‘Changing banking for good’

UK Parliamentary Commission’s Remuneration Proposals

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This McLagan Alert summarises the key points relating to remuneration from the final report of the UK’s Parliamentary Commission on Banking Standards (PCBS or the Commission), published last week. It considers possible implications, scope and the process that follows the report’s publication. Key PCBS recommendations included:

1. Changes to how firms measure performance when setting remuneration
2. Changes to how firms use variable remuneration
3. Measures to cancel remuneration at banks requiring state-support
4. Other recommendations around issues such as sales incentives, Non-Executive Directors’ pay, ‘clawback’ terms and share buy-outs on recruitment.

BACKGROUND

The PCBS was established by the Houses of Parliament in July 2012, in response to the LIBOR rate-setting scandal, the financial crisis, and other banking conduct-driven scandals. Members include a former Chancellor of the Exchequer; the Bishop of Durham, who was subsequently appointed Archbishop of Canterbury; and both the current and former Chairmen of the Treasury Select Committee. Their remit was:

- The professional standards and culture of UK banking, taking account of regulatory and competition investigations into the LIBOR rate-setting process;
- UK corporate governance, transparency and conflicts of interest, and their implications for regulation and Government policy.

The PCBS Report (the Report) was published on 19 June 2013, in nine volumes setting out the Commission’s conclusions and recommendations, how they were reached and all of the oral and written evidence given to the PCBS and its sub-committees.

The Report is highly critical of the banking sector and the standards and conduct of many senior management and employees (though it recognises that those conclusions do not apply universally). The PCBS was scathing of remuneration practices in banking and put forward a number of recommendations which, if put into place, could significantly affect pay practices in impacted institutions.

REMUNERATION RECOMMENDATIONS

The PCBS concluded that ‘Remuneration lies at the heart of some of banks’ biggest problems’. Many of their recommendations are aimed at changing the culture in the UK banking sector and remuneration is one of the mechanisms they propose to use.

The Report falls short of moves to reduce the quantum of pay in banking, arguing that banks should be free to compete in the global market. The Commission is ‘not

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convinced that a crude bonus cap [as seen in the latest changes to the Capital Requirements Directive, CRD IV] is the right instrument for controlling pay'.

In summary, they recommend the following remuneration reforms:

1. CHANGES TO HOW FIRMS MEASURE PERFORMANCE WHEN SETTING REMUNERATION

- **Firms should not depend narrowly on profitability measures**. In particular, unrealised profits from thinly traded or illiquid markets should be excluded.
- **Return on equity, return on assets or return on risk-weighted assets (RWAs) should not be relied on**. Return on equity can create a perverse incentive to increase leverage. Return on assets can incentivise the firm to hold riskier assets. Return on RWA is subject to the short-comings of the risk-weighting regime under Basel II and III.
- **Firms should disclose the range of measures used to determine remuneration**. They should explain how they were taken into account and their impact.

McLagan perspective: *These are not radical changes but a clarification and strengthening of existing practices. The difficulties of valuing less liquid assets should ideally be addressed via amended accounting standards but in the meantime excluding associated notional profit when considering remuneration may be constructive. In the absence of an alternative, Return on RWA under the Basel framework will still be used but alongside other risk-adjusted measures, such as Value at Risk and Economic Profit.*

2. CHANGE IN HOW FIRMS USE VARIABLE REMUNERATION

- **Senior staff should be required to take longer deferrals than current market practice, 'up to 10 years'**. A significant proportion of variable remuneration should be deferred. Firms should choose an appropriate period to align rewards and risks. Regulators should have the power to require more deferral and longer deferral periods.
- **Shares should not be over-used as a remuneration delivery vehicle**. Overusing shares might create perverse incentives to focus on short-term performance and to over-leverage the balance sheet. Instruments such as 'bail-in bonds' could instead be used, which convert to equity or are wiped out if capital levels are inadequate, aligning staff to the soundness of the firm in the longer-term.
- **Malus terms should be used under a wider range of circumstances** (to reduce or eliminate unvested deferred remuneration). This should include decreased bank profitability resulting from acts of omission or commission in the period for which the variable remuneration was initially paid.

McLagan perspective: *Again, this is an evolution of existing practice, not revolution. The aim is to make staff loyal to the wider bank rather than individual or team interests and to recreate some of the remuneration features characteristic of unlimited liability partnerships. McLagan believes a culture closer to that in a partnership could help manage risk more effectively, reinforcing responsible behaviour and a long-term perspective, though it may not be suitable for all firms and all circumstances.*

The Report does not mandate a particular approach but puts forward various possibilities. None is a simple solution. The attraction of bail-in or wipe-out bonds to

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align the interests of management and other stakeholders may be overstated – these instruments might create an incentive to hide losses. Very high deferrals with malus could still lead to the wrong behaviours.

Clear malus guidelines are useful and a Remuneration Committee should have the mandate to use discretion in a wider range of circumstances. This kind of backward-looking reassessment of performance is in line with the European Banking Authority's review of implementation of the Committee on European Banking Supervisors' Guidelines on Remuneration Policies and Practices in April 2012.

3. OTHER PCBS OBJECTIVES REQUIRING FURTHER INVESTIGATION

- **The recovery of vested remuneration (clawback) should be possible**. This is difficult legally, so the PCBS have asked the regulator to consider whether legislation creating new powers is appropriate for use 'in the most egregious cases of misconduct', to recover remuneration from staff who have been the subject of successful enforcement action.
- **Deferred remuneration buy-outs on recruitment should be eliminated**. Buy-outs give a clean slate on moving to a new firm, undermining the risk-reward alignment. The PCBS asked regulators to propose reforms, such as mandatory continuation of deferred remuneration on resignation or a facility for the former employer to recover from the new employer amounts that would otherwise have been recovered via malus terms. Getting international agreement to this will be very challenging so a unilateral UK move is proposed.

McLagan perspective: *These are more challenging issues, which is why further investigation is required.*

Provided any clawback power is limited to individual employees who have been subject to successful enforcement action, to recover remuneration relating to the period to which the action applies, then this may be justified. In the significant majority of cases the deferral of remuneration, over a period sufficient to provide alignment with the risks undertaken whilst recognising the need to deliver real and perceived value to employees, should be sufficient to allow appropriate performance adjustment.

The proposals to eliminate buy-outs would have clear benefits around risk-reward alignment but would be administratively complex and eliminate any retention effect of deferral. A unilateral move towards this in the UK would prevent impacted firms passing deferred remuneration costs for leavers onto competitors, while outside the UK firms could still do this.

4. OTHER RECOMMENDATIONS

- **The use of sales incentives should be limited**. The aim is to reduce the risk of mis-selling and other conduct-related failures.
- **Non-Executive Directors should not be paid in shares**. Over-use of shares might encourage short-termism and leverage.
- **The regulator should have new powers to cancel remuneration if a bank takes capital from the Government**. This should include key staff's unvested deferred remuneration, payments for loss of office and unvested pension rights.

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McLagan perspective: *Reducing incentives to poor conduct, whether via sales incentives for customer-facing staff or paying NEDs in cash as a fee for their time and expertise, is in line with existing measures in place in many jurisdictions. When a firm requires direct state support, the proposed measures would allow wholesale removal of significant amounts of remuneration. This is likely to cause concern for staff and so these extreme measures may lead to retention issues and prudential risk for the firm.*

SCOPE – WHICH PEOPLE?

Most remuneration recommendations focus on two groups of bank employees:

1. **Senior Persons** – ensuring all key responsibilities across the bank are each assigned to a suitable individual, who is aware of and formally accepts the responsibilities assigned to them. The aim is to ensure that for all issues there is a senior executive accountable. According to the Report, main board and executive committee members should always be in scope, along with other senior management as identified by each firm. At this stage there are no detailed criteria for identifying the appropriate individuals.
2. **Licenced Persons** – anyone working in banking whose actions or behaviour could seriously harm the bank, its reputation or its customers. This would include Senior Persons, and most likely all staff covered by the existing Approved Persons regime, plus potentially a range of other roles. Again, detailed criteria are not available at this stage.

SCOPE – WHICH FIRMS?

These changes would most likely be implemented via an updated Remuneration Code. In that case the scope is likely to be comparable to the current Remuneration Code. The Report refers explicitly to banks and bank holding companies operating in the UK.

NEXT STEPS FOR IMPLEMENTATION

The Report is basically a set of recommendations to the UK Government. As such, these proposals will only come into effect if they are adopted and then implemented.

The Report recommends a rewrite of the Remuneration Code to bring the proposed rules into effect. The Prudential Regulatory Authority, one of the successor regulators to the UK Financial Services Authority, is already planning a consultation on Remuneration Code changes in September, to implement the remuneration requirements in CRD IV. It is unlikely that the PCBS recommendations will be implemented in full at that stage but some elements may be included.

CONCLUSIONS

McLagan supports the efforts and intentions of the PCBS. Trust in the UK banking sector need to be rebuilt and this requires cultural and behavioural changes. However, many of the Report’s specific recommendations could be counter-productive.

The Committee’s remuneration recommendations are not radical for the most part, though the competitive impacts might be significant. They strengthen existing mechanisms, such as requirements for performance measurement, bonus deferral and malus or clawback terms. We would recommend more emphasis on aligning

remuneration with risk-adjusted returns over the longer-term, rather than singling out performance measures and deferral/clawback practices as solutions.

Many press headlines about the Report focused on deferral up to 10 years but again this is not new. Bank of England grandees Andrew Haldane and Michael Cohrs recommended this when they gave evidence to the PCBS some months ago; CRD IV aims to incentivise firms to defer pay over a minimum of five years. In practice longer-term deferral will impact the perceived value of awards which might create issues. There is a reason why five-year deferral is uncommon in the market and longer deferrals are rarer still – pay must align with risk but not forget the need to reward.

The Report sets out broad principles and then calls for firms to do what is right for their business within them. Specific rules promote a 'box-ticking' approach and so decision-making is outsourced from the banks to the rule-setter. Similarly the regulator is asked to exercise judgement rather than setting rules. Using judgement within a framework of principles should allow firms to adopt policies that suit their circumstances, but past experience suggests some firms prefer the simplicity of rules to the complexity and ambiguity that comes with a judgement-based approach.

We believe a true partnership culture, in which the most senior executives and risk-takers in the firm are symmetrically aligned to the other stakeholders in the firm, would support the cultural and behavioural changes the Committee is seeking. Management and investors would need to agree the terms of these arrangements. Some carried interest schemes in asset management firms provide that kind of alignment. An alternative might be to award preference shares, with dividends based on three-year average profitability after capital and ordinary shareholders dividend hurdles, with accrued dividends subject to clawback over 3-5 years.

McLagan is the leading Performance / Reward consulting and benchmarking firm for the financial services industry.

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