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Corporate Governance: European Banks

Big bang for big banks

■ Governance interference is the price for failure

2009 is the year of corporate governance for banks. Bailout plans have created public pressure on governments to require profound changes to a corporate governance system that has revealed its limits and failures during the financial crisis.

■ Social equity and risk control pushing new standards

Given the overall objective to re-establish public confidence and market trust in the system, we anticipate further political interference on governance reforms, driven by social equity and risk control concerns. We expect such initiatives to address: 1) the weak remuneration system and absence of transparency; and 2) the lack of board expertise and accountability to ensure the appropriate expertise to manage public-driven funding and risk control. Further pressure for regulation of tax haven shelters will also be a direct consequence of these new standards.

■ We haven't seen it all yet... from soft to hard regulation

The avoidance of capital injections from governments will not shield banks from political interference into their governance. Reform will, in our view, be applied more universally. We see further regulatory responses: the European Commission will play a role, as will the G20 rounds and the IMF, in reinforcing governance standards for banks. Amendment of the Basel II framework on capital adequacy may, in our view, lead to further governance adjustments, particularly for investment banking-heavy institutions. We see reforms in the Glass-Steagall Act mould as the ultimate option.

■ The symptoms of being minority shareholders

Regardless of their importance, shareholders in banks all face minority shareholder status with reduced rights. The ability of banks to decide whether or not to accept government help has split the banking system into two tiers in which shareholders face different risks: in the form of continued dilution via further capital increases from national governments, or in the form of banks waiving pre-emption rights in order to elicit external investment and avoid government interference.

■ Our Top Picks to benefit from new governance

We continue to discriminate between banks on balance sheet strength, funding quality, earnings diversification and business model sustainability. Among our European Sector Top Picks of **BNP Paribas, Julius Baer, National Bank of Greece** and **Nordea**, only National Bank shows a consistency between our investment recommendation and the above-average quality of its governance. We believe that the new governance reforms imposed on all banks will also benefit those that have not sourced government funding, and drive a macro positive impact.

CHEUVREUX EUROPEAN BANKS FEB 2009

NAME	COUNTRY	PRICE (EUR)	MKCAP 09 (EUR m)	RATING
AAREAL BANK	GERMANY	3.9	168.0	3/Underperform
ALPHA BANK	GREECE	5.2	2120.7	2/Outperform
ATE BANK	GREECE	1.2	1041.3	3/Underperform
AZIMUT	ITALY	4.2	599.8	1/Selected List
BANCA GENERALI	ITALY	2.7	299.7	2/Outperform
BANCA ITALEASE	ITALY	1.6	272.5	4/Sell
BANCA MPS	ITALY	1.0	6763.9	3/Underperform
BANCA POP DI MILANO	ITALY	3.8	1692.3	3/Underperform
BANCO ESPIRITO SANTO	PORTUGAL	5.2	2600.0	No Rating
BANCO POPOLARE	ITALY	3.7	2393.6	3/Underperform
BANCO POPULAR	SPAIN	4.1	5019.7	4/Sell
BANCO SABADELL	SPAIN	3.6	4260.0	4/Sell
BANESTO	SPAIN	6.1	4165.6	4/Sell
BANK OF CYPRUS	CYPRUS	2.0	1144.0	2/Outperform
BANKINTER	SPAIN	7.0	2857.5	Suspended
BBVA	SPAIN	6.3	23424.8	2/Outperform
BNP PARIBAS	FRANCE	24.6	22607.6	2/Outperform
CARNEGIE	SWEDEN	1.7	128.5	3/Underperform
COMDIRECT BANK	GERMANY	5.3	740.6	3/Underperform
COMMERZBANK	GERMANY	3.0	2667.1	3/Underperform
CREDEM	ITALY	2.9	964.5	3/Underperform
CREDIT AGRICOLE SA	FRANCE	7.8	17260.8	No Rating
CS GROUP	SWITZERLAND	21.2	24088.2	2/Outperform
DAB BANK	GERMANY	2.2	163.9	3/Underperform
DANSKE BANK	DENMARK	5.7	3958.6	3/Underperform
DEUTSCHE BANK	GERMANY	20.2	11416.2	2/Outperform
DEUTSCHE POSTBANK AG	GERMANY	8.8	1914.5	3/Underperform
DEXIA SA	BELGIUM	2.2	9308.6	2/Outperform
DNB NOR	NORWAY	2.4	3234.1	2/Outperform
EFG INTERNATIONAL	SWITZERLAND	9.4	1469.2	3/Underperform
ERSTE BANK	AUSTRIA	7.2	2261.5	3/Underperform
EUROBANK EFG	GREECE	4.5	2374.2	3/Underperform
GRENKELEASING AG	GERMANY	20.6	281.1	3/Underperform
HELLENIC BANK	CYPRUS	1.0	294.3	3/Underperform
HELLENIC POSTBANK	GREECE	4.3	605.9	3/Underperform
HQ BANK	SWEDEN	6.9	186.8	2/Outperform
HYPO REAL ESTATE	GERMANY	1.6	343.7	3/Underperform
INTESA-SANPAOLO	ITALY	2.1	27288.7	2/Outperform
JULIUS BAER	SWITZERLAND	22.4	4672.1	2/Outperform
KOMERCNI BANKA	CZECH REPUBLIC	60.9	2314.7	2/Outperform
MARFIN POPULAR BANK	CYPRUS	1.6	1319.9	2/Outperform
NATIONAL BANK OF GREECE	GREECE	11.0	5459.0	2/Outperform
NATIXIS	FRANCE	1.0	3002.4	3/Underperform
NORDEA	SWEDEN	4.3	11041.7	2/Outperform
OTP Group	HUNGARY	6.3	1625.7	3/Underperform
PIRAEUS BANK	GREECE	4.5	1496.1	3/Underperform
POHJOLA BANK	FINLAND	6.3	1267.1	3/Underperform
RAIFFEISEN INTERNATIONAL	AUSTRIA	13.3	2049.4	3/Underperform
SANTANDER	SPAIN	5.2	42573.1	3/Underperform
SARASIN	SWITZERLAND	19.1	1167.5	2/Outperform
SKANDINAVISKA ENSKILDA BANKEN	SWEDEN	3.6	2421.4	1/Selected List
SOCIETE GENERALE	FRANCE	23.4	13676.7	3/Underperform
SVENSKA HANDELSBANKEN	SWEDEN	10.4	6489.4	3/Underperform
SWEDBANK	SWEDEN	2.7	2052.1	2/Outperform
SWISSQUOTE	SWITZERLAND	26.8	392.2	3/Underperform
UBI BANCA	ITALY	7.7	4915.0	3/Underperform
UBS	SWITZERLAND	8.2	23207.6	3/Underperform
UNICREDITO	ITALY	1.0	16201.8	3/Underperform
VONTOBEL	SWITZERLAND	11.4	729.8	3/Underperform
VP BANK	LIECHTENSTEIN	70.3	416.0	3/Underperform

Source: CA Cheuvreux

Note: This report focuses primarily on Continental European banks and excludes Credit Agricole S.A. as Cr dit Agricole Cheuvreux is one of its subsidiaries.

Executive summary

The far-reaching consequences of the financial crisis justifies in our view a sector approach that goes beyond traditional bottom-up corporate governance analysis. In this report, we analyse how system failure and government interference may shape the governance structure of the European banking sector and what are the implications for shareholders and, potentially, for future company performance.

Government interference does not come for free

National governments have acted to shore up confidence in financial markets by bailing out troubled banks. However, the price of this assistance has been to expose such banks to government interference. We think the next issue for investors is uncertainty over future government intervention in business models and corporate governance. In the short term, we see no reason to own banks that have received significant government capital, although the new governance rules imposed on them will also benefit banks that have not sourced government funding, and we believe this will have a macro effect on the financial sector.

Better enforcement is the first step of governance big bang

The complexity of activities and international reach of banks call for an EU-level approach incorporating minimum standards of governance. In our view, better EU-wide enforcement of existing standards of advisory voting on remuneration policy and better disclosure of board competence is a necessity prior to the introduction of new regulations. The forthcoming G20 summits (the first of which is to be held in London on 2 April 2009) offers the best path to reform, given its commitment to reinforce governance standards for banks.

Remuneration reform: evolution for some, revolution for others

Remuneration policy is the key to reform. We have identified a need for harmonisation beyond EU members' current attempts to introduce best practice. Both UBS and Credit Suisse offer templates for future paths to reform. The issue is to restructure compensation schemes so that the majority of total remuneration will be transparently based on long-term performance. The two Swiss banks have raised the bar, and it may move even higher in challenging remuneration committees to meet shareholders' and regulators' objectives.

How competent and effective is my board?

Board independence is a crucial first step for board effectiveness and the avoidance of management conflicts of interests. Our research suggests that the battle for board independence has not yet been won in European banking. We believe national governments recognise the importance of competent and effective boards and we think it increasingly likely that government interference will spread to board competence via the appointment of government representatives to the boards of banks that have utilised state aid.

Shareholders: building the case for engagement

We do not think the new governance standards for banks will destroy shareholder value: we believe that in the long term national governments will still need shareholders. However, in the short term, bank shareholders look like stakeholders and it is not certain that government and shareholder interests will be aligned. In addition, the ability of national governments to inject significant capital into the banking system has reduced all shareholders to minority status, regardless of their importance. Furthermore, it is now clear that the banking sector has been split into two tiers that present different risks to shareholders. We believe that the avoidance of capital injections from national governments will not be enough to shield banks from government interference. We think shareholder engagement will now focus on the threat of further dilution, not primarily from national governments, but from independent banks seeking to waive pre-emption rights for existing shareholders in order to avoid government aid.

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I – Government interference comes at a price

National governments have now acted to shore up the lack of confidence in the financial markets by bailing out troubled banks. However, this assistance comes at a price not only in terms of the obvious dilution to existing shareholders but also in the exposure of banks to government interference in their business models and corporate governance. What is now clear is that government intervention has facilitated a new agreement between national governments and banks.

OVERVIEW OF EU GOVERNMENT BAILOUT PLAN MEASURES

Country	Governance interventions?
Austria	No guidance
Belgium	No guidance
France	The French government has already placed limits on golden parachutes by requiring companies to tie severance packages to performance criteria. Although no guidance has been proposed, the government has threatened to impose limits on compensation if boards fail to ensure that pay for executive management reflects performance. As a result, many CAC 40 companies are beginning to ratify the recent AFEF-MDEF guidelines on executive pay. Finance Minister Christine Lagarde announced on 12 February that France would be the first economy to impose industry-wide restrictions on bonuses to bankers, traders and fund managers. The new code, drawn up by the French Banking Federation, will require bonus awards for all French investment banks, brokers and fund managers (irrespective of whether they required state aid) to be paid over a number of years and linked to the overall profitability of the business rather than individual activities.
Germany	Current guidance on executive pay states that salaries exceeding EUR500,000 per year will be considered inappropriate.
Greece	Banks that accept the government guarantee on term funding or preferred shares will be required to apply salary caps and it has been reported that no senior executive (Chairman, CEO, BoD members) will be able to earn more than the governor of the Central Bank.
Italy	No guidance.
Ireland	The Irish Finance Minister Brian Lenihan announced on 9 February 2009 that the EUR7bn rescue package granted to Allied Irish Bank and the Bank of Ireland will be tied to dramatic reductions in all levels of senior bankers' pay and bonuses.
Netherlands	No guidance on executive compensation as part of state aid programmes. However, the Dutch government has passed legislation limiting severance payments to a maximum of one year's salary.
Spain	No guidance
Sweden	Banks participating in the government guarantee on term funding will be face restrictions to salary increases and bonuses.
Switzerland	The Swiss regulator (FINMA) announced on 3 February 2009 that, as part of the state aid granted to UBS, it had allowed UBS to distribute CHF1.8bn of variable remuneration for 2008. In addition to the limitations on the variable bonus pool that could be awarded, FINMA also decided to limit the deferred components. The latter will be distributed over several years and will be paid only if strict conditions are fulfilled.
United Kingdom	The government has the right to intervene to change the remuneration structure of banks that take part in the nationalisation process via the UK FIA. However, no limits have been disclosed although the financial regulator (FSA) has issued guidance on best practice in executive remuneration to UK-listed companies.

Source: CA Cheuvreux

■ What comes next?

CHEUVREUX OVERVIEW OF GOVERNMENT INTERFERENCE (PART 1)

Measures	UK	France	Germany	Benelux
Any initiatives for self regulation by companies or other bodies?	No.	The French professional body (Fédération Bancaire Française - FBF) on credit policy. MEDEF code of corporate governance for top management incentives.	Some companies have expressed an intention to strengthen internal risk management systems.	No.
How will further government control affect corporate governance?	Government is likely to clamp down on unreasonable bonus awards.	Moderate change in calculation of compensation for top management Moderate change in dividend policy (on the downside)	There will probably be a higher correlation between government interference and corporate governance. There have also been demands for a stronger implementation of changes to the German Corporate Governance Code.	There will be some impact on remuneration especially with regard to incentives.
Does the government have powers to limit executive bonuses and have it done so? y/n	Yes. Although the government did not involve itself in the recent payment of bonuses by Northern Rock.	Yes. The French government strongly advised banks benefiting from the support package (hybrid debt subscription) to moderate bonuses for top management. No bonus on 2008 earnings for the top management of the six main French banks.	Yes, for banks receiving either capital injection (recapitalisation) or risk shelter (assumption of risk position). Remuneration should not encourage inappropriate risks. Total remuneration has to be restricted to EUR500k p.a. for board members and MDs.	Under the state funding arrangements, the Dutch government has appointed two board members at Aegon, ING, KBC and SNS REAAL. These members are part of the remuneration committee. Furthermore, under the deal, board members of the above companies have waived 2008 bonuses.
Is there any evidence of government interference in the business model?	UK government is putting pressure on part nationalised banks to increase lending.	The French state has urged CNCE (Caisse Nationale des Caisses d'Epargne) and BFBP (Banque Fédérale des Banques Populaires) to merge before the end of February. The State would inject EUR2.5bn of preferred shares in CNCE-BFBP which would be directly (re)injected into Natixis.	Yes, granting of capital (recapitalisation) is tied to commitment to provide lending to German industry. Discussion of possible implementation of leverage ratios (equity/assets) may necessitate further deleveraging and refocus on certain business lines.	Yes at ING. The state guarantee on the Alt-A RMBS portfolio is tied to a commitment to provide EUR25bn in new lending to the Dutch private and corporate market.
Does the government have voting rights?	No.	No.	No (exception: 25% share of government in Commerzbank)	No voting rights in quoted companies. However, in Benelux, Fortis (incl ABN) is of course nationalised.
Is there any law or proposed regulation with a potential governance impact?	No.	No.	No.	No proposals so far.
Does the government have direct or indirect influence over board appointments?	Potentially with regard to Northern Rock, RBS.	Dexia (state ownership). The French state is also in the process of appointing the head of the mutual bank created from the merger of Groupe Banque Populaire and Groupe Caisse d'Epargne (and Natixis as 70% of it will be owned by the new entity). Press speculation suggests that the current Deputy Chief of staff will be appointed.	No (two supervisory board members at Commerzbank to be from government)	Yes, under the state funding arrangements, the government has appointed two board members at Aegon, ING, KBC and SNS REAAL.
What is the most likely scenario for government intervention?	National government interests are now aligned with those of shareholders. As significant shareholders, national governments are willing to work with other shareholders on executive remuneration but not wider governance issues such as board competence.	National government interests are now aligned with those of shareholders. As significant shareholders national governments are willing to work with other shareholders to engage on executive remuneration but not wider governance issues such as board competence.	National governments, as long-term owners cannot sell bad performance and therefore will engage (irrespective of shareholder support) on wider governance issues including executive remuneration where appropriate.	National governments consider that the threat of intervention as part of national bailout plans on executive pay are enough to improve standards and transparency, making actual government intervention unnecessary.

Source: CA Cheuvreux

CHEUVREUX OVERVIEW OF GOVERNMENT INTERFERENCE (PART 2)

Measures	Italy	Nordic	Spain	Switzerland
Any initiatives for self regulation by companies or other bodies?	No.	No.	No.	Discussions are underway on self regulation. However, there is no clear evidence of initiatives.
How will further government control affect corporate governance?	According to a proposal, the government should have the power to directly control banks along with prefectures and the Bank of Italy.	Any changes will be limited in scope.	Nothing expected.	We expect to see an impact on remuneration, especially with respect to short-term incentives
Does the government have powers to limit executive bonuses and have it done so? y/n	No, but banks accessing the bailout should submit a "code of ethics", regulating management compensation.	Yes, if banks join the state guarantee programme in Sweden.	No.	Government in the case of UBS (where it has a stake) will ensure that compensation is in line with best practice. There is no limit, but the bonus proposals for 2008 for UBS will have to be approved by the Swiss Banking Regulator.
Is there any evidence of government interference in the business model?	According to a draft decree, the banks accessing the bailout plan, the government might take measures once the capital shortage is acknowledged, recognised and approved by Bank of Italy.	No.	No.	There is no direct interference, but plenty of suggestions regarding UBS due to the government stake. New capital regulations give banks relief regarding capital requirements for domestic business.
Does the government have voting rights?	No.	No.	No.	No.
Is there any law or proposed regulation with a potential governance impact?	According a one draft, for Popolari bank's recapitalisation, the government would not apply the "one man, one vote system" to its stake, potentially impacting on the governance of the company	No.	No.	No.
Does the government have direct or indirect influence over board appointments?	Yes, as the law would reinforce the power of the government, the prefectures and the Bank of Italy on the bank.	No.	No.	No.
What is the most likely scenario for government intervention?	National government interests are now aligned with those of shareholders. As significant shareholders, national governments are willing to work with other shareholders to engage on executive remuneration but not wider governance issues such as board competence.	National government interests are now aligned with those of shareholders. As significant shareholders, national governments are willing to work with other shareholders to engage on executive remuneration but not wider governance issues such as board competence.	National government interests are now aligned with those of shareholders. As significant shareholders, national governments are willing to work with other shareholders to engage on executive remuneration but not wider governance issues such as board competence.	National government interests are now aligned with those of shareholders. As significant shareholders, national governments are willing to work with other shareholders to engage on executive remuneration but not wider governance issues such as board competence.

Source: CA Cheuvreux

CHEUVREUX OVERVIEW OF GOVERNMENT INTERFERENCE (PART 3)

Measures	Austria	Greece
Any initiatives for self regulation by companies or other bodies?	No.	No.
How will further government control affect corporate governance?	Not yet clear, as contracts not finalised, but most likely limited interference in Austria.	Government in Greece will take a seat on the BoD. This could affect corporate governance. The track record of the Greek government is not good.
Does the government have powers to limit executive bonuses and have it done so? y/n	No, not yet, but some banks taking government aid already did cut bonuses voluntarily.	Yes. According to the Greek government plan no bank executive can earn more than the Governor of the Central Bank. This will be implemented when the capital is distributed to banks (expected in February).
Is there any evidence of government interference in the business model?	Not yet.	Not yet.
Does the government have voting rights?	Most likely not, but contracts not yet finalised	No.
Is there any law or proposed regulation with a potential governance impact?	No.	No.
Does the government have direct or indirect influence over board appointments?	Not (yet) in Austria, but contracts not yet finalised. However, in Hungary the government would appoint board and supervisory board members, if banks take the package.	Not in private banks. There are banks in Greece that were already controlled (directly or indirectly) by the government. In those banks board appointments are influenced by the government.
What is the most likely scenario for government intervention?	National governments consider that the threat of intervention as part of national bailout plans on executive pay are enough to improve standards and transparency making actual government intervention unnecessary.	National governments consider that the threat of intervention as part of national bailout plans on executive pay are enough to improve standards and transparency making actual government intervention unnecessary.

Source: CA Cheuvreux

■ Uncertainty driving expectations

Clearly, government interference will play an increasingly important role not only in terms of its impact on business models but also on our investment cases for the sector. We remain Underweight on European Banks until we have full visibility on the Q4-08 results. We favour banks with relatively strong balance sheets, earnings diversification, a strong position in their home market and business model sustainability. Our top picks are BNP Paribas, Julius Baer, National Bank of Greece and Nordea, which we believe are the least affected by potential net asset value dilution relative to valuation.

Three main sector trends for 2009:

1) Unprecedented credit cycle downturn. With further disclosure on Q4-08 results, we believe that the focus will shift from credit-crisis related write downs on toxic assets to the deterioration of the credit cycle. We expect loan loss provisions to peak at around 90bp in 2010E, the highest level on record. Company guidance on risk provision charges, in our view, is relatively useless as these are generally based on expected loss levels and do not include single loss events, which will probably increase on the back of an expected significant rise in corporate delinquencies (as evidenced by the relationship between recent recessions, tightening credit standards and insolvency levels).

2) Pressure on business models via increased discrimination of funding conditions. Although we currently see some improvements following complete dislocations in the funding markets, conditions remain challenging. Whilst government guaranteed bonds are clearly positive, banks will continue to need to refinance substantial parts of their balance sheets in 2009 and 2010. Clearly, deleveraging and lack of loan demand will mitigate some of the funding requirements. In our view, there will be much more discrimination in terms of funding levels and access to funding among banks with different ratings going forward. We expect weaker banks with low ratings (A- or below) to significantly suffer on relative funding conditions, which may lead to pressure on future profitability, potentially prompting further sector consolidation.

3) Recapitalisation set to continue: focus on capital formation. Regulatory responses will continue to trigger further capital injections into the sector. In addition, the severity of the credit down cycle will, in our view, put further pressure on banks' balance sheets at a time when revenues are under pressure from the low interest rate environment and lower commission-related income streams stemming from the recession. In addition, many banks will carry a heavy burden from government rescue schemes in terms of interest costs, putting the focus on banks with the strongest capital formation going forward. Clearly, further regulatory and rating agency responses are on the cards. An amendment of the Basel II framework on capital adequacy is underway, which will lead to further adjustments to business models, particularly for investment banking-heavy institutions. Therefore, in the short term, we do not see a reason to own banks which have received significant government capital. We also believe that the new governance rules imposed on the sector will also benefit those banks that have not sourced government funding on the back of investor demand and what we would see as a macro impact from governance.

This expected development, which is already partially under way, would support our investment cases on the National Champions from a corporate governance point of view (i.e. shareholders get the benefit from improved governance but not the downside from government capital injection). That said, while the short-term investment outlook for many of the banks having received government funding is clouded, we believe that the governments at some stage need to open the door to investors when disinvestments are on the agenda, which will eventually provide some potential upside for minority shareholders.

The first step towards reform of corporate governance across EU requires better enforcement

II – Towards a governance big bang

First step towards reform requires better enforcement

In our view, given the rapid growth in complexity of the activities of companies operating within the financial sector a common European framework is necessary to ensure a single EU-wide approach to corporate governance and regulation. However, our research indicates that the first step towards such reform is not necessarily the implementation of new EU standards. Instead, it requires EU member states to fully implement and enforce two directives published by the European Commission in 2006 which were designed to achieve this precise aim.

- The first, the Statutory Audit Directive¹ (SAD), is concerned with harmonising the EU regulatory framework and has now made it mandatory for publicly listed companies in EU member states to have an audit committee with at least one competent member with relevant financial expertise.

- The second, the Company Reporting Directive (CRD) integrated the UK "comply or explain" regime approach into EU corporate governance. The CRD requires EU companies to disclose their compliance with a corporate governance code (including areas of non compliance) and the company's system of internal control and risk management. In our view the CRD if fully enforced would lead to improvements in board accountability by requiring companies to explain deviations from their local corporate governance code. This would be a vital tool for investors seeking to understand potential corporate governance weaknesses and potential internal control risks at banks across EU member states.

OVERVIEW OF EU GOVERNMENT MEASURES ON CORPORATE GOVERNANCE SINCE JULY 2008

Country	New/updated corporate governance code?
Austria	No.
Belgium	Draft 2009 Corporate Governance Code. Includes some significant amendments including prohibition on the CEO becoming Chairman of the board for at least two years and the stipulation that the board should be satisfied that the audit committee has sufficient expertise in accounting, auditing and finance. The code also requires termination provisions for departing CEO's to be capped at 18 months basic and variable remuneration.
France	The recent AFEF-MEDEF guidelines on Corporate Governance have focused on improving the balance, transparency and long term focus of executive pay.
Germany	2009 amendment to governance code. Amendments focus on remuneration policy with increased transparency of pay components (non performance related, long term incentive) for executive board members. In addition variable compensation should be linked to demanding performance parameters and termination provisions that do not exceed two years compensation.
Greece	No.
Italy	No. However the national regulator the Bank of Italy have published provisions concerning Banks organisation and corporate governance. In addition the Italian government is proposing to introduce a code on executive remuneration.;
Netherlands	The new code released in December 2008 focuses specifically on: Remuneration (limit to pay differentials within the company, variable remuneration depending on long term objectives, control over the board remuneration.) Emphasis on risk management (financial structure and strategy of the company) Diversity of supervisory board composition as an objective.
Norway	No. Corporate Governance code was last updated in 2007 and focused on strengthening the role of independent directors.
Spain	No.
Sweden	No.
Switzerland	No.
UK	No.

Source: CA Cheuvreux, European Corporate Governance Institute

¹The Statutory Audit Directive (SAD) was introduced in June 2008. The SAD follows the main objective of Sarbanes Oxley in that includes at its core a commitment to the restoration of investor confidence in the financial statements and annual reports published by companies within the EU.

Basel II may provide better corporate governance and protection for shareholders...

■ **Basel II equals better governance?**

Recent work by the Basel II Committee has recognised failures in macro-prudential supervision mainly related to the cyclicity of the capital regulation and to the gap between good individual behaviour and system equilibrium.

Under the existing scheme, capital ratios are following the cycle which is adding pressure to shareholders during a difficult time. Since capital ratios link risk and capital, the increase in riskiness requires an increase of capital. The current accord offset some of the cyclicity with the use of “over the cycle” risk data, but all studies and reports done highlight this effect. Supervisors generally agree that the relationship between risk and capital requirement could be relaxed during the troughs in order to counterbalance the cyclicity of the requirements.

Capital ratio could then decrease before the industry starts to rebuild capital in better times. This would be more beneficial for financial stability in the long run with the associated effect of leverage reduction over the cycle. The second weakness of the existing accord is linked to the capacity of supervisors to identify bubbles, since good risk practice at individual level is not a guarantee of a stable stage of the financial system. Most of the attention is on the rapid growth in banking assets (including off balance sheets assets) which characterise bubbles. It is a desirable aim for shareholders and stakeholders to prevent bubble formation and to have more control over the growth of a bank's size.

Work by Basel II at individual bank level reviewed 1) the transparency and disclosure of the external auditing process (December 2008) and 2) the improvement of risk analysis with the enforcement of comprehensive stress testing (January 2009) in order to increase the resilience of the banks to crisis.

This is of utmost importance since a large shareholder base is not uncommon in banking – Fortis had over ½ million shareholders, a number close to that for HSBC – but the ability of this large number of shareholders to affect management decision-making in the current crisis was quite limited. Individual shareholders of European banks should ultimately benefit from these improvements in capital management. Their first aim is to preserve financial stability and to protect depositors but they are also critical in the process of enhancing corporate governance.

The Basel committee has noted that corporate governance for banking organisations is arguably of greater importance than for other companies, given the crucial financial intermediation role of banks in an economy ‘... and is essential to achieving and maintaining public trust and confidence in the banking system.’² The same committee issued a report in February 2006 entitled *Enhancing governance for banking organisations*. This report outlined eight principles it considered necessary for effective corporate governance.

²Enhancing Corporate Governance for banking organisations February 2006, Basel Committee on Banking Supervision.

BASEL COMMITTEE ON BANKING SUPERVISION CORPORATE GOVERNANCE PRINCIPLES

Principle 1	Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.
Principle 2	The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation.
Principle 3	The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.
Principle 4	The board should ensure that there is appropriate oversight by senior management consistent with board policy.
Principle 5	The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.
Principle 6	The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.
Principle 7	The bank should be governed in a transparent manner.
Principle 8	The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency.

Source: 'Enhancing Corporate Governance for banking organisations' February 2006, Basel Committee on Banking Supervision

■ New regulation is coming

G20 summit rounds offer the best path towards reform

The main focus of the next G20 summit rounds (the next one to be held in London on 2 April 2009) will be on regulatory reform of the banking sector. In our view, any new regulatory reform will undoubtedly impact the corporate governance structures of banks.

POTENTIAL IMPACT OF G20 SUMMIT ON GLOBAL CORPORATE GOVERNANCE STRUCTURE

Reform	Proposal	Potential governance impact
Restriction of certain activities by banks	A return to some form of the previous Glass-Steagall Act under which the range of activities in which banks are allowed to engage is narrowly confined. This would require some banks to sell off some of their riskier businesses. It would also clarify the distinction between commercial banks and financial institutions as the former would be restricted from investing in complex structured products.	Simplification of banking activities would make it easier for shareholders, financial regulators and non-executive directors to understand the risk implications of banks compared with financial institutions such as investment banks. This would lead to better supervision and management of risk.
Alignment of incentives to avoid excessive risk taking	The G20 has made a commitment to discuss how to reform executive compensation to avoid excessive risk-taking.	The G20 communiqué from the last summit on 16 November in Washington recognised the responsibility of national regulators. In our view, an overall consensus may be difficult to achieve and we believe that this may lead to different solutions from national governments.
Regulatory action against tax havens	Take action against tax haven jurisdictions which often have lower regulatory standards and lack transparency.	Boards may be required to report on and justify the use of offshore financial centres.

Source: CA Cheuvreux

Restrictions on certain activities by banking institutions may now be a possibility

There is now growing consensus that banks should focus on deleveraging and de-risking their businesses so as to allow for a simpler structure and the easier isolation of bad assets which in our view could lead to new business models. The call for some form of return to Glass-Steagall has also been made by Paul Volcker former Chairman of the Federal reserve and Chairman of the Trustees for the influential Group of Thirty whose recent report, *Financial Reform: A Framework for Financial Stability*, states that:

'Large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest'

The complexity of investment banking made it much harder to control from the board room

Reaching consensus on bonus reform may be a harder nut to crack

In our view, some form of restrictions on the activities of banks is likely and necessary in order to allow national regulators to more effectively monitor and control risks. We believe that one of the reasons for this is the differences in culture between commercial and investment banking. In our view, investment banking is much harder to control from the board room as its business is more complex and its products more difficult to understand than is the case for simpler commercial banking products, which in turn makes risk control practices more difficult.

The momentum for remuneration reform is gathering pace, with French Finance Minister Christine Lagarde's proposal on 12 February sending an extremely strong signal that France would be the first economy to impose industry-wide restrictions on bonuses to bankers, traders and fund managers. The new code, drawn up by the French Banking Federation, will require bonus awards for all French investment banks, brokers and fund managers (irrespective of whether they required state aid) to be paid over a number of years and linked to the overall profitability of the business rather than individual activities. This proposal follows the restriction of UBS's bonus pool by 90% (USD1.75bn) by the Swiss regulator (Finma) in December 2008 as a condition of its bailout package.

However, we do not yet see a movement towards consensus on remuneration reform and, although we expect some discussion on how to curb remuneration practices that encourage excessive risk-taking, we do not believe a unified response on this issue will be reached at the G20.

Tax havens and corporate governance

In our view, tax havens raise two primary governance issues. The first is risk control, as offshore financial centres often have lower regulatory standards. Any movement towards tighter regulation of banking and financial services at international level cannot be effective until offshore financial centres such as Liechtenstein, the Cayman Islands, Jersey and Isle of Man, are encouraged to raise their regulatory standards.

The second concerns the increasing social equity pressure on governments to crack down on practices deployed by banks to avoid paying taxes to national governments who have been using public money to bail out the financial sector.

Various political leaders have announced that the aim for the forthcoming G20 summit in London on 2 April 2009 is to tackle 'regulatory and tax havens in parts of the world which have escaped the regulatory attention they need'. We expect this to lead to new governance standards which may require bank boards to report on and justify their incorporation of subsidiaries in offshore financial centres. The lack of disclosure we faced in our SRI research over the exposure of European Banks to tax haven related business makes it difficult to assess the potential impact further control may have on this type of business area.

We think remuneration committees should be more honest in assessing whether executive pay is in line with corporate strategic performance and whether it is reasonable

Transparency of remuneration policy and performance only becomes constructive when there is direct accountability between the company and its shareholders for decisions on executive pay...

... this is best achieved by allowing shareholders a separate vote on remuneration policy, which is not included as part of the vote on the annual report

III – Remuneration: evolution or revolution?

The financial crisis has seen the responsibility for remuneration reform shift away from shareholders (who are still owners of banks) to European national governments, who for the most part have not acquired direct equity stakes. This fundamental realignment has been a necessary consequence of the significant bailout packages granted by national governments and the realisation that shareholder pressure to reform pay has failed.

■ Effective reform may require standardisation

The central concern for European governments when looking at remuneration should be that any comparison of executive remuneration across the European banking sector remains difficult given the variation in quality of disclosure on remuneration policy and components, individual executive remuneration and performance criteria. In fact, our research suggests that only 3.3% of European banks disclose specific numerical performance targets for long-term incentive awards.

We believe that individual disclosure of pay and further transparency regarding remuneration policies and components should be required by law for all EU member states. In our view, this could best be achieved by the European Commission accelerating the implementation by member states of its 2004 voluntary proposal on director remuneration.³

This would introduce a level playing field for remuneration disclosure that we believe would allow executive remuneration across the European banking sector to be restructured so that the majority of total compensation will be transparently based on long-term performance. In our view, such reform would push remuneration committees into being more honest in their assessments of whether variable awards are in line with strategic performance and are reasonable.

However, increased transparency on remuneration policies and performance criteria is only constructive when the company has direct accountability to shareholders who are able to participate fully in decisions concerning executive pay. We think this is best achieved by allowing separate advisory vote on pay and we believe this should now be implemented by all EU member states, as suggested under the European Commission's 2004 voluntary proposals on director remuneration.

Although recent research by Ferrarini⁴ indicates that most EU jurisdictions have now implemented a "say-on-pay" law there does not appear to be uniformity on levels of disclosure and whether votes are binding. Furthermore, given that (except in the UK) the advisory vote on remuneration is included as part of vote on the annual report, we believe that shareholders may be reluctant to take the "nuclear option" of voting against the annual report when their issue of concern is limited solely to remuneration.

While an advisory vote on remuneration policy alone is not sufficient to solve the disconnect between pay and performance, we believe that in markets where an advisory vote on pay has been implemented (e.g. UK, Spain) shareholders appear to have a much better understanding of the structure of pay packages and their link with performance.

³ The European Commission report *Recommendations on the Remuneration of Directors and the Role of Non-Executive or Supervisory Directors* recommended the adoption of four measures: disclosure of remuneration policy, shareholder vote on remuneration policy, disclosure of the remuneration of individual directors prior shareholder approval of share and share option plans.

⁴ *A European Perspective on Executive Remuneration* by Professor Guido Ferrarini, Professor of Business Law and Capital Markets Law, University of Genoa. Presentation given at the E.N.G.'s 7th annual senior executive summit in Brussels on Executive Compensation and Benefits, 16-18 September 2008

Significant lack of share ownership by NEDs and Executives in the European banking sector may explain why remuneration policies were not focused on long-term performance

Unsurprisingly, only one-third of EU member states⁵ have implemented an advisory vote on remuneration policy as part of the annual report or as a separate AGM resolution. This reinforces our belief that the key to improving remuneration disclosure across the EU lies in creating standard disclosure levels across all member states.

■ A long-term view on remuneration requires share ownership

Our research indicates that within the European banking sector 59% banks have not implemented or have failed to disclose the existence of share ownership plans for non-executive directors. Such plans encourage non-executives to behave as long-term shareholders and therefore encourage remuneration policies that deliver value over the longer term. In our view, the significant absence of share ownership for NEDs may explain why remuneration policies were not geared to address long-term performance – since non-executives did not think of themselves as shareholders.

Our research also suggests that 48% of banks either do not have a share ownership plan (requiring executives to acquire a significant amount of shares outside their option grants) or have not disclosed the existence of one for executive directors.

This is not surprising given the share ownership levels for NEDs. However, it might explain the pursuit of riskier short-term strategies by executive directors who were emboldened by non-executives whose interests were not sufficiently tied to long-term success.

However, share ownership by itself with no subsequent link to long-term performance is not a panacea. The US model highlights that executives, despite significant equity in shares, have like their European counterparts, pursued strategies that ultimately proved destructive. We believe that increased share ownership must be tied to transparent long-term incentives that are properly aligned with strategic objectives and entail a majority being held until retirement.

SHARE OWNERSHIP OF NEDS/EXECS WITHIN CHEUVREUX EUROPEAN BANKING UNIVERSE

	Percentage of banks that lack / do not disclose share ownership plans for NEDs	Percentage of banks that lack / do not disclose share ownership plans for Executives
Austria	0%	50%
Belgium	100%	100%
Denmark	100%	100%
Finland	100%	100%
France	40%	40%
Germany	80%	80%
Greece	89%	89%
Iceland	33%	33%
Italy	75%	75%
Portugal	33%	33%
Norway	100%	0%
Spain	12.5%	12.5%
Sweden	100%	0%
Switzerland	25%	50%
Average	59%	48%

NB Cheuvreux does not provide investment coverage on UK banks
Source: GMI, CA Cheuvreux

⁵ *A European Perspective on Executive Remuneration* by Professor Guido Ferrarini, Professor of Business Law and Capital Markets Law, University of Genoa. Presentation given at the E.N.G.'s 7th annual senior executive summit in Brussels on Executive Compensation and Benefits, 16-18 September 2008

Use of free float market cap (FFMC) as a performance measure may reduce impact of emerging market banks in comparator group as they would normally have a lower free float

■ Unravelling the complexity of remuneration plans

In a previous research note, we focused on the remuneration of three UK banks. Our research suggested that UK remuneration policies generally contain more detailed explanations of the principles and strategy for remuneration, more information on performance measures, better detail on the breakdown between fixed and variable pay and comparative data on groups in other European member states.

However, despite their better disclosure UK banks appear to have performed worse than their European peers. Our research suggests that the increased disclosure of UK remuneration plans has not always resulted in greater transparency for those seeking to understand whether executive remuneration is appropriate.

Case study: HSBC amends its remuneration policy

In 2007 HSBC was criticised by activist investors Knight Vinke (KV), who accused it of setting insufficiently challenging performance targets, pursuing an inappropriate strategy and failing to ensure a transparent share option plan.

KV's argument was based on two criticisms:

- the appropriateness of the TSR⁶ comparator group, which excluded listed banks from China, Hong Kong, Taiwan, Singapore, Brazil, India, Korea or Malaysia, all of which had outperformed HSBC in TSR terms over the last three years;
- the use of incremental EPS, which potentially allowed a maximum payout despite there being no new increase in EPS over a three-year period; this was because incremental EPS allowed for the aggregation of EPS growth each year rather than on the more usual point-to-point basis.

As a result of the review conducted by Mercer, the remuneration committee sought shareholder approval to amend the performance conditions of the HSBC share plan at the 2008 AGM. The proposed plan, which was approved at the AGM (albeit to significant shareholder discontent), centred around three measures: TSR, economic profit (EP) and EPS. The maximum award under this plan is 700% of salary and 80% of the award is split equally between the first two measures with the remaining 20% subject to EPS.

Under the plan, the existing comparator group will be updated to reflect HSBC's growth strategy that is now focused on the emerging markets of Asia and Latin America and in recognition of the listing and performance of Chinese banks in recent years. The comparator group will be comprised of the 26 largest banks (see table below) in the world measured in terms of free float market capitalisation (FFMC). During the performance period, the remuneration committee can at its discretion remove members of the comparator group that have ceased to be quoted or to exist or whose relevance as a competitor to HSBC has significantly diminished. The committee may likewise add members to the comparator group that it believes will enhance its relevance.

1. TSR performance condition (40% of award)

HSBC's outperformance of the comparator group will be calculated by dividing the total free float market capitalisation (FFMC) of all the companies that HSBC has outperformed in terms of TSR by the total FFMC of all the companies in the comparator group. 20% will vest at threshold for TSR performance above the median of the total FFMC within the peer group. Full vesting occurs for the achievement of upper quartile performance of the total FFMC within the peer group.

⁶ TSR = total shareholder return

2008 UPDATED COMPARATOR GROUP

Banco Bilbao Vizcaya Argentaria SA, Banco Bradesco SA, Banco Itau Holding Financeira SA, Banco Santander Central ispano SA, Bank of America Corp, Bank of China Ltd, Barclays plc, BNP Paribas SA, Citigroup Inc, Credit Suisse Group, DBS Group Holdings Ltd, Deutsche Bank AG, Fortis, HBOS plc, Industrial and Commercial Bank of China Ltd, JPMorgan Chase & Co, Lloyds TSB Group plc, National Australia Bank Ltd, Royal Bank of Canada, The Royal Bank of Scotland Group plc, Societe Generale, Standard Chartered plc, UBS AG, UniCredito Italiano SpA, Wachovia Corp & Wells Fargo & Co.

Source: HSBC 2008 AGM notice

EXAMPLE OF VESTING BASED ON TSR PERFORMANCE

	Total FFMC of Comparator Group (£m)	Total FFMC of Companies HSBC has outperformed	Percentage outperformance	Percentage of award which would vest
Scenario 1	1,000,000	770,000	77	100
Scenario 2	1,000,000	500,000	50	20
Scenario 3	1,000,000	450,000	45	0

Source: HSBC 2008 AGM notice

2. Economic profit (40% of award)

Economic profit (EP) is a new performance measure and will be expressed in percentage terms and calculated as the average annual difference between return on invested capital and the group's benchmark cost of capital. For the 2008 awards, the benchmark cost of capital is 10%. This portion of the award will start to vest if EP over the performance period exceeds 3% rising on a straight-line basis to full vesting for EP over the performance period of 8% or more.

VESTING EXAMPLE BASED ON EP PERFORMANCE

	Year 1%	Year 2%	Year 3%	Total	Annual average	Percentage of award that may vest
Return on invested capital	15	14	16			
Benchmark cost of capital	10	10	10			
Economic Profit	5	4	6	15	5	40

Source: HSBC 2008 AGM notice

3. EPS performance target (20% of the award)

The company reports that following feedback during its remuneration consultation from shareholders identifying a need for a simplified EPS performance measure, the remuneration committee decided to change the calculation method for the EPS portion of the award from incremental growth to point-to-point growth. The EPS growth targets are expressed in absolute percentage terms without adjusting for inflation. This is due to the global environment the company operates in, and the committee's belief that the UK or another country's inflation index would not be suitable. At threshold 20% of this portion of the award (4% of the total award) will vest for EPS growth of 16% over the performance period (equivalent to compound annual EPS growth of approximately 5%). The percentage of the award will rise on a straight line basis to full vesting for EPS growth over the performance period of 28% (equivalent to compound annual EPS growth of 8.6%).

EXAMPLE OF POTENTIAL VESTING BASED ON EPS PERFORMANCE

	Base year	Year 1 %	Year 2	Year 3	EPS growth in year 3 over base EPS	% of EPS part which would vest
Scenario 1	100	106	110	115	15	0
Scenario 2	100	105	122	115	15	0
Scenario 3	100	105	115	122	22	60
Scenario 4	100	118	110	125	25	80
Scenario 5	100	80	80	130	30	100
Scenario 6	100	115	130	115	15	0

Source: HSBC 2008 AGM notice

Amendments proposed by HSBC appeared on the surface to recognise shareholder criticism of performance targets

Despite significant disclosure, complexity of performance targets used by HSBC makes it difficult for investors to determine if awards are reasonable

■ Better disclosure does not always improve transparency

HSBC's new remuneration plan appeared to take on the views of KV and other shareholders by amending the TSR comparator group to include banks within Asia, Latin America and China in addition to reducing the significance of EPS as a proportion of the total LTIP award and introducing a new performance target in the form of economic profit.

What is surprising is that, despite the levels of disclosure and detail provided by HSBC, all of the three performance measures appear to be overly complex making it difficult to assess whether actual payout is appropriate and reasonable. For example, the use of a simple TSR measure normally offers shareholders a reliable method of measuring how a particular company has performed over time relative to its peers from a total return basis. Yet, under the HSBC scheme, this measure has been replaced by a hybrid TSR performance measure, which incorporates both a simple ranking system in addition to a weighted average TSR calculation, which appears an overly complex method of determining performance relative to peers.

In addition, while we welcome the introduction of an economic profit performance target, there is no standard definition for this performance measure and it is not a metric that is normally forecast by analysts. This leaves its interpretation subject to management discretion, with implications for the robustness of performance targets attached.

Furthermore, we believe that the increase of bonus awards for the CEO and Finance Director from 250% of salary to 450% of salary at the same time as proposed amendments to the stock option plan undermines its effectiveness (with regard to executive management taking a more long term view) as it encourages the CEO and FD to focus on significant bonus awards that are paid annually and which, unlike stock incentive awards, do not punish poor performance over the longer term.

In our view, unless European banks acknowledge and accept that bonus payments can no longer be calculated according to short-term results that are not transparent or sustainable over the longer term, it is unlikely that executive remuneration in the European banking sector will fundamentally change.

National governments have a chequered history as regulators: will they come up with an easy solution on remuneration?

Appointment of independent directors who appear to have strong financial experience mirrors recent actions by some UK banks

■ Government interference via remuneration reform

Europe continues to lead the way in curbing executive pay on the back of the growing momentum for remuneration reform that has been pushed by both media and social equity pressure. This has given national governments the green light to interfere in the pay structure of European banks: Germany has tied stringent salary restrictions to troubled banks and the Swiss Government has heavily reduced the bonus pool available to UBS.

We believe that the significant use of public money to bail out troubled banks has now made pay reform an unavoidable political necessity. However, the need for pay reform is not solely concerned with establishing remuneration that is less risky and sustainable over the longer term. In our view, the current climate offers the opportunity for national governments to link remuneration reform to social interests that benefit all stakeholders.

This may, for example, take the form of arbitrage between dividend policy and employee layoffs, under which national governments would tolerate the layoff of workers from banks as a result of lower revenues so long as such layoffs were not followed by the payment of dividends to shareholders.

■ Remuneration reform high on the agenda of bailout packages

Our research indicates that although there now appears to be a clear desire on the part of member states to curb executive pay as part of national bailout plans, there is no clear consensus on how these reforms will be achieved.

That is not to say that national governments will not step in like the Swiss Government has recently done to slash bonus pools as part of the state aid provided to troubled banks. In fact, in the short term this is a necessary first step to halt pay practices that have contributed to unacceptable levels of risk. However, in our view national governments have not always been able regulators in the past and so it is questionable whether they will be able to implement an easy fix to the problem of remuneration. We think the best path to reform is one that is market-based, with shareholder and government engagement where necessary.

The moves by both UBS and Credit Suisse, who have recently taken a proactive approach by announcing new innovative compensation schemes designed to reward long-term performance, would appear to support this argument. In our view, the UBS plan appears (on the surface) to be the most interesting as its compensation reforms are the result of a more comprehensive overhaul of its corporate governance structure, which we will now examine in more detail.

■ UBS corporate governance changes offer a new model

In August 2008 UBS announced the introduction of new corporate governance guidelines to clarify the separation of roles and responsibilities between the board and management. In addition, the guidelines proposed that the duties and responsibilities of the Chairman's Office would be shared among a greater number of board committees, including the new Risk and Strategy Committee.

UBS's new governance guidelines proposed a number of changes to the board and were implemented at an EGM on 1 October 2008.

**Audit committee:
appointment of two
independent directors
with significant
relevant financial
experience...**

**... reduces risk of
over-reliance on one
director for financial
expertise**

**The new bonus plan is
designed so that the
financial impact of
decisions and actions
taken in one period
impact on variable
cash compensation
over successive
periods**

UBS: RECENT GOVERNANCE IMPROVEMENTS

1. Amendments to articles of association

Removed the Chairman's office, which had been used by the former Chairman Marcel Ospel to concentrate his power over the board and made the whole board responsible for the company's overall strategy and scrutiny of executive management.

2. New appointments to the board

Sally Bott, Rainer-Marc Frey, Bruno Gehrig and William G. Parrett were all appointed to the board as independent non-executives. Their appointments were part of a board refreshment programme under which non-independent directors were retired from the board.

3. New appointments to the audit committee

The appointment of two newly appointed non-executive directors, Bruno Gehrig and William G. Parrett, to the audit committee.

Source: UBS

New compensation model designed to focus on long-term performance

UBS further announced on 17 November that from 2009 it will be implement a new compensation model for its board and group executive board. UBS was surprisingly frank about the potential problems of its remuneration structure in a report to the Swiss Federal Banking Commission (SFBC), which admits that:

*"Some disproportionately large risks had been assumed within what was a relatively small and isolated proprietary trading area of the Investment Bank. Earnings – and the bonuses linked to them – had not been sufficiently tied to the amount of assumed risk. In addition, the bonus payments were calculated based on short-term results, without sufficient appraisal of the quality or sustainability of those earnings."*⁷

The UBS compensation report states that as of 2009 compensation for top executives will be focused on long-term performance with rewards that reflect realised value creation and take business risk into account.

Variable cash compensation

The new UBS remuneration report says that the variable cash component will be based on a "bonus/malus" system. A maximum of one-third of the annual variable cash component will be paid out at year-end, subject to positive business development. The larger portion of the variable cash component will be held in escrow in a bonus account. Should UBS's results be poor, a negative award, or "malus", can result and the bonus account will decline.

A negative award, i.e. a malus, will be recognised in the cash balance in the case of:

- a financial loss at group or business division level;
- a large adjustment to the group's balance sheet.

The bonus account can also decline if regulations are grossly violated, if unnecessarily high risks are undertaken or if individual performance targets are not met.

⁷ UBS compensation report: UBS's new compensation model

BONUS STRUCTURE FROM 2009

Cash Balance	Year 1	Year 2	Year 3	Year 4	Year 5	etc.
Previous year balance		100	40	120	60	80
+ Awarded bonus	150		140		60	
- Awarded malus		-40		-30		
= Interim balance	150	60	180	90	120	
x Payout	33 %	33 %	33 %	33 %	33 %	
= Amount paid out	50	20	60	30	40	
Balance after payout	100	40	120	60	80	

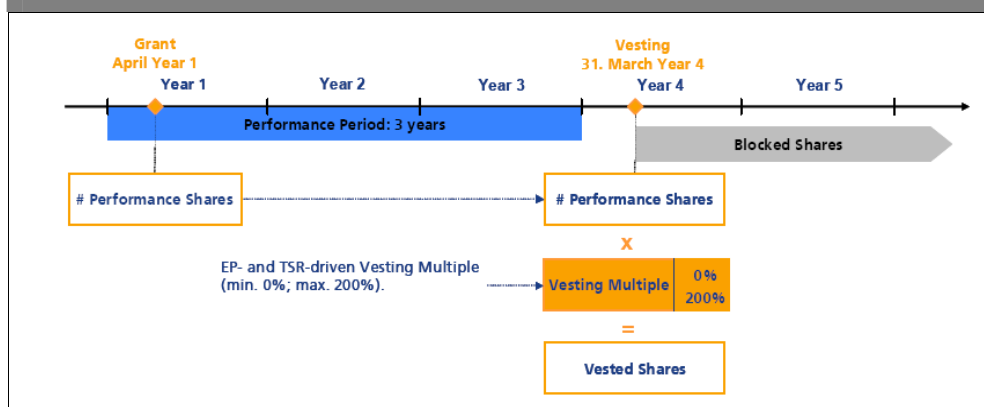
Note: The final definition of the malus regulations is still in development. They will be aligned according to best practice and the SFBC standards. Details will be communicated at the 2009 annual general meeting (AGM).

Source: UBS compensation report: UBS's new compensation model

Variable long-term equity compensation

The new Performance Equity Plan (PEP) will replace all current equity incentive plans and participants will receive a fixed number of restricted performance shares at market price. Vesting of such awards will be dependent upon two performance criteria: economic profit (EP) and total shareholder return (TSR). Upon vesting, 75% of total vested shares must be retained for several years.

STRUCTURE OF THE PEP



Source: UBS compensation report: UBS's new compensation model

Specific performance targets for economic profit and TSR are not yet disclosed...

... nor is the maximum ceiling for annual share grants

Uncertainty over bonus ceilings raises questions over how excessive or inappropriate bonus awards will be prevented

Is UBS a benchmark for others?

We believe that the governance changes proposed by UBS reflect the changing realities of the European banking sector, namely the need to re-establish trust. In our view, the bank's board structure is now more transparent and the refreshment of personnel has strengthened the competence and ability of the wider board (including the audit committee) to assess and monitor risk.

We believe that the UBS remuneration model establishes a clear and transparent link between variable awards and long-term performance and that implementation of the malus for poor performance will enhanced the sustainability of the management's performance over the long term. In addition, UBS has recognised the importance of share retention as a tool to tie both non executive directors and executive management into the long-term performance of the company.

However, although UBS's compensation plan has highlighted how bonus awards can be effectively tied to long-term performance, it requires UBS to use some capital at a time when banks are facing shareholder and government pressure to reign in bonus awards for banks that have required state aid.

The CS plan is unique in that it uses debt to remunerate employees...

... and should be welcomed by shareholders and regulators as it facilitates removal of risky assets from balance sheet, preserves capital and infuses risk directly into executive pay over the long term...

... offering a sensible solution for other banks seeking to restructure pay towards the long term

Linking risky remuneration practices to increased capital requirements would provide a direct incentive for boards to implement more appropriate pay practices

Making executive remuneration responsible

The CEO of Credit Suisse (CS), Brady Dougan, and the CEO of the investment bank, Paul Calello, announced in a memo to employees in December 2008 that 2009 bonus awards to managing directors and directors would be tied to the performance of a USD5bn pool of the most illiquid loans and bonds that Credit Suisse currently has on its balance sheet. Under the scheme the top two management grades within CS will receive 70-80% of their bonuses in partner asset facility units (PAF) which will be linked to the performance of the illiquid pool of assets. Participants cannot receive any payments for at least five years and will only receive the bulk of the award after eight or nine years. The plan also includes a retention effect with participants who choose to leave CS within a year of their participation keeping only one-third of their equity in the new system; those staying for two years may keep two-thirds; and those staying for three the whole amount.

In our view, both shareholders and regulators should welcome the Credit Suisse plan as it potentially removes risky assets from the balance sheet and preserves capital while infusing that risk directly into executive pay over the long term. Furthermore, long-term participants have the opportunity to gain some upside in the event that the toxic assets return to value. Despite the lack of specific details from CS regarding the structure of the plan, we believe it offers a sensible solution for other banks seeking to restructure pay towards the long term.

Can regulators play a part in limiting remuneration excesses?

The UK financial regulator, the FSA, which has been tasked by the UK government with curbing excessive remuneration at UK banks, has warned that it may require banks that retain remuneration policies encouraging inappropriate risk-taking to set aside more capital.

We view this as a significant step for two reasons. First, it would send a clear signal to the market and investors that risk-taking is not being properly managed and that executive incentive pay must necessarily be aligned with sustained performance over the long term. Second, increased capital requirement would potentially lead to lower profits (reducing the likelihood of huge compensation awards anyway) and subsequently a smaller dividend making shareholder engagement more likely. We believe that if European regulators were to follow suit and link risky compensation practices to larger capital requirements, boards would have a direct incentive to implement appropriate remuneration policies.

Revolution for some, evolution for others...

An interesting question is whether remuneration reform will be achieved by loud revolution or quiet evolution. It is now evident that banks that have taken government aid have experienced a revolution in the form of severe restrictions to bonus pools, prohibition on bonuses for executives for 2008 performance and possibly a freeze on salary increases.

However, while we believe it would be naive to presume that banks that have avoided government capital injections will completely escape the interference of national governments, such banks will undoubtedly face less pressure to reign in egregious practices and as such any moves towards linking remuneration to long-term performance may be enough to appease regulators, governments and shareholders.

IV— How competent and effective is my board?

Independence alone does not equate to experience or competence...

... but it is a necessary first step towards removing conflicts of interest and establishing trust

Our research into the boards of European banks has highlighted a serious lack of independence on the audit and remuneration committees. This is significant, as we believe that one of the consequences of the current financial crisis will be the emergence of the remuneration committee alongside the audit committee as a critical contributor to the assessment of corporate governance by investors.

We believe that board independence plays a crucial role in the effectiveness of boards and avoidance and management of conflicts of interests and undue concentration of power in the hands of executive management or major shareholders. Our research indicates that although on average the aggregate level of independence for boards across the European banking sector is approximately 50%, the battle for board committee independence has not been won. Although we do not believe that independence alone equates to experience and competence, we see it as a necessary first step, particularly as we recognise that many European member states do not require sub-board committees to be completely independent.

BOARD COMMITTEE NON-INDEPENDENCE WITHIN THE CHEUVREUX EUROPEAN BANKING SECTOR

Country	Percentage of companies with an audit committee that is not wholly independent	Percentage of companies with a remuneration committee that is not wholly independent
Austria	100%	100%
Belgium	75%	50%
Denmark	67%	50%
Finland	100%	100%
France	100%	50%
Germany	80%	100%
Greece	89%	72%
Iceland	100%	100%
Italy	38%	75%
Norway	0%	0%
Portugal	100%	67%
Spain	63%	75%
Sweden	75%	25%
Switzerland	25%	50%

Cheuvreux does not provide research on UK banks

Source: GMI, CA Cheuvreux

Lack of European mandatory rule on non-executive directors prevents uniformity of competence and independence

Our previous research into the corporate governance of UK banks highlighted potential weaknesses in terms of both the wider board's ability to assess risk and the audit committee's reliance on the relevant financial expertise of one director. We believe that these potential weaknesses can also be seen in the Continental European banking sector where the absence of a European mandatory rule on non-executive directors prevents any uniformity on relevant competence and independence. In our view, the variations in disclosure on independence, director biographical information and succession planning across the European banking sector have created a regulatory arbitrage that hampers any assessment by investors of whether non-executive directors are truly competent.

Our research suggests that this regulatory arbitrage could be removed by better disclosure within the annual report on why each non-executive director is considered competent and the specific expertise they bring to the board. We believe this would allow investors to judge whether non-executive directors on both the wider board and the critical sub-board committees (such as the audit and remuneration committees) understand the technical aspects of their businesses.

The German state's ability to appoint directors to the supervisory board indicates government interference is starting to spread to board

Audit committees must not be sole agitator for risk management

Danger of information overload for audit committees, without sufficient clarity on potential risks

Responsibility for risk management resides with whole board, not just audit committee

We believe it is now imperative for boards not only to assess the inherent risks they face in an uncertain market, but also to ensure that they have the appropriate expertise in the form of non-executive directors.

■ Government interference spreads to board competence

The influence of the government over the banking sector indicates a failure on the part of shareholders to effect control over the board and to properly understand the risks undertaken in their name. This has created a situation where the boards of government-aided banks are now accountable to national governments whose interests will not always be in line with those of shareholders.

We believe that both national governments and shareholders recognise the importance and need for competent and effective boards. In the UK, the collapse of Northern Rock led the financial regulator, the FSA, to begin to examine the quality of boards and demand changes where the calibre/expertise/skills of non-executive directors is substandard.

Board effectiveness and competence are pivotal if banks are to survive the current crisis and we believe that national governments will increasingly exert influence over the board appointment process as part of their bailout plans. The recent acquisition of a 25% stake in Commerzbank by the German Government, which allows for the appointment of government representatives to the supervisory board, is a prime example of this.

■ Ideal relationship between risk and audit committees

Given the current global credit crisis, the audit committee has become synonymous with the word "risk". In fact, a recent survey of international audit committee members by KPMG⁸ highlighted that audit committees were somewhat concerned that they had been assigned or had assumed too much responsibility for risk oversight beyond financial reporting. While this is not surprising, given the current economic crisis, we have concerns that the expansion of audit committee oversight may divert the committee's focus away from its primary mission, which is the oversight of financial reporting and internal controls.

Both audit committees and boards now receive (and must therefore digest) a great deal of information on risk from the internal risk management department, internal auditors, external auditors, executive management and where necessary other sources (which may include external consultations). However, we would question the quality of information flow and whether this volume is actually useful. In addition, we believe there is a danger that audit committees are simply being swamped with information that has not been condensed to provide clarity on the specific risks that businesses in the financial sector may face. For example, remuneration and the potential effect on long-term performance is now an issue that audit committees in the banking sector could be asked to examine. We consider this to be a significant issue, particularly as we believe that audit committees should not become involved in the detail of remuneration, given their detached oversight role and the time pressure this creates on their ability to collate and assess information.

We believe that the ideal relationship between risk and audit committees begins with the notion that the responsibility for risk management resides with the whole board, which collectively delegates the oversight and monitoring of risk to the audit committee. In our view, this is why it is imperative that the board is comprised of directors who can understand and act on the findings of the audit committee where necessary. Second, the quality and quantity of information provided to the audit committee should enable it to efficiently carry out its role.

⁸ KPMG International Survey of Audit Committee Members, Audit Committee Institute 2008.

Despite detailed risk management functions used to mitigate and control risk in the financial sector, banks did not or could not understand the levels of risk being taken

Audit committee members in the financial sector should have a demonstrable understanding of their business

Audit committees need to give greater detail on group approach to risk

However, this is not a simple process, as the board sets the risk appetite of the business based largely on information provided by management. What the financial crisis has highlighted is that despite the detailed risk management functions that are used in the financial sector to mitigate and control risk, banks did not or could not understand the levels of risk that were being taken. In his recent appearance before the UK Treasury Committee⁹ the former Chairman of RBS Sir Tom McKillop admitted that:

'...At the heart of this I think there was an issue not about risk recognition but about how the risk was calibrated. They [traders] were holding positions in what we perceived to be triple A securities and they turned out to be worth 5 or 10 cents in the dollar. The risk was recognised but in the risk systems it was quantified as being very small: it turned out to be very large and it was wrong.'

■ What is an effective audit committee?

Our recent research has looked at the quality of expertise and experience of non-executive directors in the banking sector, particularly those directors who are members of audit committees. However, while we believe there is a clear need for audit committees to contain a majority of directors with relevant financial experience, we also think that some directors sitting on audit committees should have an understanding of the technical aspects of the business.

For example, the audit committee chairman's statement on the investment banking business of Barclays Bank Plc in its 2007 annual report states that a separate session for committee members on accounting and valuation of derivative and complex investment banking instruments was held in February 2008. However, according to our research none of the audit committee members presently appear to have any obvious experience of investment banking, which would enable them to assess the inherent risk derived from Barclays' investment banking business. Furthermore, the annual report did not indicate whether outside expertise had been brought in to help the audit committee understand and interpret Barclays' derivative investment banking instruments.

While this does not mean that Barclays' audit committee is unable to assess or review these risks, it does support our view that audit committees need to explain in more detail how they approach the inherent risks facing companies in the financial sector, particularly risks involving complex financial instruments.

In our view, the role of head of group risk should now be a board position. This would allow direct interaction on a regular basis between the board and the individual directly responsible for monitoring and controlling risk.

POTENTIAL QUESTIONS FOR INVESTORS TO PUT TO AUDIT COMMITTEE CHAIRMAN

1	Do you feel that the audit committee has been assigned too much responsibility for the oversight of significant risks?
2	If you were part of the executive management what would you have done differently?
3	How has the expertise and experience of audit committee members been used during the year to oversee and monitor risk?
4	Do you feel that the skill mix of the audit committee is appropriate, given the risks the business faces?
5	In your opinion, is the right amount of risk being taken?

Source: CA Cheuvreux

⁹ Uncorrected transcript of oral evidence, minutes of evidence taken before Treasury Committee – Banking Crisis – Former Bank Executives, Tuesday 10 February 2009.

SAD requirement for a minimum of one director with financial competence may recreate UK problem of audit committee over-reliance on the financial experience of one member

The consequence of minimum harmonisation is the potential for regulatory arbitrage as some member states go further than the required minimum

■ Statutory Audit Directive

Harmonising audit committee competence?

The Statutory Audit Directive (SAD) was implemented in June 2008 and has been called Europe's answer to Sarbanes-Oxley (SOX). The measures under this directive are significant because they incorporate a core set of uniform principles that will affect all EU member states. This will be achieved by harmonising the EU framework for the statutory auditing of company accounts and public oversight for the audit profession. One of most significant outcomes of SAD is the requirement for all publicly listed companies to have an audit committee with at least one member who has relevant experience in accounting or auditing designated as the financial expert. In addition, the requirement for auditors to report key governance matters such as material weaknesses within internal control should provide the audit committee with a better picture of the overall risk appetite. However, we consider the requirement to have a minimum of one director with financial competence potentially recreates the UK problem of audit committees being overly reliant on the financial experience of one member.

Furthermore, despite the promise of uniformity there will be some scope for variation at individual country level. This is because the SAD is concerned with 'minimum harmonisation', which provides minimum compulsory standards for all member states while allowing flexibility for them to go further than the minimum requirements. This would allow a member state such as France, for example, which currently employs a stricter approach to the types of non-audit services, to maintain its own national approach even after the adoption of the SAD.

WHAT THE STATUTORY AUDIT DIRECTIVE MEANS IN PRACTICE

Auditor independence	Under the directive, statutory auditors will not be prohibited from providing non-audit services to their audit clients, but they are required to consider if their independence is under threat and, if there are not sufficient and appropriate safeguards, the audit firm must withdraw from the audit or the non-audit service concerned.
Mandatory audit partner rotation	Reinforcement of auditor independence by requiring the key audit partner to rotate at least every seven years from the date of their appointment. The audit partner is then only allowed to participate in the audit of the audited entity only after a minimum two-year cooling-off period.
Audit committees	Each public interest entity will have an audit committee and the member state will be responsible for determining whether the audit committee is comprised of non-executive directors or supervisory members. At least one member of the audit committee must be independent and have competence in accounting or auditing. Furthermore, the new role of the audit committee in choosing external auditors and ensuring their independence is positive step and sends a clear signal to investors about the key role of this committee.
Internal controls	The audit committee will be required to monitor the effectiveness of the company's internal controls, internal audit and risk management systems. To enhance the quality of financial reporting, the statutory auditor or audit firm must communicate to the audit committee on key matters of governance arising from the audit, in particular on any material weaknesses observed in internal controls relating to the financial reporting process.
Public accounting oversight	The current system of self regulation will be removed and EU members will be required to appoint oversight boards for statutory auditors. The Directive also seeks to establish a common European architecture for the independent oversight and regulation of the profession across member states to enhance credibility and facilitate discussions at EU level with the US Public Accounting Oversight Board (PCAOB). Member states will also be required to register firms and establish investigative and disciplinary systems. In addition third-country auditors who issue audit reports in relation to securities traded in the EU will need to be registered in the EU.

Source: CA Cheuvreux

Government does not necessarily rhyme with governance and shareholder value

V— The symptoms of being a minority shareholder

■ Government does not necessarily rhyme with governance

The present banking sector crisis has highlighted the inadequate control that shareholders have been able to exert over their boards. However, we believe shareholder support is key to the success of any government-led reforms.

The main question for shareholders now is how their interests align with those of the governments. Governments are clearly more concerned with stabilising the system and mitigating the negative economic impact of the crisis than with shareholders' interests.

COMPARISON OF GOVERNMENT AND SHAREHOLDER INTERESTS

	Government	Shareholders
Primary interest	System stabilisation Possible business model intervention to achieve political aims i.e. forced lending to businesses and consumers Eventual investment yield and exit	Avoidance of complete dilution through nationalisation.
Secondary interest	Reform of executive remuneration New regulation on a national /supranational basis	Dividends Avoidance of unnecessary government interference in business model Reform of executive remuneration

Source: CA Cheuvreux

Over the long term shareholder and government interests are aligned

Risk of shareholder dilution through nationalisation or regulation

Do governments still need shareholders?

For shareholders, regardless of their importance, the primary threat is the complete dilution of their economic interests through government nationalisation (not the reform of remuneration or appropriate board expertise), but also indirect government influence via changes to (national) regulation. In this context, we would highlight our view that while many banks have failed on operating performance and risk management in the past, the fact that the government becomes a majority shareholder does not constitute a higher likelihood of successful bank management. Governments too have not performed well when regulating banks in the past, which has been particularly evident in the German Landesbanken sector.

Furthermore, a review of the experience of state intervention in Europe reveals two categories of intervention:

- the dogmatic approach, as in the French nationalisation plan of 1982, or the Portuguese example of 1974;
- the pragmatic approach, as in the bankruptcy of Nordic banks in the early 90s (property bubble) or in Spain.

The French nationalisation plan was part of the programme implemented by socialist President François Mitterrand, after winning the 1981 election. This plan was massive, involving all domestic banks with deposits of over FRF1bn (EUR150m). Despite concerns in the markets at the time, the price paid to shareholders of nationalised banks was ultimately considered unfair, since most of the banks were exposed to the default of Mexico and other Latin American countries.

However, the state intervention created an opaque system of management, with the appointment of “political commissioners” who were executives responsible for changes at board level. A change of mind occurred in 1985-1986 and the right's victory in the 1986 election drove the privatisation process of 1986-1990. However, the selling of banks' property to private shareholders was conducted in such a way as to create a complex “web” of cross-shareholdings between banks, insurance companies and large industrial groups. This created a “non-shareholder-friendly” market during these years.

The dramatic failure to properly monitor and rescue Crédit Lyonnais in the early 1990s and the poor management of the associated bad bank (CDR) flagged the inherent limitations of state management of the banking sector. Crédit Lyonnais was finally privatised in 1999, but despite the gain made at the IPO the net balance was quite negative for taxpayers.

Norway, Sweden and Finland were more pragmatic in their interventions in the early 90s, to support first the medium-sized banks and then the banking system as a whole. The framework that was followed (although not always exactly in this precise order) was to force the recognition of (property) losses, then inject capital (with or without voting rights) while retaining enough influence or control to work effectively at creating “bad banks” to house the “toxic” assets. The restructured banks were then given back to private shareholders through the repayment of government support packages.

Spain followed the same formula when rescuing the bankrupt Banesto in the early 90s, but the partially restructured bank was sold via public auction to another Spanish bank, Santander.

In France the government has imposed the appointment of a senior advisor from President Sarkozy's cabinet to head the mutual bank that will be created from the merger of the Groupe Banque Populaire and Groupe Caisse d'Épargne, two of France's biggest savings banks who together own 70% of Natixis.

This appointment is the direct counterparty to the French state taking a 15-20% stake in the bank. Whether or not it causes controversy (due to the potential conflict of interest during the merger follow-up), we believe it actually demonstrates that the financial crisis has made old principles temporarily redundant and that state intervention can reshape all standards. This appointment may not be such bad news for shareholders as the government seems committed to restructuring the bank and will certainly feel accountable for it towards all stakeholders.

In our view, governments have to leave something on the table for shareholders as this will be in the governments' own interests when seeking to privatise the banks in a few years' time and clearly there is no economic rationale for keeping the sector nationalised long-term.

Government and shareholder interests not set to converge short-term

While there may be a short-term lack of alignment between the interest of shareholders (shareholder returns) and governments (preventing systemic fallout), their long-term concerns are not so dissimilar as governments should (rightly) receive a decent return on their investment given the risk they face by potentially losing taxpayers' money.

There should to be a trade-off between governments exercising necessary influence on the banking sector (via either direct participation or regulation) and providing the banks with enough breathing space to sustain and develop their business model. Investors are increasingly concerned that, for example, excessive bonus cuts could damage a franchise and/or affect other divisions of the firm. Governments will therefore have to ensure that interference on the business model is conducted with a view to risk reduction but also with an eye on an eventual exit strategy.

Current "too big to fail" status of European banks may weaken consensus for governance reform

At UBS the fact that bonus pools were recently cut by 90% is seen as a major risk by investors as it will make it difficult for UBS to retain key staff within Wealth Management. In our view, the interests of the government and shareholders are not necessarily aligned on this issue given that the government's main concern is to curb overall executive pay and the significant decline in UBS's balance sheet, even at the cost of destroying shareholder value. Unlike other governments, which have talked about limiting compensation, the Swiss government is the first to have acted and we believe that investors generally share the view that this could damage UBS's core Wealth Management franchise.

Shareholders have been reduced to minority status

What is now clear is that the lack of confidence within the banking system and the ability of national governments to inject significant capital into failing banks means that, irrespective of the size of their holdings, all shareholders are now in effect minority shareholders vis-à-vis national governments.

European banks have also become "too big to fail" with those not requiring some form of government aid forming a small minority. In fact, our research suggests that one of the significant effects of banks becoming "too big to fail" is the weakening of the current consensus for governance reform that is now necessary as big banks recognise that national governments will not let them fail, irrespective of their risk profile.

■ Two-tier banking system presents different risks

The ability of European banks to choose whether or not to accept government help means that there is now a two-tier system: one group of banks that have taken up state aid and another group that are somewhat freer of government influence. We believe that shareholders within these two tiers will undoubtedly face different risks going forward.

RISKS/ADVANTAGES OF GOVERNMENT-BACKED BANKS VS INDEPENDENT BANKS

	Risks	Advantages
Tier 1: Government-backed banks	Threat of complete dilution in the event of full government nationalisation. Uncertainty over effect of government intervention on executive remuneration, lending strategy and dividend payments.	Injection of government capital to shore up funding/capital requirements. Eventual upside for governments may also eventually provide some upside for remaining shareholders who have invested in a bank that is now "too big to fail". Shareholder engagement more likely to receive the support of national governments who require sustained long-term performance as they cannot sell bad performance in the short term.
Tier 2: Independent banks	Access to capital may be limited and investor concerns over hidden risks may lead to a lack of confidence and eventual need for government injection of capital. Shareholder engagements seeking governance reform may be more difficult without support of national governments. Activist investors more likely to target independent banks who have not sufficiently reformed corporate governance.	Ability to determine growth based on capital protection/funding requirements. Retention of control over business model, remuneration and dividend payments. Revenue is shared between employees and shareholders only.

Source: CA Cheuvreux

National governments may view interference in troubled banks as necessary for creating sustained value over the longer term

Our research indicates that shareholders of banks that have participated in government bailout programmes will be primarily concerned with the prevention of further dilution of their interests and uncertainties over government interference. This interference may take the form of pressure to provide lending to business and retail customers irrespective of whether this is aligned with the current business strategy. At the same time, national governments have now become in effect captive shareholders who are unable to sell bad performance but who may view their interference in respect of remuneration and board competence as necessary to creating sustained value over the longer term.

Avoidance of capital injections from national governments will not be enough to shield banks from government interference on remuneration reform

Waiving of pre-emption rights by banks seeking to raise capital may be biggest threat to shareholders

Independent banks: a safe haven for shareholders to invest?

Shareholders of banks that have not so far participated in government bailout programmes (given the strength of their capital, funding and liquidity) will still face the potential threat of government influence, although this threat will diminish the longer such banks continue without calling on government help.

However, we do not believe that the avoidance of capital injections from national governments will be enough to shield banks from government interference on executive remuneration. In our view, the momentum of this issue means that national governments must now act to ensure that all banks (irrespective of whether they require state aid) have acted to ensure that their remuneration policies are sustainable over the long term.

■ The case for shareholder engagement

As we have stated previously, the influence of national governments has effectively reduced shareholders to minority status and increasing interference by national governments in traditional governance spheres such as remuneration and board competence places shareholders in danger of being treated as just another stakeholder rather than as owners.

This fundamental shift in status for shareholders appears to be necessary in the short term as government interference has forced banks to limit bonus payouts and salaries, something that shareholders have failed to do in the past. However, most of the bailout plans that have been enacted by European governments have not been in the form of direct equity stakes and we believe that national governments will need shareholders to provide capital in the future. In turn, we believe that the dilutions of shareholders' economic rights is a necessary trade-off for government intervention in the form of better governance that will benefit all shareholders.

The real threat to minority shareholders may come from banks that have chosen not to seek government support and who instead choose to dilute the rights of existing shareholders by waiving pre-emption rights in order to enable new investors to inject capital. This scenario, in our view, creates a dangerous precedent.

The waiving of pre-emption rights destroys the relationship between a company and its investors and creates divergent interests between shareholders. Furthermore, the absence of pre-emption rights may make it harder for pension funds to maintain their positions in banks over the longer term.

Shareholder engagement alone could not have prevented the current financial crisis. However, we believe that more responsible ownership is now urgently required to re-establish trust between shareholders and management in the banking sector.

Shareholder engagements are now likely to increasingly shift to the more fundamental concern of protecting interests, which will require more intensity from shareholders as they seek to reduce the possibility of further nationalisation or dilution of their interests via the waiving of pre-emption rights.

VI – Correlating governance with financial performance

In this chapter, we attempt to shed light on the correlation between strong corporate governance and risk levels. We measure risk by using credit default spreads (CDS), as we believe these are currently the best measure of a bank's risk profile. We have excluded UK banks as we looked at them in a previous note and do not generally provide equity research on them. Our conclusions are in line with previous research. We show that risk levels are lower for banks with a record of strong governance.

■ Does governance matter?

We searched for quantitative evidence of a correlation between governance and risk levels among the banks we cover. Our analysis relied on ratings from Governance Metrics International (GMI) to evaluate governance performance.

According to our sample, there is a medium-term effect of governance on risk (measured by CDS spreads).

Corporate governance has a low but significant explanatory power (15%). This result strengthens our view that corporate governance is an area that investors should focus on.

These results must be corroborated further. We are cautious with our conclusions, since figures only go back to four years.

Key results

Less visibility on banks with below-average governance

There is evidence that banks with good governance have lower risk levels. Among the banks with below-average governance, risk levels are higher, and far more dispersed. We believe that below-average governance is a sign of potentially higher risk, especially in a bear market.

Link between risk and governance: small but significant

Corporate governance accounted for 15% of the variations in the current risk levels. The null hypothesis – "strong/weak governance does not affect risk levels" – is rejected with a level of confidence superior to 99%.

Risk levels: board accountability and remuneration the key drivers

Among the factors rated by GMI, *board accountability* and *remuneration* were the main drivers of the correlation. *Shareholder rights* and *market for control* were less significant.

Governance matters for investments with medium-term horizon

We find that banks with strong records of governance (from 2005 to 2007) have currently lower CDS spread levels. In contrast, we believe that there is no short-term correlation between governance and risk. Recent ratings (from the beginning to the end of 2008) are not reflected in the current risk levels.

Adjusting statistical biases

We looked for biases that may affect our analysis, using a set of control variables: market cap, country of origin, growth rate, etc. Size was the only major bias at play. Larger banks (Deutsche Bank, BNP Paribas) display both low risk levels and strong governance. On the other hand, for medium-sized banks (Natixis, SHB), the risk levels are more sensitive to governance. Due to lack of data available, we did not test the influence of exposure to investment banking.

Our research suggests investors would be well advised to focus on corporate governance...

... which has clear implications for risk levels

Methodology

We used governance ratings and track records (2005 to 2008) provided by GMI, to explain banks' risk and performance levels. We believe corporate governance has a medium-term influence on banks' risk levels. It is not correlated with returns.

- We measured risk with credit default swaps spreads. As a CDS is the price to guarantee a company bond, it provides a market assessment of the risk of default. It also directly impacts access to capital and the cost of refinancing. In our view, CDSs are a more reliable indicator of risk and cost of capital than betas.
- We evaluated performance based on growth in book value and dividend per share. This measure is cumulative (and thus less affected by exceptional returns) and robust to perimeter change.
- We used two data sets: 30 banks covered by Cheuvreux and a larger group of 37 European banks to control results.

Elements of financial stability

As a result of a series of simple regression, size (measured by market cap or total income) and governance indicators stood out as two significant elements in explaining current risk levels. Correlations are not high because the relationships they describe are not linear.

REGRESSING INDIVIDUAL FACTORS ON CURRENT RISK LEVELS

Variables	Individual coefficient of determination r^2	Level of significance
Governance rating	0.19	0.013**
Market cap 2007	0.08	0.10*
Core capital ratio 2007	0.04	0.269
ROE 2007	0.02	0.423
Growth in book value + dividend per share 05-07	0.02	0.415
Total income 2007	0.14	0.032**

Source: GMI, CA Cheuvreux

Remuneration and board accountability were key governance factors

We also tested the individual impact of each of the six category ratings used by GMI in the calculation of their overall governance rating. Two of the categories displayed a higher influence on risk levels.

Board accountability and remuneration were key in explaining differences in CDS spread levels. Other category ratings (market for control, corporate behaviour and shareholder rights) were less significant, although we believe they should not be disregarded in the future, as they may yet prove another source of risk.

At any rate, the main catalysts for the current higher risk levels were remuneration and board accountability; quantitative analysis suggests these issues must be addressed.

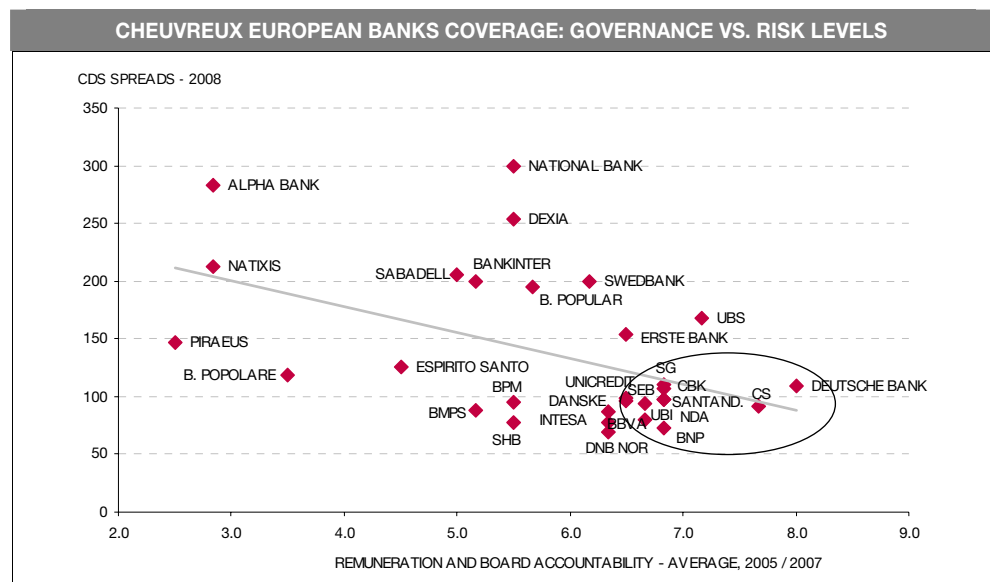
EXPLAINING RISK LEVELS: KEY GOVERNANCE FACTORS AT STAKE

Governance ratings category	Coefficient of determination: r^2	Level of significance
Remuneration	0.19	0.015**
Board accountability	0.15	0.028**
Financial disclosure & internal controls	0.07	0.153
Corporate behaviour	0.06	0.200
Shareholder rights	0.03	0.323
Market for control	0.02	0.423
Overall rating	0.15	0.046**

Source: GMI, CA Cheuvreux

Record of strong governance associated with lower risk

It appears that a record of strong governance (2005/2007) is correlated with current risk levels, accounting for 15% of the variation in CDS spreads. Using correlations on this data is somewhat misleading, for the relationship is non-linear. However, there is a clear relationship between good governance and lower risk levels. The best way to look at it is to distinguish between two groups: banks with above vs below-average governance.



Visibility lower for banks with below-average governance

Good vs. below-average governance

The banking industry's overall increase in CDS levels did not affect banks with strong governance so much. Our findings reflected two clearly defined groups: banks with good ratings vs below-average ratings¹⁰.

- CDSs were significantly lower for banks with good governance (BNP Paribas, Commerzbank, Credit Suisse, BBVA).
- For banks with below-average ratings (under 6.2 in remuneration and board accountability), spreads were higher and on the whole more dispersed. Weak governance does not automatically imply a higher risk, but there is less visibility on those banks with below-average governance.

Good governance is likely to carry more weight in a bear market, when investors turn to financial quality.

CDS SPREAD LEVELS: GOOD PERFORMERS VS. BELOW AVERAGE

	Number of banks	Average CDS spreads 2008	Standard deviation	ANOVA / level of confidence
Good performers	16	101	27	0.0007***
Below average	14	173	72	
All	30	136	64.3	

Source: GMI, CA Cheuvreux

¹⁰Here we used a clustering technique to differentiate between homogeneous subsets.

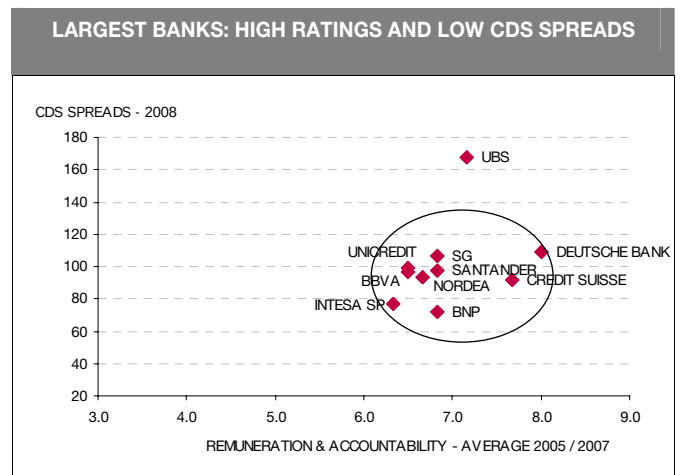
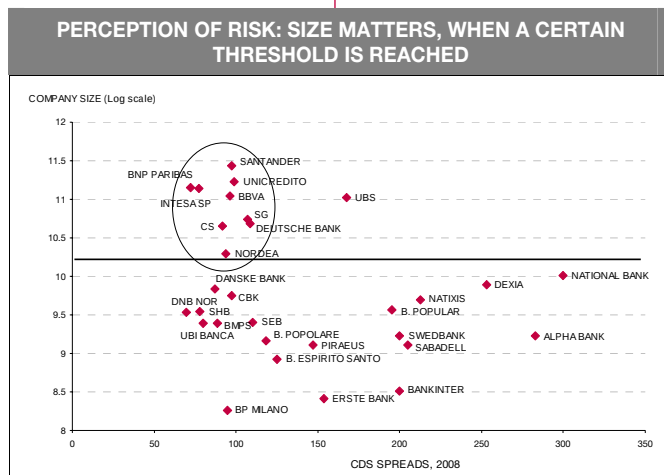
■ The "too big to fail" effect and our conclusions

Using a set of control variables (market cap, growth, country of origin, core capital and other financial ratios), we tested the influence of these factors on our results, looking for any unwanted bias. Because of the lack of data available, we could not test the degree of exposure to investment banking; this limits our analysis and conclusion.

We did not identify a country bias in our data set. In our view, the fact that UK banks have strong governance and comparatively high CDSs does not challenge our conclusion. Indeed, we conducted a previous study on UK banks, and the results of both studies are consistent.

Market cap was the only significant bias, as it was correlated with both risk and governance. Most of the biggest banks have comparatively good governance structures and are also considered less risky. Correcting the size effect, we show that our conclusion holds for smaller banks.

The largest banks benefit from lower CDS spread levels (being "too big to fail") and also display higher governance standards:



RISK LEVELS: BIG BANKS VS SMALLER BANKS

	Number of banks	Average	Standard deviation	ANOVA / Level of confidence
Bigger banks	10	102	26	0.008***
Smaller banks	21	152	71	
All banks	31	136	64	

Source: CA Cheuvreux

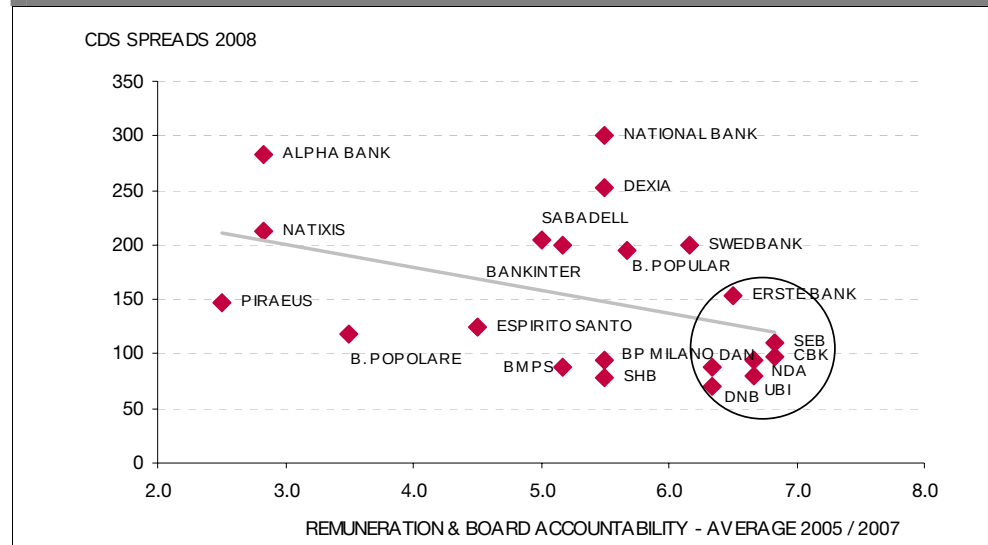
We corrected the effect of size on our results by separating large and medium-sized banks:

- Among the largest banks, governance ratings are high. Therefore, we cannot differentiate between the effect of governance and the "too big to fail" effect.
- Excluding the largest banks from the data set, the correlation between risk and governance still holds.

Risk levels appear to be more sensitive to governance ratings for medium-sized banks.

Those banks with a history of good governance show lower risk levels. Below a certain level of governance the relationship breaks, and variance in risk levels is high.

Regardless of the "too big to fail" effect, good governance is a factor worth considering

EXCLUDING THE LARGEST BANKS: OUR CONCLUSIONS ARE ROBUST TO THE SIZE EFFECT


Source: GMI, CA Cheuvreux

CDS SPREAD LEVELS AMONG SMALLER BANKS: GOOD PERFORMERS VS BELOW-AVERAGE

Value	Number of banks	Average CDS spreads 2008	Standard deviation	ANOVA/level of confidence
Under average	13	177	74.4	0.020**
Above average	8	111.5	43.8	
All small banks	21	152	71.1	

Source: CA Cheuvreux

We recommend looking for good governance, when making investment decisions

■ Governance and investment decisions

Drawing from this analysis and our previous research, we believe good governance should be one of the elements investors should look for when selecting a stock.

We did not detect lower returns among those banks with stronger governance. Below-average governance, on the other hand, led to higher financial instability. In summary, based on our quantitative analysis, we advise investors to:

- take a closer look at remuneration and board accountability;
- distinguish between banks with above-average governance and those with below-average ratings, especially because it is not yet priced in by the market;
- interpret below-average governance as a potential sign of increased risk on a medium-term investment horizon;
- search out companies with good governance, as this indicates a lower default risk that can be leveraged in a bear market, when investors seek financial quality.

OUR GOVERNANCE SELECTION: WITH A FOCUS ON REMUNERATION AND BOARD ACCOUNTABILITY

Above-average	Average	Below-average
Skandinaviska EB	BNP Paribas	Banco Popolare
Danske Bank	UBI Banca	Natixis
UBS	Nordea	Deutsche Postbank
National Bank	Deutsche Bank	Alpha Bank
BBVA	Credit Suisse	BMPS
		Banco Sabadell

Source: CA Cheuvreux

Our governance selection is for the most part in line with Cheuvreux recommendations, especially concerning those banks with below-average governance. The only inconsistencies are Cheuvreux's 3/Underperform ratings on UBS and Danske Bank.

To choose banks with above-average governance ratings, we also looked at national champions that ranked well above the country average, such as National Bank.

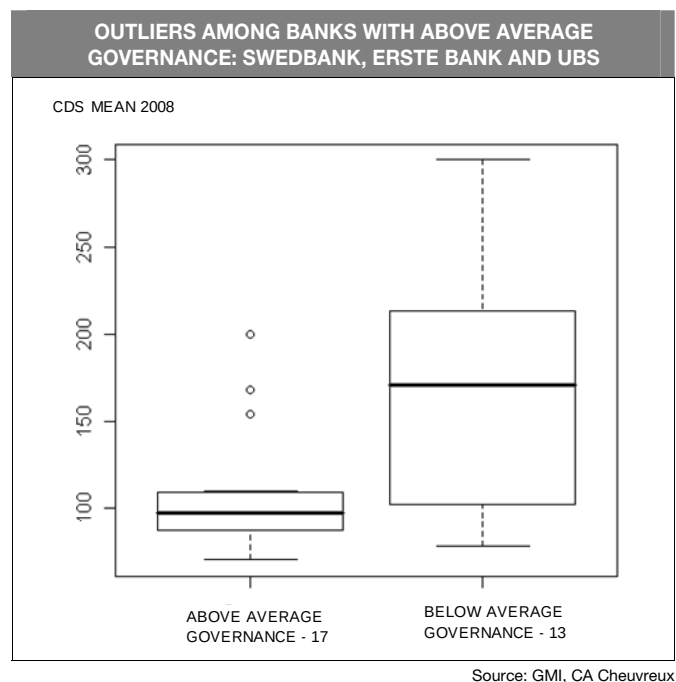
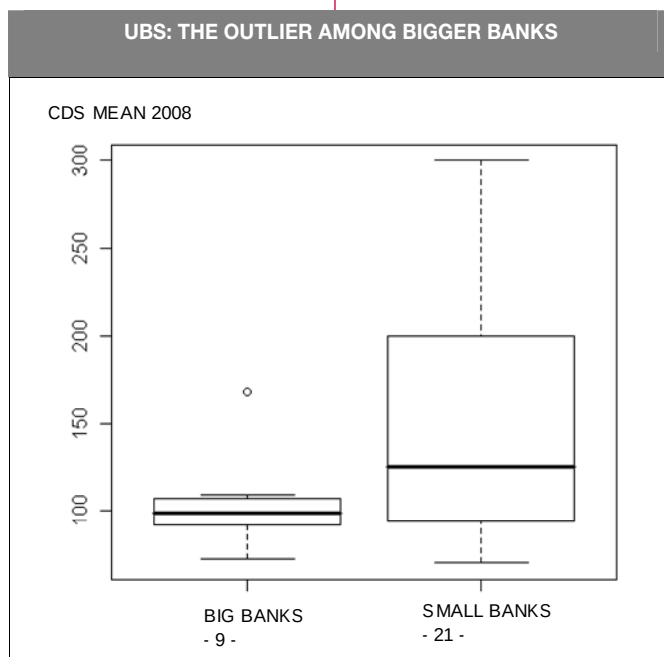
UBS: the outlier

We used boxplots here, as they offer a visual means of identifying outliers in a data set, as well as highlighting differences between populations.

A boxplot graphically describes a group of numerical data through a five-number summary (smallest observation, lower quartile Q1, median, upper quartile Q3 and largest observation). Boxplots draw attention to differences between populations (on the left, big vs smaller banks; on the right, banks with above vs below-average governance). The darker line designates the median observation. The spacing between the different parts of the box indicates a general degree of dispersion.

Boxplots are also useful for identifying outliers. An outlier is an observation that lies more than 1.5x the interquartile range (the height of the box) above the upper quartile Q3.

In the boxplot on the left, UBS is the only bank that we might consider an outlier. On the right, UBS, Erste Bank and Swedbank are the outliers.

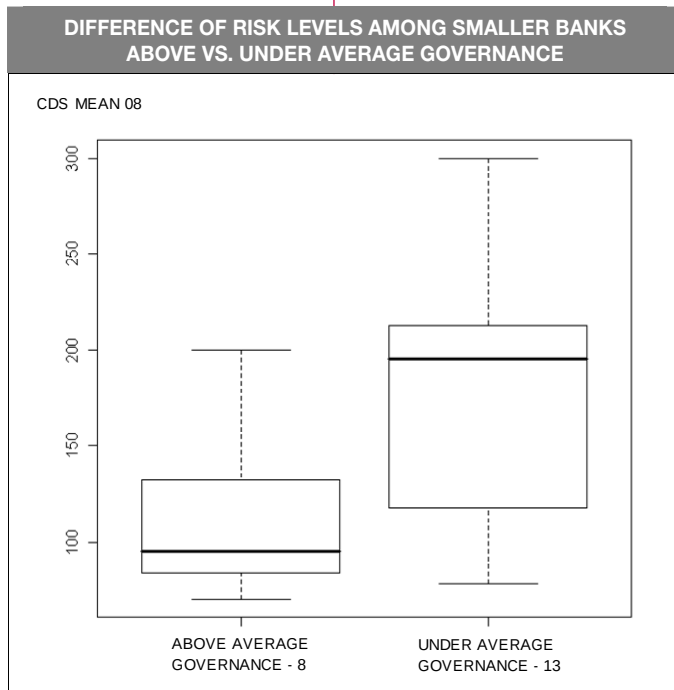


UBS tells a different story

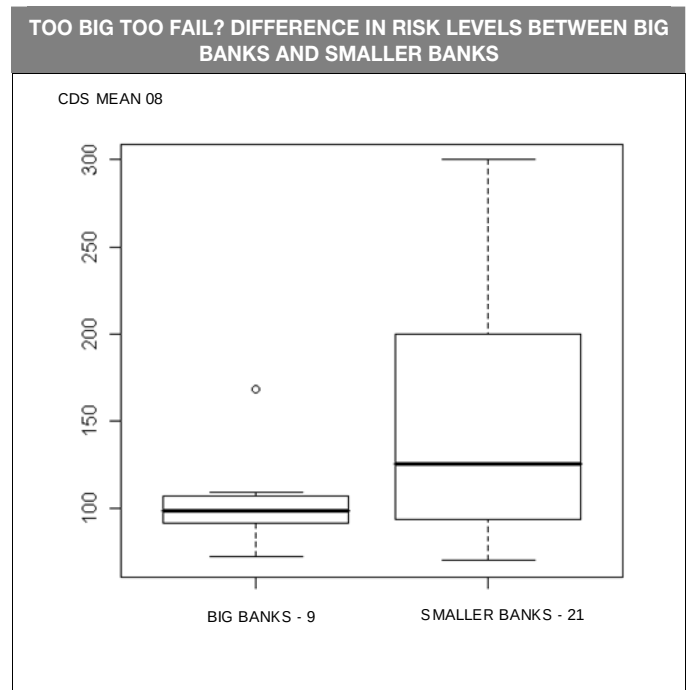
Among the bigger banks (on the left), UBS (the dot) is a clear outlier, as it has relatively higher CDS spreads levels. As illustrated in the boxplot (on the left), UBS case does not quite fit in the analysis.

We believe that UBS's improvement in governance, focusing compensation on long-term value creation, is a positive move and justifies its presence in our selection. We do not suggest that governance has a direct impact on spreads nor that it is priced in the short term by the market. So far, news flow is still bound to past decisions and their consequences. In our view, however, corporate governance is significant in the long run.

Summary: the size effect, and the specific effect of governance



Source: GMI, CA Cheuvreux



Source: GMI, CA Cheuvreux

As shown on the right hand-side, bigger banks benefit from lower CDS spreads levels, with a small degree of dispersion. Among them, UBS stands out as an outlier.

As those bigger banks also have a history of above-average governance, this does not go against our general argument, although we cannot observe a specific governance effect.

On the left hand-side, we spot what might be the specific effect of good governance. This graph only displays smaller banks, where the "too big to fail" effect is not at play. For those banks that had better governance in the past three years (2005-2007), current CDS levels are lower and less dispersed.

VII— Top picks: governance profiles

BNP Paribas

Julius Baer

National Bank of Greece

Nordea



Governance Profile

BNP Paribas

■ CORPORATE GOVERNANCE HIGHLIGHTS

1. Does the company disclose its corporate governance policies or guidelines?	No
2. Does the company have a combined chair/CEO?	No
3. Percent Independent Directors	66.70%
4. Do all executive board members own shares after excluding options held?	Yes
5. Do all common or ordinary equity shares have one-share, one-vote, with no restrictions?	Yes
6. Is there a single shareholder or shareholder group which controls a majority of the voting power of the company?	No
7. Do shareowners have a right to act in concert through written communication?	Yes
8. Do shareholders have a right to convene an EGM with 10% or less of the shares requesting one?	Yes
9. Is the company currently under investigation for accounting irregularities?	No
10. Has the company adopted a shareholder rights plan ("poison pill")?	No
11. Potential Dilution from Stock Options Outstanding + Not Yet Granted Under Old or New Plans	0.00%
12. Disclosure on CEO remuneration details (amount detailed if disclosed)	EUR1.1m

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Source: GMI

■ CORPORATE GOVERNANCE ANALYSIS

BNP Paribas has split the roles of Chairman and CEO at the top of the company, which we consider to be in line with current best practice. The corporate information provided by BNP Paribas is limited and it is unclear which non-executive director are considered independent. Individual components of remuneration are disclosed for key executives and we note that the Chairman participates in the annual bonus programme. However, the method by which annual bonus awards and long-term incentive grants are awarded a determined is not disclosed.

GOVERNMENT INTERFERENCE IN THE CONTEXT OF THE FINANCIAL CRISIS

BNP Paribas has announced that it is planning to take part in the second phase of the French government's state aid for the country's banking sector, which would allow it to increase its Tier 1 capital ratio. The use of state aid requires BNP to submit to some government interference in terms of remuneration policy and dividend payouts.

Board accountability

The French government does not have the right to appoint directors to the board.

Remuneration

Both the CEO and President of BNP Paribas have announced that they will not seek to take any bonus awards for 2008. This is line with conditions laid out by the French state which required executives to forego any results-related bonus awards in exchange for state aid. In addition, BNP Paribas will be affected by the recent proposal by the French banking federation on 12 February 2008, which will require bonus awards for bankers, traders and fund managers to be paid over a number of years and linked to the profitability of their employer rather than individual activities. These rules will apply to bonuses paid from 2010.

Shareholder rights

The French government has stated that it will limit dividend payments for banks that accept state aid.



Governance Profile

Julius Baer

■ CORPORATE GOVERNANCE HIGHLIGHTS

1. Does the company disclose its corporate governance policies or guidelines?	No
2. Does the company have a combined chair/CEO?	No
3. Percent Independent Directors	87.50%
4. Do all executive board members own shares after excluding options held?	Yes
5. Do all common or ordinary equity shares have one-share, one-vote, with no restrictions?	Yes
6. Is there a single shareholder or shareholder group which controls a majority of the voting power of the company?	No
7. Do shareowners have a right to act in concert through written communication?	Yes
8. Do shareholders have a right to convene an EGM with 10% or less of the shares requesting one?	Yes
9. Is the company currently under investigation for accounting irregularities?	No
10. Has the company adopted a shareholder rights plan ("poison pill")?	No
11. Potential Dilution from Stock Options Outstanding + Not Yet Granted Under Old or New Plans	0.00%
12. Disclosure on CEO remuneration details (amount detailed if disclosed)	EUR 5M

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■ CORPORATE GOVERNANCE ANALYSIS

The roles of Chairman and CEO are split at the top of the company and in our view the board is not under the influence of any one significant shareholder. In addition, the board of directors has an independent internal auditing unit at its disposal. This unit has an unlimited right to information access to documents and the head of the internal auditing unit is appointed by the board of directors.

Disclosure of individual components of remuneration for key executives are disclosed, although we note that annual bonus awards can be (at the discretion of participants) paid in shares, which are then subject to a restriction period prior to their vesting. It remains unclear whether long-term incentive awards are linked to strategic objectives or whether annual grant levels are reasonable. However, share awards are tied to a vesting and forfeiture clause under which shares cannot vest before the expiration period and then only if participants remain employed by the company. We have concerns that both non-executive directors and executives are able eligible to receive loans from Julius Baer and we note that the Chairman Raymond J. Baer currently has an outstanding loan of CHF12.5m.

There is no evidence of a shareholder rights plan that could be used to diminish the rights of minority shareholders.

GOVERNMENT INTERFERENCE IN THE CONTEXT OF THE FINANCIAL CRISIS

Banks that accept state from the Swiss government aid will face restrictions on salary increases and bonuses. However, Julius Baer has not needed to take any form of state aid and therefore will not immediately face government interference with regard to its remuneration policy or ability to pay dividends.

Board accountability

The Swiss government has no immediate rights to appoint directors to the board of Julius Baer.

Remuneration

Despite the momentum for remuneration reform, we do not believe that Julius Baer will face government interference in its bonus pool or remuneration policy. However, it may face pressure from shareholders seeking to implement sustainable remuneration practices similar to those proposed by UBS.

Shareholder rights

The government does not have any authority to interfere in the payment of dividends.



Governance Profile

National Bank of Greece

■ CORPORATE GOVERNANCE HIGHLIGHTS

1. Does the company disclose its corporate governance policies or guidelines?	Yes
2. Does the company have a combined chair/CEO?	Yes
3. Percent Independent Directors	60.00%
4. Do all executive board members own shares after excluding options held?	No
5. Do all common or ordinary equity shares have one-share, one-vote, with no restrictions?	Yes
6. Is there a single shareholder or shareholder group which controls a majority of the voting power of the company?	No
7. Do shareowners have a right to act in concert through written communication?	No
8. Do shareholders have a right to convene an EGM with 10% or less of the shares requesting one?	Yes
9. Is the company currently under investigation for accounting irregularities?	No
10. Has the company adopted a shareholder rights plan ("poison pill")?	No
11. Potential Dilution from Stock Options Outstanding + Not Yet Granted Under Old or New Plans	4.00%
12. Disclosure on CEO remuneration details (amount detailed if disclosed)	No

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Source: GMI

■ CORPORATE GOVERNANCE ANALYSIS

Although the roles of Chairman and CEO are combined at the top of the company the level of board independence is an appropriate counterbalance to this concentration of power. The Risk Management & Corporate Governance section of the annual report contains a significant amount of detail concerning NBG's risk practices and compliance with SOX and Basel II regimes and improvements to internal controls. We also note that the audit Committee Charter establishes a degree of oversight that is far above standard in the Greek regulatory environment, including pre-approval of non-audit services, review of financial filings and guidance, and establishment of hiring policies for employees of the auditor. The committee also meets separately with management, the independent auditor and the internal auditors.

Furthermore, in 2007 NBG for the first time adopted principles and a policy for determining the remuneration of executive members of the board including a framework for determining the pay of senior executives. In addition, a stock option plan was implemented for executive board members and staff of affiliated companies.

GOVERNMENT INTERFERENCE IN THE CONTEXT OF THE FINANCIAL CRISIS

NBG's participation in the plan is extremely limited (EUR350m out of total equity of c.EUR5bn as the Tier I is already at 10.4% without assistance) while, of course, it does not need any liquidity (it has a huge retail deposit base and can actually finance the Greek government rather than the other way round). In our view, NBG taking EUR350m out of a plan of EUR28bn indicates that their participation was mostly for reasons of conformity and possibly pressure from the government/central bank. If all banks entered the plan, except NBG, there would have been a risk that the transfer of deposits from smaller banks to NBG could continue, creating serious problems for the local banking system. As a result, NBG agreed to enter into the plan with a minimal amount. Note that, for most people in Greece, NBG is regarded as a 'state bank'.

Board accountability

NBG received shareholder approval to participate in a share capital increase through the issuance of preference shares in favour of the Greek state on 7 January 2009 and the government will appoint a state representative to the board.

Remuneration

Under the Greek bailout plan no executives will be able to earn more than the Governor of the Greek Central Bank. However, we note that salaries at NBG do not exceed those paid to the governor of the Central Bank and we do not believe that NBG will be a primary focus for remuneration reform.

Shareholder rights

We note that participation in the Greek Government bailout plan entails a restriction on dividend payments to 35% of the parent bank's profit including the dividend on all outstanding preference shares.



Governance Profile

Nordea

■ CORPORATE GOVERNANCE HIGHLIGHTS

1. Does the company disclose its corporate governance policies or guidelines?	Yes
2. Does the company have a combined chair/CEO?	No
3. Percent Independent Directors	66.70%
4. Do all executive board members own shares after excluding options held?	Yes
5. Do all common or ordinary equity shares have one-share, one-vote, with no restrictions?	Yes
6. Is there a single shareholder or shareholder group which controls a majority of the voting power of the company?	No
7. Do shareowners have a right to act in concert through written communication?	No
8. Do shareholders have a right to convene an EGM with 10% or less of the shares requesting one?	Yes
9. Is the company currently under investigation for accounting irregularities?	No
10. Has the company adopted a shareholder rights plan ("poison pill")?	No
11. Potential Dilution from Stock Options Outstanding + Not Yet Granted Under Old or New Plans	0.00%
12. Disclosure on CEO remuneration details (amount detailed if disclosed)	EUR 1.3m

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Source: GM, Nordea

■ CORPORATE GOVERNANCE ANALYSIS

Nordea is controlled by the Swedish Government, which holds 20% and Sampo which holds 10%. The Swedish Government had announced that it would sell its stake before the next election in 2010; however, it is uncertain whether it will now do so. The planned divestment of the Swedish Government's stake would leave Sampo Oyj as the largest single shareholder and this could encourage the company to engage more widely across its shareholder base, especially given that non-Nordic shareholders account for 24% of the current issued share capital. In addition, the recent appointment of Christian Clausen has led to a refocusing of the company's strategy towards building up the customer base and it is unlikely that this will be altered by the eventual divestment by the Swedish Government. However, the composition of the nomination committee will change given that it comprises representatives of the company's four biggest shareholders. Yet it remains unclear whether the nomination committee will consider the recruitment of independent non-executive directors from outside the Nordic region, given Nordea's plans to establish itself within new fast growing European economies such as Russia.

Executive compensation is disclosed for individual executive directors and we note that long-term incentive awards are subject to pre-determined performance conditions, which are designed to create long-term shareholder value. In addition, there is no evidence of a shareholder rights plan or poison pill that could be used to prohibit a change in control.

GOVERNMENT INTERFERENCE IN THE CONTEXT OF THE FINANCIAL CRISIS

In our view, the influence of Nordea's two largest shareholders the Swedish government and Sampo may have had an effect on the avoidance by Nordea of capital injections from the Swedish government.

Board accountability

Although the Swedish government owns 20% of Nordea this shareholding dated from before the financial crisis and the Swedish government has no current rights to appoint directors to the board.

Remuneration

We are unaware of any government interference in Nordea's remuneration policy. However, we believe that there is significant momentum for remuneration reform particularly with regard to bonus awards being structured over a number years to avoid excessive risk taking. In our view, the recent introduction by UBS of a new compensation plan may put pressure on Nordea to review its own remuneration policies.

Shareholder rights

On 10 February 2009 Nordea announced a rights issue of EUR2.5bn. However, this was not a result of government interference and was instead a defensive move to take up available capital. Sampo will take up its pro rata part of 12% and will in certain conditions also guarantee an additional 13%. The rights issue has been fully guaranteed by Nordea's largest shareholders and two investment banks, JP Morgan and Merrill Lynch.

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