Governance reforms at financial institutions should involve lower executive pay, argues law professor

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Compliance and legal staff and senior executives at financial institutions need to deeply engage their bankers and traders to convince them to accept lower compensation for sound corporate governance, said a British law professor. Following a recent event in Hong Kong, the academic said all institutions needed to implement simpler pay structures for good stewardship. He said responsible remuneration plans — without pre-global financial crisis-level bonuses and complex incentives — should be implemented at financial firms the world over.

"Stewardship is the way forward … and long-term engagement with your company and your executives. That, to me, seems to be lower pay and more responsible pay strategies, no bonuses and no complex incentives," said Alan Dignam, a professor of corporate law at Queen Mary, University of London. "Move towards more simple structures for pay if you want to be good stewards of your company over the long term," he told Compliance Complete.

Dignam, speaking at the University of Hong Kong’s (HKU) Asian Institute of International Financial Law, said that the corporate governance reforms of the past 30 years had made elite remuneration problems worse. They had created a regulatory construct that neutered executives and distanced shareholders from important internal governance matters, such as remuneration, while treating the disclosure of elite salaries as a legitimising tool.

In the public sector, he said, the mimicking of private sector agency cost-reducing norms and transparency initiatives had a similar accelerating effect on the salaries of the upper echelon. The result in all sectors was high elite pay, as neutered executives and public servants sought remuneration as a proxy for power, prestige and service.

Yet, Dignam said there was a steady increase in public awareness of and unhappiness about top remuneration.

He said the answer to remuneration problems was in returning discretionary managerial power to executives and public servants, by removing agency cost-reducing initiatives. Genuine solutions, said Dignam, were likely to be found by ending quarterly financial disclosure, exempting public sector salaries from Freedom of Information Act requests, ceasing to use performance-related targets, reducing the influence of non-executive directors, increasing exit costs for shareholders, allowing boards to use their powers to defend takeovers, using average pay ratios and employee say-on-pay rights, and removing compensation disclosure requirements.

"The financial sector has got to have greater regulation and … separation of retail and investment [banking]. There has got to be a culture change and probably a bottling up of disclosure," Dignam said.
But he said that solutions for the financial sector would be different from the corporate world more generally.

“There isn’t an easy one [solution] for the financial sector. The UK is regarded as getting there, but the only element that is missing is the separation of retail and investment banking, which does not look like it is ever going to happen.”

The fluid nature of banking and financial talent was also problematic with regard to recompense, he said.

“The difficulty with pay for financial services is that there is a global element and it is not necessarily at the chief executive level, but at the trader level. The culture of pay is driven by the fact that ... people move around from different banks; talent moves around,” he said.

**Compliance implications**

A continuing issue is the gap between legal and compliance professionals at institutions and those that bring in business, with those manning compliance teams not making as much those in sales. Dignam said it was a perennial issue since compliance functions were cost centres, but added that post-financial crisis, compliance staff had more power.

"In the British context, compliance officers are now at the board level. They are very close to the top and much more highly regarded than they were before the financial crisis; they are way more powerful than they used to be ... and for some people, that may be enough," he said. "They have become essential to financial services, but the question is, ‘are you after money or power?’"

He said Dignam many of his former students had in recent years left law firm jobs to take up compliance roles at financial institutions.

"The attraction for them is partly lifestyle, but also power. They are a power centre; things come through them all the time. Most of the board decisions have to come through them," he said.

Dignam said his students had found compliance positions to be fulfilling partly because their authority was respected as the UK’s financial sector was taking regulatory compliance more seriously post-2008.

"There is a lot of fear at the moment in the British financial services sector. They tell me that nobody tries to get around them," he said.

**Lessons for Asia**

The UK’s experience may not necessarily apply to regional financial hubs like Hong Kong and Singapore because results seem to be the region’s sole imperative, Dignam said.
"If institutions want to engage with the public debate about pay, that is separate from performance," he said. "The focus here [in Hong Kong] is probably still on performance. In the UK, there is a public debate that pay should be restrained as almost a moral equality issue. But in Hong Kong and Asia more generally, inequality is greater."

Dignam added that regional debates and responses on the topic of executive pay were not as emotionally charged and rancorous. He attributed this to relative views of financial institutions in Asia compared to the UK.

"People do not seem to get as angry here about these large salaries. There are deeply cultural and societal aspects to these things," he said. "Banks in the UK are not well regarded at the moment, but they are probably better regarded here than there."

Disclosure will not fix everything

The financial sector had contributed to salary inflation because large financial centres had pushed for open disclosure of recompense, Dignam said.

"We have an open disclosure system in the UK whereby all salaries are now in annual reports. You can find any director's pay level. In that context salaries have gone up because everybody knows what everybody else is paid. So you can see where this headed," said Dignam.

Average salaries in the financial sector had, therefore, been pushed up which increased both remuneration and risk.

"The financial crisis has firmly established a link between remuneration policy and risk which we did not understand before. Generally, the proposition before was 'no one would … consciously try and put together a remuneration package that would destroy a company," said Dignam. "We now know that actually, you could do that. So risk has become a new part of the debate on remuneration."

Dignam's approach may not appeal to the U.S. or Asian societies, said some.

"It does not follow … that reducing disclosure will solve the problem to restore fiduciary responsibility because executives will somehow get their [power] back," said Syren Johnstone, associate adjunct professor of law at HKU. "In my view, reducing transparency would be a backward step. The forward step would be to ask ‘through what means can we make better use of what transparency provides?’"

Stewardship is key for financial firms

Concerns over compensation and risk have triggered a new round of corporate governance reforms in the UK, said Dignam, with focus on more non-executive directors and greater disclosure.

Dignam, on the other hand, is an advocate of stewardship, which, he argues is a paradigm shift from the centuries-old practice of disclosure in most common law jurisdictions.
"Stewardship is totally different; it means going in a different direction which requires engagement," Dignam said. "Our whole system for the past 100 years has been based on disclosure and then, more recently, since the 1990s, on non-executive directors."

For example, the UK Enterprise and Regulatory Reform Act (2013) requires shareholders to engage and vote to approve remuneration and policy.

"We have had lots of reports, lots of reviews of what went wrong with the banking sector and none of it stemmed the public's anger. This is the first year where the banks have tried to get a lid on remuneration," Dignam said.

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