Conforming to new rules on pay linked to risk

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IESE Prof. Sandalio Gómez and the consulting firm KPMG analyze the impact of a new European directive on variable compensation on regulators, financial entities and companies.

Recent circumstances in the financial sector have prompted regulators to employ special measures to try to jump-start markets, boost confidence and raise levels of supervision. One of the most controversial moves is variable pay linked to the level of risk undertaken, which forms part of a bill that modifies the European Commission's Directive 48/2006.

To understand the impact of these new rules on Spanish companies in particular, IESE Prof. Sandalio Gómez and the consulting firm KPMG have published "Moving Toward a New Model of Differential Pay Adjusted for Risk in the Financial and Insurance Sector."

They focused on banks, savings banks, credit unions and insurance companies, and interviewed executives involved in designing and managing their companies' pay systems. Their report analyzes how companies perceive the new rules and to what extent they are adapting to them before the December 2010 deadline.

From fulfillment to punishment

The overriding goal of the proposed changes is to encourage financial entities and insurance companies to consider value generation over the medium and long term, based on three principles: tighter control, prudent and efficient risk management, and greater transparency.

In Spain, the central bank will be in charge of monitoring, supervising and imposing sanctions. Instead of merely urging companies to "comply or explain," the central bank will assume greater oversight and impose penalties if companies do not comply.

According to those interviewed, over 60 percent of Spanish companies feel they have achieved a high or very high level of adaptation to the new rules established by national or international regulators.

Structural challenges

This shift of emphasis poses structural challenges for the sector, affecting not only financial entities, but also all companies within a group, from the highest-level executive to the lowest-level employee who take on risk for the company.

Banks, savings banks and other financial companies will have to reconcile compensation policies with risk management policies. This means it will be necessary to rationalize metrics, taking into account all kinds of risk, not just risk involving credit, at a time when regulation is still evolving.

The authors say it will be necessary to seek a joint solution among many different departments — human resources, planning, systems, organization, general directorate — and set short-, medium- and long-term deadlines.

Among other measures, it will be necessary to incorporate new concepts such as deferred pay or clawback clauses, and to revise the functions of committees that determine pay levels as well as the profiles of the people comprising them.

These days, less than half of companies include the setting of long-term goals as part of their pay systems. Most acknowledge they have not established any kind of link between variable pay and the level of risk undertaken.

Unfinished business

The report shows that before the crisis, growth-related goals were the strategic priority of 44 percent of companies in the financial sector. Now that figure is even lower, while risk management and solvency have taken over as top priorities.

The authors make several recommendations to help companies address the many issues that need to be resolved in order to adapt fully to the new regulations.

- *Good Governance*. Companies must decide who determines pay levels, and with what degree of independence, knowledge and control. Furthermore, these governance bodies must work in sync with the risk committee and comply with the various rules in place.
- *Value Creation Over the Medium and Long Terms*. The new rules require mechanisms for the return of pay incentives if goals are not met, the introduction of qualitative elements when it comes to deciding on pay, and linking remuneration to future performance. Many changes must be introduced to meet such requirements.
- *Transparency, Supervision and Reporting*. Providing information to the market and within the company is one of the key aspects of the new rules. Among other measures, companies must have their remuneration policies reviewed by independent pay committees, and give advance notice of the criteria and procedures to be followed to all people affected by pay policies.

Given the ingrained business culture focused on immediate growth, a radical change in remuneration policies will not be easy. For this reason, companies need to come up with a transitional plan designed to nudge the organization toward a new remuneration model linked to proper management of risk.

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