Unique Features in the Governance of Bankers' Compensation

Guido Ferrarini [1]
Maria Cristina Ungureanu [2]

June 2009

Abstract

This article provides an analysis of the most important elements responsible for the system of managers' compensation at banks. The specificity of bankers' pay structures raises issues regarding the regulatory and corporate governance framework of banks themselves. An overview of main reforms in banks' compensation and of disclosure practices is presented.

Keywords: Banks, EU reforms, compensation, corporate governance

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

INTRODUCTION

Firms' board, ownership and compensation structures are determined by one another as well as 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. The role of banks in the economy as main lenders induces higher risk levels with higher potential losses in the long run. Banks' capital structure is particular: they have little equity relative to other firms and receive 90% of their funding typically from debt.[1] Many are cross-border financial institutions of significant complexity as a consequence of the increased merger and acquisition activity in the past decade.[2] The complexity of the banking sector calls for increased regulation and supervision.

The financial crisis has revealed weaknesses in the regulatory and supervisory framework of banks. Before the financial crisis, regulation focused on several restricting measures for banking activity, such as bank entry on foreign markets, banks' capital structure and ownership structure and the safety net role (i.e. lender of last resort, deposit insurance schemes). Disregarding the need for particular controlling and monitoring of the banking system through regulation has led to the deterioration of its corporate governance framework.

The most serious effect generated by ineffective oversight is a lack of credibility in banks. Today, banks need to regain investor confidence in order to resolve the crucial issue of raising capital, all this against a backdrop of increasing demands for taxpayer protection as a way for re-launching economies. The adoption of effective best practice regulation ("soft law") and public legislation are equally important in curing the ills of the banking system and it appears that the two approaches are complementary.

Sound corporate governance practices of banks have recently become a main concern for authorities and banks' stakeholder groups. In particular, compensation practices at large financial institutions are considered one of the main factors that contributed to the financial crisis.[3] Academic research generated several studies on the link between executive remuneration and firm performance. However, prior to the financial crisis only a limited number of studies had analysed the specific corporate governance of banks and, even to a lesser extent, their compensation system.[4]

---

[1] Macey and O'Hara (2003).

[2] Particularly during the 2000-2005 period, the EU experienced a concentration phenomenon in the banking sector reflecting, on the one hand, the decline in the number of banks and, on the other hand, the dynamic growth of certain banking groups, partly as a result of mergers and acquisitions (M&A) activity. For banks' M&A developments in the EU, see report by the ECB: *EU Banking Structures*, ECB Publications, 2008.

[3] According to Financial Stability Forum (FSF), several surveys conducted at major financial firms find that over 80% of market participants believe that compensation practices played a role in promoting risk that led to the crisis; at the same time, few respondents believe that compensation was the sole cause of the crisis, nor do they believe that changes limited to compensation practice will be enough to prevent future systemic crisis. See Financial Stability Forum, *FSF Principles for Sound Compensation Practices*, April, 2009. For further debates on the causes of the financial crisis, see Viral A. and M. Richardson (Eds.) (2009), *Restoring Financial Stability: How to Repair a Failed System*, NYU Stern.

[4] Some examples of studies on corporate governance of banks prior to 2007 include: Houston and James (1995); Bliss and Rosen (2001); Adams and Mehran (2003); Macey and O'Hara (2003); Barth et al. (2006); John and Qian (2003).

CONSIDERATION ON BANKS' PAY STRUCTURE

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 share incentive plans. According to the optimal incentives theory, performance-related awards based on measured targets are a key component of remuneration.[5] Over the last decade the policy to grant options to key management has become popular, justified by the ability of option plans to encourage identification with shareholders' interests. However, research shows that compensation structures that have low pay for performance sensitivity are more effective and restrain risk-shifting incentives on the part of managers, thus minimising the agency cost of debt.[6]

The literature has observed that banks' remuneration structure is particular. One of the reasons could be that poor performance is easier to identify at banks in comparison to other sectors. Executives will try to protect their future rewards in case of bank failures. Another supporting argument for the specificity of banks' remuneration systems is the superior bargaining power that bankers enjoy over society, owing to the key role banks play in managing its wealth.

Bankers will take advantage of this power so as to increase their own income.[7] Typically, bankers receive about 30 per cent of their total remuneration in stock and 70 per cent in cash. However, the mix varies from bank to bank and fluctuates widely according to market conditions.[8] The cash component includes a basic salary and annual bonus that is intended to reflect firm-wide profitability and individual contribution. Annual bonuses in the pay package of financial institutions, particularly banks, weigh heavier than in any other industries.[9]

CEOs of distressed firms get paid according to their pay contracts, even when their firms enter bankruptcy. In the banking industry, distress usually leads to liquidation and the incumbent is removed from management. Bankers are therefore expected to demand more cash-based compensation because incentives become worthless in the event of liquidation.[10] The practice of benchmarking annual salaries against peers amplifies the ratcheting effect in the banking sector.

Short-term gains are significantly higher at banks.[11] This allows executives to extract a significant share of bank profits for themselves. Deferred compensation schemes are quite common especially at investment banks, who argue that these are essential in retaining key

---

[5] For analysis of the optimal incentive theory, see Ferrarini *et al*. (2004), Ferrarini and Moloney (2005).

[6] This was predicted by John & John (1993) and empirical evidence is provided 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.

[7] Posner (2009).

[8] For example, one of the ABN Amro deferred-compensation plans paid as much as 50 per cent of bonuses above €100,000 in company units that could be cashed in only after a waiting period of two to three years. See Financial Times: *Court fight over right to bonuses on quitting*, by Megan Murphy, 12 June 2008.

[9] Also according to the evaluation by the European Commission. See COM(2009) 211, *Communication from the Commission accompanying Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector*, 30/04/2009.

[10] Mehran and Winton (2001).

[11] These are not always real gains: income is realised immediately, while the riskiness of a transaction becomes often only known after a considerable time delay. This is considered one of the causes that led to the crisis.

employees who otherwise would have little or no financial incentive to stay with one firm. Deferred plans are structured so that part of an employees' bonus is paid in shares, rather than cash. Those shares can only be cashed in typically after a two to five-year vesting period, subject to continuous employment.[12]

Banks are highly-regulated institutions. Until the crisis, authorities considered this to be a substitute for monitoring bankers. This could explain a lower pay-performance sensitivity of banks in comparison to non-banking firms.[13] Taking an example of US regulation, in 1992-1993 the SEC required enhanced disclosure on executive compensation and Congress enacted tax legislation,[14] limiting the deductibility of non-performance related compensation over one million dollars. Studies show that the pay-performance sensitivity increased following these measures, especially for million-dollar firms.[15] The lower pay-performance sensitivity argument is also sustained by the fact that, in time, banks' capital structures have become more complex and the leverage ratios have increased. Large banks are typically followed by a significant number of analysts, which may give rise to a relatively higher degree of transparency, implying lower pay-performance sensitivity.[16]

The theory aligning managerial interest with the interest of shareholders is applied to listed companies across sectors. Scholars have long debated the issue of whether corporate governance should focus exclusively on protecting the interests of equity owners, or to expand its focus to deal with the problems of stakeholders.[17] At banks, this theory expands to non-shareholder constituencies.[18] A unique feature of banking is that it extends performance pay to all of its employees.[19]

The core issue is how performance and strategic objectives can be best measured in order to align bankers' interests with the interest of shareholders, creditors and customers and, ultimately, the overall economy. Company profits may be unsustainable, as proved by banks' financial results around the start of the crisis. Individual performance may be too short-lived; hence manager's pay could be reduced to nil. Nonetheless, an economy still needs a process that not only rewards success, but also motivates and attracts talent.

---

[12] See COM(2009) 211, *supra* note 9.
[13] See John and Qian (2003) analysis on the pay-performance sensitivity at banks' CEOs.
[14] I.e. Internal Revenue Code Section 162(m).
[15] See for example Perry and Zenner (2001).
[16] Flannery, Kwan, and Nimalendran (1998) document that stock analysts have less disagreement about forecasts of future earnings of bank holding companies relative to forecasts of earnings of nonfinancial firms of similar size. See: *Flannery, M., S. Kwan, and M. Nimalendran* (2002), *Market Evidence on the Opaqueness of Banking*, Unpublished paper, University of Florida.
[17] Macey and O'Hara (2003).
[18] New reforms expand this theory across sectors. See Ferrarini *et al*. (2009).
[19] One of the solutions discussed by international policy makers is a bonus pool for employees.

THE ROLE OF REGULATION

Proper understanding of the incentive structures for bankers' compensation can be important for designing effective regulation in the banking industry.[20] By understanding the particularities of the pay structure of banks' management, we also gain an understanding of the interaction between public regulation and corporate governance.

Regulatory system pre-crisis

The financial crisis revealed significant gaps in regulation and supervision; it also showed that banks' governance models were not sufficiently robust, which led to a raft of failures in the areas of risk management, the design of proper pay contracts and the transparency of risk and remuneration policies. Regulators focused too much on linking pay to good performance and on aligning remuneration with shareholder interests. Banks' boards viewed compensation systems as being unrelated to risk management and risk governance, while worrying mainly about the upper end limit of compensation. Perverse incentives amplified the excessive risk-taking that threatened the global markets. Downside risks that could be realised later were not as important to directors, nor were the exogenous factors driving firms' performance. Emphasising long-term performance without acknowledging risks turned directors' focus towards achieving short-term performance. The issue of penalising failure was not targeted sufficiently. Losses were borne entirely by the firms, shareholders and society, and not by directors.

Regulators are also to blame for allowing directors too much discretion in setting bankers' pay. However, reform proposals following the crisis encourage non-executive directors to exercise discretion to change the actual remuneration in order to ensure that the total pay executive directors receive is fair in relation to the company and individual performance.[21] In fact, the increasing responsibility of independent directors in the remuneration system, if used appropriately, may decrease the need for further regulation.

While best practice or voluntary action from the part of the institution would be desirable, simple guidelines are unlikely to be effective, given the competitive pressures in the banking sector. Because governance has limited effects in preventing excessive risk taking by banks, the intuitive reaction is to request tighter public regulation. However, enhanced public regulation might become a substitute for governance. In practice this model has not proved efficient, as a general reliance on regulation has led to the weakening of internal governance mechanisms. For 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 each other rather than one being the substitute of the other, i.e. regulation should bolster the design of internal governance mechanisms.

[20] See John & Qian, 2003. 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.

[21] See for example *Statement of the European Corporate Governance Forum on Director Remuneration*, 23 March, 2009.

Bank supervision could also play a general monitoring role.[22] This should improve the use by regulators of existing tools of prudential supervision, to ensure that the remuneration policies of financial institutions are compatible with sound and effective risk management.[23] Increased supervision could also respond to demands for enhanced disclosure.

Market discipline has assumed an important role in the conduct of the banking industry in recent years.[24] It encompasses the concept that shareholders, creditors, and peers ('market participants') can influence the investment, operational and risk-taking decisions of bank managers.[25] Market discipline can be considered 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 must be empowered with the necessary rights and be provided with the appropriate disclosure framework. Transparency can also serve as commitment to such a framework on the part of banks, as they provide 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.[26]

A positive relationship between disclosure levels and firm performance has been acknowledged and this relationship applies to the banking industry in particular.[27] Disclosure can be a powerful tool in banking regulation, by enhancing the accountability and transparency of banks' governance and affairs.[28] The mere fact that governance structures or particular actions have to be disclosed, and therefore explained, creates an incentive to renounce structures outside the confines of what is considered to be best practice.[29] High-quality relevant information is an indispensable adjunct to the effective exercise of governance powers.

The lack of transparency in reporting directors' remuneration has prompted a range of proposals for enhancing public disclosure by banks.[30] The EC Recommendation on directors' remuneration (2004) contains provisions for enhancing company accountability through appropriate disclosure of the remuneration policy, thereby enabling shareholders to

---

[22] Adams and Mehran (2003).

[23] See COM(2009) 211, *supra* note 9.

[24] 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).

[25] Flannery (2001), Bliss and Flannery (2002).

[26] Cumming and Hirtle (2001).

[27] For empirical evidence, see Burghof & Hofmann (2000); John and Qian (2003).

[28] The UK 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 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.

[29] See the report "A Modern Regulatory Framework for Company Law in Europe: A Consultative Document of the High Level Group of Company Law Experts http://ec.europa.eu/internal_market/company/modern/index_en.htm.

[30] For "directors' remuneration", we refer to the Commission's definition of the director as "any member of the administrative, managerial or supervisory bodies of a listed company" (2004/913/EC, Art. 2.1).

appreciate directors' remuneration in the light of the overall performance of the company.[31] 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 (2005) complemented the former through enhancing the role of the non-executive board and its committees, and eliminating and preventing conflicts of interest.[32] Through these recommendations, the Commission did not envisage the adoption of binding rules, but rather relied on national corporate governance codes based on the "comply or explain" principle, thus respecting the diversity of corporate governance systems within the Community. This in fact puts additional responsibility on each Member State to transpose rapidly and fully the Community regulation.

Evidence from practice

Within a wide study on 300 European firms, we addressed 48 European banks,[33] analysing their behaviour towards the disclosure of directors' compensation. We used a set of criteria for measuring the level of disclosure of directors' remuneration following measures included in the 2004-2005 EC Recommendations and international best practice guidelines. These banks are significant players on the new unified European market, most have a complex structure and wide cross-border operations and are representative in their home state. The analysis shows dispersed levels of compliance with the underlying requirements for disclosure within the main areas of governance, remuneration policy and individual disclosure. This is applicable across sectors and may be explained by the divergences in national regulatory requirements. Firms tend to follow national regulation, which, in turn, has not fully implemented Community regulations.

We compared bank with non-bank behaviour towards directors' remuneration disclosure. The overall results show that, although not significantly, banks have a lower level of disclosure of the remuneration policy and individualised disclosure. Requirements for the presence of remuneration committees are followed by the majority of firms. We find that it is mostly banks that do not comply with best practice guidelines for independent membership of committees. Disclosure of the details of the remuneration policy for directors' (particularly related to the importance and performance criteria of variable and non-variable remuneration and the remuneration setting process) is partial across sectors. Although the forward-looking approach of the remuneration statement generally meets low levels at all firms, we find that this element is even less adopted by banks. This is somewhat surprising as one would expect banks to have a long-term focus in their remuneration policy, given the risks associated with their business models.

Individual disclosure of directors' remuneration is not satisfactory, regardless of the sector. Individual remuneration of the preceding years is reported by banks to a lower extent than non-banking firms. The fact that banks do not have a historic or a forward-looking

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

[32] 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).

[33] See analysis of overall study in Ferrarini *et al*. (2009). Our overall dataset consists of Europe's largest 300 companies by market capitalisation, in 16 Member States; the banking subset is spread throughout 15 States. The sample may not be large enough to be considered representative for the entire European banking sector, therefore generalisations are to be avoided.

approach leads to the observation that banks' remuneration policy is focused on the current financial year, without relating to past or future overviews. Requirements for individual disclosure of share incentive details appear to be followed less by banks than by non-banking firms. This justifies current concerns on the high levels of pay that are not supported by performance: either issuers do not disclose enough or the link between remuneration and rewards is non-existent. Either way, investors do not feel assured.

"Crisis" reforms

After the emerging of the financial crisis in 2007, international policy makers engaged in a new round of reforming the system of directors' pay, with the aim of enhancing disclosure and adopting appropriate pay contracts. These reforms focused particularly on financial institutions, considered as the prime culprits of the crisis. Regulatory measures do not only analyse the link between remuneration and the achieved performance, but raise awareness for a design that enables an appropriate balance between risk appetite and risk controls, and between individual or local business unit goals and firm-wide objectives.[34]

One way to address remuneration risk-adjustment was put forward by the Basel Committee. The Basel II capital accord already contained such mechanisms in pillar II, enabling regulators to impose additional capital charges for incentive structures that encourage risky behaviour. These provisions were consequently endorsed by the European Commission in the Larosière Report.[35] Specifically, the Capital Requirements Directive will include certain provisions regarding remuneration in the financial sector.[36]

Given the fact that implementation of the existing regulation has not been satisfactory, the Commission has extended its objectives with two new Recommendations in 2009.[37] Through these reforms, the Commission aims to redress imbalances in directors' pay at all listed companies and pursue a revision of remuneration policies in the financial sector. The Recommendation regarding the regime for the remuneration of directors strengthens the previous one by setting out best practices for the design of an appropriate remuneration policy.[38] The Commission is attempting tougher measures to avoid perverse compensation by limiting bankers' financial rewards in case of failure. In pursuing this objective, the Recommendation on remuneration policies in the financial sector sets out guidelines on the structure of pay, the design process and the role of supervisory authorities in the review of remuneration policies of financial institutions.[39] Measures are addressed to all categories of staff who perform activities that have a material impact on the institution's risk profile, and not exclusively to directors. Particular transparency requirements to be met by internal staff of the financial institution as well as its supervisory authorities are stipulated. This places stronger emphasis on the accountability of the financial institution towards its investors,

---

[34] See for example initiatives for reforming pay in financial firms by the UK Financial Services Authority (FSA), the Institute of International Finance, the Basel Committee, the FSF and the OECD. For comprehensive overview of reforms See Ferrarini *et al*. (2009).

[35] See *Report by High-Level Group of Financial Supervision in the EU*, chaired by Jacque de Larosière, February 2009.

[36] At the time of writing, the European Parliament has adopted the new rules on capital requirements (on 6 May 2009), to be implemented by banks by 2010.

[37] Both Recommendations require Member States' transposition by 31 December 2009.

[38] C(2009) 3177.

[39] C(2009) 3159.

clients and supervisors. Inversely, it also seems to put more responsibility for the remuneration system on financial supervisors, who will need to take account of the nature, scale and complexity of each financial institution.

CONCLUSIONS

Some of the measures already taken by the Commission and several national supervisors may have helped banks improve their remuneration framework. However, there is still criticism about the Commission's vulnerability, exposed through adopting non-binding guidelines instead of legally-binding rules.

The next step towards better governance of directors' remuneration 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 improving the corporate governance of banks through self-regulation. The responsibility for applying guidelines or legislation in practice stays not only with the bank, but also with its investors, who need to make use of their rights and prevent public outrage rather than generate anger after the harm was done.

Financial institutions differ in goals, culture, strategy and organisation, so one size does not fit all. Compensation policies need the support of other internal mechanisms, such as internal controls and audit, in pursuit of prudent risk taking. Bank supervisors should take a special interest in compensation to create a healthy competitive environment for best practice.

References

Adams, R. and H. Mehran (2003), *Is Corporate Governance Different for Bank Holding Companies?,* FRNBY Economic Policy Review.

Barth J., G. Caprio Jr and R. Levine (2006), "Rethinking Bank Regulation: Till angels govern", Cambridge University Press.

Bliss, R.T. and R.J. Rosen (2001), *CEO Compensation and Bank Mergers*, Journal of Financial Economics, 61.

Bliss, R. R. and M.J. Flannery (2002), *Market Discipline in the Governance of U.S. Bank Holding Companies: Monitoring vs. Influencing*, *European Finance Review*. 6, 361-395.

Burghof, H.P. and C. Hofmann (2000), *Executives' Compensation of European Banks – Disclosure, Sensitivty and their Impact on Bank Performance,* Munich Business Research Paper 2000-01, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=237250.

Cumming, C.M. and B.J. Hirtle (2001), *The Challenges of Risk Management in Diversified Financial Companies*, FRBNY *Economic Policy Review*, 1-17.

Ferrarini, G., N. Moloney and C. Vespro (2004) *Executive Pay: Convergence in Law and Practice Across the EU Corporate Governance Faultline*, in *Journal of Corporate Law Studies*, Hart Publishing, Cambridge (UK), p. 243.

Ferrarini, G. and N. Moloney (2005), *Executive Remuneration in the EU: The Context for Reform*, 21 Oxford Review of Economic Policy, 2005, p. 304.

Ferrarini, G., N. Moloney and M.C.Ungureanu (2009), Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis, ECGI Law Working Paper, available at: http://www.ecgi.org/wp/index.php.

Flannery, M.J., S. Kwan and M. Nimalendran (1998), *Market Evidence on the Opaqueness of Banking*, Federal Reserve Bank of Chicago, Journal Proceedings, May issue, p. 470-485, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=234988.

Flannery, M.J (2001), *The Faces of 'Market Discipline'*, *Journal of Financial Services Research*, 20: 2/3, 107-119.

Holmstrom, B. and P. Milgrom (1987), *Aggregation and linearity in the provision of intertemporal incentives*, Econometrica 55, no. 2 (March): 303-28.

Houston, J.F. and C. James (1995), *CEO compensation and bank risk. Is compensation in banking structured to promote risk taking?*, Journal of Monetary Economics, 36.

John, T. A. and K. John (1993), *Top-Management compensation and capital structure*, Journal of Finance 48, no. 3: 949-74.

John, K., A. Saunders and L.W. Senbet (2000), *A Theory of Bank Regulation and Management Compensation*, Review of Financial Studies, Vol. 13, N. 1.

John, K. and Y. Qian (2003), *Incentive features in the CEO compensation in the banking industry*, FRBNY Economic Policy Review.

Macey, J. and M. O'Hara (2003), *The corporate governance of banks*, FRNBY Economic Policy Review.

Mehran, H. and A. Winton (2001), *Executive Compensation, Leverage, and Banks: Theoretical Considerations*, Unpublished paper, Federal Reserve Bank of New York.

Perry, T. and M. Zenner (2001), *Pay for performance? government regulation and the structure of compensation contracts*, Journal of Financial Economics, Vol. 62, Issue 3, p. 453-488.

Posner, R. (2009), *Are American CEOs Overpaid, and, If So, What if Anything Should Be Done About It?*, 58 Duke L.J. 1013.

Viral A. and M. Richardson (Eds.) (2009), *Restoring Financial Stability: How to Repair a Failed System*, NYU Stern.