ROBECOSAM
We are Sustainability Investing.

Insight

# Driven to Destruction: why incentives matter in the banking sector

**Understanding organizational incentives is an integral step to evaluating the quality of a bank's business model. So much so, that RobecoSAM's research analysts incorporate an incentives assessment into every sustainable equity research recommendation. The additional insight allows RobecoSAM to uncover underappreciated, high quality and sustainable investments. This insight report further highlights the importance of incentives through two research extracts taken from banking sector investment recommendations used in RobecoSAM's Sustainable European Equities portfolio. In future, RobecoSAM intends to incorporate the incentives evaluation from the investment process into the annual Corporate Sustainability Assessment to encourage best practice within the banking industry.**

### Cutting through complexity

The universalization of banks and resulting expansion into products beyond the realm of prudent credit risk management has increased operational complexity for executives. Inherently, as banks launched more business units and products, management knew less about the situation on front line operations. To tackle the challenge, good managers directed their employees by instilling a company culture that promoted values aligned with good banking and maximizing long term value creation.

Leading up to the global financial crisis (GFC), less cautious managers neglected the importance of company culture and found their employees were involved in increasingly risky business practices. The result was that many banks accumulated low quality assets, faced intense regulatory scrutiny and suffered unprecedented penalties. In most cases, incentives were cited as a key contributor to employee misconduct and poor business practice. Indeed in 2009, 98% of bank employees surveyed believed that executive pay schemes were a factor that triggered the GFC (Institute of International Finance, 2009)

RobecoSAM conducted an incentive scheme review on banks that either failed during or faced significant penalties after the GFC. One finding highlighted that the misalignment of non-executive employee incentives was a crucial element in some of the largest banking offences. In particular, sales and client facing employee incentives were the greatest sources of operational risk, but often the situation was exacerbated by conflicts of interest within risk management and compliance divisions.

### Ugly Design

There are many examples of poor incentive design for client facing employees, but in general they exhibit common characteristics in their mishandling of strategy, incentive structure and business ethics. Strategically, badly designed incentives focused solely on short-term financial objectives and remunerated to encourage the unscrupulous sale of highly profitable products. Their structure typically relied on quantitative data to determine bonus pay and often used volumes sold as the primary performance metric for success. While reps frequently sold products to clients irrespective of their suitability, or acted on the behalf of, and at the detriment to, customers in order to meet their variable compensation targets. Examples of such incentive driven misconduct increasingly emerged across the globe as organizational and product complexity shrouded employee wrongdoing.

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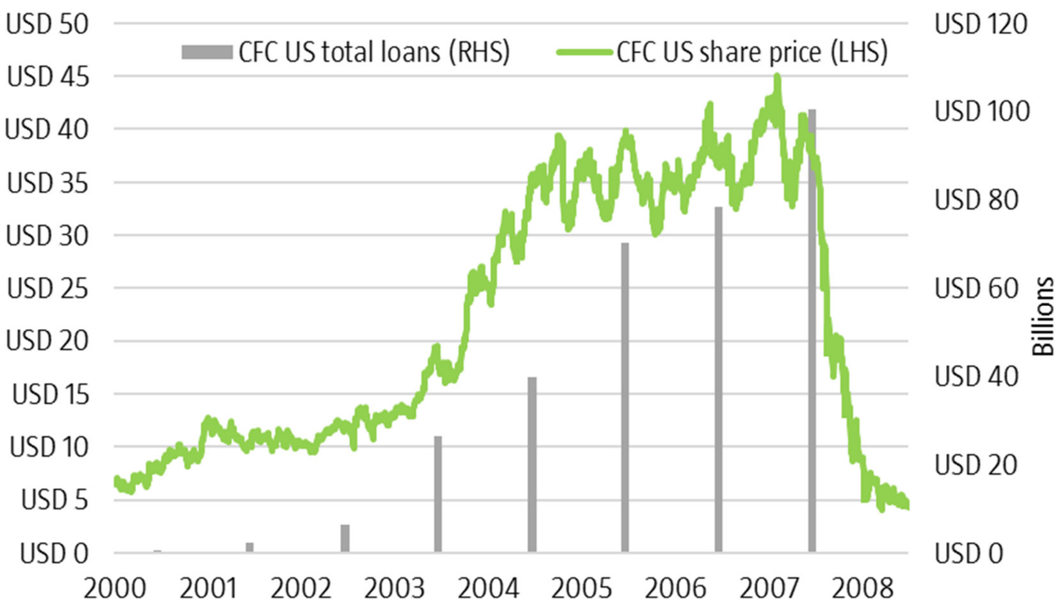
### Risky Business

Lenders in the United States suffered considerably from their volume based incentives. More particularly in April 2007, New Century Financial Corporation filed for bankruptcy after the company announced its intent to reinstate 2006 accounts, was unable to secure wholesale lines of credit and saw its share price plummet nearly 95%. From 2000 to 2006, investors rewarded New Century's rapid growth in lending volume, pushing up the bank's stock price by almost 600%. During the six years, New Century increased its real estate loans from 0.03% to 2.8% of the US total and in three of those years originated approximately 10% of all new US real estate lending – see Figure 1 (FRED, 2016). The expansion was largely attributable to New Century's unmonitored relationships with mortgage brokers and the bank was resultantly unaware of its new assets' inferior quality. At the center of the lender's unintentional and heightened risk exposure were poorly designed broker compensation agreements, which encouraged the origination of low quality sub-prime loans. New Century compensated its mortgage brokers with origination fees and also the yield spread premium (YSP). In theory, YSPs were an indirect way for New Century to incentivize brokers to sell more of their product (Permanent Subcommittee on Investigations, 2011). What the bank had not realized was that the compensation arrangement rewarded its brokers more when they offering mortgages to lower quality borrowers. Indeed when controlled for other factors, New Century loans associated with higher broker profits had a greater risk of future delinquency (Berndt, et al., 2010).

Figure 1: Investors clamored for New Century's rapid growth strategy until the bank filed for Chapter 11




Source: FRED, 2016

Credit card issuers in the UK are still compensating customers for their misconduct around payment protection insurance (PPI). Since 2011, UK banks have cumulatively provisioned more than GBP 30 billion for consumer PPI misselling redress (UK High Street Banks, 2015). Retail banks prioritized selling PPI and in total sold over GBP 44 billion worth of policies between 1990-2010 (Dunkley, 2016). The focus arose largely because PPI was extremely profitable through high commission rates and minimal claimant costs. Management's focus on product profitability was translated into PPI focused variable pay, which encouraged relationship managers to sell products for profitability over customer needs (Financial Conduct Authority, 2008). The PPI strategy made retail banking extraordinary profits because the policies were sold to consumers regardless of their needs and using unethical sales practices. In the years leading into 2006, PPI represented a growing percentage of retail banking profits. Indeed, more than 33% of one UK high street bank's net income was from PPI premiums after claims and expenses (Lloyds Banking Group, 2006). Ultimately, management's variable compensation drove the strategy because many executives were evaluated using divisional or company-wide profitability. However, those goals cascaded through the organizations resulting in advisors and relationship managers becoming highly incentivized to sell the product.

Spanish banks inappropriately sold preferred shares and subordinated debt, known as hybrid securities, to their savings customers causing them significant losses. The regulator established an arbitration scheme and initiated enforcement action on all the involved banks. The Spanish banks sold the hybrid securities as substitutes for simple deposits, however in reality customers received variable income and were at risk of losing their capital. In addition, the banks led customers to believe they were liquid securities, but in fact the bank did not guarantee the customer's ability to sell when they needed the cash. Sales incentives schemes were used to encourage banking staff to sell the riskier hybrid securities instead of promoting normal savings accounts (Zunzunegui, 2013). The order came from management because Spanish banks needed to recapitalize after incurring substantial losses on real estate loans. Some banks discovered that misselling hybrid securities to retail customers could expedite the capital raising process. To meet regulatory capital requirements, management implemented branch level hybrid product sales targets. However to meet those targets, sales staff coerced customers into buying hybrid securities by understating the products' risks and misleading depositors with false information (Bloomberg, 2012). Customers incurred losses when Spanish banks needed to recapitalize bailing in the hybrid securities, which led to widespread complaints from consumers, regulatory intervention and significant penalties.

## RobecoSAM's quick guide to non-executive incentives

The findings from the banking sector remuneration review informs RobecoSAM's investment recommendations through an organizational incentives evaluation framework. Admittedly, there is no clear best practice incentive scheme setup, as remuneration elements will be relevant for certain business models and not others. Instead there are governance and structure characteristics that indicate whether bank employees are well aligned with its shareholders and other stakeholders' interests. RobecoSAM's analysts look for the following positive incentives characteristics when analyzing potential investments.

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**Governance**

i. Senior management and the board of directors should monitor and manage pay policies.
ii. Pay policies should be approved only after taking advice from the compliance function.
iii. Measures should exist to identify and monitor employees that fail to act in the best interests of their clients.
iv. Senior management should be responsible for conduct risks posed by remuneration practices.
v. Employees should be clearly informed of the criteria, timing and method used to determine pay.

**Structure**

i. Pay policies and performance evaluation should reflect a balance of strategic objectives together with business health indicators, such as risk and capital management, compliance and client satisfaction.
ii. Fixed and variable compensation should reflect the best interest of the client and other stakeholders.
iii. Clawback mechanisms should be used to ensure employees consider the life time of products sold.
i. Qualitative criteria should be included that encourage employees to act in the best interests of the client.

## RobecoSAM's investment research insight

Good and bad employee incentives schemes do not determine investment recommendations alone, but they are an important tool to understand the quality of a banking business. To illustrate how RobecoSAM incorporates incentives into investment recommendations, this report takes extracts from investment recommendations.

### Attractive incentives: Svenska Handelsbanken

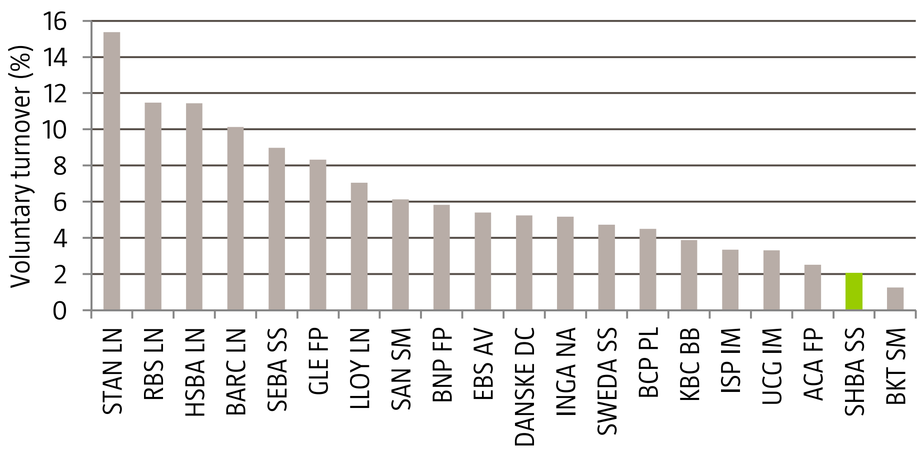
Svenska Handelsbanken's organizational structure and remuneration ensures accountability, flexibility and a risk conscious approach to banking. More particularly, incentives are successfully utilized within the bank to align employees with customers, strategy and investors.

Handelsbanken's structural characteristics ensure accountability and a client-centric culture. Every Handelsbanken branch is led by a manager who is solely responsible for all local operations. Local management is therefore accountable for their local strategies. Branch staff also almost always live in the same town where their branch is located. Both characteristics allow branches to deliver a community focused service and also to adapt more quickly than competitors to local market developments.

Awarding employees with moderate salaries and no bonuses avoids short-term high risk business decisions. CEO and other executives are paid a fixed salary, but no variable remuneration nor any severance pay. Indeed, no variable remuneration is paid to any other employees with single or joint responsibility for credits, limits or risk related decisions. Handelsbanken as a result has the sector lowest credit losses across European peers.

Profit sharing incentivizes employees to work for long term group performance and also retains talent. If the Handelsbanken Group generates a higher return on equity than a weighted average of comparable listed European banks, part of the bank's profits enter into a profit-sharing scheme for employees managed by the Oktogonen Foundation. The Oktogonen foundation invests c. 80% of its funds into Handelsbanken shares and 98% of the Group's employees benefit from the scheme. Oktogonen beneficiaries can only access their investments after their 60$^{th}$ birthday which contributes to Handelsbanken's near sector low mean of c. 2.5% annual employee turnover over the last seven years. Employee loyalty also results in alignment. RobecoSAM considers share ownership a key driver of employee alignment, but only management incentives typically mandate high levels of share ownership. In this respect, Handelsbanken is best in sector because it is estimated that the average employee has accumulated c. 1.60 times their annual compensation through their long-term contribution to the profit sharing scheme.

Figure 2: Svenska Handelsbanken has one of Europe's lowest rates of employee turnover




Source: RobecoSAM Corporate Sustainability Assessment

**Unattractive incentives: Deutsche Bank**

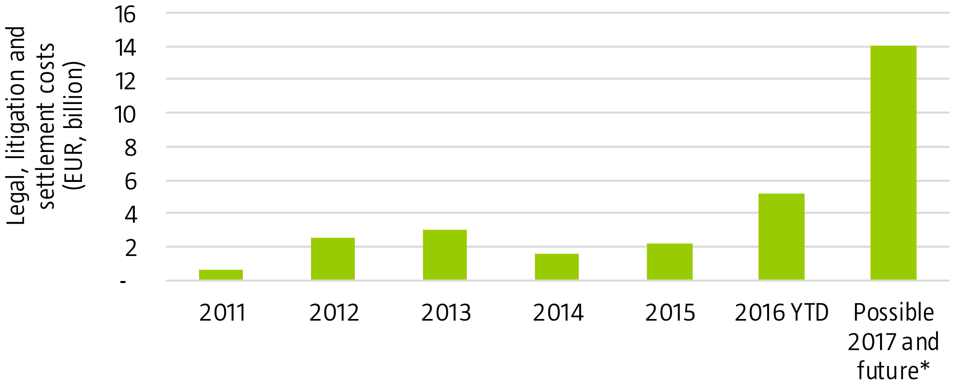
Deutsche Bank's costly spats with regulatory authorities and ex-customers can be largely attributed to the culture fostered within its growth and short-term profit driven strategies in the 2000s.

Deutsche has a history of misconduct. The DoJ's latest announcement requiring Deutsche to settle USD14 billion over its mortgage lending and securitization misconduct during the 2000s housing bubble, is only the latest evidence of the bank's past unethical practices. Deutsche also faces regulatory and law enforcement scrutiny regarding its FX, high frequency trading, interbank offered rates, asset- and mortgage-backed securities, precious metals, hiring practices, Russian equities and U.S. dollar payment activities (DB Annual Reports, Current Individual Proceedings). Legal, litigation and settlement costs since 2011 have exceeded an unprecedented EUR15b and it is possible that these numbers could double in future years.

Deutsche' short-term profitability focus was embedded throughout the organization through divisional goals and incentives. Since Deutsche's four strategic priorities were announced in 2003, the bank focused almost entirely on pretax-profits. Despite group goals to maintain BIS Tier 1 capital between 8-9%, the only consistently reported target metric for each of the four divisions was absolute pre-tax profit. At a group level, pre-tax RoE was also used, but the return metric remained the same pre-tax profit (DB Annual Reports, Corporate Profile). Certainly until 2009, executive incentives focused Deutsche's executives on profits too by linking cash bonuses and mid-term cash incentives to pre-tax RoE and relative TSR respectively. The short-term focus was exacerbated because the largest portion of remuneration was short- to mid-term cash variable pay and the longest executives needed to wait for their equity compensation was three and a half years (DB Annual Reports, Compensation Report).

Rewarding employees for generating short-term profitability resulted in misconduct throughout the organization. In particular, Deutsche's Corporate Investment Bank pursued aggressive pre-tax profit targets, which caused highly unethical business conduct. The foreign exchange (FX) trading division was one hub of misconduct because its employees rigged rates to exploit clients. To maximize proprietary trading profits, Deutsche traders would "bang the close", which was to manipulate the WG/Reuters Rates by pushing through trades before and during the 60-second window when the benchmarks were set. The manipulation was entirely the result of conflicting obligations to the client versus internal strategic targets. Ultimately internal targets took precedent because it was more profitable and better remunerated to manipulate rates to clients' disadvantage and then make profits by taking the other side of clients' trades (US District Court, Southern District of New York, 2013). The bank now faces multiple putative class actions in the US and Canada.

Figure 3: Deutsche Bank's possible legal, litigation and settlement costs could dwarf historical penalties




*The Possible 2017 and future legal, litigation and settlement costs includes the USD 14 billion civil claims announced by the US Department of Justice and reported by the Wall Street Journal in September 2016. A Deutsche Bank spokesperson expressed that the bank had no intention to settle the full amount.
Source: RobecoSAM, FT, Bloomberg

## Leveraging investment insight to improve industry practice

Financial incentives are a powerful force within any organization, and they should be designed so that individuals act in the best interests of shareholders, customers and society as a whole. The financial crisis demonstrated that poorly designed, short-sighted monetary incentives in the banking sector had catastrophic consequences, leading to shareholder losses, taxpayer bailouts and layoffs. RobecoSAM carefully considers the consequences of perverse incentives and conflicts of interests in its sustainable equity research. Incentives analysis extracts from investment recommendations highlight the depth of knowledge and expertise required to understand organizational incentives when evaluating a bank's business model. To encourage better remuneration practices in the banking sector, RobecoSAM intends to leverage its unique investment research capabilities to develop detailed incentives questions within the Corporate Sustainability Assessment.

Aaron Re'em, CFA
Financials Analyst, SI Research
RobecoSAM

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**About RobecoSAM**

Founded in 1995, RobecoSAM is an investment specialist focused exclusively on Sustainability Investing. It offers asset management, indices, impact analysis and investing, sustainability assessments, and benchmarking services. Asset management capabilities cater to institutional asset owners and financial intermediaries and cover a range of ESG-integrated investments (in public and private equity), featuring a strong track record in resource efficiency themed strategies. Together with S&P Dow Jones Indices, RobecoSAM publishes the globally recognized Dow Jones Sustainability Indices (DJSI). Based on its Corporate Sustainability Assessment (CSA), an annual ESG analysis of over 3,800 listed companies, RobecoSAM has compiled one of the world's most comprehensive databases of financially material sustainability information. The data of the CSA is also included in USD 87.3 billion of assets under management by the subsidiaries of the Robeco Group.

RobecoSAM is a sister company of Robeco, the Dutch investment management firm founded in 1929. Both entities are subsidiaries of the Robeco Group, whose shareholder is ORIX Corporation. As a reflection of its own commitment to advocating sustainable investment practices, RobecoSAM is a signatory of the UNPRI and a member of Eurosif, ASrIA and Ceres. Approximately 130 professionals work for RobecoSAM, which is headquartered in Zurich. As of June 30, 2016, RobecoSAM had assets under management, advice and/or license in listed and private equity* of approximately USD 10.8 billion.

*RobecoSAM Private Equity is the marketing name of the combined private equity divisions of Robeco Institutional Asset Management B.V. ("Robeco") and RobecoSAM. Any funds or services offered by RobecoSAM Private Equity are managed and offered by Robeco, who may have delegated certain investment advisory functions to RobecoSAM.



**RobecoSAM** | Josefstrasse 218 | 8005 Zurich | Switzerland | T +41 44 653 10 10 | F + 41 44 653 10 80 | www.robecosam.com | info@robecosam.com