ANTI-CORRUPTION HELPDESK

PROVIDING ON-DEMAND RESEARCH TO HELP FIGHT CORRUPTION

CODES OF ETHICS AND REGULATING REMUNERATION IN BANKS

QUERY

Please provide us with examples of countries that a) force banks to have a code of ethics and, if so, with what successes, and b) have mechanisms to limit salary gaps between senior and junior employees.

PURPOSE

We are preparing for a parliamentary debate.

CONTENT

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SUMMARY

Following the 2007/2008 financial crisis, governments have carried out a variety of regulatory reforms aimed at curbing risky behaviour in the banking sector and preventing future crises. Nested within corporate governance initiatives are regulations on codes of ethics and remuneration policies that set standards and limits for executive compensation. Such measures aim at aligning the interest of bankers with those of shareholders and the market overall.

In terms of existing regulation, there are few countries that mandate the adoption of codes of ethics for publicly listed companies, including banks. In most cases the adoption of a code of ethics is voluntary, as in the case in the UK, Colombia, South Africa and Japan.

In contrast, there have been many national and international initiatives to curb what is deemed "excessive" executive compensation. The mechanisms vary from establishing a fixed pay ratio between CEOs and average workers, to setting caps on bonuses and giving shareholders a "say on pay". While generating popular support, these initiatives have been criticised for being allegedly too arbitrary and having unintended consequences.

1 BACKGROUND ON REFORMS FOLLOWING THE FINANCIAL CRISIS

Many experts agree that the 2007/2008 financial crisis was the worst crisis to hit the global economy since the Great Depression (The Guardian 2011). Many of the major banks in the United States received massive publicly funded bailouts, but the ensuing recession still took a major toll on the global economy (The Economist 2013). With many countries still in recovery mode, the effects of the financial crisis were widespread and detrimental.

In response to the financial crisis, the governments of the 20 leading industrialised and emerging economies (the G20) agreed on a set of actions in order to regulate the global banking sector and prevent such a crisis from recurring. Actions included lowering interest rates, announcing stimulus packages, allowing quantitative easing[1] and committing to bank reforms (Spiegel Online 2013). In the United States, the financial crisis led to the passing of the Dodd-Frank Wall Street Reform Act in 2010, which established mechanisms to monitor systemic risk, limit risky trading practices and protect consumers. Hailed as one of the most significant regulatory reform measures in recent history, the Dodd-Frank Act has both been praised for reducing the risk of another financial crisis and also criticised for over-constraining the financial system (Council on Foreign Relations 2013).

One of rationales behind recent efforts for increased regulation in the banking sector is that banking can be a risky enterprise. According to experts, excessive risk-taking played an important role in the 2007/2008 financial crisis (Bebchuk and Spamann 2009). Banks, in particular investment banks, can have up to 90 to 95 per cent debt (Bolton et al 2011). At the same time, banks can change the risk composition of their assets quickly and easily hide problems (Bolton et al 2011). Moreover, in light of the recent bailouts of some failing banks, it has become evident that this riskiness can also affect taxpayers.

[1] *Quantitative easing is a monetary policy in which a central bank purchases securities from the market in order to lower interest rates and increase the money supply. The goal is to promote increased lending and liquidity.*

Many of the banking reforms therefore attempt to address the moral hazard inherent in certain banking practices. It is argued that executives often do not have to bear the brunt of risky activities. Moreover, the size of large financial institutions also brings challenges related to criminal liability. In recent years, the United States has struggled with bringing criminal charges as these could threaten the existence of the bank and therefore endanger the national and global economy (CNN 2014). Legislators and regulators are therefore moving toward regulating corporate governance to align the activities of executives with the interests of shareholders (Bebchuk and Spamann 2009). This is particularly important as the role of banks and the private sector goes beyond shareholders and can affect the entire economy and wide sectors of the population (OECD 2004).

Among the OECD's Principles of Corporate Governance (currently under review) is the pursuit of strong business ethics – such as embodied by a code of ethics – and an executive remuneration policy that is aligned with the longer term interests of the company and its stakeholders (OECD 2004).

2 CODES OF ETHICS IN THE BANKING SECTOR

While there are differing definitions, a code of ethics generally refers to "a set of behavioural rules employees should follow to ensure the company's values are reflected in all business dealings" (Chron 2014). For example, according to the Sarbanes-Oxley Act in the United States, a company's code of ethics must promote honest and ethical conduct - in particular in cases of conflicts of interest – as well as full disclosure as required, and compliance with applicable government rules and regulations.

National legislative approaches regarding corporate codes of ethics are often found in a country's overall corporate governance regulatory framework. Good corporate governance is meant to gain the trust and confidence of shareholders (TAGLaw 2014).

Enforcement

According to experts consulted within the framework of this Helpdesk answer, most codes of ethics for banks are not regulated by governments but adopted voluntarily. Codes of ethics are usually seen to be areas of self-regulation that are to be decided upon by banks and within the framework of banking associations. There are few countries with a mandatory corporate governance framework, and India, for example, is one of the only countries where the stock exchange authority actually requires publicly listed companies – including banks – to adopt a code of ethics.

The following are some country examples.

Country-level examples

India

India is one of the few countries that mandates the adoption of codes of ethics. Clause 49 of the listing agreement for stock exchanges requires all stock exchange listed companies to adopt a code of conduct/ethics applicable to all members of the board of directors and senior management one level below the board and for this to be published on the company's website (Deloitte 2009).

Within the banking sector, there is also an additional level of self-regulation. Based on the 1977 Ground Rules and Code of Ethics, the Indian Banks' Association (IBA) revised these rules in 1999 and turned them into the IBA Code for Banking Practice, applicable to all associated banks (Indian Banks' Association no date). The code includes restrictions regarding gifts and undue payments, engaging in speculative ventures, in addition to good practices specifically related to banking.

USA

The United States has a legally binding regulatory framework that addresses corporate governance for listed companies, in particular, through the Sarbanes-Oxley Act (SOX) of 2002. Some have criticised the SOX for being too burdensome for companies, in particular, small ones. Other studies show, however, that strict requirements have filtered out firms that are opaque, risky or prone to financial mismanagement and thus regulation has positively affected the market (RAND 2007).

Nevertheless, while the SOX generally takes a "comply or else"[2] approach on most corporate governance matters, it is takes a "comply or explain"[3] approach on the specific issue of codes of ethics. It requires public companies to disclose whether the company has adopted a code of ethics applicable to its chief executive officer (CEO) and its senior financial officers, and if not, why not. Despite this light-touch approach, experts still agree that this "effectively mandated the creation of such codes at public companies." (Dinkoff 2011).

However, this is not the only regulation to cover codes of ethics. Both the New York Stock Exchange and the NASDAQ stock exchange require listed companies to implement procedures that go further than the SOX. In particular, these requirements call for a publicly-accessible, company-wide code applicable to all employees that encourages reports on unethical behaviour and offers protection to those who come forward with any reports (Dinkoff 2011).

United Kingdom

The UK does not have specific provisions on codes of ethics. On other corporate government issues, however, the UK has a Corporate Governance Code (revised in 2012) which is applicable to all listed companies incorporated in the UK, which includes banks. Companies are required to apply the principles in the Corporate Governance Code – which does not specifically refer to ethical issues – and explain to shareholders how they have done so. Deviation from the code is permissible so long as the justification is appropriate (Bloomberg Law 2011).

Since the start of the financial crisis, there have been some moves towards stronger self-regulation in the UK banking sector. A coalition of some of the UK's biggest banking institutions have signed up to a new ethical code of conduct that would include commitments on acting fairly and paying attention to risks (Financial Times 2011). This voluntary initiative – called the Chartered Banker Professional Standards Board – is overseen by a board of senior-level members from the banking industry who monitor the banks' progress (Financial Times 2011). In September 2013, it was announced that a new

[2] *Where provisions are legally mandatory.*

[3] *Where companies can be non-compliant on the basis of reasonable justification.*

professional body would monitor standards within the banking industry (The Telegraph 2013). Sir Richard Lambert, former director-general of the Confederation of British Industry has been asked to design and chair this body, with recommendations expected to be published by the end of March 2014.

Colombia

According to experts consulted within the framework of this Helpdesk answer, the Financial Superintendence of Colombia (FSC) has an internal department with professionals specialised in the supervision of corporate governance, including on codes of ethics. Colombia takes a “comply or explain” approach. Therefore, its recommendations are for voluntary adoption by the supervised institutions. However, companies are expected to justify their corporate practices and send these annually to the FSC, which then carries out a survey of the best corporate practices in the country.

South Africa

In South Africa, business ethics are primarily shaped by the King Reports (named after Mervyn King, the chair of the committee on corporate governance) of 1994, 2002 and 2009. Compliance with the reports is a requirement for companies listed on the Johannesburg Stock Exchange (Institute of Directors in Southern Africa 2009). The reports also establish recommended standards of ethical conduct for board members and directors of listed companies and banks. Although some governance issues are legislated, the section on companies adopting a code of ethics is not enforced through legislation. Instead, the Johannesburg Stock Exchange requires listed companies to provide a narrative statement as to how they complied with the principles of the report and whether their reasons for non-compliance were justified (Institute of Directors in Southern Africa 2009).

The 2004 Code of Banking Practice – formalising standards of transparency, good conduct and fairness – is a voluntary measure by all major consumer-lending banks in South Africa (The Banking Association of South Africa 2013). It was revised in 2008 and 2012 to adapt to changes in the banking environment.

Japan

The Financial Services Agency (FSA) serves as a regulatory authority of financial institutions. In 2008, it published the Principles in the Financial Services Industry, which sets a code of conduct that is the underlying basis for laws and regulations and should be respected by financial firms (Japanese Bankers Association 2009).

In the wake of recent manipulation scandals, the Japanese Bankers Association is launching a code of conduct, which banks must observe when they set financial benchmarks (Financial Times 2013). The association said it would also set up an independent monitoring body to oversee the operation of the process and hire outside auditors to improve governance (Financial Times 2013).

3 REMUNERATION POLICIES IN THE BANKING SECTOR

Background

Criticism of “excessive” compensation schemes

In light of the financial crisis, experts and policymakers are concerned about the level of risk-taking by executives in the financial sector, which appeared to be fuelled by specific remuneration policies. Critics argue that executives are often incentivised to go for quick wins rather than focusing on long-term shareholder value (Bebchuk and Spamann 2009). It is argued that while bank executives share the gains of a successful company by owning shares, they are insulated from its losses.

While companies in North America, Western Europe and Australia still top the list of highest earning executives, emerging markets are steadily increasing their executive compensation (The Indian Express 2013). In fact, experts predict that executive compensation in Asia will surpass executive pay in the United States in the near future (Howard 2013). Experts warn, however, that the executive pay rise in Asia is linked with little or no oversight by government institutions or formal regulatory bodies (Howard 2013). Howard (2013) notes the Indian government has embraced the “spirit of corporate governance” by permitting self-governance of executive compensation. In China, a lack of transparency in remuneration packages has often masked hidden payments (Howard 2013). However, there has been a recent move towards greater regulation and public disclosure of executive compensation in Asia. For example, in India, salaries of banking heads need to be approved by the Reserve Bank of India (The Economic Times 2013).

A 2013 report by the Institute for Policy Studies revealed that of the 500 highest-earning CEOs over the last 20 years, 112 were from companies that collapsed or received government bailouts (Institute for Policy Studies 2013). In the UK, the pay of senior executives at some banks was the source of public anger as, in the case of Barclays, this was done despite a 30 per cent drop in share price and, in the case of the Royal Bank of Scotland, after thousands of employees were made redundant (The New York Times 2012).

Critics have recently gone beyond pointing to the absolute amount of executive compensation and looked at its relation compared to non-executive employees. The American Federation of Labour and Congress of Industrial Organisations has a global map of CEO-to-worker pay ratios in public companies of different countries. According to their calculations, the United States tops this list with a ratio of 354:1. In comparison, countries such as Austria (36:1), Norway (56:1), Japan (67:1) have much greater parity in terms of salaries. While this ratio covers both finance and non-finance firms and is substantial on its own, it has been noted that the compensation of CEOs in the financial sector outpaces that of other firms (Core and Guay 2010).

Mixed views on regulating remuneration

As a result, some of the leading financial countries, such as the United States and in the EU, have taken steps to force banks to regulate their remuneration and reduce excessive compensation. Many of these policies aim at aligning executive compensation with the interests of shareholders. In other words, executives should receive the same losses as shareholders when the company underperforms. However, some experts are cautious about this. Experts consulted within the framework of this Helpdesk answer note that most investors hold shares for less than a year, which is not necessarily a long-term perspective. In addition, some studies have found no evidence proving that banks with CEOs whose incentives were better aligned with shareholder interest performed better during the crisis, with some banks actually performing worse (CATO Institute 2010).

Another counterargument offered is that there is no “excess” in executive compensation, justifying it as necessary to retain and reward quality staff. Core and Guay (2010) also attempt to debunk the notion that US executives far out-earn other CEOs by pointing out that executives are subjected to greater equity risk. Moreover, some also argue that growth in salaries has followed the growth of the stock market (CATO Institute 2010) and the increased size and complexity of companies (Core and Guay 2010). It is also argued that high levels of compensation alone are not destabilising to individual firms or the overall financial system or to be seen as a failure of corporate governance (Council on Foreign Relations 2010).

Some experts advise against governments setting compensation levels (Council on Foreign Relations 2010). They point to the unintended consequences of government regulation, which can, for example, push the most talented staff to unregulated firms in other countries (Council on Foreign Relations 2010).

Practices

The practices listed below provide an overview of the approaches regulators and policymakers have taken in addressing bankers’ remuneration. There are also a variety of other approaches proposed by experts and academics that are not listed here.

Addressing the pay ratio directly

Disclosure

Due to the high salaries of some executives, the compensation structure of banks in the **United States** has come under extensive criticism. One of the indicators used to assess the extent of these salaries and whether they can be deemed “excessive” is to compare them with the median salary of other employees. However, this median pay data often does not exist for many companies (Bloomberg 2013). The first step, therefore, is to increase disclosure and transparency.

In September 2013, the US Securities and Exchange Commission (SEC) voted to propose a new rule that would require public companies to disclose the ratio of the compensation of its CEO to the median compensation of its employees. The rule, which was required under the Dodd-Frank Act, is meant to foster greater compensation fairness within companies. However, it has been widely criticised by business groups, such as the US Chamber of Commerce and the Centre on Executive Compensation – and even by some members of the SEC – for adding an administrative burden on companies (Reuters 2013b). Proponents of the bill counter that this argument is an exaggeration. The bill allows companies to use statistical sampling or estimation to calculate the median play and thus gives companies flexibility (Wall Street Journal 2013).

While new rules in the **UK** require banks with more than £50 billion (US$83 billion)[4] in assets to publish details of pay of their eight highest-paid non-board executives (Telegraph 2011), to date no regulation has been passed regarding disclosure of pay ratios, despite the urging of experts in a report on pay commissioned by the UK government in 2011 (Bloomberg 2011).

Fixing ratios

The Trade Union Congress, a federation of trade unions in the **UK**, has called for a 20:1 pay ratio cap for companies in the UK (Trade Union Congress 2013). Following the success of its "say on pay" referendum (see below) and going further than the proposal of the British labour movement, in November 2013 Swiss citizens voted on a referendum that would cap ratios at 12:1. However, this was rejected (The Guardian 2013).

The **European Commission's** revised rules on state aid for failing lenders caps the salary of senior staff at banks receiving new state funds to no more than 15 times the national average salary or 10 times the wages of the average worker at the bank (Financial Times 2013). According to experts, the European Commission hopes that this will motivate bailed-out banks to quickly pay back their loans and act as a deterrent (Financial Times 2013).

[4] *Note: Transparency International takes "billion" to refer to one thousand million (1,000,000,000).*

In addition, the European Commission is currently working on a draft proposal – due to be unveiled in April 2014 – that would give shareholders the right to vote down the ratio between board pay and the average full-time worker (Financial Times 2014). The draft proposal would require shareholders to approve remuneration for directors, set a maximum pay and bonus level, and a policy to determine the director-worker pay gap and an explanation for why this ratio is considered appropriate (Financial Times 2014).

Capping bonuses

The practice of capping bonuses in banks is one that has gained much traction over the past few years. In light of scandals surrounding large bonuses paid out to executives of bailed out and/or failing firms, the argument used to justify bonus caps is that bonuses reward success without penalising failure and thus encourage short-term excessive risk-taking – one of the alleged causes of the financial crisis (The Spectator 2013). Therefore, bonus caps are argued to help prevent another crisis. However, some studies have attempted to debunk this argument. A study of Wall Street banks by the University of Southern California actually found that bonus schemes reduce incentives for risk-taking and that the financial crisis of 2008/2009 had little or nothing to do with the Wall Street bonus culture (The Spectator 2013). Experts argue that targeting bonuses is a result of frustration by the general public and politicians rather than based on evidence (Core and Guay 2010; BBC 2014).

In a move to prevent excessive payouts and curb risk-taking, the **EU** agreed on rules in May 2013 that would implement a bonus cap of 100 per cent of annual salary or 200 per cent with shareholder approval, for any bankers earning more than €500,000. By December 2013, the regulation was reduced to allow banks to ask for exemptions for staff earning up to €1 million. However, many observers have noted that the bonus cap would not have any effect on executive pay, as banks simply off-set the bonus by increasing the salaries (EU Observer 2013).

The original EU proposal from May 2013 was challenged by the **UK** government in September 2013 both on a substantive basis (it was doubtful of the proposal's ability to improve stability among the banking system) as well as concerns about the proposal going beyond the powers delegated to the European Banking Authority (Mondaq 2013). While the challenge does not delay or suspend the enforcement of the bonus cap provision, it is expected that the UK's challenge may be reflected in a lenient interpretation of the bonus cap in the UK (Mondaq 2013). In fact, in February 2014, EU regulators were questioning the Bank of England over novel forms of "fixed pay" that allegedly appear to be circumventing the bonus cap (Financial Times 2014).

The government of the **Netherlands** is preparing a proposal due to be submitted in spring 2014 that would require a 20 per cent cap on banker bonuses in the Netherlands (Dutch News 2013). This is a significantly lower cap than the EU regulation.

Following public outrage in the **United States** about the record bonuses banks paid to senior staff in 2009 following public bailouts (CNBC 2013), the US government established new rules under the Troubled Asset Relief Program (TARP) for regulating remuneration at firms receiving government assistance, which includes limiting bonuses to one-third of total compensation that must be paid in long-term restricted stock (Core and Guay 2010). The condition on long-term restricted stock aims at ensuring that executives cannot quickly cash in their stocks and thus have to adopt a more long-term perspective. Other rules under the TARP include clawback[5] provisions on any bonus deemed to have been earned based on inaccurate financial statements; prohibiting severance for the most highly paid executives; and increasing disclosure on perquisite consumption[6] (Core and Guay 2010).

"Say on pay"

In recent years, experts and observers noted what they called a "shareholder spring" in which investors have protested against the salaries for top executives at big public companies and, in some cases, overturned them (Bloomberg View 2012). Although the term and phenomenon remain contested, experts note the recent initiatives taken by lawmakers, both national and international, to strengthen the role of shareholders in having a "say on pay" (Corkery and Medarevic 2013). The justification behind such measures is that while deciding on salaries is a managerial task and not necessarily the role of shareholders, a self-managing system where executives are determining their own remuneration can lead to one in which the performance hurdles are low and remuneration is excessive (Corkery and Medarevic 2013).

The aim of "say on pay" measures is to signal to a board not to raise salaries beyond reasonable levels. A variety of measures have been implemented in different countries, some more successful than others. Some give shareholders an advisory role, whereas other mandate active shareholder involvement.

For example, in the **United States**, as mandated by the Dodd-Frank Act, all public companies must give their shareholders an advisory vote on executive pay (Business Insider Australia 2013). Shareholders in **Belgium**, **Canada**, **France** and **Germany** have a non-binding say on pay (CFA Institute 2013). In contrast, **Italy**, **Netherlands**, **UK** and **Switzerland** give shareholders a binding vote (CFA Institute 2013). For example, the new legislation from 2012 requires remuneration policy in UK public companies to be subject to a binding shareholder vote at least every three years (Business Insider Australia 2013). In Switzerland, Swiss voters passed a referendum in 2013 that would give investors complete control over executive compensation. In detail, this means that shareholders can veto executive pay proposals as well as ban big rewards for new and departing managers (Reuters 2013a).

In **Australia**, shareholders can vote against pay rises of board members but the vote is non-binding. However, shareholders can sack some or all of its board members. Some observers have noted that this has strengthened pay-performance linkages (Business Insider Australia 2013). However, others have criticised the construction of the rules on voting as being unconducive to any meaningful changes (Towers Watson 2013a). In March 2013, **Germany**'s ruling coalition said it would introduce legislation to give investors more control over executive compensation, however this proposal – that would have required a binding annual shareholder vote on

[5] Clawbacks are contractual provisions to recoup bonuses paid to executives based on financial statements or performance metrics that turn out to be materially inaccurate.

[6] Perquisites are non-salary or benefit-related privileges.

pay policies for German-listed companies – was rejected by Parliament in September 2013 (Centre on Executive Compensation 2013).

With the exception of **India**, say-on-pay policies have not yet become common in corporate governance in Asia (Investopedia 2013). In India, compensation policies and limits are approved and, in some cases altered, by shareholders. In contrast, in **China**, shareholders are only sometimes given a binding vote on specific compensation, such as bonuses.

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