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Remuneration Reform: G20 – Breakthrough?

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The down side of attempting to lead reform and debate is the risk of a not so obedient "herd" finding their own path.

A case in point is the climb-down for Nicolas Sarkozy on the emotive banker bonus debate. Mr Sarkozy had at the height of the summer, publicly campaigned for a cap on bankers' bonuses, but the consensus of the G20 Pittsburgh summit does not go so far. At the other end of the scale, it appears that the UK's Financial Services Authority, which had gone live with remuneration proposals in February of this year (in the form of a draft Code of practice on remuneration policies, which was then subsequently watered down by August in the fear that the proposals would choke UK's competitive position in the international financial markets), may have to, yet again, review its proposed Code of practice to see if it satisfies the higher standards set in Pittsburgh.

The idea of a cap on bankers' bonuses was really never one which was not going to wash through; it was a barely disguised play to the public gallery that failed to address the point about the causes of the financial crises. With US resistance to the concept of a cap, the "cap debate" has now almost been relegated to the pile of Franco-German summer frenzy.

Questions Arising from G20 Proposals

What is now on the cards then in terms of remuneration reform? The official communiqué from the G20 supports the general line advocated by the Financial Stability Board (FSB) aimed at aligning compensation with long-term value creation and not excessive risk-taking. This would include (i) avoiding multi-year guaranteed bonuses; (ii) requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate clawback and to be vested in the form of stock or stock-like instruments; (iii) ensuring that compensation for senior executives and other employees having a material impact on the firm's risk exposure align with performance and risk; (iv) making firms' compensation policies and structures transparent through disclosure requirements; (v) limited variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base; and (vi) ensuring that compensation committees overseeing compensation policies are able to act independently. The FSB has been tasked with monitoring the implementation by domestic regulators of these FSB standards and proposing additional measures as required by March 2010.

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While the overall slant of the G20 proposals is to be applauded for its focus on alignment of reward with risk over a longer timeframe, there is much for domestic regulators to consider when implementing these proposals. To what extent should these standards extend beyond the banking sector? Lord Myners, the UK's City Minister, recently recommended that remuneration disclosure proposals should extend to all listed companies as these would inform decision making and act as a control on excesses. Many, however, doubt the efficacy of enhanced

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disclosure and consider that reform must go to the heart of remuneration structures and packages. Putting the banking/ non-banking sector debate to one side, there are numerous other points of principle to be addressed. What much of the rhetoric on remuneration reform fails to address is that risk taking within these multi-service financial organizations varied. The debate focuses on the universal pool of bankers' bonuses, but surely, a banker who has engaged his bank in a global M&A transaction, where not much more than reputation of the bank is at stake in the event of "failure" of the transaction, should not necessarily be treated in the same way as the banker in the same institution but in the securitization team, who has committed many hundreds of millions of pounds of the bank's capital to a large securitisation transaction. What is to be regarded as a "significant portion" of variable compensation that should be deferred or vested in the form of stock? To what extent should the remuneration culture in different nations be recognised? For example, when comparing the US and the UK, absolute executive packages in the US have historically been significantly higher, according to a Watson Wyatt report, and non-cash, incentive-based pay represented about three-fifths of US chief executives' overall packages versus one-fifth in the UK. This could potentially mean a significant change in remuneration packages for the UK industry?

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Other Points of Principle

The UK Chancellor, Alistair Darling has already urged bankers to show restraint in the new bonus season and to endeavour to follow the principles emanating from Pittsburgh even though these will not have been translated into new legislation in time. The Chancellor has criticised the "greed and recklessness" that endangered the whole global economy and lives of millions. How much of these comments however should be treated as mere political grandstanding? While it is generally accepted that many bankers' remuneration packages were structured by reference to extremely short-term targets, what is often forgotten, is that many thousands of employees in the big failed banks had reinvested significant portions of their cash bonuses into stock in their own companies. What better method than is there to align the interests of these bankers with the future longer term prospects of their organisations? These large stakes (particularly prevalent amongst the senior bankers/ decision makers) did not however seem to result in any greater awareness of, or concerns about, the risks these firms were running. The Pittsburgh proposals similarly fail to address this issue: how do we deal with what appear to be errors and faulty judgements in a number of cases and not deliberate betting on the bank to make a quick buck?

Regulators do need to consider the wider back drop and the fundamental causes of the financial crises when devising their remuneration package principles. The FSA have stated that they will be looking again at the proposed Code of practice on remuneration policies in light of Pittsburgh. It looks like, at the very least, another u-turn on clawbacks will need to be made if the UK is to be in line with Pittsburgh. And what of Lord Turner's recommendations in his "Review of Corporate Governance in UK Banks and Other Financial Industry Entities" in July? In this report, Lord Turner makes a number of recommendations on remuneration, including disclosure of "high end" remuneration of executives whose total remuneration exceeds the executive board's median total remuneration? The report also makes a series of recommendations which will impact on the scope and duties of remuneration or compensation committees. It is not clear to what extent these proposals are going to be adopted and incorporated into new legislation or codes of practice.

While Pittsburgh certainly should be seen as the foundation for consensus on global remuneration reform and hopefully an end to the year-long battle to control bankers' bonuses, we have yet to see if it can truly be described as a breakthrough. As noted above, there are a number of points of details to be fleshed out and yet more points of principle to be addressed. Even if these matters are not clear, what is certainly clear at this stage is that remuneration committees of banks and other major financial institutions around the globe do not have an enviable task; the challenges before them in devising packages that meet these standards are considerable. Bonne chance!

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