Directors' Remuneration Policies And Other Compliances: General Economic-Banking Views And Evaluations Within The Framework Of The Post Crisis World For Financial Institutions

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ABSTRACT

This article sets forth current legal legislations and recent developments related to directors' remuneration policies and other compliances of financial institutions based on the approach for Corporate Governance Principles in Turkey after the economic crisis in the world. At the outset, general economic and banking views in the world considering selected countries' situations were presented, both global and Turkey's evaluations were discussed in terms of Average Annual Real Gross Domestic Product (GDP) Growth, Real GDP Growth and Selected Soundness Indicators in Turkish Banking Sector. In addition, this article emphasizes the general dominant principle of new Turkish Commercial Code. At last, the normative system of the regulatory bodies in Turkey was explained in details.

Introduction

All countries have been faced to different serious financial obstacles due to economic crises since 2007. The global recession has affected the entire world economy, with greater detriment to some countries than others. It is a major global recession characterized by various systemic imbalances and was sparked by the outbreak of the U.S. subprime mortgage crisis and financial crisis of 2007–08. At that point, a more broad based credit boom fed a global speculative bubble in real estate and equities, which served to reinforce the risky lending practices.[1]

In addition to the bad financial situation was made more difficult by a sharp increase in oil and food prices. The emergence of sub-prime loan losses in 2007 began the crisis and exposed other risky loans and over-inflated asset prices. With loan losses mounting and the fall of Lehman Brothers on September 15, 2008, a major panic broke out on the inter-bank loan market. As share and housing prices declined, many large and well established investment and commercial banks in the United States and Europe suffered huge losses and even faced bankruptcy, resulting in massive public financial assistance.[2]

For that reason dominating the big picture for economic developments, it is required to determine general view of role of finance both in the world and in the Turkey based on post economic crisis before presenting directors' remuneration policies and other compliances for financial institutions in Turkey.

I. General Economy

Europe experienced a substantial decline in systemic downside risk in the summer of 2012 as a result of credible reform momentum in Italy and Spain, as well as conditional but strong commitment by the ECB and the euro-zone core to stabilize the banking sectors and the sovereign debt markets while those reforms take effect. Generally, the emerging economies look to be faring better. In 2012, the ongoing crisis in the euro-zone retarded growth, but it did not completely derail development. IMF has announced the growth estimations of emerging economies for 2012 and 2013 respectively as 5.6% and 5.9%. It was observed that the emerging economies are affected from the decrease in global

[1] Foldvary Fred E., The Depression of 2008 (PDF).(September 18,2007)The Gutenberg Press. ISBN 0-9603872 O-X Retrieved 2009-01-04; Nouriel Roubini, A Global Breakdown of the Recession In 2009 (Jan.15,2009), Forbes.

[2] "Great Recession", Wikipedia, www.wikipedia.org.

trade volume and that many economies are trying to provide a soft descent within the aim of pursuing their domestic macroeconomic balances.[3] China, entering the complex middle-income transition, experienced a bout of systemic risk associated with its leadership transition and a decade-long decline in reform momentum. That risk has declined with a successful leadership handoff and early signs of a forceful commitment to reduce corruptions alter the role of government in the growth.

On the whole, the global economy, while not yet free of downside risk, appears to set for a year of transition to better-balanced economic growth, albeit with lagging employment and income inequality continuing to hamper a robust recovery.

Global growth performance has lost power in the second quarter of 2012. The loss of confidence to developed countries' medium-term policy perspectives is considered as the main reason of this development. As a matter of fact, it was observed that the improvements faced to the developed economies' public sector balances in short-term were not supported by implementations to provide remarkable improvements in the debt stock. This situation indicates that the measures necessary for the growth policies and sustainability of public debt within following period shall be conducted in a delicate balance. It is observed that in countries within the center of global crisis, even if monetary policies supporting growth are sustained, the reflections of uncertainties brought by the public borrowing problems are still continuing.

Emerging countries which still have a relatively strong domestic demand and maintain a strong public finance are applying new policy strategies to minimize the reverse effects formed by foreign trade and capital channels and to support global growth. In addition, it is observed that financial markets are affected negatively from the increasing macroeconomic risks and deterioration of expectations.

In an environment where global uncertainties are continuing, Turkey conducts incentive systems and monetary policies minimizing macro financial risks simultaneously to make its growing strategy sustainable. The essence of these policies is composed of increasing the competitive power, protecting financial discipline, reducing current deficit, increasing domestic savings, fight against informal economy, encouraging own funds usage instead of borrowing within the companies sector, improving investment environments and supporting Istanbul International Finance Project.

The reliability of macro policies implemented and the endurance of Turkish economy face to external shocks was approved by an international rating agency by increasing the country note, even if it's a bit delayed. As of the third quarter of 2012, the improvement in foreign trade balance is continuing, current

[3] Financial Markets Report, BRSA, June 2012, Issue 26, p. iii.

deficit is slowing down, measures are taken to prevent deviation from financial discipline and elastic monetary policy is preserved face to fast capital inflows depending on possible monetary expansion following the note increase.[4]

Figure 1 Average Annual Real GDP Growth (%) 2002-2011[5]

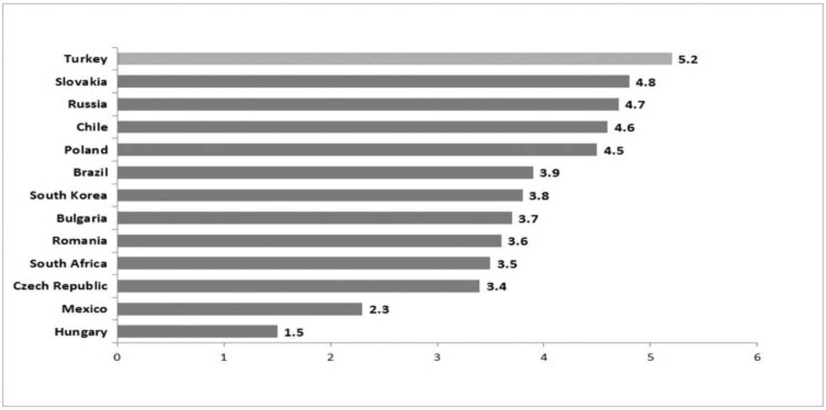
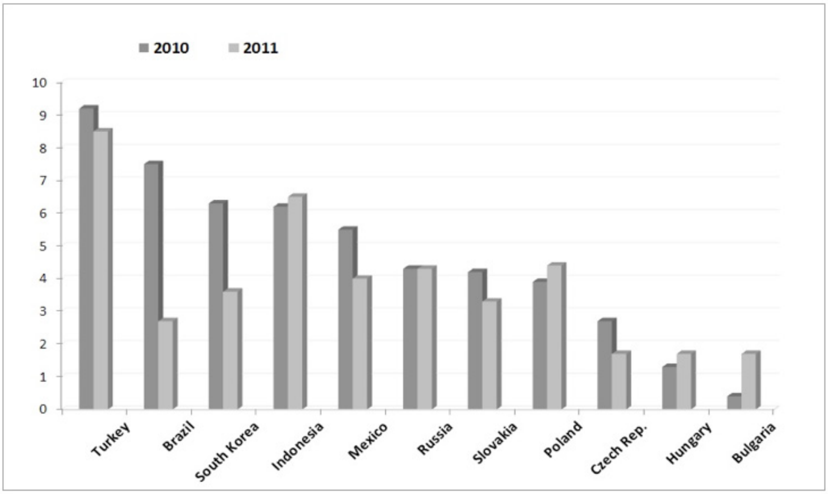


Figure 2 Real GDP Growth (%)[6]



[4] Financial Markets Report, BRSA, Sept. 2012, Issue 27, p. iii.

[5] IMF World Economic Outlook April 2012, Turkish Statistical Institute (TurkStat), Investment Support and Promotion Agency of Republic of Turkey Prime Ministry, www.invest.gov.tr.

[6] IMF World Economic Outlook April 2012, Turkish Statistical Institute (TurkStat), Investment Support and Promotion Agency of Republic of Turkey Prime Ministry, www.invest.gov.tr.

II. Banking Sector

Table 1 Selected Soundness Indicators in Turkish Banking Sector[7]

%	2007	20008	2009	2010	2011	03.12	06.12	09.12
Loans/Total Assets	49,1	50,1	47,1	52,2	56,1	56,9	57,9	57,7
1 Month Liquidity Adequacy Ratio	155,1	141,0	144,0	137,1	115,8	114,8	115,9	124,1
Capital Adequacy Ratio	18,9	18,0	20,6	19,0	16,5	16,6	16,5	16,5
Own Funds/Total Assets	13,0	11,8	13,3	13,4	11,9	12,5	12,5	12,9
NPL (Gross)/ Loans	3,48	3,68	5,27	3,66	2,70	2,74	2,66	2,95
Net Interest Margin	4,9	4,8	5,4	4,3	3,5	1,02	2,01	2,98
Spread	4,5	4,6	5,3	4,1	2,6	1,04	1,99	3,05

In looking at the flow chart for selected soundness indicators in Turkish banking sector, we can see that the banking sector financial soundness indicators are indicating a strong structure. 57.7% of sector assets are composed of loans expressing the main intermediation function. The sector is operating with an asset structure having high liquidity. Liquidity adequacy ratio with one month maturity is 124.1% which is above 100%.

The usage of liabilities in the sector indicates a manageable leverage ratio; 87.1% of the assets are financed by liabilities. Non-performing loans ratio, which is the most essential indicator concerning asset quality has been decreasing since 2009, but showed a partial increase by 0.32 point in the third quarter of the year and realized as 2.95%.

When the income-expenses and profitability ratios are analyzed, it is observed that income creating and profitability ratios of the assets have been increasing since the first quarter of this year. The decrease in the sector's non-interest incomes/non-interest expenses ratio kept continuing also in the third quarter.

[7] Financial Markets Report, BRSA, Sept. 2012, Issue 27, p. iii.

The convergence to equilibrium between non-interest incomes and non-interest expenses will be positive for profitability.

With respect to the changes in fund flows in the banking sector during the last year as of September, while loans and required reserves have been the important items creating asset increase, securities portfolio and receivables from banks had a decreasing effect.

In recent years, banks' policies to conduct efficiently their liability costs and the efforts to diversify their liability possibilities are being effective on the composition of liability structure. Banks increasing their liability possibilities other than deposit is affecting positively the maturity structure and product diversification.

Off-balance sheet operations kept increasing depending on the growth in commitments item. Revocable credit allocation commitments, showing the possibility of banks to allocate credit to the counterparty have been the item increasing off-balance sheet transactions depending on the increase of loans.[8]

Considering comparative recent economic and banking developments both in the world and in the Turkey, remunerations of board of directors' of financial institutions was determined with the sustainable, legitimate and accountable criteria and standards due to post economic crisis both in the world and in the Turkey.

Especially, at the European Union level, remuneration policies in the financial services sector include a general principle that firms should establish and maintain comprehensive remuneration policies, applying to those categories of staff whose professional activities have a material impact on the risk profile of the financial undertaking, which are consistent with sound and effective risk management and do not induce excessive risk-taking. Complementing this general principle, there are more specific recommendations relating to the balance between fixed and variable components of remuneration (that is, between core salary and bonus); the determination of the bonus element on the basis of performance; deferred payment of bonuses with a link to the firm's future performance; the responsibility of the (supervisory) board for overseeing the policy and its application and the involvement of properly independent control functions in its design and operation.[9]

[8] Financial Markets Report, BRSA, Sept. 2012, Issue 27, pp. iv-v.

[9] Commission Staff Working Document related to Amending Capital Requirements Directive on trading book, securitization issues and remuneration policies/Impact Assessment, Commission of the European Communities, July,13,2009, p.19.

III. Main Approach of New Turkish Commercial Code

With respect to addressing global economic and banking sector's issues both in the world and in the Turkey during last year new Turkish Commercial Code, came into force on July, 2012.

New Turkish Commercial Code enlightened new corporate governance approach. It is required to describe corporate governance approach of new Commercial Code due to directors' remunerations of financial institutions being determined by Corporate Governance Principles in Turkey. The corporate governance approach of the New Code is based on four pillars that have universal characteristics within the context of corporate governance.

These are as follows:

(1) Full transparency,

(2) Fairness,

(3) Accountability,

(4) Responsibility.

Full transparency has been sought in (1) financial statements, (2) boards of directors' (BoD) annual reports, (3) independent audits, (4) transactional auditors, (5) all audit reports of individual companies and group of companies.

Fairness has been ensured by establishing a balance of interests and by objective justice.

Accountability has been embodied in the BoD reports, flow of information, right to information and oversight.

Responsibility has been regulated in parallel with accountability.

The Capital Markets Board (CMB) has been provided with exclusive authority to regulate corporate governance principles for listed companies under new Code. This authorization will ensure it remains dynamic and up-to-date.

The BoDs of publicly held companies are now obliged to publish corporate governance reports.

There are two main prominent principles in this respect under this Commercial Code are as follows:

- The principle of equal treatment: Shareholders of joint-stock company either listed or non-listed shall be subject to equal treatment under equal terms.
- Not to become indebted to the company: Shareholders are prohibited from borrowing money from the company unless they perform their due debts resulting from subscription of capital, and unless the profit of the company together with independent reserve funds cover the loss of the company for previous year. It's unclear whether guaranties are also restricted, and whether affiliates/relatives of the shareholder are subject to the same restriction. Creditors of the company have a direct claim against shareholders who violate this rule. There are similar restrictions applicable to directors and other affiliates of a company.

The new Commercial Code dispenses with the prior regime of indivisible and absolute responsibility for the entire board with respect to actions of the company. The more modern approach apportions liability across responsible directors/officers based on the delegation of authority among them and their respective degree of fault. Intra-group transactions to the detriment of a specific subsidiary must be compensated by the controlling parent.

IV. Legislations of Regulatory Bodies

When we look at the company directors' remuneration, we can see two main regulations in Turkey.

A. Capital Market Board's Communique

Capital Market Board (CMB) has authority to regulate corporate governance principles for listed companies.

According to "The Communique on The Determination and Implementation of Corporate Governance Principles" for listed companies issued by CMB as follows:

(1) Remuneration principles shall be writing and remuneration policy shall be published on the web-site.

(2) Remuneration committee shall propose to the Board for determining remunerations regarding board of directors and top management in compliance with the following criteria:

(a) Long- term targets of companies,

(b) Performance criterion related to performance of company and directors,

(c) The degree of achievement criteria for directors and top management.

(3) Remuneration of the independent board members shall be provided at a level to sustain independence. The independent board members cannot receive stock options or performance based payment plans.

(4) The remuneration and other benefits given to the board members and the top management shall be disclosed to the public via annual report.

B. Banking Regulation and Supervision Agency's Regulation

Concerning the banks; all banks should determine own corporate governance principles according to annexed Corporate Governance Principles for Banks of "The Regulation on Corporate Governance Principles for Banks"[10] issued by Banking Regulation and Supervision Agency (BRSA).

[10] This Regulation was entered into force by published in the Official Gazette Nr. 26333 on the dated of November 1st, 2006. The amendments related to mentioned Regulation was entered into force by published in the Official Gazette Nr. 27959 on the dated of June 9th, 2011.

In addition, there is the most highlighted point that Turkey adopted all principles based on European Union (EU) legislations such as directives etc. in spite of Turkey is not still EU member.

All banks shall determine and ensure remuneration policy in compliance with the bank's ethical values, strategic goals and internal balances under the Article 6th of Corporate Governance Principles for Banks of the mentioned Regulation.[11] At that point all banks can determine own remuneration policies freely based on the Corporate Governance Principles for Banks.

A written remuneration policy shall be determined in compliance with the scope and structure of the bank's activities as well as its strategies, long-term targets and risk management structures which will prevent undertaking extreme risks and promote effective contributions to the risk management under mentioned BRSA principles.

The board of directors shall review the remuneration policy at least once a year to ensure its effectiveness. The board of directors shall ensure the remunerations of board of directors and top management and the other staff involved are in compliance with ethical values, internal balances and strategic goals of the bank. This remuneration shall not, only, be related to the bank's short-term performance such as profit or income. The responsibilities assigned to members of committees comprised of board members shall be taken into consideration in payments to be made to such members.

It is possible to make incentive payments to members of the board of directors equipped with executive duties as well as the top management (top team, executive leaders etc.) on the basis of the bank's performance, such incentive payments shall be made in a way to make positive contributions to the bank's corporate values and be subject to certain objective criteria to be observed. The amounts of performance-based payments shall not be guaranteed in advance.

The performance-based payments shall be made in instalments and in consideration with the maturity of risks undertaken according to mentioned Corporate Governance Principles.

The criteria taken into account in the performance-based payments and the information regarding the method and average amounts of such payments shall be presented in the banks' annual reports prepared within the framework of the "Regulation on Principles and Procedures of the Preparation and Publication of Annual Reports by Banks", under the section titled "Information on Human Resources Applications".

We can see that the following condition will be valid for the remunerations of managers and staff at the internal control, internal audit as well as risk management. The payments to be made to managers and staff at the internal control, internal audit and risk management units shall be determined independently from the performance of such units they audit, supervise or control; but, the

[11] Servet Taşdelen, Banking Law Commentary, pp. 309-312.

performance in the own function of the related staff shall be taken into consideration in this respect.

On the other hand, when we survey the other compliances with remunerations, these are counted as below:

(1) Incentive payments

(2) Indemnity payment

(3) Performance based payments

(4) Promotion

Concerning the incentive payments, the criteria regarding job descriptions and distributions of the staff as well as their performance-based incentive payments shall be determined and announced by the top management. The said criteria shall be reviewed regularly on the basis of their standards determined and special duty related responsibilities.

Moreover; the indemnity payments are to be made to the staff leaving from the bank shall be determined on the basis of the staff's past performance and in consideration with the contribution made by the related staff to the bank's long-term performance.

The board of directors has authorities for cancellation of performance based payments of banks' staff if certain cases arise as below:

The actions necessary shall be taken by the board of directors against the staff detected to endanger the bank's operations in a secure manner or be responsible for failures in the bank's financial structure as a result of their activities, including also the cancellation of their performance-based payments.[12]

The authorities of top management related to recruitments and promotions of the staff are as follows:

The top management shall implement and supervise the processes required to ensure the recruitments and promotions of the staff involved are based on objective criteria and to take into consideration for the purposes of education, experience and responsibility. Such processes shall be in compliance with the organization's general policies as well as relevant procedures on issues like staff recruitment, training, measuring, consultancy, promotion, indemnity and discipline.

The responsibilities of top management in compliance with the remuneration policy of banks are as follows:

- The top management shall ensure that requirements on necessary knowledge and competencies are continuously observed and that the organization has the capability to acquire the manpower in compliance with the goals set.
- The top management shall ensure that the staff involved are oriented and trained after their recruitment for purposes of increasing their knowledge and skills to required levels. The education and training programs prepared with the aim to increase technical and administrative skills of the staff effectively shall be reviewed on a regular basis.

[12] Seza Reisoğlu, Banking Law Commentary, pp. 371-374.

Conclusion

All countries in the world adopted unanimous principles and criteria for determining remunerations of board of directors' of financial institutions due to economic crisis. With respect to addressing these issues from the framework of EU legislation, there is now a widespread recognition that remuneration practices in financial institutions have contributed to the financial crisis through encouraging excessive risk taking and pro-cyclical behavior. Specifically:

– There was an excessive concentration on short term profits without adequate regard to longer term risks;

– Perverse incentives were created that exacerbated excessive risk-taking: if the reward for risk-taking is too high, there are incentives to relax controls within the organization and to take on imprudent levels of risk;

– Remuneration policies likely fostered conflicts of interest by motivating certain categories of staff to behave in a way that prioritizes their personal remuneration over the interests of the institution: managers may focus on improving quarterly profits over long-term growth of the business; traders may take excessive risks to increase their bonus even if the trading strategy is not consistent with the risk appetite of the bank.

As a result, remuneration policies have a pro-cyclical effect where they entail (possibly disproportionate) rewards on the upside and insufficient penalties on the downside, e.g., bonuses based on short-term profits that are paid immediately, with no risk adjustment or deferred payment to take account of future performance of the business unit or institution as a whole.[13]

For this reason Turkey made required amendments related to previous legislations in compliance with the European legislations and the other international standards after the economic crisis in the world. When we look at the general implementations of corporate governance principles in Turkey related to directors' remuneration policies and other compliances for financial institutions in the post crisis world, we can reach three crucial points for Turkey in spite of existing different applications in other's European countries. These are as follows:

The principle of "Say on Pay Rule" is not valid for Turkey for determining remunerations of board of directors in the financial institutions.

All banks have an obligation to act in compliance with the Regulation on Corporate Governance Principles for determining remunerations of board of directors of banks.

The claw-back process in Turkey generally will not apply unless any violation of mentioned Law and regulation exist.

[13] Commission Staff Working Document related to Amending Capital Requirements Directive on trading book, securitization issues and remuneration policies /Impact Assessment, Commission of the European Communities, July 13, 2009, p.46.