

# Discussions in Europe on Variable Compensation in the Financial Sector

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## ABSTRACT

Bonuses – which are often used to mitigate principal-agent problems and to encourage employees to work harder – have increased tremendously in the financial sector during the last decade, and have often been seen as a contributing factor to the financial crisis of 2008. The recent European Union (EU) action to adopt a policy that restricts bonuses paid to bankers may seem promising at first, but this does **not** address the real issues behind variable rewards. Compensation policies should be changed to encourage responsible risk-taking and decision-making through the implementation of broader performance metrics, forfeitable holdbacks and hybrid bonds. Furthermore, a change in organisational culture is needed to improve ethical behaviour leading to a re-balancing of stakeholders' interests in the financial sector.

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## **DISCUSSIONS IN EUROPE ON VARIABLE COMPENSATION IN THE FINANCIAL SECTOR**

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### **Introduction**

In order to mitigate the principal-agent problem and, thereby aligning the interests of the management to the stakeholders of financial organizations, managers received bonuses which were linked to the financial performance. The bonuses received by employees as a share of the total compensation in the financial sector has increased incredibly during the last decade (Bell & Van Reenen 2010). Although bonuses may stimulate employees to work harder (Gehrig et al. 2008), these variable rewards have encouraged excessive risk taking through short term orientation in the financial sector, and this was seen as one of the contributing factors to the financial crisis of 2008.

### **Political Response**

The global financial crisis of 2008-09 and its consequences to the real economy have led to various political leaders pushing for legislation to regulate the financial business and limit the associated variable compensations. Partly driven by these proposals, some financial players have adjusted their compensation policies (Moore et al. 2013) while others seem reluctant to change their incentive systems (Touryalai 2013).

In the European Union (EU), the European Parliament has recently approved a policy that restricts the bonuses paid to bankers (The New York Times, 2013). As a result upfront cash awards are limited and banks are obliged to set at least fifty per cent of their bonuses apart for three to five years. This proposal is supported by several papers, including Bebchuk and Fried (2009) and

Sanjai Bhagat and Romano (2009), which argue that this policy would stimulate a longer-term view among managers instead of a short-term focus. This structure aims to eliminate the incentive to temporarily boost financial performance in one year at the expense of others. Given that a trend towards more deferred compensation already exists and thus is already partly embedded in the culture (see Figure 1), it would be easier to implement further postponed remuneration. However, legislation labelling the entire financial sector as similar is scientifically challenged (Curran et al. 2012). The nature of the respective banking activities should preferably be considered in order to match the deferral period to the associated risks.

Additionally, the European Parliament's policy tries to encourage financial corporations to attract and reward employees through other channels including flexible working hours, educational opportunities and career development (Mercer 2013).

Although this seems promising at first sight, reality reveals a different story. The truth is that these regulations address the symptoms of the variable rewards rather than the true causes (The Economist 2012). Base salaries are expected to rise thereby compensating for the lower variable remunerations. As a consequence, the fixed labour costs of banks are expected to rise. Variable payments, in contrast, vary in accordance to the financial performance. The proposed legislation, thus, weakens the financial position if revenues do not live up to the expectations. Moreover, the obligation of offering deferred compensation may result in bigger variable compensation since employees want to be compensated for the lower present value of their bonus compared to the new remuneration (The Economist 2012).

### **True Causes and Solutions**

In order to effectively evaluate the potential of these measures, the true causes of excessive risk-taking and the related variable compensations should be scrutinised. First of all, excessive risk-

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taking by employees is rooted in the difference between debt and equity. That is, bonds entail a fixed claim on a firm's assets which is repaid if the organisation has sufficient funds and stakeholders will acquire the remainder of the earnings. However, if the bond's value exceeds the assets' value the bondholder will suffer. Since employees' remuneration often consist of stock options their behaviour is, thus, more likely to be risk seeking which contrasts to financial stability that society as a whole would like to have.

To prevent this conflict in interests, bond-like features should be added to the personnel's variable compensations. Firstly, instead of cash-in rewards the variable remuneration should be deferred for at least a couple of years and be forfeitable if the financial institution's performance declines or worst, when it needs governmental support. These compensation holdbacks align the employees' incentives to bondholders' meaning that the compensation has a restricted upside and a considerable downside (Small 2013) and, therefore, the interests of employees are aligned with taxpayers' (Curran et al. 2012).

Another option would be to offer employees hybrid bonds, a debt instrument that will automatically be converted into equity once a firm financially struggles. This option will offer a financial institution a buffer of equity and thereby limits the possibility of needed governmental support (Small 2013). Synergy effects are created if both options would be implemented, that is, the price of contingent debt will be dependent on investors' beliefs about management's willingness to forego compensation and thereby issue new equity. Contingent debt will rise in price if bond investors presume managers will recapitalize the firm before it crosses the threshold for conversion of debt to equity.

Moreover, it is questionable whether the current determination of bonuses which highly focuses on the organisation's stock performance is a sound variable to reflect managers' performance. Linking the variable compensation to more variables is likely to broaden the currently narrow view

adopted by executives and thereby enhancing the long-term soundness of the organisation (Sharma 2012). Ideally, these additional measures would be sound indicators for the corporation's long-term performance. One of these options would be to tie variable compensation to a combination of the value of common shares, preferred shares and bonds (Bebchuk & Spamann 2009). The aggregate value could also be adjusted by governmental support to the financial institution and thereby inversely relating it to bonuses. This restructuring of the performance management would foster managers to evaluate a range of consequences of their actions rather than just the effect on the stock price and will therefore reduce the likelihood of excessive risk-taking.

On top of the malfunctioning of monetary compensation the financial sector also suffers from several structural impediments. One of these factors is peer comparison which fosters herding (Drasic & Velinova 2011). In essence, this means that individual risk-seeking behaviour is stimulated through the risk-taking norm in the herd. Moreover, an institutional, monetary pressure exists to outperform peers and thereby initiates riskier behaviour. Although individual managers may realize they are taking on excessive risk, it pays off to stay and conform to the crowd. This group process evolves into a market herding trend and thereby increased the volatility of the entire financial sector. Therefore, the hindsight effect should be eradicated, that is, success as well as failure should be attributed to the manager instead of the company as a whole. Furthermore, teamwork should be one of the determinants for rewards rather than a competitive force and excessive individualism.

Another structural deficiency is the asymmetry in compensation and unemployment incentives. Whereas high returns are significantly compensated, unemployment incentives are hardly present (Drasic & Velinova 2011). This dichotomy encourages risk-seeking behaviour if investments are poorly performing.

## Call for Cultural Change

However, just restructuring compensation schemes might not trigger an ultimate turnaround. Noe and Young (2012) argue in their paper that the structure of financial products may suggest a sound performance even over a long period of time when in actual fact there still exist a hidden risk. Secondly, the authors state that the complexity of financial products and the size of banking corporations hamper effective monitoring of risky activities. Therefore, the authors call for extra attention on ethical behaviour among financial managers.

As a means to improve ethical behaviour in the financial sector, the organisational culture, being its primary determinant, should be improved (Lim et al. 2010). A cultural change seems to be necessary as fifty per cent of financial managers indicated that negative public perception of the banking sector is a fair representation of the recent past, and only eight per cent believed that these problems of the banking culture belong to the past (CIPD 2013). The challenge for human resource departments is to realise such a cultural change. Many critics have questioned whether bankers are aware of their primary function in society - that is to channel funds to sound investments instead of regarding personal gains as their main goal. To achieve this ambition, Barclays introduced a 'balanced scorecard' to evaluate its staff (Barclays 2012). Core values include service, excellence, stewardship, respect and integrity. However, a single initiative is unlikely to establish a rigorous shift in the culture within the financial sector.

KPMG (2013) has outlined additional steps that should be taken to realise a transformational change in the culture of the financial sector. Firstly, the commitment of senior management to transformational change is crucial since role-modelling of values appears to be vital to make change happen. By adopting a cultural change, decisive leadership is portrayed which will prevent the re-emergence of behaviour which is unacceptable. Moreover, a rigorous approach should be taken to monitor risk-takers, that is,

those individuals that deviate from prescribed, expected behaviour (Deloitte 2012). All these should be included in the overall risk management and controlled by the human resource department. The change in culture could be promoted through symbolic actions that convey the determination of the financial institutions to a cultural change, for example, scrapping business activities that are being perceived as contentious and radical overhauling of traditional norms. Rabobank, a Dutch multinational bank, engaged in this practise by voluntarily eradicating bonuses for its board members (Schäfer 2013).

In order to foster professionalism among bankers and regain society's trust in the industry as a whole, several practices should be initiated. Firstly, the financial sector should refocus its attention on the customer. Currently only one third of the financial managers believe shareholders are the most important stakeholders (CIPD 2013). Through organisation-individual relationship management, human resource departments should integrate a customer-centric mentality in financial institutions. In addition, compensation could be tied to customer satisfaction through an evaluation procedure. Moreover, professional standards should be developed to promote ethical awareness among professionals and thereby foster a stimulus in societal confidence in the entire sector. Aside realigning compensation policies, financial institutions should clearly communicate on how pay is determined to encourage transparency and enforce desirable behaviours (Institute of International Finance 2009).

## Evaluation by the Sector

The proposed measures have been evaluated by several employees of the financial sector (who are not named for the purpose of privacy). Below are some of their comments regard the viability of the proposed policies and potential obstacles which might hinder the implementation:

A senior officer in the Central Bank Reporting Team, at a Singapore multinational bank, with \$252 billion total assets and a net income of \$2 billion in

2012, acknowledged the importance of a revised variable compensation policy. However this individual also expressed his doubts regarding the viability of a cultural change. A change in culture is hard to establish because the decision-makers, that is, the “top management, will not personally benefit; instead they will see their total income decline.” The importance of societal pressure by either the customer or the government is needed to promote this necessary change. Moreover, “cultural change is a solution, but only in the long run”. To strengthen the sector’s image in the short term, the sector should convey its determination to fundamental change and should implement changes in services that are observable by the customer.

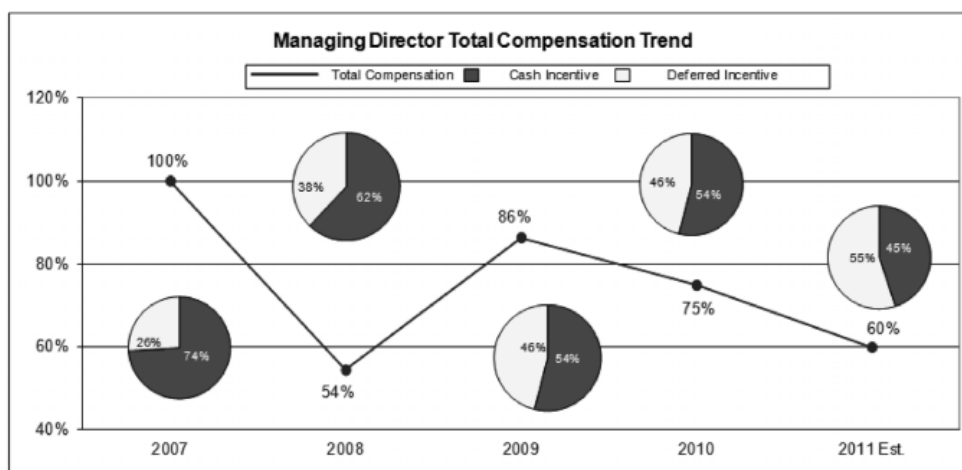
Another insight is given by a compliance controller employed by a Dutch multinational bank, serving 7.5 million clients with an aggregate worth of €752 billion in financial assets. “Variable compensation can lead to more focused results if they are aligned with the goals of the financial institution. However, individual performance should not be the sole determinant of variable compensation because that would worsen team performance.” Regarding the recommendations, the controller felt that “The proposed solutions are valid, but might be limited in their effectiveness given the intrinsic endeavour of individuals to gain rewards. It will take a long time to inhibit this natural drive.” In addition, an international, collaborative approach is needed to solve this problem: “Given the international character of financial institution, it is relatively easy

to evade national restrictions or legislation. Therefore, global measures are called for. Because of the high influence of the financial sector on the real economy and in particular, its impact on retail, wholesale and small and medium enterprises, measures should be taken quickly in order to restore trust in the sector and restore economic prosperity”.

**Conclusion**

Altogether, the financial sector needs structural change to depart from the past. Changes in various human resource policies are necessary to reach that state. In essence, compensation policies should be changed to encourage responsible risk-taking and decision-making. Ideally, these new compensation systems should solve the difference between equity and debt. Implementation of broader performance metrics, forfeitable holdbacks and hybrid bonds could reach such an end. Likewise, financial culture should be reformed. Reorientation of the core values of the financial institutions should be realised through changes in ethical behaviour leading to a re-balancing of stakeholders’ interests. These changes are essential to recover the trust in the sector by the society. However, as expressed by individuals working in the sector, the practical implementation might be difficult to attain and therefore initiatives should have a global character. Additionally, social pressure should function as a catalyst to engender serious structural changes.

**Figure 1. Total compensation trend for managing directors: pay levels and cash vs. deferral split (Curran, M., Gundy, G., & Watson, T. (2012)).**



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