REMUNERATION POLICIES AT STATE-AIDED BANKS

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European Capital Markets Law: Problems and Cases

Center for Research in Law & Economics (CRELE)
Bolzano, 27-28 November 2009

- International and EU regulatory framework

- Regulation State-aided financial institutions
  - At the Community level
  - At Member State level

- UK Government intervention: Lloyds and RBS

- UBS and Credit Suisse: Remuneration Policies

- Regulation extending across the banking sector

International & EU Regulatory Framework

- FSF Principles for Sound Compensation Practices
- CEBS High-Level Principles for Remuneration Policies
- EC Recommendation on remuneration policies in the financial sector
- Capital Requirements Directive (Proposal)

General principles:

- Effective governance of compensation
- Alignment of compensation structure with prudent risk taking
- Compensation consistent with the maintenance of a sound capital base
- Effective disclosure and supervision

US Government Intervention & Conditions

TARP Related regulations

- Emergency Economic Stabilization Act of 2008 (EESA):
- American Recovery and Reinvestment Act of 2009 (ARRA)
  - No Risks Limitations
  - Clawback Requirement
  - Golden Parachute Limitation
  - Deduction Limitation

Pay Czar appointed pursuant to this regulation – substantial authority to review executive pay and other highly compensated employees at TARP Recipients

EC Regulation:
State-aided Financial Institutions

EU State Aid Schemes – Financial Sector

- State guarantee schemes

  (for bank deposits and newly issued debt securities)
- Recapitalisation measures
- Asset relief measures
- Nationalisations
- Ad hoc State interventions

Measures are subject to close coordination at the EU level through common principles

Conditions for FI applying for State aid schemes:

- Reporting requirements
- Restoring borrowing capacity
- Dividend policy
- Adoption of specific business strategies
- Financing the real economy
- Government board representation
- ***Limitations on remuneration of directors***

Oct 08: **<u>Banking Communication</u>** for rescue operations in order to stop or prevent runs on FI

- Management should not retain undue benefits – States may have, *inter alia*, the power to intervene in remuneration

Jan 09: **<u>Recapitalisation Communication</u>** set of standards & safeguards for bank recapitalisation, to endure adequate levels of lending to the economy

- Limitation of executive remuneration and distribution of bonuses

Feb 09: **<u>Impaired Asset Communication</u>** framework for removing toxic assets and underperforming loans

- Caps on executive remuneration should be considered

Member States Conditions for State-aided Financial Institutions

Limitations on Remuneration

Sustainable remuneration policy
Taking account of risks
Avoiding rewards for failure

Restrictions on:

- salary increases
- bonus payments
- award of stock / shares
- executive severance packages

United Kingdom

Feb 09: FSA - **draft Code of Practice on Remuneration Policies** (effective from 1 January 2010)

Initially aimed at financial institutions receiving State aid

- Main principle: Remuneration policies consistent with effective risk management
- Quantum: a matter for boards and shareholders
- No contracts providing guaranteed bonuses for > 1year
- For senior employees 2/3 of bonuses spread over 3 years

Turner Review: a Regulatory Response to the Global Banking Crisis

Walker Review on Bank Corporate Governance

Germany

Financial Markets Stabilisation Fund (SoFFin)

Measures to be adopted by banks during the scheme:

- Re-examination of compensation systems
- Reporting and risk-reduction requirements
- EUR 500,000 annual salary cap for top executives for the financial years 2008 and 2009
- No bonus payments that are not legally required
- Baring stock option grants and option exercises
- No payout of compensation upon termination

France

2 Decrees on rules of compensation for senior corporate executive of State-aided or State-supported companies

- Variable remuneration defined in the light of both quantitative & qualitative performance criteria
  - Pre-defined
  - Unrelated to share price
- Bonuses authorized for a period not exceeding 1 year
- No bonuses if "large scale lay-offs" are necessary
- Prohibiting the allocation of stock options and free shares
- Controller appointed to supervise banks' compliance of internal policies with national & international rules

Italy

Law on Urgent Stability Measures

- Banks to adopt a Code of Ethics providing for, among other things, rules governing the remuneration of the issuer's top management

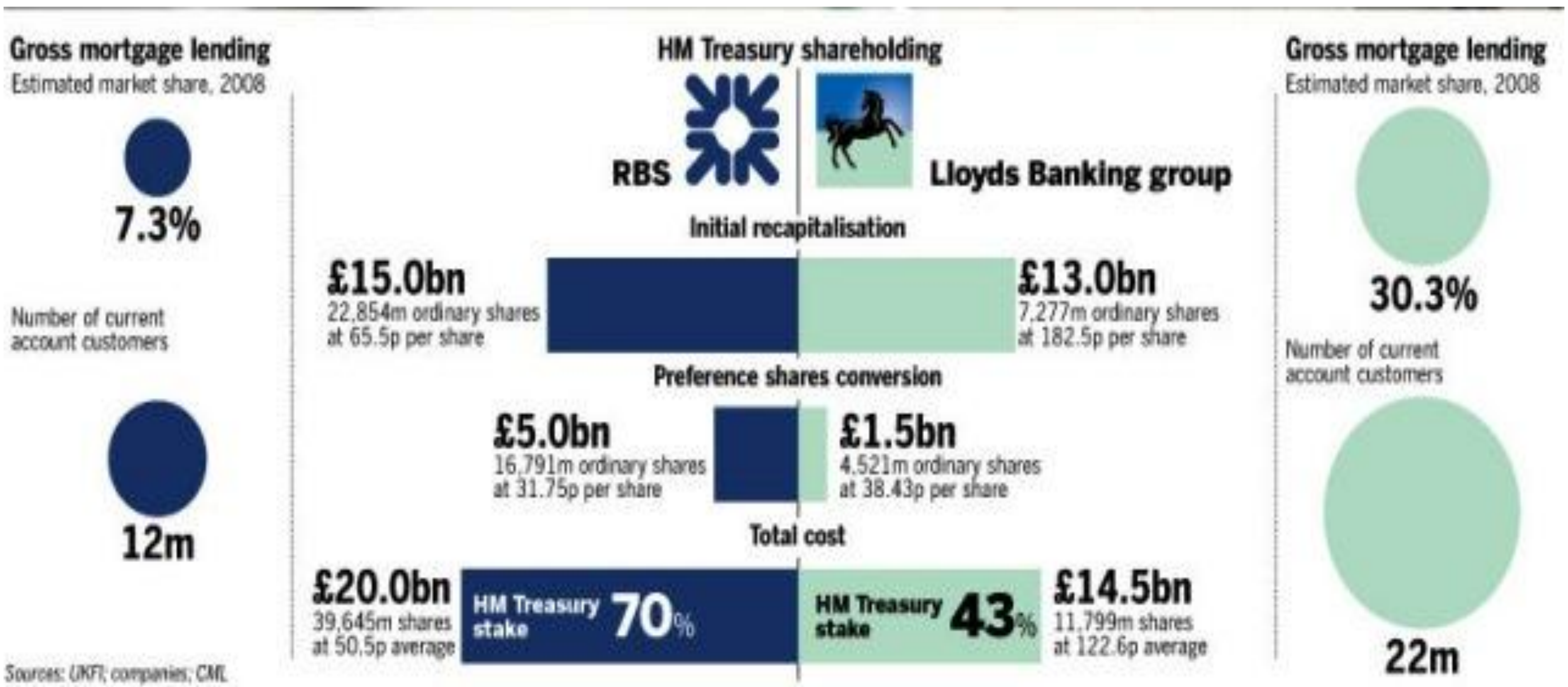
Netherlands

- Implementation of a "sustainable remuneration policy"
  - linked to long-term value creation
  - limiting rewards for failure
  - limiting termination arrangements to 1 y fixed salary to departing executives, even where contractual arrangements exist

Most other MS: adopted measures curbing executive pay

UK Government Intervention
Lloyds TSB & Royal Bank of Scotland

HM Treasury Shareholding (until Nov. 2009)



Remuneration Conditions

Recapitalisation:

- For 2008: no cash bonuses to board members
- Remuneration policy for subsequent years:
  - Incentive schemes to be reviewed
  - Linked to long-term value creation
  - Taking account of risks
  - Reducing the potential for rewards for failure

APS (Asset Protection Scheme):

- Remuneration policies consistent with the principles of the FSA Code of Practice on Remuneration

2008 Measures

- No bonuses or pay increases made to staff associated with major losses
- Executives would not receive bonus for 2008 performance and no pay increase in 2009
- No discretionary cash bonuses to be paid in 2009 for performance in 2008
- Only legally binding guaranteed bonuses to be paid
- Bankers "essential to the bank's recovery" would receive a deferred award for 2008 releases in 3 equal instalments payable in subordinated debt (not cash)

2008 Measures

- Committed to a restructuring based on the same principles as the RBS settlement

  and:

- No discretionary bonuses to be paid in 2009 except to the most junior staff earning an average of £20,000
- No annual free shares to anyone in the bank
- Payment of contractual bonuses to former HBOS employees

Debates

- The continuation of bonus payments to staff, despite the large taxpayer support and despite major losses –

Guaranteed bonuses: holds banks to continue to make bonus payments where these had been written into employment contracts

  - RBS: paying bonuses to former ABN Amro employees
  - Lloyds: paying bonuses to former HBOS employees

- Generous pensions

RBS former CEO Fred Goodwin: £703,000

RBS former deputy CEO: £500,000

Understood as "unavoidable legal commitment"

Similar Problems, Different Strategies -Governance

RBS
The Royal Bank of Scotland

Changed its management team, appointing a new chairman and chief executive

Rebuilt entire Board

Lloyds TSB

Stayed loyal to incumbent executives, only replaced chairman

Similar Problems, Different Strategies -APS

RBS
The Royal Bank of Scotland

2009 Half-year results: £1 billion losses

Signed up for its APS, in which the State provides insurance against certain losses

Lloyds TSB

2009 Half-year results: £4 billion losses

Embarked on a capital raising strategy

November 2009

UK Government to invest an additional £37 billion

£25.5 billion (+ £8 billion) capital injection

Government interest to increase at 84%

World's biggest State rescue

Raise £13.5 billion through rights issue, to which State would contribute

The largest capital raising in UK history

New Remuneration Conditions

- No discretionary bonuses in relation to 2009 performance to any staff earning more than £39,000 a year
- Executive directors to defer all bonus payments due for 2009 until 2012

Some more flexibility: both banks are allowed share-based bonuses

These circumstances mean that over the long term the two banks would offer deferred compensation in the form of shares

CEO Remuneration 2007 - 2008

CEO	Total cash	Base	Bonus	Deferred shares/plans	Benefits
£					
2007					
Lloyds	2,884,000	960,000	1,811,000		113,000
RBS	4,190,000	1,290,000	2,860,000		40,000
Barclays	4,218,000	975,000	1,425,000	619,818	
HSBC	3,536,000	1,040,000	1,915,000		581,000
Std Chartered	6,997,000	1,504,000	2,005,000	3,425,000	63,000
2008					
Lloyds	1,151,000	1,035,000	0,000		116,000
RBS*	216,000	163,000	0,000		53,000
Barclays	1,075,000	1,075,000	0,000	0,000	
HSBC	1,667,000	1,070,000	0,000		597,000
Std Chartered	6,006,000	1,516,000	1,051,000	3,374,000	65,000

* Stephen Hester was appointed CEO on Nov 2008; previously non-executive

UBS and Credit Suisse Remuneration Policies

Bank’s Crisis

- 2008: Bank posted a SFr 20 billion loss, the largest financial loss in Swiss corporate history
- The Swiss Government injected SFr 6 billion, taking 9% ownership
- Additionally, UBS moved toxic assets to a central bank-run fund
- August 2009: Swiss Government sold its stake making considerable profit (SFr 1.2 billion)
- 2009 half-year reporting SFr 1.4 million operating loss

CREDIT SUISSE

Bank's Strength

- Despite its write-downs, it was far less affected by the sub-prime crisis than UBS
- Exposures to leveraged loans and commercial mortgage-backed securities were among the lowest in its peer group
- The 2009 half-year results: 29% rise in profit showing from its investment bank
- The bank obtained this by offering traditional, more standardised products
  - *Emerging from the crisis as one of the strongest banks*
  - Competing on the American market

2008 Crisis Remuneration Policies

Common features UBS and Credit Suisse

- Payment structure: historically, variable remuneration (cash- and share- based) a substantial part of total compensation
- Decrease in variable compensation mainly in the investment banking division
- In 2008 no cash variable remuneration paid to Chairmen, CEOs and executives (except for contractual arrangements)

UBS

2008: The 1st bank to change Remuneration Policy

- Establishing a new HR & Remuneration Committee
- Awards depending on the achievement of performance targets linked to long-term, risk adjusted value creation
- 3-year deferral period for bonuses
- Bonus-malus (clawback)
- Performance equity plan linked to performance of the bank for an initial period of 3 years
- Executives required to keep a minimum of 75% of all shares for a further 5 years
- Introducing a non-binding advisory vote on remuneration principles

CREDIT SUISSE

2008: No major changes to its Remuneration Policy

- considered as already having strong enough principles
- not requesting State aid

- The Bank maintained its approach to deferred variable compensation:
  - Mandatory deferral rate ranged from 16% to 65% of variable compensation
  - Variable compensation exceeding SFr 4 mil subject to 100% deferral

Changes:

- Clawback applied to a portion of cash-based component
- Introducing performance awards linked to the performance of a pool of illiquid assets primarily used in investment banking

CEO & Chairman Remuneration 2007 - 2008

CEO (highest paid) Chairman					
CHF					
	Total cash	Cash compensation	Bonus	Benefits & Pension	Value of share-based awards
2007					
UBS					
Chairman	2,568,379	2,000,000	0	568,379	0
CEO	10,306,920	1,291,960	4,501,900	11,156	4,501,904
Credit Suisse					
Chairman	14,624,000	2,000,000	6,500,000	24,000	6,100,000
CEO	22,300,000	3,400,000	included in the cash column	990,000	17,900,000
2008					
UBS					
Chairman	1,565,647	1,333,333	0	232,314	0
CEO	1,814,602	1,500,000	0	314,702	0
Credit Suisse					
Chairman	2,024,000	2,000,000	0	24,000	0
CEO	2,860,000	1,250,000	0	1,610,000	0

CREDIT SUISSE

2009 Remuneration Policy

The 1st global bank to change its remuneration policy soon after and in line with the G-20 Summit

- Payment of an increased proportion of compensation in the form of fixed salary
- Annual cash awards higher than SFr 125,000 subject to deferral
- Two new instruments for deferred variable compensation:
  - Scaled Incentive Share Units:

    on a 4-year pro-rata basis

    adjusted upwards / downwards
  - Adjustable Performance Plan Awards: cash base

    Tying payouts to ROE

    Clawback

UBS

2009 Remuneration Policy

- Following Credit Suisse, in line with G-20 recommendations
- Increase fixed salaries to a level high enough
  - that the variable portion can still be adjusted yearly
  - while maintaining total compensation in line with market standards
- Cash plan providing a multi-year reflection of performance
- 3-year deferral period
- Bonus-malus system (clawback)
- Share / options: 3-year vesting period, on performance
- Executives required to retain 75% of all vested shares during appointment and for 8 years from the date of grant

French and German Banks

Main French banks that applied for State-aid

- •BNP Paribas (French biggest recapitalisation: € 5 billion)
- •Societe Generale
- •Credit Agricole

✓waived executives' variable cash & share awards remuneration
✓officially endorsed bonus measures announced by the French Presidency in August 2009

- •Commerzbank (25% owned by German State)

✓restricted remuneration according to SoFFin
annual cap 500,000, no bonus, no share awards
✓10 Nov. 09: announced a review of the compensation model to be introduced in 2010

- •Rival Deutsche Bank (no State aid) followed suit

Regulation Extending Across the Banking Sector

- FSB Implementation Standards (September 2009)
- UK: Agreement by top 5 banks Barclays, HSBC, Standard Bank, RBS and Lloyds to apply international standards
- German Law on the Adequacy of Remuneration of Executive Board Members (VorstAG)
- Dutch Banking Code
- French Banking Federation Compensation Guidelines
- Bank of Italy: Remuneration and Incentive Systems
- Swiss Minimum Standards for Remuneration Schemes of Financial Institutions

Conclusive Remarks

- Banks : prove their restructuring plans are viable
  Remuneration is part of the plan
- Regulatory intervention for:
  eliminating systemic risk
  maintaining systemic stability
- Supervision's role: overseeing implementation of principles
- Importance of governance
  - Issue: international coordination of regulation

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