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compliance i briefing series

#2 executive compensation

Raising the Issue

Researched and written by Complinet's in-house team of former regulators, attorneys and industry practitioners, this iBriefing series will provide insight into current key regulatory topics that educate compliance staff, inform business lines and escalate dialogue with senior managers.

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Raising the issue

Complinet's iBriefings provide a summary of current key regulatory topics that are under consideration for fundamental regulatory reform or a significant shift in approach in the aftermath of the recent financial crisis. The series aims to provide a focused update on the main issues, talking points, trends and potential developments that will impact the compliance teams at financial services firms globally. The commentary will cover the situations in the EU and North America, and will also include any relevant perspectives from APAC and the Middle East if these are divergent.

Researched and written by Complinet's in-house team of practitioners, the iBriefings are designed to educate compliance staff, inform business lines and initiate dialogue with senior managers. More than ever, now is the time to establish a culture of compliance throughout the firm. The iBriefing series provides relevant analysis to demonstrate the issues and convey compliance concepts to all levels of management.

Executive summary

"The banking crisis has exposed serious flaws and shortcomings in remuneration practices in the banking sector and, in particular, within investment banking" is the conclusion of the UK Treasury Select Committee report entitled "Banking Crisis: reforming corporate governance and pay in the City" published in May 2009. There is a gathering international consensus that compensation schemes based on short-term returns which did not have adequate recognition of the corresponding risks were a key contributor to excessive risks being taken by financial services firms. High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks being run by firms. These perverse incentives amplified the excessive risk-taking that severely threatened the global financial system and left firms with fewer resources to absorb losses as risks materialized. The lack of attention to risk also contributed to the large, in some cases extreme, level of compensation in the industry.

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The reform of compensation structures has become a global priority in recognition of the need to reduce incentives for excessive risk taking. At the same time there is need for a global consistency to avoid losing talent to less onerous jurisdictions. As a result, the remit of compliance departments and supervisors has expanded irrevocably to include the assessment, monitoring and mitigation of the risks inherent in inappropriate compensation systems.

Background

Before the crash, the link between compensation schemes and risk management had not been made. Compensation schemes were designed to incentivize employees to work hard in pursuit of profit and to attract and retain talented employees. Risk management systems were put in place to act as a framework to control and report on risks being run. In theory, if the risk management and control systems were robust and effective, the incentives to take risks wouldn't matter because risk would stay within the firm's appetite.

However, the practical reality of the financial crisis has shown that all risk management and control systems have limitations and can, and did, fail to mitigate and manage risks properly. The incentives provided by compensation can be extremely powerful. Without attention to the risk implications of the compensation system, risk management and control systems can be ineffective in managing the actions of risk-takers. As a corollary, there are also wider concerns about the substantial increases in executive remuneration and the constantly growing importance of variable pay in the composition of directors' remuneration across all sectors.

The connection between compensation schemes and risk management having been made, there is now the unedifying sight of bankers being vilified around the world for being seen to have taken huge bonuses whilst their firms went bust. This situation has been further exacerbated by revelations of bankers awarding bonuses, or "rewards for failure," when their firms are being supported by tax payers' money. The regulatory, supervisory and political backlash on excessive compensation is serious and will pave the way for wholesale change in the way compensation is structured, supervised and disclosed in financial services firms. In the US, Treasury Secretary Timothy F. Geithner has said that the government should not impose caps on executive pay at institutions that receive federal bailouts, but instead should set policies that discourage all financial companies from rewarding excessive risk-taking. Mr. Geithner said, "I think we can bring about broader reforms of compensation incentives in finance as a whole" not just at companies in the Troubled Asset Relief Program. "We'll make it much less likely that people get paid to take large amounts of short-term risk at the expense of their firm and the system as a whole."

> *Without attention to the risk implications of the compensation system, risk management and control systems can be ineffective in managing the actions of risk-takers.*

Regulatory change (recent and potential)

The global tsunami of regulatory change on compensation and remuneration structures reached full force when the Washington G20 summit in November 2008 requested that the Financial Stability Board ("FSB") produce global principles on sound compensation practices. The resulting principles, published in April of 2009, are intended to form the basis on which regulators, supervisors and firms reform their policy and approach to remuneration. The FSB is not seeking to limit the absolute levels of pay but rather to improve risk management and to align pay incentives with the sustainable performance of the firm. The principles take a significant step towards improving the governance of compensation and its alignment with prudent risk taking, together with enhanced supervisory oversight and engagement by stakeholders.

> *The regulatory, supervisory and political backlash on excessive compensation will pave the way for wholesale change in the way compensation is structured, supervised and disclosed in financial services firms.*

The nine principles are:

1. The firm's board of directors must actively oversee the compensation system's design and operation.
2. The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.
3. Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

"Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action."

4. Compensation must be adjusted for all types of risk.
5. Compensation outcomes must be symmetric with risk outcomes.
6. Compensation payout schedules must be sensitive to the time horizon of risks.
7. The mix of cash, equity and other forms of compensation must be consistent with risk alignment.
8. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
9. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

Given the G20 political will behind the FSB principles on sound compensation, the expectation is that supervisors around the world will seek to adopt them and build them into their local regulatory expectations. In the UK, the FSA has published a series of proposals which may change again in light of the Treasury Select Committee's accusations that the regulator has downplayed the role that remuneration played in causing the banking crisis. The UK has not placed prescriptive remuneration limitations on firms in receipt of government assistance.

In the US, compensation reform has moved along two parallel tracks. First, Congress has placed limits on compensation paid to certain senior executives of firms which received government funding under the Troubled Assets Relief Program ("TARP"). The restrictions apply only to the highest paid executives and include:

1. Prohibiting the payment of bonuses to these executives
2. Requiring the ability to clawback compensation paid based on earning or other factors found to be inaccurate
3. Limiting the tax deduction available for compensation paid to these executives above $500,000
4. Governance requirements including the establishment of a compensation committee composed entirely of independent directors within the Board of Directors and the provision of a non-binding vote by shareholders on the company's compensation arrangements.

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The second stream of work in the US will address broader issues of compensation across the financial industry, including institutions which do not receive TARP funds. Ben Bernanke, chairman of the Federal Reserve Bank, has said that the Fed is working on rules that will "ask or tell banks to structure their compensation, not just at the top level but down much further, in a way that is consistent with safety and soundness – which means that payments, bonuses and so on should be tied to performance and should not induce excessive risk."

Demonstrating the global reach of required changes, the Australian Compliance Institute has developed a model linking all individuals' remuneration, not just those in financial services, to an industry-agreed set of corporate governance standards. The proposed model, which uses key performance indicators to align executive salaries with the interests of stakeholders is likely, if agreed by the Australian Productivity Commission, to become final recommendations before the end of 2009.

The EU has issued a pair of joint recommendations — one on the structure and determination of directors' remuneration and the other on the principles for the remuneration of risk-taking staff in financial services institutions. The recommendations are seeking to implement the FSB principles on a coordinated basis across Europe which, whilst not legally binding in the same way as a directive or regulation, have the advantage of being a principles-based approach allowing guidance to be given rapidly without having to wait for the often lengthy EU legislative process. The EU is taking a "name and shame" approach on compliance and has asked for progress reports by the end of 2009. It intends to monitor the situation closely through annual scoreboards, a mutual evaluation system between Member States and a formal evaluation report after a year.

In terms of prudential impact, the Basel Committee on Banking Supervision is bringing forward proposals to change the risk-based capital approach in Basel II to include requirements for firms to hold additional capital against excessive compensation schemes. This would require firms to formally assess the risk inherent in their compensation structures as part of Pillar 2 of the Basel II requirements, and then allocate capital accordingly. Supervisors would be specifically empowered and encouraged to ensure that firms held, on an ongoing basis, sufficient risk-based capital against the compensation risks being run.

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Impact for the Compliance Department

It's clear that the remit of the compliance function has been extended to include policy, monitoring and reporting of compensation and compensation structures within their firm. Compliance officers will need to undertake a gap analysis on the firm's current practices and the expectations set out by the FSB and domestic regulators. Compliance officers will also be at the forefront in assisting their firm in designing an appropriate policy and supporting systems and controls framework. A common theme in the roll-out of the new approach to compensation is the enhanced disclosure requirements. Remuneration policy needs to be disclosed to all stakeholders and should, at a minimum, set out the core elements of the policy as well as its practical design and operation.

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Compliance departments need to ensure that their own remuneration is appropriately structured and transparent. The FSB has made it clear that "staff engaged in financial and risk control should be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm." The FSB goes on to state that the compensation of back-office and risk-control employees should not be influenced by personnel in front-line business areas. Compliance and other control functions are expected to play an ongoing role in the practical operation of the compensation system, particularly with regard to the effectiveness of qualitative (within risk appetite, compliance with policies etc) adjustments made to the gross quantitative bonus assessment. In recognition of the importance of compliance officers, the FSB stated that if the level of compensation for risk and control functions is too low, the quality of such employees may be insufficient to their tasks and their authority may be undermined.

In the US compliance oversight of remuneration structures is likely to sit alongside the developing luxury expenditures monitoring work required by the revised US Treasury requirements whereby TARP firms need CEO certification on excessive or luxury expenditure.

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Impact for Business Lines and Senior Management

Before the financial crisis, the senior management of financial services firms viewed compensation systems as being largely unrelated to risk management and risk governance. That attitude is changing rapidly. The impact of changing expectations and requirements around compensation packages and structures has become a key priority for senior management. Changes to corporate governance arrangements, risk management and policies will all need senior management time, attention and resources. The board should take responsibility for design and oversight of the revised remuneration policy. The remuneration policy itself should be transparent, properly documented and avoid conflicts of interest.

Senior managers need to take the lead in explaining the changes and revised expectations to all staff as well as external stakeholders including regulators and institutional investors. This ties in with the increased pressure on fund managers to play a more active role in governance and risk oversight at the firms in which they invest. The US administration favours introducing "say on pay" legislation which would move the US closer to the UK's position where shareholders have a greater say in board remuneration, as seen recently in the case of Shell, where more than 60 per cent of shareholders voted against the Board's executive pay proposals at the Annual General Meeting in May 2009. Shell had been criticized for awarding bonuses as part of a long-term incentive plan despite missing performance targets. Directors are, however, unlikely to have to repay any money. This is not one-off in the UK and follows recent shareholder revolt against compensation practices at BP, Pearson and Xstrata.

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In a similar vein, the Swiss financial market regulator, is looking to introduce a bonus system for all Swiss banks which will involve pay cuts for bankers judged to have put in poor performances. The regulator is also said to want to command a far greater say in the payment of bonuses, and is looking for them to be geared much more to longer-term performance goals.

Most senior management are shareholders in their firms and much of the change is intended to align more closely the interests of owners with those who work there. It's therefore in senior managers' own interests to ensure a robust and demonstrable rethinking of their firm's approach to remuneration. There is an expectation that non-executive directors have a clear role to play in the design process and in the assessment of the operation of the policy in practice. Suitably experienced non-executives need to be appointed to act as the firm's Remuneration Committee and should receive reports directly from the risk and control functions regarding the operation of the risk management framework for remuneration.

As well as the most senior management, the business lines themselves will also need to be involved in the structuring of pay to ensure that it is consistent with, and promotes, sound and effective risk management throughout the business. An appropriate balance needs to be struck between the level of core pay and any bonuses. Bonuses need to be based on "net" measures where quantity measures are adjusted for risk quality. In addition, the expectation is that the payment of the major part of any bonus should be deferred to take into account all significant risks and costs throughout the business or product lifecycle. As part of the structure of compensation, firms need to be able to claw-back any bonuses already paid where it is subsequently shown that they were paid based on erroneous data. This is already in action in a number of retail firms where the variable elements of the overall reward are tied to compliance measures such as successful completion of training, upheld complaints, quality of advice, persistence and churning. Increasing numbers of institutional firms are directly linking bonuses to products designed or traded, leading to some employees being given a direct stake in toxic assets. In a parallel move, several leading investment banks have stated they intend to raise base salaries to both reduce the variable element of remuneration and to retain key talent. Firms should be aware that the latter argument is under challenge from other sectors, such as pharmaceuticals, which attract and retain talent without the excessive compensation arrangements.

An additional incentive to ensure compensation schemes are in line with prudent risk management principles is the potential for supervisors to insist that additional capital is required to be held against any schemes deemed to encourage excessive risk-taking. For banks Basel II is already being amended to accommodate remuneration and it has been mooted that the international standards for risk-based solvency for insurers are likely to follow suit.

Regulator relations and focus

Most regulators around the world are entering uncharted territory with the express inclusion of the regulation and supervision, both conduct of business and prudential, of remuneration in their remit. Regulators have admitted in the past to having placed excessive reliance on the judgement of senior management in financial services firms and the judgement call on the appropriateness of remuneration structures is a key case in point. This was combined with a failure of firms' risk management and governance structures to challenge imprudent compensation practices, leading regulators to conclude that senior management competence (including specifically non-executive directors), as well as remuneration structures themselves, need to be under the spotlight.

As with all assessments of quality it will be an ongoing challenge for supervisors to robustly and consistently determine what a "good" compensation structure looks like. One size does not fit all and, as with systems and controls frameworks, the approaches that work best are those specifically tailored to the activities of that part of the business.

Regulators are still under considerable political pressure for perceived failures in the supervision of financial services firms and will be keen to demonstrate their pro-active approach to the oversight of senior management's stance on appropriate compensation schemes.

Conclusion

The world of financial services has already changed profoundly in the wake of the financial crisis and the resulting severe global downturn. One of the key changes has been with regard to the attitude to compensation schemes and its links to strong risk management. Senior managers and compliance officers will be expected to rethink the

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structure and policy for remuneration within their firm and be visibly robust in ensuring that the approach is working as intended. With all of the uncertainties in the current financial climate it is clear that the active regulation and supervision of compensations schemes is here to stay.

Practical Approaches

It is essential for compliance personnel to stay informed of the latest developments around the globe that may have an impact on them, their senior management and their firm. Keeping track of regulatory themes and trends in compensation standards allows compliance departments to proactively manage risk. Complinet Complete is a solution that provides regulatory insight and analysis with live rulebook connections, allowing users to stay abreast of the latest regulatory themes and trends.

It is essential for HR professionals working within UK financial services to have access to the latest news, analysis, case notes and best practices. Complinet's HR service provides this, as well as comprehensive and up-to-date online documentation. This service will save hours of research time by directing HR professionals to the most up-to-date legal documentation in an instant. All legal policies, letters, documents and guidance notes have the relevant wording to suit UK FSA requirements.

Providing training for all staff strengthens an organization's compliance culture and educates the business lines and senior management on regulator expectations. Training also helps to significantly mitigate the risk and expense of regulatory failure. Complinet's suite of e-learning courses covers relevant topics such as conflicts of interest and senior management responsibilities and is a cost-effective and efficient way to keep employees up to date on firm and regulatory expectations.

Storing past and current versions of firm policies provides for successful recordkeeping and the ability to quickly reference remuneration policies during supervisory inspections. Complinet's Policy Manager provides an instant snapshot and record of the policies in force at any previous date, and an audit trail that demonstrates which personnel have read and accepted said policies, if there is litigation or enforcement at a future date.