risk management framework[11]. In its 2013 review of the 28 largest European banks, Vigeo found that 16 of these (57%) have adopted risk-adjusted performance conditions for the allocation of annual bonuses.

Beyond the adoption of risk-alignment parameters, more balanced and social acceptable compensation structures may also be obtained through the integration of **ESG performance indicators**. This practice can reinforce the company's reputational asset and improve the relationship with both investors and communities. In addition, "carrot incentives" for sustainability can effectively contribute to improve the company's social and environmental sustainability, thus anchoring the bonuses of managers to a perspective of long-term value creation. On the basis of the opportunities and the practical difficulties of implementing ESG-linked incentives, the UNPRI (United Nations Principles for Responsible Investment) published in June 2012 a set of guidelines[12] with the aim to support and enhance the investor-company dialogue on this topic.

The 2013 sector review of Vigeo revealed that 13 out of the 28 European largest banks have adopted performance conditions linked to various ESG indicators. However, there are still few best practices of banks which integrated quantitative ESG-linked performance conditions in their executive remuneration plan (see Best Practices Box).

Best Practices
ESG-linked performance conditions for the allocation of annual bonus

Crédit Agricole	The variable compensation of the CEO and Deputy CEOs is based on two sets of criteria: the first (50%), on three economic and financial criteria relating to the performance of the Crédit Agricole S.A. Group; the second (50%) is determined by non economic criteria based on predefined targets. These non-economic criteria are quantitative and can include for instance the absenteeism rate, the annual interviews completion rates, the customer satisfaction rate, the percentage of employees trained in ethics and compliance or the rate of pay discrimination between men & women.
DNB	The variable remuneration of the group CEO and other executives are performance-based. The return on risk-adjusted capital (RORAC), Tier 1 capital ratio and cost/income ratio constitute the Group's key figures for 2012. In addition to the financial key figures, measurement criteria include the Group's customer satisfaction index and reputation scores. The variable remuneration of the group chief executive cannot exceed 50% of fixed salary.

Conclusion

All in all, the presence of perverse short-term incentives in banks – and more generally in the financial sector - is considered among the major causes of the financial crisis sparked in 2008, and still not overcome. In order to limit the short-termism of compensation policies and the excessive risk-taking of bankers, CEBS introduced in 2010 the Guidelines on remuneration policies and practices. However, as showed by the survey carried out in 2012 by EBA, these guidelines have been implemented unevenly amongst Member States and, in general, with a 'soft' interpretation of their provisions. Vigeo's 2013 review of the European Diversified Banking sector confirmed the results of the EBA's survey.

In general, the banking sector appears slow in anticipating and adapting to the international recommendations on remuneration, indeed, it proved quite good in getting around them. For this reason, the EU institutions are introducing additional stricter regulations, including a well-known bonus cap applying from 2014. Morevoer, beyond regulation, the increased awareness of the public opinion and the stronger activism of shareholders will in the next years increasingly push banks to adopt more acceptable compensation policies.

In this context, the integration of CSR-linked objectives into the compensation plans represents an opportunity for strengthening trust among stakeholders, reinforce institutional culture and improve corporate reputation.

Contacts

For further information, please contact the analysts:
Stefano Ramelli stefano.ramelli@vigeo.com and Roberto Savia roberto.savia@vigeo.com

Disclaimer

All rights reserved. Reproduction and dissemination of material in this report for educational or other non-commercial purposes are authorised without any prior written permission from Vigeo provided the source is fully acknowledged. Reproduction of material in this report for resale or other commercial purposes is strictly prohibited without written permission of Vigeo.

vigeo rating

Notes and Sources

1) OECD, “Crisis squeezes income and puts pressure on inequality and poverty”, May 2013.

2) EBA, “High Earners 2010 and 2011 data”, July 2013.

3) In June 2012 the UK government announced the introduction in late 2013 of a binding say-on-pay to start applying in October 2013 (see “*Consultation on revised remuneration reporting regulations*”, UK Department for Business Innovation & Skills, June 2012), and more recently also Spain announced the plan for a similar move. But the introduction of a binding say-on-pay has also been proposed in 2012 at the European level (see The Financial Times, May 15 2012: “*EU to push for binding investor pay votes*”).

4) See for instance the “Corporate Governance and the Financial Crisis: Key Findings and Main Messages” published by OECD in June 2009.

5) Committee of European Banking Supervisors (CEBS), "*Guidelines on Remuneration Policies and Practices*", December 2010.

6) EBA, "*Survey on the implementation of the Guidelines on remuneration policies and practices*", April 2012.

7) EBA, 21 May 2013 “Consultation Paper. Draft Regulatory Technical Standards. On criteria to identify categories of staff whose professional activities have a material impact on the institution’s risk profile”.

8) EBA (2012), p16.

9) See for instance: Financial Times, February 28, 2013: "EU agrees to cap bankers’ bonuses".

10) CEBS (2010), p50.

11) EBA (2012), p4.

12) “*Integrating ESG issues into executive pay*”, UNPRI, June 2012, available at http://www.unpri.org/.