

# THE ETHICAL FOUNDATIONS OF MANAGEMENT REMUNERATION IN THE BANKING SECTOR

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## I. Preamble

- The ethical principles on which management remuneration systems are based are becoming an indispensable factor for sustainable success in the banking sector.
- Sustainably successful banks form an essential part of the economic and social fabric of stable societies. They perform core service functions for citizens, the economy and the state. They make a significant contribution to maintaining confidence in the system and they promote growth and welfare. Consequently, their decision makers carry a large burden of responsibility.
- Responsible leadership essentially requires that decisions and actions are always deducted from and accounted for on the basis of two distinct principles: a common ethical basic understanding on the one hand and the global options for action that exist in practice on the other.

Accordingly, both of these aspects need to be taken into account when responsible leadership is assessed:

This implies that, as well as strategic criteria and financial indicators, an ethical dimension must be introduced into the performance appraisal criteria that determine the remuneration of managers in the banking sector based on the leadership decisions.

- Introducing an ethical dimension into management remuneration systems demands a framework for orientation that complements the regulatory constraints and defines the principles of responsible corporate conduct against which the decisions and actions of management can be judged. The necessary self-conception for that cannot be mandated or enforced by legislation or legal ordinance. Instead, a credible self-imposed commitment on the part of decision makers is required, accompanied by appropriate action, so that the banking sector and its leaders can regain the trust of the people.
- To this end, the banking sector needs to respond to demands from the general public to formulate its own definition of performance. This is based on the conviction that the banking sector can only fulfil its obligations successfully in the long term by observing ethical principles, adopting sensible rules and winning the approval of society at large. This consent demands that the remuneration arrangements of managers do not contain any incentives to profit realisation that damage the community.

## II. Key messages

- Management remuneration also needs to be based on ethical principles as well as on measurable factors and financial indicators.
- This means that corporate activities should not be oriented towards short-term profitability alone, but taking a long-term view on criteria that lasting economic success depends on. Every company needs to demonstrate its own trustworthiness, to win the trust of people working in the banking sector and to gain the confidence of the social market economy in general.
- An ethical framework for the remuneration of management must be included in company-specific target agreements and performance assessments. This demands the following:
  - Every payment must be clearly justifiable and appropriately associated with a services rendered.
  - One of the decisive factors in performance assessments is that managers are required to act according to company-specific values that need to be clearly transparent inside and outside the company.
  - Accordingly, the satisfaction of employees and customers are relevant factors for calculating variable salary components.
  - Every company should set maximum limits for the overall remuneration of its management staff for the financial year in question and justify them accordingly.
  - Appropriate consideration needs to be given to market-driven earnings that cannot be specifically attributed to the performance of the company's management when decisions are taken on profit-oriented variable payments. This implies that variable salary component must not be exclusively fixed to a rigid set of financial indicators.
  - Any loss of earnings, short-time working or redundancies among employees that are necessary in times of crisis and the measures that are adopted need to be given appropriate consideration in the variable remuneration of managers.
  - Management remuneration systems must counteract any incentives that promote excessive risk-taking.
  - Managers that take risks and that stand to gain an advantage from taking them must also suffer the disadvantages caused as a consequence of taking these risks and be in a position to pay the price.
  - Decision-makers must deal with the issue of external expectations and be in a position to deliver a credible opinion and enter into a dialogue, if these expectations are found to be excessive (dialogue ability).

### **III. Principles for an ethical foundation of management remuneration systems**

#### **1. The role and responsibilities of the banking sector in business and society**

- Banks provide an extensive range of services in the field of monetary transfer and supply private customers, corporate clients, the state and state institutions with credit:
  - Banks provide payment services for the real economy, they supply companies with liquidity and credit and they assist them in managing risks. They trade their own capital and clients' capital on the financial markets, and they provide the necessary support functions that enable goods and services to be traded successfully on international markets. They help create value for their customers.
  - They also provide services to private customers such as wealth management, pension provisions and setting up and incorporating enterprises.

#### **2. Sustainability and fairness**

##### **2.1. Reliable regulatory framework**

- Banks depend on having a reliable regulatory framework. They are required to act according to a set of rules and regulations that are imposed by national and international bodies, and they avoid engaging in regulatory arbitrage that leads to disadvantages for others.

##### **2.2. Value orientation**

- Establishing trust is one of the most important prerequisites for sustainability in business. Companies need to gain the trust of their workforce and stakeholders, of the wider banking sector, and of the market economy as a whole. This also includes entering into a social partnership based on mutual respect.
- Aside from measurable factors, key figures and financial indicators, one of the most effective ways to gain and retain trust is to publicise value according to which company decisions are made and implemented. Employees, customers, the general public and the political arena all need to be able to identify the values on which the actions of management are based. They also need to appreciate how these values are implemented in decisions and actions, as otherwise management will be in danger of losing trust. Therefore, the satisfaction of customers and

employees are both factors that need to be taken into consideration for calculating variable salary components.

- In view of their fundamental importance for sustainable success of the company, value-oriented performance assessments must be incorporated in the company's own strategies, contracts and/or target agreements.
- Value-oriented management involves making a critical appraisal of the incentives contained in the company's management remuneration system in order to assess whether they encourage or discourage behaviour that conforms to these values, which is designed to gain trust.

### **2.3. Sustainability, performance orientation and self-imposed restrictions on rewards**

- In the banking sector, sustainability does not depend on short-term profits alone. Lasting success depends to a much greater extent on long-term factors. One of the most important of these factors is trust.
- Every payment must clearly be justified and appropriately associated with a service rendered.
- The company's resources, including the resources that are used to pay salaries, must be managed prudently. To this end, all banks need to apply maximum limits to the overall remuneration - consisting of fixed and variable components and including *long-term incentives* (LTI) - of their management staff at the time at which payment is decided upon for each financial year, and they also need to justify this decision.
- Companies need to ensure an appropriate balance is struck between overall remuneration and retirement pensions and similar auxiliary benefits.

### **2.4. Taking special effects into account**

- Appropriate consideration needs to be given to market-driven earnings that cannot be specifically attributed to the actions of management when profit-oriented variable payments are calculated. This implies that the variable salary components must not be exclusively bound to an inflexible set of financial indicators.
- A successful response to crises – when compared to competitors – ought to be rewarded appropriately in the variable remuneration of managers.
- Any loss of earnings, short-time working or redundancies among employees that are necessary in times of crisis and the measures that are adopted need to be given appropriate consideration in the variable remuneration of managers.

### **2.5. Avoiding false incentives**

- The stability of the system plays a decisive role in determining the lasting success of the company and its long-term viability. It must therefore be reliably ensured that management remuneration systems do not contain any incentives that may lead to excessive risk-taking. Managers that take risks and that stand to gain an advantage from taking them must also suffer the disadvantages caused as a consequence of taking these risks and be in a position to pay the price. This is the only way to ensure the stability of the system.
- Management remuneration systems must counteract any incentives that promote excessive risk-taking. In particular, it needs to be ensured that variable payments are not determined by the return on shareholders' equity alone.

### **3. Ability of dialogue**

- Nowadays, management responsibility involves contributing to the social discourse beyond the immediate focus on the company. The demanding challenges that society is faced with today will only be overcome collectively through cooperation in the fields of politics, businesses and civil society organisations. Correspondingly, the public also expects companies and their decision makers to play a constructive part.
- One of the most important features of responsible leadership is that managers are be prepared and able to make and review their decisions in the light of their values as well as the facts, and to justify their decisions in front of others. In particular, being open to dialog involves taking a critical approach to external expectations and being prepared to criticise them if they prove to be excessive.

### **4. Implementing an ethical foundation for the remuneration of management**

- The implementation of an ethical foundation for the remuneration of management in contracts, target agreements, performance assessments and in the company's own management remuneration system is the responsibility of the respective executive and supervisory bodies.

#### **Companies:**

Commerzbank AG

DZ Bank AG

HypoVereinsbank

Deutsche Bank AG

HSBC Trinkaus & Burkhardt AG

#### **Facilitator:**

Wittenberg-Center for Global Ethics ([www.wcge.org](http://www.wcge.org))