

Banker compensation at a crossroads¹

Concern over banker compensation² has united heads of state, finance ministers, institutional investors, the popular press, and financial institution (FI) leaders themselves, all of whom have expressed frustration (and, in some cases, outrage) over pay levels and bonuses in banking. Compensation, which few believe to be among the most important causes of the financial crisis, is nevertheless a lightning rod issue that galvanizes public support for broad scale bank reform.

Banker compensation truly finds itself at the intersection of risk governance, politics, and public policy. Accordingly, FI boards will find it difficult to ignore the politics and public policy issues that swirl around their compensation decisions.

- § Regulators have been very focused on changing the *structure* of compensation arrangements to ensure that excessive risk taking is not incentivized. It makes no sense to reform risk governance and then incentivize imprudent risk taking. Banks themselves largely support revised structural guidelines for keeping risk taking in check, and in some cases have already introduced approaches consistent with regulatory guidance.
- § Politicians, on the other hand, have been focused on finding ways to rein in what they, and the general public, consider to be exorbitant pay *levels*. They are offended by high pay in the best of times, but find it intolerable in the wake of the global financial crisis and the huge cost to the public treasury of underwriting banks deemed too big, or too interconnected, to fail.

High pay, notoriously in the form of bonuses, would not be possible without the robust profits derived from banks' capital markets businesses. Consumer and commercial banking (i.e., deposit-taking, payments, and lending) tend to be much less profitable. Accordingly, politicians' ire over pay is not directed so much at community bankers (even though bank failures in 2009 in the US already exceed 100, costing the FDIC over \$25 billion), but rather at the largest global FIs. Goldman Sachs has become the poster child for excessive pay, based on estimates of a 2009 bonus pool which had reached \$16.8 billion by the end of the third quarter.³

The size of FI profits raises public policy issues extending beyond banker compensation. The offending banks are the very institutions that many feel are "too big to fail." The remedies to the important "moral hazard" issue range from an extra layer of required capital to the re-introduction of the Glass-Steagall Act in the US (i.e., the separation of proprietary trading from retail banking, as proposed by some members of Congress⁴) to other forms of restructuring banks with the aim of restricting government guarantees to utility banking (as suggested by Mervyn King, Governor, Bank of England).⁵ In a similar vein, Lord Turner, Chairman of the UK Financial Services Authority (FSA), has proposed that perhaps banks need to shrink, simplify their structures and get less profitable in the public interest.⁶ He had earlier suggested the imposition of a tax on FI transactions as an option for "stop[ping] excessive pay in a swollen financial sector."⁷

It is beyond the scope of this *ViewPoints*⁸ to examine these crucial public policy issues that sprout from, or at least intersect with, concern over high banker pay. Nor did the discussion on compensation at the October 5 and 6, 2009 Financial Institution Directors Summit,⁹ or the extensive body of research developed in its preparation,¹⁰ explore these policy issues in any detail. We cite them here as a reminder that bank compensation decisions must be carefully considered in a broad context. See “About this document” (page 13) for more on the research and “FI Directors Summit participants” for a list of attendees.

Key takeaways from the summit discussion are covered in three sections of this *ViewPoints*:

§ **Changes to FI compensation structure and oversight are well under way** (*page 2*)

Summit participants noted that FI boards have been proactively working to change their firms’ pay practices. Banks have adopted new structures to better link pay with risk- and capital-adjusted performance. Board oversight has been strengthened, with compensation committees stress-testing potential, and retaining more discretion over actual, payouts. Risk professionals are also being drawn into evaluating the risk dimensions of pay.

§ **The public debate over absolute levels of banker pay obscures complex issues** (*page 7*)

The financial crisis has triggered considerable public anger over the levels of FI compensation. Politicians initially responded with calls to cap pay, but have since relented, and now most intend only to regulate pay structures. Summit participants acknowledged that in some instances, FI compensation has been too high, but they emphasized that it is an extremely complex issue that depends on a variety of factors, including each bank’s mix of businesses, the mobility of top-performing talent, and the ways in which individual companies allocate profit.

§ **External stakeholders could have a major influence over the future of FI compensation** (*page 10*)

Summit participants highlighted that in the future, key external stakeholders could have a major effect on future pay practices and levels. They are concerned that regulatory involvement will be too detailed and uneven across borders and worry that more investor influence will have unintended consequences. They predicted that 2009 year-end compensation payouts, however much they are merited based on firm performance, may inflame public and political outrage even further.

Changes to FI compensation structure and oversight are well under way

Research and summit participants stressed that FI directors¹¹ are not simply watching the political debate unfold on compensation. Board leaders are taking a proactive approach to assessing and, where necessary, adapting pay and related practices to reduce the likelihood that pay creates excessive risks.

They outlined five specific ways in which FI boards have been addressing compensation:

1. Ensuring a robust risk management approach is in place
2. Appropriately capital-charging business and bonus pools
3. Implementing an array of new pay practices
4. Improving board and committee oversight of pay
5. Incorporating the views of the risk management organization

Ensuring a robust risk management approach is in place

Summit participants agreed that a strong risk management structure and culture is crucial to ensuring that employees at FIs are not incentivized to take excessive risks. As one put it, “[*The structure [of pay] has to be more aligned with risk management.*” A strong risk management structure includes an independent chief risk officer (CRO) who reports routinely to the board or its key committees, a well-defined board risk oversight mechanism, and a culture of challenge at the board level. Also important is active, cross-committee engagement and firm-wide awareness of how individual decisions may impact the enterprise at large.

A firm’s approach to compensation must also not undermine its risk control processes. As the Basel Committee on Banking Supervision put it, “For a broad and deep risk management culture to develop and be maintained over time, compensation policies must not be unduly linked to short-term accounting profit generation.”¹² Risk oversight was a critical focus of summit discussions and is covered in more detail in “Risk governance in a new era.”¹³

Appropriately capital-charging business and bonus pools

Throughout the summit, participants stressed that FIs have more work to do on properly charging their business units for the capital they use to generate returns. Most agreed with one director’s view that, while improvements have been made, banks “*need to spend more time getting the capital charge right.*” Participants observed that ineffective capital charging has a direct effect on compensation. As one noted, “*Compensation-fueled behavior contributed to the crisis; that behavior was made possible in part by a loose allocation of capital.*” Another said, “*We are trying to get the capital charge right, so [employees] aren’t trading on our capital.*”

Prior to the summit, one director expressed a similar view: “High pay is a by-product of too much leveraged equity, too much capital at risk, and not enough capital being held. These factors meant we had artificially high profits, and as a result we could pay out more.” That director continued, “I don’t mind if compensation [is] based on ... higher returns. But ... not [when] ... people are incentivized to misprice risk or empowered to take risks without a counterweight ... They need to get a capital charge for that additional risk.” At the summit, Credit Suisse CEO Brady Dougan suggested FIs should allocate bonus pools “*based on risk-adjusted capital returns. The more capital-intensive your business model, the more you are going to charge.*”

Implementing an array of new pay practices

There is strong political support for the *Principles for Sound Compensation Practices*,¹⁴ published by the Financial Stability Forum, or FSF (since reconstituted as the Financial Stability Board, or FSB) at the two G-20 meetings in April and September 2009. Individual regulators have been charged with implementing the principles in their own jurisdictions. The final rules of the FSA are closely aligned with the FSF/FSB principles, and the somewhat abbreviated version of the FSA's principles presented below helps illustrate the broad thrust of the FSB's recommendations:¹⁵

- § These structures apply to any person who performs a significant-influence function for the firm or who could have a material impact on the firm's risk profile.
- § The structure of compensation should be consistent with and promote effective risk management.
- § The fixed portion of compensation should be a sufficient proportion of total compensation to allow a firm to operate a flexible bonus policy – including no bonus at all in a year when the firm made a loss.
- § A significant proportion (at least two-thirds) of any bonus should be deferred, with a minimum vesting period of at least three years.
- § A significant proportion of variable compensation (bonus) should be linked to the future performance of the firm and the person's own business within the firm.
- § Compensation paid in shares should be based on risk-adjusted performance measures.
- § Compensation paid in cash should also be subject to performance criteria.
- § Bonus pools and individual bonuses should be based on employee, division, business unit, or firm performance during the period under review. They should also be linked to the future performance of the business unit and firm.
- § Guaranteed minimum bonuses for a period of more than one year not based on performance during that period are likely to be inconsistent with the FSA's principles.

Pay approaches announced earlier this year by Goldman Sachs¹⁶ and UBS¹⁷ are broadly consistent with these principles. Mr. Dougan noted at the summit, "*The G-20 schemes are healthy and seem right to adopt;*" subsequently, Credit Suisse announced a set of changes to its 2009 compensation approach for a large number of top earners, including changing the mix of base salary to bonus, tying incentive payouts to specific financial metrics, and incorporating clawback provisions.¹⁸

Political and regulatory pressure on global banks to implement G-20 recommendations is growing. Just before the summit, the UK's five largest banks agreed to adopt recommendations from G-20 rules and to:

have an independent committee submit annual compensation reports to the U.K.'s Financial Services Authority. In addition, they say senior executives and employees who manage risk

must defer 40% to 60% of compensation over three years, and at least 50% should be in shares. There is also a requirement that poor performance should lead to a return of a person's bonus. Banks could be subject to additional capital requirements if they don't comply with the standards.¹⁹

Shortly after the summit, the UK subsidiaries of leading foreign banks, including Bank of America, Merrill Lynch, Citigroup, Credit Suisse, Goldman Sachs International, JP Morgan Securities Ltd., Morgan Stanley, Nomura, and UBS also agreed to the principles.²⁰

Research and summit participants highlighted a number of changes FI boards are putting in place to be consistent with the FSF/FSB principles.

Changes FI boards are implementing in light of the FSF/FSB principles

- Ø **Retaining more discretion in payout.** Even after ensuring pay decisions are appropriately risk- and capital-adjusted, compensation committee are retaining more discretion to override formulaic pay, if necessary. One summit participant noted that *"[our] committee has the option to move pay up or down ... based on risk. Normally it would be an adjustment of plus or minus 20%, but [we] have the right to take it to zero."*
- Ø **Stress-testing payouts.** As one summit participant noted, *"We made some projections for shareholder value based on history, picked a mix of compensation, and stressed it up and down ... You have to tie compensation as close to shareholder value as you can over the long term."*
- Ø **Moving to longer vesting periods.** "Employees need more skin in the game, over longer periods," said one research participant prior to the summit. Companies are lengthening the vesting time frames of various forms of compensation, including cash equivalents, options, stock, and restricted stock units.
- Ø **Increasing deferred compensation.** Several directors stated prior to the summit that they believed that "three-year deferral could become the norm." FI leaders whose firms do not already have deferrals in place reported that they are working on or considering plans to do so. Firms that currently use deferred compensation are lengthening deferral periods and/or increasing the percentage of pay subject to deferral.
- Ø **Incorporating risk-weighted metrics.** Some companies are linking bonus payouts to measures such as weighted-average loss ratings of loan portfolios. As one director noted before the summit, *"We can show that we're thinking about it and making linkages [between risk metrics and compensation]."*

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Changes FI boards are implementing in light of the FSF/FSB principles (*continued*)

- ∅ **Instituting clawbacks.** Most summit participants agreed with Mr. Dougan's statement that "*having broader clawback is healthy.*" One director criticized the current concept of clawback as "*too narrow. Legal clawback has no teeth.*" A participant in the pre-summit conversations said, "We need clawback provisions, not just tied to fraud, but tied to future years' performance, if the trading book loses value." In practice, FIs are holding some portion of each individual's earned pay, with the option to keep it or pay it out, depending on future years' performance.
- ∅ **Increasing base salary.** Some companies are increasing salary levels and/or the percentage of fixed compensation vis-à-vis variable compensation.

Improving board and committee oversight of pay

Many of the summit participants said that their compensation committees are spending more time on pay matters. One noted, "*This summer, we had four extra committee meetings and changed our compensation structures.*" Board leaders reported that their compensation committees are considering two methods for improving board-level oversight of pay:

- § **Going deeper into the ranks.** During our research, there was general agreement that compensation committees now have to look more broadly at pay within their firms; a focus solely on top executives is no longer sufficient. When the issue was discussed prior to the summit, views varied as to how deep to go:
 - ú Some said the committee should review the pay packages of the 100 highest-paid employees.
 - ú Others argued the committee should review "anyone who takes risk at a level which impacts the firm."
 - ú Others said the committee should "just look at the overall philosophy. If the board has to decide on compensation plans, it's too late; the [senior] management team should have resolved the issue already."
- § **Coordinating better with other committees.** The compensation committee must now work much more closely with other committees and with the full board. Certainly, the risk committee has stepped up its involvement, as have audit committees.

Incorporating the views of the risk management organization

Summit participants said that FI boards cannot take on the task of conforming to structural guidelines on their own. They are now involving the risk organization in compensation matters, and particularly the CRO. For many FIs, this is the first year that risk professionals have been formally called upon to evaluate and comment on – and in some cases, attest to – the riskiness of pay structures. Summit participants spoke about executives' increased involvement in

compensation planning. One participant said, *“Our CRO will be coming to compensation committee meetings twice a year with a full report on whether earnings reflect the risk appetite.”*

However, our discussions with risk professionals prior to the summit suggest that they do not want to get drawn too deeply into pay matters. They agree with summit participants that the most effective approach is to ensure risk management processes are robust and that effective mechanisms for capital-charging businesses and bonus pools are in place. Few had a clear view on how they would certify that all their firm’s actual pay practices do not encourage undue risk taking. They noted that FIs can have hundreds, even thousands, of distinct pay plans, and consequently they are unsure if they should sample individual programs across the firm or examine them all.

In any case, there was strong agreement that central oversight responsibility for pay should remain firmly with the compensation committee, even if the CRO becomes more involved. Noted one research participant prior to the summit, “The CRO and risk committee can comment on the methodology and help validate the assumptions behind the numbers, but it’s not [their] role to decide what the compensation scheme should be, or to approve it.”

The public debate over absolute levels of banker pay obscures complex issues

Politicians on both sides of the Atlantic have expressed sympathy for the widespread public sentiment that banker pay is excessive. Political leaders have consistently identified banker compensation as one of many causes of the financial meltdown (although few rank it as a primary factor). Some initially expressed a desire to cap pay, though most have since backed away from that stance. For their part, summit participants conceded that, in some instances, pay may have been too high, but said the public debate has been conducted in a way that greatly understates the complexities of FI compensation.

The political debate has centered on curbing “excessive pay”

The political debate about compensation has evolved during the past 12 months and intensified considerably during the two G-20 meetings this year, in April and September. Initially, the energy to address pay emanated from the United States and the UK, in the run-up to the April G-20 meeting in London. In February, President Obama asserted, “What gets people upset – and rightfully so – are executives being rewarded for failure. Especially when those rewards are subsidized by U.S. taxpayers.”²¹ In the same month, the UK’s FSA issued its consultative paper on compensation, promising tougher regulatory intervention.

Since then, however, the discussion on pay has evolved significantly. Politicians and regulators in the UK and the US have pulled back from pay matters, to some degree, with the exception being institutions that have received and still retain sizeable government subsidies. (On October 22, Kenneth Feinberg, the US Treasury’s “pay czar,” announced the decision to cap salaries and limit total pay at banks and other companies receiving significant government funding.²²) For all other FIs, President Obama has reasoned that shareholders, not government, should determine compensation levels,²³ via an advisory vote on pay (say on pay)²⁴ and with improved pay disclosure requirements from the Securities and Exchange Commission (SEC). The FSA has also backed

away from strong intervention on pay matters; its revised pay principles, issued in August, were less aggressive than expected.²⁵

Meanwhile, European politicians have become more vocal on the need to intervene in pay matters, with some forcefully arguing in favor of imposing caps on compensation and taxing bonuses.²⁶ In September, Britain's Prime Minister Gordon Brown, Germany's Chancellor Angela Merkel, and President Nicolas Sarkozy of France sent a letter to Fredrik Reinfeldt, Sweden's prime minister and current chair of the EU, in which they argued for a cap on bonuses: "We should explore ways to limit total variable remuneration in a bank either to a certain proportion of total compensation or the bank's revenues and/or profits."²⁷ Mr. Sarkozy proposed that regulators be given the authority to cap banker pay, arguing, "A bank (making a profit) should retain an important part of it, as it will enable it to increase lending to households and companies. Supervisors have to be given the power to cap bonuses in relation to a bank's revenues."²⁸

However, despite this pressure, G-20 leaders repeated their endorsement for the FSB's pay principles and avoided detailed rules or caps on pay at their September 2009 meeting.²⁹ For their part, regulators have said that capping pay is not their responsibility. For example, Hector Sants, the FSA's CEO, stated, "Often conflated with the issue of the incentives created by the remuneration policies is whether large individual awards are somehow inherently immoral. This is not a question that the Financial Services Market Act (FSMA) requires the FSA to answer, nor in my view is it one that any regulator should be seeking to address."³⁰

Bank directors recognize the problem, but highlight the complexities ignored by politicians

Many summit participants acknowledged that the *"quantum of pay"* has, in some instances, been too high. One board leader stated bluntly, *"Compensation is too high and leads to excessive risk taking."* Several leading FI CEOs agree. Lloyd Blankfein, chairman and CEO of Goldman Sachs, said in September, "Compensation continues to generate controversy and anger. And, in many respects, much of it is understandable and appropriate. There is little justification for the payment of outsized discretionary compensation when a financial institution lost money for the year."³¹ Royal Bank of Scotland chief Stephen Hester told the UK Treasury Select Committee in February that, in some cases, banker pay was "way too high."³²

Summit participants noted two factors that may be pushing pay levels too high:

- § **Overpaying the middle 80%.** Many participants agreed with one director's view that *"the issue is not paying the top talent. It's paying the middle ... that didn't earn [high] bonuses. The issue is whether we are significantly overpaying the middle 80% of the bell curve, and I think we have been."* Addressing that issue could greatly reduce each firm's cost base and defuse some of the public anger.
- § **Excessive dependence on lateral hires.** Mr. Dougan pondered the effect of changing the manner in which FIs deal with filling open positions. He noted that a high percentage of replacements are hired from other firms, with the remainder hired from university campuses. He speculated that rebalancing that ratio *"would [not only] change the cost base, it would be a*

huge shift in culture, and a real way to create value. Managers would have to invest more time to develop people.”

However, overall, summit participants believe serious debate on pay levels requires careful consideration of a range of complex and interrelated factors. They noted a number of issues that need to be taken into account:

- § **A mobile talent pool makes compensation a cross-border issue.** Summit participants discussed how the cross-border dimension of the war for top talent is a major driver of pay. They agreed with one participant who pointed out that the highly mobile talent market dictates banker pay: *“The whole debate over compensation is interesting, but not useful. Regulators will back down. Sarkozy will change his mind once French banks become non-competitive. When banks start losing business, regulators will change their minds in five minutes.”* Prior to the summit, several research participants pointed out that the locus of business operations can also be shifted. As one director put it, “Politicians’ brave words and chest thumping [about compensation] will come back to haunt them ... when push comes to shove, and banks start moving their head offices.”
- § **The real war for top talent is between banks and unregulated hedge funds.** Summit participants observed that politicians routinely forget that FIs also compete with unregulated entities for talent. Several participants said pay caps on banks could trigger a migration of talent to hedge funds. *“If compensation is regulated, these guys will just go to the shadow markets. Their solution is to chase the hedge funds.”* While one participant argued that perhaps hedge funds *“could not absorb the amount of people leaving banks,”* another said, *“That’s true, but it’s only the top performers who leave. It’s a fight for [top] talent, not volume. If we get into a battle for compensation with hedge funds, we can’t win. We’ll lose our best people.”*
- § **Global pay levels are influenced by a small number of FIs.** Politicians rarely distinguish one FI from another in the context of pay. By contrast, summit participants highlighted that the majority of banks do not engage in significant capital markets activities and therefore do not need to compete for the highest-paid talent. *“In reality, this is about the major firms operating in the capital markets business. There are four or five firms that matter in terms of pay,”* noted one participant. Another said, *“When you are not in New York and don’t have a trading floor, you don’t have this set of issues.”* Yet, as one director pointed out, the entire banking industry has been tarnished by the compensation issue. Summit participants noted that strong earning-and-profit results for a number of large investment banks, which seem to point to high 2009 bonus payouts at these firms, will continue to fuel public anger at the industry as a whole.
- § **Pay levels are symptomatic of the broader issue of the allocation of profits.** Thoughtful commentators have highlighted that high pay is a symptom of the profit-generating capacity of the industry and have suggested that should be discussed prior to considering caps on pay. For example, Lord Adair Turner, the FSA chairman, noted,

If you want to stop excessive pay in a swollen financial sector you have to reduce the size of that sector or apply special taxes to its pre-compensation profit. Higher capital requirements against trading activities will be our most powerful tool to eliminate

excessive activity and profits. And if increased capital requirements are insufficient I am happy to consider taxes on financial transactions. The problem is that getting global agreement will be very difficult ... Insisting that someone 'does something' about bonuses, by contrast, is a populist diversion.³³

Summit participants agreed that the allocation of profits is the broader issue that deserves public discussion. They expressed concern about indications that politicians, searching for ways to restrict compensation, may take steps to limit bank profits or force banks to reduce or sell off their trading operations. Participants dismissed the notion of blanket regulation as unhelpful, given that each bank has different responsibilities to different stakeholders. One participant pointed out that not all banks distribute profit equally and suggested that restricting compensation at government-owned banks would only widen the competitive gap in the industry. *"We should have a thoughtful debate about how we should divide up compensation. [Investment banks] don't pay their shareholders, they pay their employees. Some FIs now have three mouths to feed: the government/taxpayer, employees, and shareholders."*

§ **Clamping down on bank pay will likely have negative unintended consequences.**

Summit participants worry that in addition to pushing talent out into hedge funds or pushing firms to redomicile in other countries, political pressures on pay will have other unintended consequences that are not good for the individual firms or capital markets at large. An example may be the decision a week after the summit by Citigroup, which is 34% owned by the government, to sell its highly profitable energy trading outfit, Phibro, for "slightly more than book value" to Occidental Petroleum.³⁴ Arguably, Citigroup sold Phibro, despite its having brought in earnings of over \$2 billion in the last five years, because of public pressure on the firm to renege on its contractual commitment to pay Phibro's top trader a reported \$100 million bonus.³⁵ Prior to the summit, one participant articulated the view of many that it was worth paying top dollar to retain high-performing talent: "As a taxpayer, I want these firms to have the best talent so that they can pay us back."

External stakeholders could have a major influence over the future of FI compensation

FI boards are addressing pay issues with increased diligence, but directors recognize that in substantive ways, the future of FI compensation will depend on the actions of external parties as well as boards. Specifically, members said that regulators, shareholders, and the public will help shape compensation structures at FIs in potentially significant ways.

Regulatory influence

Summit participants expressed concern that regulators may get drawn too deeply into pay decisions. As one participant put it, *"There's a concern that regulators will take principles – the model is the FSB principles – and turn them into specific, black-and-white rules."* At the summit, directors said they were closely following the various reform proposals aimed at restricting pay plans that encourage risk taking, including mandated deferrals, clawback mechanisms, and requirements regarding how much capital banks set aside against certain risks.

Bill Rutledge, who is the executive vice president of the Bank Supervision Group of the Federal Reserve Bank of New York, addressed this issue: *“The Fed will soon be offering guidance focusing on incentive structures for individual firms.”* In terms of ensuring regulators have the skills necessary to review pay, he noted, *“We will be reaching out to internal risk management experts and HR professionals ... to tap resources to do micro supervision effectively.”* In late October, the Federal Reserve Board issued proposed guidance on compensation and announced two supervisory initiatives designed to “spur and monitor the industry’s progress towards the implementation of safe and sound incentive compensation arrangements,” including a detailed review of pay practices at a number of “large, complex banking organizations.”³⁶

Summit participants wondered how much further detailed regulatory involvement would go, particularly in light of statements from key influencers like the SSG that “Supervisors are concerned about the durability of [FIs’] proposed [compensation] changes,”³⁷ and in the context of threats of additional capital requirements for firms deemed to have “risky pay.” As one participant noted, *“There’s a paragraph in the FSA document [on pay] that has the potential for material regulatory interference on capital adequacy.”*

Participants were even more concerned about a lack of cross-border coordination when it comes to implementing new pay principles. As one director noted, *“At the end of the day, it isn’t the process; we know how to change it. It’s how to make sure it is consistent across all regulatory bodies.”* Another said, *“Everybody understands there is a need for greater regulatory scrutiny in the industry. What we fear like hell is the way it might actually play out in the field – with regulators going in all different directions.”* Another participant agreed: *“[Cooperation] moves very slowly. Regulators become totally nationalistic.”* Mr. Dougan noted that *“a big challenge is [regulatory] coordination across different jurisdictions and potential policies being uneven across borders.”*

Both Mr. Rutledge and Sally Dewar, the managing director for risk at the FSA, acknowledged FIs’ concerns about the need for regulatory coordination. Ms. Dewar noted, *“There should be an international global response with key regulators ... engaging with higher-impact firms. We need to work with common aims, work with the home host model.”* In this context, one participant said that in talking to his firm’s regulators, he has made clear to them that *“they need to go and talk to other regulators and ensure there is consistency – otherwise, I’ve violated my fiduciary duty to our shareholders [by not offering competitive compensation].”*

Shareholder influence

Summit participants suggested that shareholders may also have a significant impact on FI compensation, particularly given that they are being urged by politicians to play a much more active role in this regard.³⁸ Politicians and regulators have sought to arm shareholders with more power in dealing with FI boards. Advisory votes on executive compensation (say on pay) are being considered in the United States, and UK regulators are actively encouraging more substantive dialogue between board directors and investors.³⁹

Summit participants believe that shareholders' involvement in setting pay could have a number of significant effects beyond banker compensation itself. One participant said, *"I would expect to see say on pay, as well as contested director elections. Inevitably, they will target financial institutions. I expect to see directors stand down from FI boards."* Another predicted, *"Say on pay will have big unintended consequences – I don't think this is appreciated enough. Due to cultural differences, it will play out very differently in the US versus the UK versus Europe. In general, it will force more dialogue between investors and companies. There will be turbulence in the early years of say on pay."* Some research participants noted prior to the summit that, in the past, investors pushed for pay for performance and heavy use of stock options. In the aftermath of the financial crisis, they rue the fact FIs implemented their demands.

One participant said say-on-pay requirements will provide boards with an opportunity to establish better relationships with influential shareholders. *"I asked a big institutional investor recently, 'Do you have a plan for how you'll carry out evaluations if say on pay passes?' Most of them don't have the resources or capability to do so, but we can begin to deal with it if we can get a dialogue going with shareholders earlier than when the [Compensation Discussion & Analysis in the proxy statement] comes out. We have an opportunity to get them on our side."*

Public influence

Summit participants spent time talking about the industry's need to regain the trust of its key stakeholders. For more on this topic, see ["Restoring trust: lofty expectations for post-crisis bank boards."](#)⁴⁰ Summit participants recognize that year-end 2009 compensation decisions will have significant impact on the direction of the public debate. They already foresee that some firms will have to make some challenging decisions because firms' profits will likely be significantly more favorable than anyone expected in the first half of 2009. A *Wall Street Journal* survey published after the summit found that "total compensation and benefits at the publicly traded firms analyzed by the *Journal* are on track to increase 20% from last year's \$117 billion – and to top 2007's \$130 billion payout."⁴¹ At the summit, most participants agreed with one director's view that *"producers will continue to get paid a lot – and 'a lot' will be somewhat less than it was in 2007."*

The media attention on year-end payouts has been growing materially, with several noteworthy figures calling FIs to rein in pay. Even some regulators have been drawn into the debate. Mr. Sants noted,

There is this wider question as to whether, given banks are arguably still in receipt of some form of underpinning, soft guarantee, they should recognize this in their bonus policies ... personally, I think they should recognize their wider responsibility to society. They should recognize what has happened in the last few years and they should recognize that without the interventions made by government and taxpayers around the world, the situation they would be in now would be far worse ... I think it would be reasonable for them to take that into account as they go into their bonus rounds.⁴²

Ultimately, as one participant noted, “[*The public and their elected officials*] need a demon, and it is easier to demonize someone who took a lot of money. Which is easier [for the public] to demonize ... compensation, broad public policy, or bad capital allocation?”

Conclusion

Summit participants acknowledged that, to some extent, compensation policies played a role in the financial crisis, and they understand the public anger over large payouts. They noted that regulators are primarily focused on reforming the structure of bank pay, ensuring capital has been properly assigned in order to risk-adjust profits, and improving the links between the governance of compensation and risk. On these issues, substantive progress has been made in setting policy, by banks themselves as well as by regulators. Board leaders highlighted a range of actions FIs are taking to address pay, including instituting improved risk management practices, more effective capital charges across business, and longer-term pay structures.

Meanwhile, politicians, institutional investors, the press, and the public are focused on the absolute levels of banker compensation and are asking questions about what kind of banking sector would serve society best. At the summit, directors stressed that the problems with FI compensation cannot be fixed by simply putting limits on pay levels, because many factors influence compensation, including the bank’s lines of business, the allocation of profits, and competition for highly mobile talent.

Summit participants recognized that because the board’s oversight of pay matters does not happen in a vacuum, board leaders need to respond to both sets of concerns. The actions of regulators, shareholders, policymakers, and the general public will have some degree of influence over the future of FI compensation.

About this document

The Financial Institution Directors Summit brought together leading non-executive directors from North American and European financial institutions on October 5 and 6, 2009, to share perspectives on proposals for strengthening corporate governance. *ViewPoints* summarizes the proceedings of the summit. The peer-to-peer discussions were informed by prior interviews with over 120 FI directors, executives, regulators, investors, and other key stakeholders. Tapestry Networks conducted the research, orchestrated the summit, and prepared *ViewPoints*. Ernst & Young sponsored the research and summit as part of its deep, continuing commitment to board effectiveness and good governance.

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Endnotes

- ¹ This *ViewPoints* is part of a larger report which integrates participants' discussions at the Financial Institution Directors Summit with extensive research conducted over the past year. The full report is available at http://www.tapestrynetworks.com/documents/Tapestry_EY_BGLN_Nov09_fullreport.pdf.
- ² "Compensation" and "remuneration" are used interchangeably throughout this document.
- ³ "Goldman profit quadruples; bonus reserve lower," Reuters, October 15, 2009. Available at <http://news.moneycentral.msn.com/ticker/article.aspx?Feed=OBR&Date=20091015&ID=10494797&Symbol=MS>.
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- ⁵ Mervyn King, remarks to Scottish business organizations, Edinburgh, October 20, 2009. Available at <http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf>.
- ⁶ Adair Turner, "Large systemically important banks: addressing the too-big-to-fail problem," speech at the Turner Review Conference, November 2, 2009. Available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1102_at.shtml.
- ⁷ Phillip Inman, "Financial Services Authority chairman backs tax on 'socially useless' banks," *The Guardian*, August 27, 2009. Available at <http://www.guardian.co.uk/business/2009/aug/27/fsa-bonus-city-banks-tax>.
- ⁸ The *ViewPoints* reflects the use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by members before and during meetings are not attributed to individuals or corporations. However, Messrs. Dougan and Rutledge and Ms. Dewar, who were all speaking in a personal capacity and whose views do not necessarily represent those of their organizations, have given permission for their remarks to be attributed. Comments by these guests and summit participants are shown in italics.
- ⁹ On October 5 and 6, 2009, 18 board members from leading European and North American financial institutions met in New York to discuss the future of bank governance. They were joined for portions of the meeting by Brady Dougan, CEO, Credit Suisse Group; Sally Dewar, Managing Director, Risk, UK Financial Services Authority; Bill Rutledge, Executive Vice President, Bank Supervision Group, Federal Reserve Bank of New York; and Jim Turley, Chairman and CEO, Ernst & Young.
- ¹⁰ Tapestry Networks has published two briefing notes under the title *Shaping bank governance in a new era*. The first, subtitled *Enhanced oversight versus radical reform*, was published in June 2009. The second, subtitled *A revised compact with management and shareholders*, was published in August 2009. Both are available at http://www.tapestrynetworks.com/networks/net_bank.html.
- ¹¹ In this document, "director" refers to non-executive, non-employee board members on a firm's unitary or supervisory board.
- ¹² Basel Committee on Banking Supervision, *Proposed enhancements to the Basel II Framework* (Basel: Basel Committee on Banking Supervision, 2009), 25. Available at <http://www.bis.org/publ/bcbs157.pdf?noframes=1>.
- ¹³ Tapestry Networks, "Risk governance in a new era," *ViewPoints*, November 2009. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_BGLN_Nov09_View2.pdf.
- ¹⁴ Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (Basel: Financial Stability Forum, 2009). Available at http://www.financialstabilityboard.org/publications/r_0904b.pdf.
- ¹⁵ Financial Services Authority, *Reforming compensation practices in financial services: Feedback on CP09/10 and final rules* (London: Financial Services Authority, 2009), Annex B, 11–12. Available at http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf.
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- ²⁴ House Resolution 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009, would provide shareholders with a say on pay and require appropriate regulators to prescribe regulations that prohibit any compensation structure or incentive-based payment arrangement that encourages inappropriate risks.
- ²⁵ Caroline Binham, "FSA Rules Seek to Rein In Risky Bonuses at U.K. Banks," *Bloomberg.com*, August 12, 2009. Available at <http://www.bloomberg.com/apps/news?pid=20601208&sid=a17Ur.K0pOus>.
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- ³⁸ The Walker Report (*A review of corporate governance in UK banks and other financial industry entities*), the FSA policy statement, and HR 3269 all stress shareholder involvement.
- ³⁹ As discussed earlier, HR 3269 includes a provision for say on pay, while thirteen of Canada's largest companies have voluntarily adopted say on pay provisions. See Andrea Hopkins, "Big Canada companies sign up for votes on exec pay," *Yahoo Finance News*, October 26, 2009. Available at <http://ca.news.finance.yahoo.com/s/26102009/6/finance-big-canada-companies-sign-votes-exec-pay.html>. The Walker Review encourages more substantive dialogue between directors and investors.
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