



Credit Quality as a Bonus Underpin

Posted by Scott Hirst, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Monday February 14, 2011

Editor's Note: This post comes to us from [George Dallas](#), Director of Corporate Governance at F&C Management Ltd., and is based on a concept paper prepared by F&C Management.

In the aftermath of the recent financial crisis, bank remuneration remains a critically sensitive issue – for shareholders, creditors, regulators, governments and the general public. This is particularly the case for those systemically important financial institutions that received government bailouts. While many of these institutions are beginning to recover, the negative effects of increased debt taken on at the public sector level to protect the financial system have resulted in serious and lingering economic problems in many countries, including the UK and the US. Indeed, the impact of public sector balance sheets absorbing losses of the banking sector has had the after-effect of contributing to sovereign debt crises in several smaller European jurisdictions — which continue to plague investors, taxpayers and the wider economy.

In this context, the legitimacy of granting substantial bonus awards to executives of systemically important banks — particularly those that have benefited from the state as a provider of financial support — is continuously, and fairly, called into question. While often played out in the media in a sensational or populist manner, this is a serious concern that calls for a fundamental rethink.

There are no easy answers. To compete in a complex environment, rebuild financial strength and wean themselves from state support, banks need to be able to attract and retain capable managers in a competitive marketplace for executive talent. We appreciate this as investors, and recognise that the ability to pay competitive salaries and to grant fairly-earned bonuses is a commercial necessity.

At the same time we believe that remuneration structures in banks generally remain problematic, and that even broad regulatory reform frameworks, such as the G20 Principles and the more recent FSA Remuneration Guidelines, have not resolved all the outstanding concerns. We are generally discouraged by the inability of banks to work together to show restraint in the area of pay, and believe that even with many remuneration reforms that have been put into place bank remuneration, in particular the granting of bonuses, will continue to be an area of controversy.

Bank Remuneration and Moral Hazard

Specifically, we still have not cracked the asymmetry of reward problem sufficiently with banks. In good times bankers are set to make fortunes both at executive and below board levels of the organization; in severely bad times the state — and ultimately the tax payer — foots the bill because of their systemic importance to the economy. This moral hazard issue is a particular feature of the financial sector¹, and is why, in part, we have seen specific attempts (including the Walker Review and the recent European Commission Green Paper) to frame corporate governance issues specifically for this sector. A key point of differentiation is that for systemically important banks, where the state is an implicit guarantor because of the “too big to fail” concern, it is critically important that banks manage themselves to avoid not only default in the extreme, but also a meaningful deterioration of their standalone credit quality that could result significant operational and financial impacts. That has to be job one, and incentive systems must encourage this.²

In this context we have seen balanced scorecards in remuneration schemes at banks calling for improvements in risk management and bank credit quality as key performance indicators. While this is positive and laudable, it is even more important that remuneration schemes provide incentives for banks to avoid material *deterioration* of credit quality — a focus on the downside, not the upside. This is obviously a concern of creditors, but it is also a concern shared by shareholders, particularly in the case of banks, where funding costs and funding stability are critical to the long-term sustainability and value creation of the enterprise.

Credit Quality as a Binding Constraint for Bonus Payouts

Hence, an idea to explore with large banks: establish the maintenance of a minimum standard of credit quality as an underpin – or precondition – to bonus awards. The starting point would be to define a base level of acceptable credit quality. If these credit quality standards are met, then bonus payments could be paid – in accordance with other guiding performance metrics (e.g. economic profit, earnings growth, share price, total shareholder return (TSR), strategic metrics, etc). If credit quality standards are not met, then a bonus payment is not justified, even if other performance criteria are satisfied. This would most likely apply to executive management, who are accountable for the health of the bank as a whole, and probably not to company managers focused only on one division of the bank.

¹ It could also extend to non-financial national or regional “champions” that have particular economic importance in other countries or jurisdictions.

² For example, a recent academic paper has encouraged the use of debt instruments as a form of executive remuneration to reinforce a more prudent perspective among its executive managers: see “Inside Debt”, by Alex Edmunds and Qi Liu, The Wharton School, University of Pennsylvania., Oxford University Press, 2010 (available [here](#)). In practice, Barclays plc has announced its intention to use contingent capital instruments (“Co-cos”) as executive incentive remuneration, as a way both to build its capital base and provide an incentive for responsible bank stewardship.

Details of measuring credit quality require some thought, but this should be workable and measurable. A non-exhaustive list of possible metrics that could be used either on a standalone basis, or jointly with other metrics, includes the following: credit ratings³, credit default swap spreads⁴, the bank's cost of capital, Basel III capital ratios or the level/growth of non-core liabilities in the bank's funding mix.⁵ The threshold for such an underpin could be established sufficiently below the bank's existing credit standing to provide some degree of cushion from slight changes in credit quality, but would be a safeguard against a wholesale credit deterioration. It would be important for the credibility of such a credit metric to be objective and independent — and not simply reflections of the bank's own risk management systems.

Conclusion

Establishing credit quality as an underpin for bonus awards would mean that systemically important banks will reward executives for profitability and value creation for shareholders only if the bank's credit profile is not put at undue risk. While clawbacks/malus already exist for extreme situations, those are “nuclear” deterrents that no one wants to see exercised. By having a credit benchmark as a backstop, there is an additional layer of protection — and an additional incentive for systemically important banks to manage their risks responsibly.

We believe that this form of incentive discipline has economic legitimacy, and could contribute to investor support of bank remuneration plans in their voting activity. Moreover, by demonstrating that remuneration systems are guarding against the type of downside risks that threaten systemic stability, the inclusion of credit quality as an underpin also stands to be received positively by regulators and broader stakeholders, and will help banks to be forward-looking and defend the granting bonus awards in these still uncertain economic conditions.

³ This could relate to the standalone financial strength rating of a bank (e.g. a rating that excludes implicit state support and reflects the contingent liability to the state). While the credibility of credit rating agencies has been under attack for their contribution to the financial crisis, we still believe their ratings could be a useful component of such a performance metric. Credit rating agencies' main mistakes leading up to the crisis were in the rating of securitizations, not corporate entities. Moreover, credit ratings are less volatile than market sentiments and are established to withstand normal economic cycles and market volatility.

⁴ The idea of using credit default swaps in bank remuneration has been proposed in an academic paper: “Executive Compensation and Risk Taking” by Hamid Mehran, Patrick Bolton and Joel Shapiro; paper presented at Columbia University (available [here](#)).

⁵ The relationship of non-core liabilities to systemic risk is explored in a recent essay by Hyun Song Shin, Princeton University. “Macroprudential Policies Beyond Basel III”. Winner of the ICFR-FT Research Prize 2010, published by the International Centre for Financial Regulation (available [here](#)).