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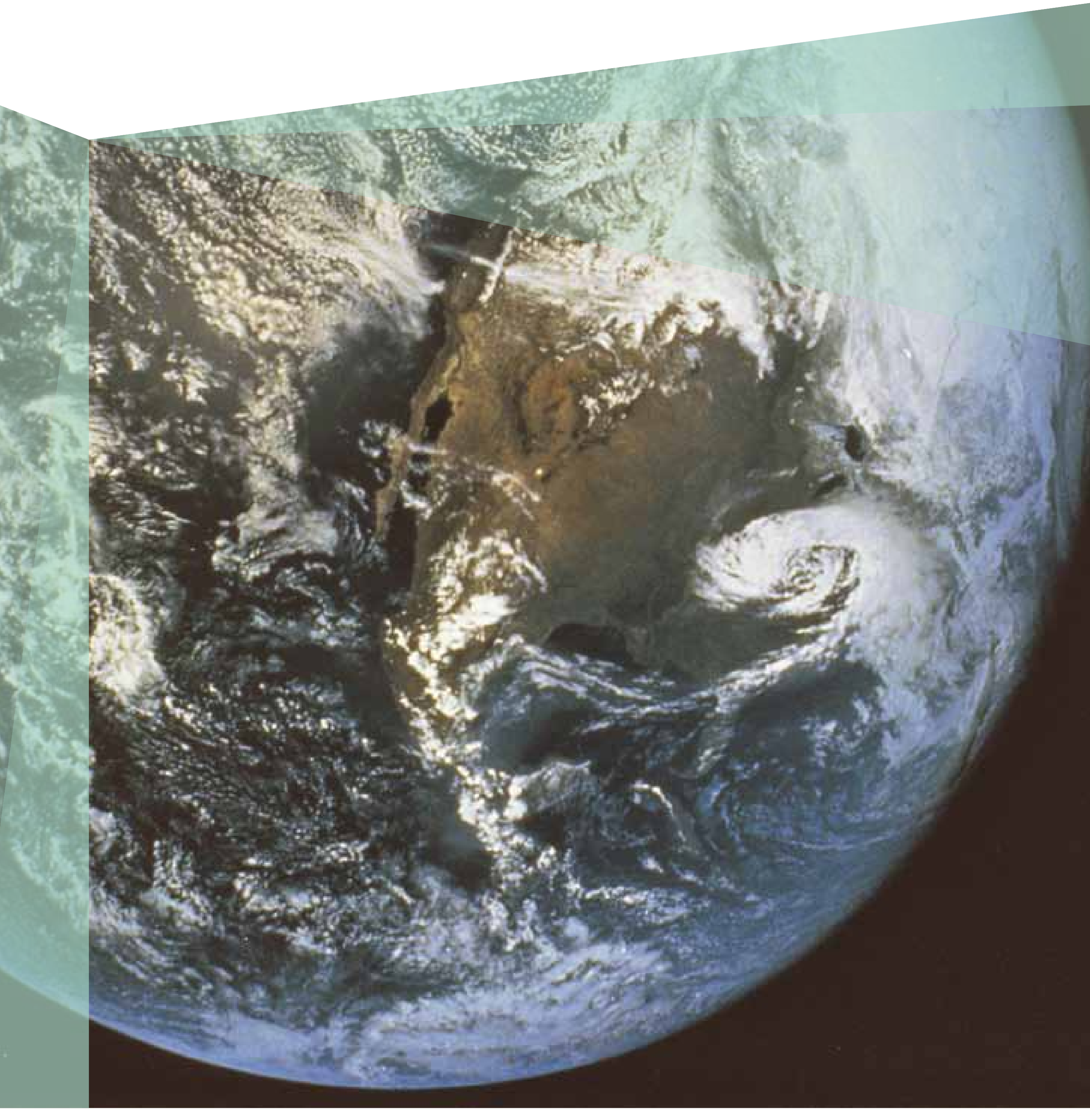
EXECUTIVE REMUNERATION IN GLOBAL FINANCIAL SERVICES



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EXECUTIVE REMUNERATION IN GLOBAL FINANCIAL SERVICES

REGULATORY DEVELOPMENTS LEADING TO STRUCTURAL CHANGES IN EXECUTIVE COMPENSATION AND THEIR UNINTENDED CONSEQUENCES

In the wake of the financial crisis, remuneration regulations were imposed on the financial services industry to discourage imprudent risk-taking by crucial players in the sector. As these regulations continue to be subject to changes, and as their implementation is nearly complete, organisations in the financial sector have significantly changed their executive compensation programmes. These developments have led to a number of unintended consequences that may potentially present new difficulties for the sector.

Mercer recently held a roundtable discussion among major financial services companies, during which senior HR and compensation executives discussed these topics and their organisations' related actions. This article reflects the major issues emerging from these discussions, which were reinforced by a snapshot survey of the actions participants had taken.

REGULATORY REQUIREMENTS AND DIFFERENCES AROUND THE GLOBE

The Financial Stability Board's (FSB's) *Principles on Sound Compensation Practices and Implementation Standards*[1] contains three principles for regulating compensation effectively and addressing possible ways to minimise potentially harmful, excessive risk-taking. First, an appropriate balance of risk and reward needs to be found by both deferring payment and establishing longer performance periods. Payment should not be made until risk outcomes are better known, subject to adjustments for performance that become clearer over time. Second, incentives are adjusted to the risk the institution is exposed to by the respective individual's activities through implementing appropriate risk management and effective controls. And third, the involvement of independent

[1] Available at http://www.financialstabilityboard.org/publications/r_090925c.pdf.

bodies, such as the Risk Management function and Board of Directors, in the structuring and implementation of incentive-based remuneration should be ensured, leading to stronger corporate governance.

Unfortunately, this is not a level playing field, with national regulators taking somewhat different approaches towards their respective remuneration requirements.[2] There are meaningful differences globally, such as companies in scope (for example, incorporating proportionality and insurance companies), employees covered by regulations (for example, identification of material risk takers) and the way pay needs to be structured (for example, prescriptive set of rules versus principle-based guidelines). The FSB's 2012 review[3] indeed indicates that no common criteria exist about how to identify material risk takers and the application of the proportionality principle. In addition, the details of criteria or even the existence of any criteria vary heavily among jurisdictions. Implementation differences may apply according to the business model and the risk profile of the respective organisations, but cross-border supervisory cooperation should improve to ensure that it does not lead to regulatory arbitrage.

Although institutions are primarily bound by the regulations of their home regulator, they also experience pressures and requests from local regulators in a large number of the jurisdictions to comply with local requirements. It is an ongoing challenge to meet the local requirements while also remaining compliant with the home regulations, as the different requirements can present conflicts. These local differences make it difficult for organisations to comply with all the regulatory requirements in various jurisdictions and to maintain a consistent global compensation philosophy.

REGULATORY REQUIREMENTS GOING FORWARD

The media continues to debate the topic of compensation extensively, often receiving and discussing commentary from legislators. In order to restore trust in the sector and establish sound banking markets, new legislation has been proposed that should also address the regulatory differences within Europe and globally. Currently, the European Parliament, European Commission and European Council are discussing the final rules on Capital Requirements Directive 4 (CRD4) in order to react to the industry's needs. The directive aims mainly to level the global playing field in an effort to prevent competitive distortion among European member states and the global market, as the European Parliament's Executive Summary[4] indicates. CRD4, in comparison with its predecessor, CRD3, has a stronger focus on the fact that performance should be assessed over a multi-year period, which takes into account

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[2] See Mercer's *Executive Remuneration in Global Financial Services* Executive Remuneration Perspective (Issue 1, 2012), available at http://www.mercer.com/erperspectiveeu.

[3] Available at http://www.financialstabilityboard.org/publications/r_120613.pdf.

[4] Available at http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm.

the underlying business cycle of the company and of business risk. In addition, CRD4 requires institutions "to set the appropriate ratios between the fixed and the variable component of total remuneration where the variable component shall not exceed one times the fixed component of the total remuneration". Final agreement on the directive has not yet been reached, but preliminary reactions have been fear that an even-less-level playing field will develop, with both other geographies and unregulated industries.

STRUCTURAL CHANGES IN EXECUTIVE REMUNERATION

With CRD4 looming over the industry, responses to previous regulations did their share to change the compensation structures of financial services organisations. In reaction to the regulations, the banking industry and some insurance companies were required to make alterations in their pay structure, performance assessment, guarantees, multi-year compensation (mandatory deferrals and long-term incentives) and governance. During the past three years, as data from Mercer's Global Financial Services Executive Compensation Surveys[5] have shown, organisations intensified their emphasis on base salaries in their pay mix while heavily decreasing annual cash bonuses. In addition, the majority of banking and insurance companies introduced or changed their mandatory bonus deferral and forward-looking long-term incentive (LTI) programmes (which grant awards for rewarding future success in addition to the short-term incentive award; an LTI award generally vests based on performance over a multi-year timeframe going forward). Mandatory deferral programmes have a portion of the short-term incentive award deferred over time, and this portion potentially vests based on performance criteria that consider how business written in an award year develops over a multi-year period (for example, in 2015, performance of 2012 will be tested). These deferral programmes are most prevalent in the banking industry (83% of banks use them), while almost all insurance organisations (94%) use forward-looking LTI programmes. Fuelled by regulatory requirements, the portion of executive variable compensation that is deferred varies between 40% and 60%, with higher risk-taking positions usually having a higher percentage of their variable compensation deferred and at risk based on additional performance conditions.

As for mandatory deferrals, data show that most businesses thus far have opted to base their mandatory deferral payout on corporate performance and not on business-unit or individual performance. This is in spite of existing regulatory guidance, which encourages the latter. According to Mercer's Financial Services Executive Compensation Survey, eligibility for mandatory deferral is typically determined based on both the job level (68% of organisations) and the level of bonus award (68%), but the predominant factor in LTI eligibility is job level

[5] For more information, visit http://www.mercer.com/hc-financial-services.

(91%). The most common design elements for mandatory deferrals are pro rata, vesting over three years. The vehicles used most commonly are cash and stock-based programmes. Generally, a change in the mix of vehicles used in man-datory deferrals can be observed: the preference clearly shifts from stock options to restricted stock and cash. The most prevalent metric to determine final deferral payouts is net/operating profit or loss. As Mercer's 2012 Financial Services Executive Compensation Snapshot Survey indicates, 42% of organisations in all regions and industries use this performance metric.

Comparing mandatory deferrals to forward-looking LTIs, several key differences can be observed:

- While mandatory deferrals are positioned as "carve outs", forward-looking LTIs are considered "separate" from the annual bonus and part of total compensation.
- Forward-looking LTIs are frequently rank- and role-based and thus commonly render only top employees eligible, while deferral plans usually address a considerable population of employees (based on bonus size).
- Mandatory deferral award amounts are directly related to short-term incentives/bonuses, while forward-looking LTI award amounts are defined more consistently based on top management roles.
- Mandatory deferrals are usually paid out of an annual bonus pool and are at least partly expensed in the performance year. Forward-looking LTIs, on the other hand, are not restricted to the annual bonus pool and are generally expensed between grant and vesting.
- Forward-looking LTIs commonly have a longer vesting period, while mandatory deferrals' vesting periods are more typically on a pro rata basis.
- Although most deferral plans are structured to have only a downside and no upside, forward-looking LTIs generally possess both.

In addition to restructuring performance measures to adjust for risk and capital charges, another structural change has been occurring in the performance assessment area: in response to regulations, clawback and malus mechanisms were introduced. The first is intended to reclaim already vested or paid compensation when negligence or other malfeasance occurs. Malus conditions are any performance-based adjustment in unvested deferred compensation over the life of the mandatory deferral. Data show that both clauses are implemented within a majority of banks (80%) and insurance companies (60%). The mechanisms apply to the deferred part of both equity and cash compensation. As clawbacks are relatively new in practice, only a few organisations have reported actual clawbacks of payments (17% in 2011).

Another structural change can be observed in the decrease to near elimination of multi-year bonus guarantees granted in the industry. Single-year bonuses still exist, but more governance is required by the Compensation Committee in monitoring them.

The regulations encourage more involvement from control functions in the design of performance measurements and compensation plans. Our studies show that in addition to Human Resources, the industry tends to involve Risk Management in the design of compensation plans, and this group's influence is planned to increase. At the same time, Compliance and Legal are significantly more involved in the review process, while Audit's role remains unchanged.

INDUSTRY EXPECTATIONS: UNCERTAIN TIMES AHEAD

Uncertain times are not yet in the past. Firms are still cutting jobs in the financial services sector – that much is obvious. The majority of organisations (55%) are expecting some small layoffs, and more than a third of banking organisations expect moderate to large layoffs. Layoffs are least expected in Asia Pacific (33% of the organisations do not anticipate any). In Europe, on the contrary, 86% expect layoffs, and 43% expect them to be moderate to large in number.

Higher capital requirements will have to be faced, and this requires most banks to reconsider and change their compensation programme designs. The most prevalent expected compensation programme changes related to higher capital requirements are changes to performance measures, particularly the use of risk-adjusted return on capital measures.

UNINTENDED CONSEQUENCES OF THE NEW REALITY

As we described, most major banks and insurers have made and will continue to make crucial changes to their compensation programme design in response to regulatory requirements, which have included in the recent past increasing base salaries, placing performance conditions on mandatory deferrals and establishing rather diligent governance by the Remuneration Committee while ensuring more involvement of other control functions in the compensation design process. However, this new reality has triggered a number of unintended consequences.

A major unintended consequence has been the shift from annual incentives to base salary. This increases the fixed compensation costs and diminishes the flexibility to reduce costs in a lower-performance year. At the same time, employees are likely to perceive their compensation opportunities as less valuable, since large amounts are now deferred over time and vesting is linked to performance conditions. As a consequence, pressure is applied on organisations to increase total compensation in order to avoid being rendered less competitive in the face of unregulated industry segments nationally or less-strict geographic markets internationally. The sole reliance on mandatory bonus deferrals has caused a decline of forward-looking LTIs. When annual bonuses are limited or not provided at all, the link to long-term performance is lost. Most important, because the payout of mandatory deferrals is primarily linked to overall company performance, the impact on individual performance and risk-taking behaviour is questionable.

Some side effects can also be observed from these developments. Naturally, the focus of much of the industry is on being compliant with the regulations – which ultimately results in reduced flexibility and, possibly, reduced effectiveness in the design of compensation programmes. Due to the need for more shares, there is a risk of increased shareholder dilution. And although risk-adjusted performance measurements have improved, there are challenges with comparability between organisations. There is now a disconnect between proxy advisers and regulators regarding the use of relative total shareholder return and other published accounting metrics rather than risk-adjusted, economic metrics in judging pay for performance.

STRATEGIES TO IMPROVE CURRENT SITUATION

As the main challenges of attracting, engaging and retaining talent become even more difficult in the financial services industry, effective strategies must be employed. Rebuilding the financial services industry's image and managing talent perceptions and expectations effectively will be key. Focusing on the total employee value proposition beyond pay strategies may help bring better balance and more of a career development perspective to the industry. Communication will be even more important to help employees understand the rationale and purpose for the structure of their compensation programmes. And companies will be challenged to improve their performance measurement and evaluation processes for considering risk-adjusted outcomes and risk management factors and behaviours. As we have said all along, this is a moving target, so stay tuned for navigating the future.

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