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*"A better governance for financial institutions:  
what can we do?"*

**- Check against delivery! -**

Ladies and Gentlemen,

It's an honour for me to represent the Federal Financial Supervisory Authority (BaFin) – the German Authority responsible for supervision of Banks, Insurance Undertakings, Pension Funds, Investment Firms and Securities Markets – among such esteemed attendees at the Crans Montana Forum 2009.

My name is Thomas Schmitz-Lippert. As Executive Director I head BaFin's department "International Policy/Affairs". In this function I am responsible for steering and co-ordinating all international activities on a cross-sectoral and fully integrated basis. Basically this means – for me and my staff – to represent BaFin and its interest in all relevant global and European committees and working groups in banking, insurance, occupational pensions and market supervision, to negotiate bilateral and multilateral agreements and to provide technical assistance with regard to supervisory regulations and practices. All together BaFin staff participates in around 170 international working groups.

***Why put the focus on the topic "governance" today?*** Well, the financial crisis showed dramatically how important good governance is, especially for financial institutions. This is because the impact of a bank failure, in particular large and strongly interconnected institutions (like Lehman Bros.), has so much higher repercussions than the failure of a non-financial

undertaking. The Lehman case made it painfully clear to all players at the financial market that the fall of *one* institution (if it is large and interconnected enough) can bring the global financial system to the brink of collapse.

***What went wrong?*** Failures were manifold as the crisis unfolded. All lines of defense fell like dominos. Even though the crisis clearly originated in the US due to a fatal break-down in prudential lending standards on the side of the originators of credit. These toxic assets were instantly pumped into the global system via unchecked distribution mechanism. The originate-to-distribute-model proved near lethal. The so-called distributors of risks were themselves hit hard as they severely underestimated legal and reputational risks – at least those that even were aware of the extent of risks they were running. How could this have happened? In most cases the answer is simple: lack of internal governance and risk culture. Which brings us to the subject matter at hand: failure of internal governance structures. The manner in which *governance* failures have been analysed and discussed, meaning very detailed and quite open to the public, show abundantly, how important this issue is. Let me mention only some key points that led to the current financial crisis

- Risks were fundamentally underestimated or misvalued.
- Innovative products became more and more complex and were not understood by the management.

- Modelling and Stress-testing was based on overly mild or even outright wrong assumptions, underestimating tail risks.
- Over-The-Counter credit derivatives market imploded and went out of control. Instead of facilitating risk mitigation additional risks were created.

After all, these issues were aggravated by the fact that checks and balances of corporate governance also failed.

- Board and senior management members of financial institutions neither understood the characteristics of the highly complex products they were dealing with, nor were they aware of the aggregate exposure of their companies.
- Thus they underestimated the risks they were running.
- In addition board members did not provide the necessary oversight or control of management.

A fundamental aspect – but not the only one as indicated above – of governance that dramatically did provide wrong incentives lay in **remuneration and compensation**. There existing incentive schemes led to excessive risk-taking as short-term expansion of the volume of (risky) trades was rewarded overly much. Long-term profitability of investments and sustainable growth were definitely not in the driver's seat when managers ran their company.

The creation of a framework of sound compensation practices for the future is a top priority item on the agenda of all relevant global and European committees at the very moment.

Therefore I want to touch upon this issue in more detail.

***What did regulators and supervisors do in this area so far?*** Following a thorough analysis by a dedicated working group led by Philip Hildebrand (then Vice-Chairman of the Swiss National Bank's governing board), the then Financial Stability Forum (now: Financial Stability *Board*) did publish "Principles for Sound Compensation Practices" on 2 April this year. In parallel the Committee of European Banking Supervisors (CEBS) developed its "High-Level Principles of Remuneration Policies" which were published on 20 April 2009. On 30 April 2009 the European Commission published recommendations for the regulation of compensation of board members of listed companies and for remuneration policies in the financial services sector. They also made proposals to amend the capital adequacy directive with regard to requirements for remuneration structures.

The above mentioned working group of the FSF found out, that 80% of market participants believed that the existing remuneration structures were aiding to the development of the crisis. According to the report of the group the compensation schemes were not really related to the risk management of the institutions. Especially *tail risks* were not in the primary focus at all. But these risks, even though their likelihood in the normal curve of distribution is very small, they did lead to extremely high losses. Moreover, the working group found that

remuneration committees of the undertakings were only responsible for compensation of the top management level. However, this is not enough with respect to banks and financial intermediaries. At least as important for institutions operating in the financial sector is to have the right incentive structures on the second and third level. Moreover it seems to be important that the back-office staff will be paid just as well as the staff members initiating the risks, namely the traders.

***How can the existing structures be changed?*** It seems quite clear that voluntary agreements of the industry won't be enough. The financial institutions are too high under a competitive pressure with regard to hiring the best personnel. Therefore, the FSF working group proposed to improve independence of the persons responsible for the arrangement and implementation of remuneration schemes. In addition it should be made sure that the responsible persons are high ranking in the organisation. Finally, a better disclosure of the remuneration principles to all stakeholders shall lead to a stronger control by the "prudential investor". Short-termism as it is coined by supervisors has to come to an end. Sustainability and durability of revenues has to come back to the fore-front.

In preparation of the G20 Summit in Pittsburgh the FSB Principles were further sharpened by the FSB working group. Last not least this happened because of the insistency of a few countries – including Germany – vis-à-vis the FSB Chairman. For example it was agreed that guaranteed bonuses should – as

exceptional minimum - only occur in the context of hiring new staff and be limited to the first year.

The latest G20 Summit in Pittsburgh on September 24/25 2009 resoundingly confirmed that *"reforming compensation policies and practices is an essential part of our effort to increase financial stability."* Heads of States and Ministers of Finance fully endorsed the implementation standards of the FSB aimed at aligning compensation with long-term value creation, not excessive risk-taking, including

- **avoiding** multi-year **guaranteed** bonuses;
- requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate **clawbacks** and to be vested in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk;
- ensuring that compensation for senior executives and other employees having a material impact on the firm's risk exposure is aligned with performance and risk
- making firms' compensation policies and structures **transparent** through **disclosure** requirements
- **limiting variable compensation** as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base; and
- ensuring that compensation committees overseeing compensation policies are able to act independently.

Altogether this is much more as one could expect before the meeting. The German delegation contributed vehemently to the rather strong wording as it was finally incorporated in the leader's statement. Especially **reining in guaranteed bonuses** and having the possibility to **clawback** remuneration that has already been paid, if the individual or the institution has not performed well in the long run (sustainably), were important aspects for the German government.

The G20 thankfully also elaborated on the **role of supervisory authorities**. It is conventional wisdom that the best principles and rules make no sense if they are not implemented and enforced properly and consistent across jurisdictions.

The G20 believe that it is the task of the supervisory authorities to assess firms' individual compensation schemes in this respect carefully. In doing so, they need to have sufficient authority. In more detail:

- Supervisors should have the responsibility to review firms' compensation policies and structures with institutional and systemic risk in mind
- if necessary they should offset additional risks, apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices
- Supervisors should also have the ability to modify compensation structures in the case of firms that fail or require extraordinary public intervention.

The FSB will be monitoring the implementation of standards very closely.

***What further work is under way?*** Currently, initial stock-taking is underway to assess whether and how institutions have implemented the principles. Implementation of CEBS' guidelines by the institutions is for example expected to take place by the end of Q3 2009 in order for supervisors to make a first assessment of the institutions' progress in transposing the principles. This is surely a very ambitious target. However, as remuneration is a highly important topic with a huge political dimension quick action is essential.

In Germany requirements on the risk management of insurance undertakings including the incentive structures were recently elaborated in the "Minimum Requirements on the Risk Management of Insurance Undertakings (MaRisk VA)". These requirements were published by BaFin in February this year. Existing requirements for the risk management of banks were already sharpened by adding detailed standards on the form of remuneration schemes and incentive structures which are consistent with the FSB and CEBS principles.

With regard to listed companies *in general* - not only in the financial sector - a law concerning the adequacy of manager's compensation was passed by the German parliament on 18 June 2009. In parallel the *German Corporate Governance Code*

(the Code) was revised by the responsible government commission. The new version has been announced on 5 August 2009.

What are the main points of the new regulation?

- > The Code stipulates that the management board and the supervisory board are obliged to run the company in line with the principles of social market economy and to take care of undertaking's stability and sustainable revenues.
- > The criterion of an **adequate relation** between manager compensation and the work performed has been fixed in the German Stock Companies Act (Aktiengesetz).
- > In addition the criteria of remuneration's adequacy were further substantiated; the term "habitualness of compensation" was introduced.
- > In this regard horizontal (industrial sector, size and country) as well as vertical comparability (compensation arrangement inside the company) should be taken into consideration.
- > Compensation structures of listed companies have to be aimed at a **sustainable development** of the company and **risk mitigation**. Compensation structure must not tempt to take inadequate risks.
- > Remuneration should consist of **fix and variable components**. Variable components should have a perennial assessment base.
- > Variable compensation components could be stock options for example. These options should henceforth be exercised four years after granting the option at the earliest.

- > The obligation to publish managers' compensation will be extended by amending the German Commercial Code (HGB). In the future detailed information with regard to benefits for the case of premature or regular cessation of management activities have to be published. The same applies to amendments of assured benefits.

The signals sent from the US government do also confirm that the issue is taken seriously. Mr. Feinberg, Special Master for TARP Executive Compensation – the so-called "*compensation czar*" – mentioned during a recent Testimony before the House Committee on Oversight and Government Reform that "*the subject of executive compensation **continues to be a top priority of the American people and the international business community***". Mr. Feinberg's mandate was to consider the terms and conditions of the 2009 executive compensation for senior executives at those seven corporations that received exceptional financial assistance from the federal government: AIG, Bank of America, Citigroup, Chrysler, Chrysler Financial, General Motors and GMAC. The proposals by Mr. Feinberg designed to tie compensation to prospective company performance are thoroughly substantial:

- > He reduced cash (which, in the past, included cash base salaries and cash bonuses) by approximately 90%.
- > He reduced overall *total* compensation by approximately 50%.
- > Cash was substituted by "stock salary" which, in accordance with Treasury regulations, vests immediately upon issuance

but may only be redeemed in three equal, annual instalments beginning in 2011, with each instalment redeemable one year early if TARP obligations are repaid.

- > Any such perks beyond \$25,000 per individual must first receive the approval of the Office of the Special Master.
- > The mentioned companies mostly agreed to restructure guaranteed contracts and other forms of guaranteed compensation into prospective, performance-based compensation packages.

To sum up, governance and risk culture are key. Those financial institutions that were best at it – far from perfect – got through the crisis reasonably well, others that did not were only saved by the timely and decisive intervention of their respective governments. Integral parts of internal governance are remuneration and compensation practices as they reflect the overall risk culture in any financial institution. Remuneration schemes need to be closely tied to

- > a sustainable development of a company
- > and sound risk management.

Self regulation in this respect has failed. Only “hard core” regulation implemented consistently across the globe can achieve this purpose. It is the tasks of the regulators and standard setters to strike the right balance between prohibitive rules that ultimately hamper innovative developments and at

the same time leave enough room for flexibility and growth of the financial sector.

Thank you very much for your attention!