Fixing Bankers’ Pay in Europe: Governance, Regulation and Disclosure

Guido Ferrarini 1
Maria Cristina Ungureanu 2


Abstract

Corporate governance variables such as board structure, ownership structure and compensation structure have different features at banks; this creates special compensation settings. After the reforms set around the 2004-2006 period, international policy makers are engaging in a new round of reforming the directors’ pay system. The European Union provides a fertile ground for the discussion on directors’ remuneration. Our insight into the particularities of the pay structure of banks’ boards assist in gaining an understanding of the interaction between public regulation and corporate governance. We emphasise the role of disclosure as a remedy for solving the weaknesses in the design of pay contracts and governance structures. An analysis of the disclosure behaviour by Europe’s largest banks is conducted using criteria based on the European Commission’s Recommendations.

Keywords: Directors’ remuneration, European banks, disclosure, corporate governance, regulation

1. Professor of Law, University of Genoa; Director, Genoa Centre for Law and Finance; Vice-Chairman, European Corporate Governance Institute
2. PhD Econ. “Al.I.Cuza” University of Iasi, Romania; Researcher, University of Genoa; Fellow, Genoa Centre for Law and Finance
Corporate governance of banks

Governance structures are industry-specific. Sound corporate governance practices of banks are of particular concern to regulators, investors and public. Such concerns are warranted because of the unique role played by banks in the global economy and their particular features, which put them at the core of the financial crisis. Banks are an important source of liquidity; they provide maintenance of deposits backed by government insurance; they coordinate the nation’s payment system. The health of economy depends on the performance of banks.

Moreover, banks possess unique features that engage and challenge policy makers to make important reforms during times of financial distress. These features have been brought into a stronger light during the crisis. Banks are complex organisations, most havin a significant size: the wave of mergers from the latest decade has increased the sizes of banks and cross-border operations. The variety of stakeholders enhances banks’ complexity: in addition to investors, depositors and regulators also have a direct interest in bank performance. Banking is a highly leveraged industry and possible failures may lead to negative externalities. Banks’ capital structure is different: i) little equity relative to other firms (financing mostly from debt), ii) illiquidity assets that often take the form of loans without maturity; iii) liabilities in the form of deposits to other firms. The information flow is complex due to the opaque environment in which banks operate. These characteristics lead to the banking industry being highly regulated comparing to other industries.

Board structure, ownership structure and compensation structure are determined by one another and by a range of variables such as risk, real and financial assets, cash flow, firm size and regulation. These variables have specific features at banks and this creates different compensation settings. Theory and practice have shown us that there are higher anticipated gains in banks.

An analysis of the executive compensation framework initiates from banks’ unique features, pointing us to the need for a “spring-clean” of the compensation system. Banks’ lack of credibility is related to low levels of transparency and to the reward for failure. It is important that banks regain analyst and investor confidence, so that they can resolve the stringent issue of raising capital. In the same time, there is a call for investor and taxpayer protection in order to re-launch economies. The European Union (EU) provides a fertile ground for the discussion on directors’ remuneration. After the reforms set around the 2004-2006 period, international policy makers are engaging in a new round of reforming the directors’ pay system.

1 Other industries that have experienced this effect are the oil industry in the 1970s and the defense industry in the late 1980s.


3 In the US, the “The American Recovery and Reinvestment Act of 2009” bill (February, 2009) will significantly rewrite the original executive compensation and corporate governance provisions of Section 111 of the Emergency Economic Stabilization Act of 2008 (12 U.S.C. 5221, "EESA") and will apply to all institutions that have received or will receive financial assistance under the Troubled Asset Relief Program ("TARP"). In the UK, in October 2008 the FSA issued a statement to all bank CEOs setting out high-level criteria for good and bad remuneration policies for directors’ remuneration. The FSA makes clear that it does not want to become involved in setting remuneration levels but explains that it wishes to see firms adopt remuneration policies which are aligned with sound risk management systems and controls.
Considerations on banks’ pay structure

By understanding the particularities of the pay structure of banks’ management we gain understanding of the interaction between public regulation and corporate governance.

The executive compensation issue derived from the theory based on i) managerial productivity; and ii) optimal incentives. The theory aligning managerial interest with the interest of shareholders is well-known and followed by the traditional firm. In banks this theory sees aligning management incentives also with the interest of nonshareholder constituencies. The scope of the duties and obligations of corporate officers and directors should be expanded in the special case of banks (Macey and O’Hara, 2003).

The typical elements of the remuneration package for executive directors are basic salary and benefits, a performance-related annual incentive plan, a contributory pension scheme and participation in the share incentive plans. Performance-related awards based on measured targets are a key component of remuneration. The role of incentive contracts in ameliorating agency problems is also well-known. Over the last decade the policy to grant options to key management has become popular with the justification that option plans encourage identification with shareholders’ interest. However research shows that compensation structures that have low pay for performance sensitivity are more effective, restraining risk-shifting incentives on the part of the managers, thus minimising the agency cost of debt. This was predicted by John & John (1993) and empirical evidence is brought by John & Qian (2003), Adams and Mehran (2003). Holmstrom and Milgrom (1987) argue that the optimal performance-related compensation component for risk-averse managers should be inversely related to firm’s risk. As Jensen and Meckling (1976) observed, risk-shifting incentives of management closely aligned with equity interests are stronger in high-leveraged firms. In this sense, banks with controlling shareholders, which are mostly encountered in Continental Europe, have a higher tendency to risk-taking.

Literature has observed that banks may have a different structure of executive pay and the compensation structure has effects on banks’ performance. A higher level of stock options motivates executives to pursue riskier investment strategies; nonshareholder constituencies do not benefit from this. We have also seen that executives started to hedge their options in the market. This can destroy the incentive character of the award, constituting a redistribution income from shareholders to management (Kichmeier, 2008). Poor performance is easier to identify at banks; consequently, stock options tend to be less important in homogenous industries such as banking. A number of stock options larger than needed may be issued by banks, which creates a dilution effect.

The financial crisis that started in 2007 showed us that banks’ risk models failed to capture risks. Managers with large off-balance sheet exposures did not appreciate the full magnitude of economic risks they were exposed to. Remuneration itself can be a risk. Despite the concerns of regulators, promoting risk taking is not the only (or perhaps even the most important) factor influencing the structure of banks’ compensation contracts (Houston, James, 1995). The structure of

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At the beginning of 2009, the French government toughened its approach to pay at banks receiving public money. In return for a €10.5bn tranche of state capital in December 2008, it required them to curb severance payments and only offer share options to management if they were available to all employees, which the banks have complied with.

In October 2008 the German government approved strict conditions for banks that make use of its rescue package, including limits on managers’ salaries, bonuses and severance.

In 1992-1993, the SEC required enhanced disclosure on executive compensation and Congress enacted tax legislation, i.e. Internal Revenue Code Section 162(m), limiting the deductibility of non-performance related compensation over one million dollars. Studies (e.g. Perry and Zenner, 2000) show that the pay for performance sensitivity has increased following the regulations, especially for million-dollar firms.
Bank compensation contracts will reflect factors such as: the cost of monitoring managers; the nature of the assets managed; the regulatory environment; the firm's investment opportunity set; the capital structure.

The way in which directors are remunerated determines the way they drive the business, therefore it should relate not only to the performance of the business but also to its strategic objectives. How can performance and strategic objectives be best measured in order to align banks’ interests with the interest of shareholders, creditors and customers and, ultimately, the overall economy? Company’s profits may be unsustainable (as it has been proved by banks’ latest financial results); individual performance may be too short-lived, hence the manager’s pay could be reduced to nil. Nonetheless economy still needs a process that rewards success, motivate and attract talent.

Most banks state that their policy on directors’ remuneration is designed to attract and retain directors of the highest caliber and to reward performance. Perhaps one of the criteria for setting incentives should be the measure of bringing good governance to the firm. This will ensure the alignment of banks’ interest with the interest of all stakeholders, as well as full compliance with regulation.

Regulation and market

We refer to ‘regulation’ as the mix of public regulation, recommendations and best practice codes.

A proper understanding of the incentive structures of top management compensation can be important for designing effective regulation in the banking industry (John & Qian, 2003). Bank supervision that ensures that the bank complies with regulatory requirements could play a general monitoring role (Adams and Mehran, 2003). John, Mehran, and Qian (2003) support this argument by showing that weak bank holding companies’ examination ratings are correlated with high pay-performance sensitivity of CEO compensation. John, Saunders and Senbet (2000) predicted that regulation that takes into consideration management incentives will be more effective than capital regulation in ameliorating risk-shifting incentives. The argument is extended, proposing that bank regulation and pricing of FDIC insurance premium incorporate incentive features of top management compensation.

The ability to attract capital is extremely important for banks. This ability depends on the expected returns for potential investors. Especially in a turbulent market where quality matters more than ever, investors are integrating corporate governance research into the investment decision-making process in a number of interesting ways. Some use governance research as an adjunct to traditional security analysis, others to support engagement programs; some use it to support dedicated ESG (Environmental, Social and Governance information) research and investment products, others to adjust the discount rate in capital asset pricing models. Several studies found a positive relationship between corporate governance and shareholder returns, return on equity, return on assets and return on capital, among other parameters.\(^5\)

\(^5\) For example, Gaver and Gaver (1993), Smith and Watts (1992), and Kole (1993) find higher levels of cash compensation and greater reliance on stock-based incentive compensation for firms with more growth options relative to tangible assets. These studies also find that the reliance on incentive compensation varies with the regulatory environment that the firm operates in.

\(^6\) See for example Gompers et al. (2003), Brown and Caylor (2005), Durnev and Kim (2005), Black et al. (2006).
Investors are not in the position to supervise pay across the banking system. There are three angles in the remuneration system: policy makers represented by regulators and supervisors, the market represented by investors, creditors and customers, and the banking system, which assumes the top angle. The market interacts with the policy makers in order to set up the remuneration framework. The three components of the remuneration framework have a common objective: to underpin and reinforce an ethical culture. Public regulation has been written and implemented at a EU centralised level and at national levels. In their corporate governance statement, banks generally affirm that they comply with national regulation and corporate governance guidelines. Since the market has not been content with the regulation on remuneration, we can conclude that regulation and guidelines have not been appropriate, either being too lax or insufficient. Regulators have placed additional expectations on banks; more so, in case they are owners, governments have had a role in setting the pay policy for boards.

Because governance might have limited effects in preventing excessive risk taking by banks, the intuitive reaction is to request tighter public regulation. Enhanced public regulation then becomes a substitute for governance. In practice this model has not proved efficient, as a general reliance on regulation has lead to the weakening of internal governance mechanisms. Do market solutions work better than enhanced regulation? How to avoid overregulation? In order for the regulation to be properly reformed and applied, the functioning of banks’ boards and the remuneration structure have to be improved, meaning that public regulation and governance need to complement themselves and not substitute. The presence of regulation should affect the design of internal governance mechanisms.

Markets can fulfill an important role in the remuneration process on two conditions: they must be empowered with the necessary rights and they should be provided with the appropriate disclosure framework. Supervision with an enhanced role in the governance of banks would lessen, or at least would reason, with capital markets’ demand for the increasing of disclosure. This is where market discipline plays a role. Market discipline has taken up an important place in the conduct of the banking industry in recent years. It encompasses the concept that shareholders, creditors, peers can influence the investment, operational, and risk-taking decisions of bank managers. Bank supervisors have embraced market discipline as a complementary element to supervision and regulation for monitoring risk at individual banks and for mitigating systemic risk in the banking system. For market discipline to be effective, market participants need sufficient information to assess banks’ current position and future prospects. This has prompted a range of proposals for enhanced public disclosure by banks. Greater disclosure can also serve as commitment from the part of the bank, by providing sufficient information to the market about its condition and future prospects; in this way, the bank is constrained from altering its risk profile in a way that disadvantages either investors or creditors.

A positive relationship between disclosure levels and the performance of firms has been acknowledged. This relationship is also applicable to the EU banking industry in particular (see empirical evidence Burghof & Hofmann, 2000; John and Qian, 2003). Transparency can be a powerful tool in banking regulation. It enhances the accountability and the transparency of banks’ governance and affairs. The mere fact that governance structures or particular actions have to be

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7 The Basel II regulatory capital regime incorporates market discipline as the “third pillar” along with minimum capital standards and supervisory oversight (Basel Committee on Banking Supervision, 2004).
8 In the UK the Cadbury Committee (1992) advocated disclosure as a mechanism for accountability, emphasising the need to raise reporting standards in order to bypass the threat of regulation. The Hampel Committee constituted in 1995 consolidated the recommendations of the Cadbury Report in 1992 (focusing on financial reporting) and the Greenbury Report in 1995 (focusing on directors’ remuneration), into a ‘Combined Code’ on corporate governance. The aim of the
disclosed, and therefore have to be explained, creates an incentive to renounce structures outside what is considered to be best practice. High quality, relevant information is an indispensable adjunct to the effective exercise of governance powers. If the disclosure system is not properly designed, costs will exceed benefits. Disclosure must be comprehensive to prove that remuneration ties to company’s long-term performance as measured by recognised criteria. Previous studies show that the level of disclosure is important for banks’ performance and that harmonisation of disclosure is an efficiency factor for the capital markets. However, harmonisation should be limited to promoting convergence in disclosure, which is central to effective pay practices and effective governance in pay-setting (Ferrarini and Moloney, 2005).

There is a conflict of interest when executive directors take part in setting their own pay. Shareholders should be better informed: they are the owners of the company, not the management. They want to make sure that the remuneration policy gives enough incentive to directors and is right for the company. An investor provided with sufficient information on the remuneration policy for directors may be able to infer agency costs and the management potential to implement decisions that align with the objectives of shareholders. Proper disclosure and giving shareholders effective control are therefore essential to restore confidence in the EU banking system.

**EC Recommendations. Findings**

The Recommendations on directors’ remuneration and on the role of non-executive directors are part of the European Commission (EC) Plan of Modernising Company Law and Enhancing Corporate Governance in the European Union. This plan aims to strengthen shareholder rights and third party protection and to foster efficiency and competitiveness of business, with special attention to specific cross-border issues. The EC Recommendation on directors’ remuneration contains provisions for enhancing company accountability through appropriate disclosure of the remuneration policy, enabling shareholders to appreciate the remuneration in the light of the overall performance of the company. This initiative aims to make remuneration systems subject to appropriate governance controls based on adequate information rights. The Recommendation on the role of non-executive directors and on the board committees published two months later complemented the former through enhancing the role of the non-executive board and its committees, eliminating and preventing conflicts of interest.

These reforms, albeit not binding law, contain provisions already dealt with by certain EU Directives. The EC does not envisage the adoption of binding rules, but rather relies on national corporate governance codes based on the “comply or explain” principle to complement public laws.

code of corporate governance was not to prescribe corporate behaviour in detail, but to encourage disclosure so that investors and others can assess companies’ performance and governance practice and respond in an informed way.


10 See for example Cumming and Hirtle (2001), (Flannery 2001).

11 EC Recommendation fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC).

12 EC Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC).

13 Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward (COM (2003))

14 For example, the Transparency Directive and the Accounts Modernisation Directive call for transparency and consistency and a forward-looking approach in corporate reporting. The “family” of accounting directives including the Fourth Company Law Directive (78/660/EEC) and the Seventh Company Law Directive (83/349/EEC) have already defined the circumstances in which consolidated accounts are to be reported, laying down rules on disclosure and content of reports.
In the same time the two Recommendations respect the diversity of corporate governance systems within the Community. This in fact puts additional responsibility on each Member State to transpose the Community regulation timely and comprehensively. Effective transposition would ensure more transparency and consistency in corporate reporting when companies follow their laws and guidelines.

Transparency and harmonisation are therefore essential ingredients for the EU reforms on directors’ remuneration. The comparability of financial statements prepared by publicly traded companies is important because it enables them to compete on an equal footing in the international capital markets\textsuperscript{15}. Disclosure must be comprehensive to prove that remuneration ties to company’s long-term performance as measured by recognised criteria. Moreover in the case of banks, due to externalities, disclosure can have strong impact on banks’ valuation, third party relationships and competition, hence on the entire banking system. In order to ensure a solid banking system, bank competition (product competition, market competition, monetary variables) must be protected and sustained.

We have carried out a study on firms’ behavior towards the disclosure of directors’ compensation. Our dataset consists of Europe’s largest 300 companies by market capitalisation\textsuperscript{16}. The analysis is based on the annual financial statements and corporate governance reports for the financial year ending December 2007 or March 2008. Amongst the overall company data, we address the 48 European banks, with headquarters in 15 countries. The sample may not be large enough to be considered representative for the entire European banking sector, therefore generalisations are to be avoided. However these banks have relevance for the new unified European market, most have a complex structure and wide cross-border operations and are representative in their home state. We used a set of 25 criteria for measuring the level of disclosure, under the main areas of governance, remuneration policy and individual disclosure. In setting the criteria we followed the provisions stated in the EC Recommendations and in the international best practice guidelines.

The results show very dispersed levels of compliance with the underlying requirements for disclosure within the main areas of governance, remuneration policy and individual disclosure. Given that the sample is made up of a small number of banks in a variety of countries, the dispersion is mainly explained by the variations between national regulatory requirements. Banks tend to follow their national regulation, while national regulations have not implemented the provisions in full. The UK had implemented many of the provisions (found later in the EC Recommendations) into public regulation already in 2003 and banks have generally complied with these ever since. Banks from Continental Europe comply with the recommendations only in part and there are differences regarding the levels of disclosure between banks.

There are situations where banks do not comply with their national corporate governance recommendations and provide explanations on their approach. Non-compliance with certain criteria can also be “blamed” on the national regulations for not having implemented the provisions. An additional explanation can lay in the fact that banks that are part of the eurozone, supervised by their National Central Banks and protected by the European Central Bank to which they have transmitted some of their responsibilities, tend to focus more on national responsibilities than on

\textsuperscript{15} The Lisbon European Council of 23 and 24 March 2000 emphasised the need to accelerate completion of the internal market for financial services, set the deadline of 2005 to implement the Commission's Financial Services Action Plan and urged that steps be taken to enhance the comparability of financial statements prepared by publicly traded companies (Recital 1, of Regulation (EC) 1606/2002 of the European Parliament and of the Council of 19 July 2002 of the application of the international accounting standards.

\textsuperscript{16} FTSEurofirst 300 as November 2008.
Community responsibilities. In the same time, they put stronger emphasis on profit achievements, thus focusing more on operational responsibilities and less on best practice compliance. Moreover, European old banking groups have preserved their fundamental articles and codes of conduct.

The levels of disclosure and the requirement for a comprehensive remuneration policy are different across states and across banks. In some cases banks are more transparent on the individual disclosure of remuneration and provide a less comprehensive remuneration policy; or vice versa.

We included a criterion allowing us to observe the way that the information relative to remuneration is consolidated under the statement. Although results indicate that the majority of banks have a remuneration statement in the annual report, the “consolidation” criterion achieved a low level amongst European banks, which concluded our observation that banks do not have a consolidated remuneration report. With the exception of the UK firms, most of the European banks lack exhaustive reporting. Elements of the remuneration policy are scattered throughout the annual report. “A clear and comprehensive overview of the company’s remuneration”\(^\text{17}\) has not been achieved by the majority of banks, which creates impediments on governance controls and on the assessment of the remuneration system adopted by the firm. We consider this to be an important requirement in order to gradually move towards consolidated, bottom line reporting on remuneration.

The disclosure of the policy on directors’ remuneration is the area that banks comply least with. Indeed the requirements regarding the presentation of the remuneration policy statement, the terms of contract, the information on the preparatory and decision making for the remuneration process and the information that needs to be set out under the remuneration statement (related to the importance and performance criteria of variable and non-variable remuneration) are followed partially by banks. Re-confirming directors on a yearly basis would assure investors and give them a stronger voice in banks’ affairs. In fact, not disclosing the terms of office or the role of the General Meeting reveals the limited role that shareholders have in the process of setting the remuneration policy and in elections.

Remuneration policy’s focus on subsequent years is the less compliant criterion; approximately 20% of the banks have a forward-looking approach of the remuneration policy. Benchmarking, as a criterion found mostly in the UK remuneration reports, is not a rule for disclosure at other EU banks. A right balance between the benefits of disclosing forward-looking information and withholding sensitive information could be found. This approach could be an opportunity to provide board’s view on the fundamentals of value and to stress the link between rewards and the objectives of the bank. It is important to set up an employment market peer group, not limited to national banks, which acts as reference for the remuneration levels of the (supervisory) board to ensure an adequate alignment with the relevant market competitive standards as adopted by banks of similar size and complexity.

The area of governance represented by the requirements for boards to have a remuneration committee is best complied with. However, the presence of a remuneration committee is not always associated with the compliance with the membership requirements for having non-executive, majority independent directors. This criterion is applied differently among banks from various states, which is explained by the differences in the corporate governance codes, reflecting the different governance structures\(^\text{18}\). However even accepting that the corporate governance framework

\(^{17}\) Preamble (5), Commission Recommendation 2004/913/EC.

\(^{18}\) For example, German banks do not have separate remuneration committees; the German Corporate Governance Code, whilst recommending the presence of a special committee that deals with the remuneration of directors, does not
needs improvement in the area of directors’ compensation, designing measures that can bolster independence of the remuneration committee is a better remedy than the expansion of the shareholder power (Gordon, 2005).

The level of compliance with the requirements for individual disclosure of remuneration is 60%. This area contains criteria for individual disclosure of the remuneration components of executive and non-executive directors and of any share-based remuneration schemes granted to directors. Not all the banks that disclose individual remuneration of non-executive directors provide individual disclosure of their executive remuneration. Only 35% of banks provide disclosure of remuneration for the preceding financial year. However, it is important to provide shareholders with information on the basis of which they can hold the individual directors accountable for the remuneration they have earned, and appreciate the remuneration in the light of the overall performance of the company. The criterion requiring individual disclosure of share incentives details has an approximate 50% achievement level. This justifies current concerns on the high levels of pay that are not supported by performance: either the issuers do not disclose enough or the link between remuneration and rewards is non-existent. Either way, investors do not feel assured.

Conclusions

Consistent with previous findings on the approach to remuneration, we find that the levels of disclosure of the remuneration policy reflect the differences in regulations across the EU. Considering our analysis, a first step to a better disclosure of the remuneration policy by the European firms is a complete transposition of the Community requirements into national law and best practice guidelines. This is not aimed at tightening regulation at Community level but rather at aligning national regulation to the level recommended by the EC. Public regulation and corporate governance guidelines need to be complementary, perhaps with listing rules supporting the corporate governance guidelines.

Secondly, regulators and supervisors should take a special interest in banks, issuing specific regulatory and best practice provisions for the banking sector, directors’ compensation being one of the key points. This would reduce the managerial pressures on boards and facilitate supervisors’ control. Examples of such initiatives already exist: the Bank of Italy issued in March 2008 “Supervisory provisions concerning banks organisation and corporate governance”.

Thirdly, avoiding conflict of interest by enhancing the role of an independent remuneration committee would not only reinforce governance principles, but would also put more ethical responsibilities on boards against managerial pressure, giving banks more credibility.

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19 See Ferrarini, G., N. Moloney (2005) who found that the degree of sophistication of regulatory intervention on pay, and the extension to which highly-powered, equity-based incentive contracts are adopted, reflects governance systems across the EU.

20 For example, the UK Combined Code on Corporate Governance (2006) is a non-statutory Code which sets the principles of good corporate governance for UK listed companies, applied through the Listing Rules.

An analysis of the disclosure behaviour of banks from Continental Europe, where there is no legal requirement for a separate remuneration report, and the disclosure provided by UK companies and by a small number of European companies that produce a separate remuneration report, leads to our next conclusion: that only a separate remuneration report providing a bottom line evaluation of the different compensation elements could provide a consolidated, clear and comprehensive overview of the remuneration policy. Member States should move this requirement into public regulation, also for the sake of a speedy compliance.

Some of the measures already taken by the EC and several national supervisors may already help improve banks’ remuneration framework, if introduced in national legislation and applied in practice. Some extra measures that either enforce or complement the existing ones could further help. Disclosure may be a remedy for solving the weaknesses in the design of pay contracts and governance structures.

\[22\] Gordon (2005) had similar recommendations for US companies to adopt a separate remuneration report, named “Compensation Discussion & Analysis”.

References


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