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REMUNERATION OF BANK MANAGERS – PROBLEMS AND POTENTIAL SOLUTIONS **

The issue of the remuneration of bank managers is indicated as one of the fundamental problems of corporate governance and is pointed out as one of irregularities that led to the financial crisis. Based on the literature review, the paper summarizes the identified inadequacies of management compensation systems in banks: overcompensation, short-termism and the related incentive for excessive risk-taking, manipulation by managers, poor disclosure and the lack of proper oversight from the supervisory boards. Another problem is that – although as a rule the management compensation system should be used as a tool to motivate managers (agents) to act in a way to achieve the objectives of the owners (and other legitimate stakeholders) – the literature shows the unequivocal results of the pay-performance research.

As the described problems in the banking industry have grown enormously, the recommendations and regulations concerning the management remuneration policies and practices are being enacted. The paper shows however that their implementation raises many problems and challenges. Therefore there is a need to further analyze the issue of designing a proper bank managers' compensation model. The postulates concerning performance evaluation process, linkage with risk, instruments and disclosure are presented.

Keywords: management compensation, corporate governance in banks

1. INTRODUCTION

The recent financial crisis has evidenced many problems specifically connected with the regulations and attitudes of many actors, in particular the financial sector. The main blame for the collapse of the financial markets was – not unduly – assigned to banks; the weakness and inadequacy of the mechanisms of corporate governance in these institutions were indicated[1]. The necessary changes needed to strengthen corporate governance were identified and some regulatory changes have been carried out and proposals of further reforms have been formulated.

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[1] The problems of corporate governance in banks are discussed by: Kirkpatrick (2009), Turner (2009), Walker (2009), OECD (2009), European Commission (2010a), Marcinkowska (2012).

The board of directors and the remuneration committee are responsible for determining the level and structure of compensation paid to the CEO and other executive directors. The issue of the remuneration of the bank managers in recent years was indicated as one of the fundamental problems of corporate governance and is pointed out as one of the irregularities which led to the financial crisis.

Compensation packages must be sufficient in terms of their level and structure to attract, retain, and motivate qualified executives to create shareholder or stakeholder value (Larker, Tayan 2011, p. 237).

In theory, the level of compensation should be determined upon the analysis of expected value creation by the managers and the decision of the proportion of that value that should be offered to those managers who contributed to generating those effects. In practice, however, the compensation level is determined by benchmarking CEO's pay with their peer group. Although this aims at remaining competitive with regard to compensation, it has obvious drawbacks, of which the most dangerous is determining pay without explicit regard to value creation, and another is the ratcheting effect: when multiple companies within a group try to meet or exceed the median, the median increases (Larker, Tayan 2011, p. 247-248).

Ezzamel and Watson's research (2002), indicates that both external labour market and internal (within the board) remuneration comparisons are important in explaining directors' bonuses. The efficiency of the labor market for chief executives has important implications on corporate governance quality. The efficiency of the labour market for CEOs is relevant for corporate governance as CEOs are the primary agents responsible for managing the corporation and ensuring that long-term value is preserved and enhanced; if the manager knows he/she can be replaced for poor performance, self-interest behaviour is limited; the efficiency of the labor market sets the stage for how much compensation is required to attract and retain a suitable CEO. When the labour market is efficient, the board of directors have the information needed to evaluate executives, which leads to improved hiring decisions and compensation packages, it also disciplines managerial behaviour. If the market functions inefficiently, the executives may be hired or compensated inadequately, which may be harmful for the long-term value creation of a company (Larker, Tayan 2011, p. 203).

The objective of the paper is to discuss the design of an optimal system of bank managers' compensation and indicate the potential problems concerning this issue. First (Section 2), the evolution of the problem of management compensation in the banking system is presented, and – based on the literature review – the main causes of the problems are identified (section 3). The next section (4) presents new regulations and recommendations enacted as a response to the diagnosed problems within this area. Some of these principles raise practical challenges and issues of concern – are discussed in Section 5. Based on the analysis of the roots of the problems, with regard to the new regulations and recommendations and the findings of empirical research presented in literature, I present the postulates concerning the design of the optimal bank managers compensation model (Section 6).

2. MANAGEMENT COMPENSATION IN THE BANKING SECTOR – EVOLUTION OF THE PROBLEM

During the last thirty years, salaries in financial sector companies have been growing substantially. As Rampel (2011) reports, in the record year of 2007, the average pay in the securities industry (mainly banks) was over five times higher than the average for all other private sectors. Banks are paying their officers a high base salary (see Table 1), and the total compensation often reaches 7-digit numbers.

Table 1

Average base salary in the 15 best-paying big banks

	Average base salary for vice presidents [USD]	**Average base salary for financial analysts [USD]**
Goldman Sachs	169,896	69,461
Capital One	165,514	73,462
American Express	163,908	66,459
MetLife	145,583	57,115
Morgan Stanley	143,489	63,100
HSBC	129,686	n/a
Wells Fargo	128,805	62,195
Citigroup	119,240	66,280
JPMorgan Chase	117,058	63,229
Bank of America	112,501	71,435
Bank of New York Mellon	111,397	n/a
State Street	110,801	n/a
SunTrust	109,112	n/a
U.S. Bank	106,010	62,458
PNC Financial Services Group	102,265	56,375

Source: *The 15 Best-Paying Big Banks* 2013

It must be admitted that after the global financial crisis began, the remuneration of top banking managers dropped, but in subsequent years was rising again. Figure 1 presents the mean and median compensation of chief executive officers of banks: European (the 25 biggest banks in Europe) and Polish (all banks listed on the Warsaw Stock Exchange). There is a high differentiation among the banks (Spanish and British banks pay their managers more, and Scandinavian banks are the most parsimonious[2]), and the median differs substantially from the arithmetic average. The differentiation among the Polish banks is much smaller. It is however worth noticing that the level of remuneration of Polish banks' CEOs is nearing the median of European banks, though the size of the banks differs substantially.

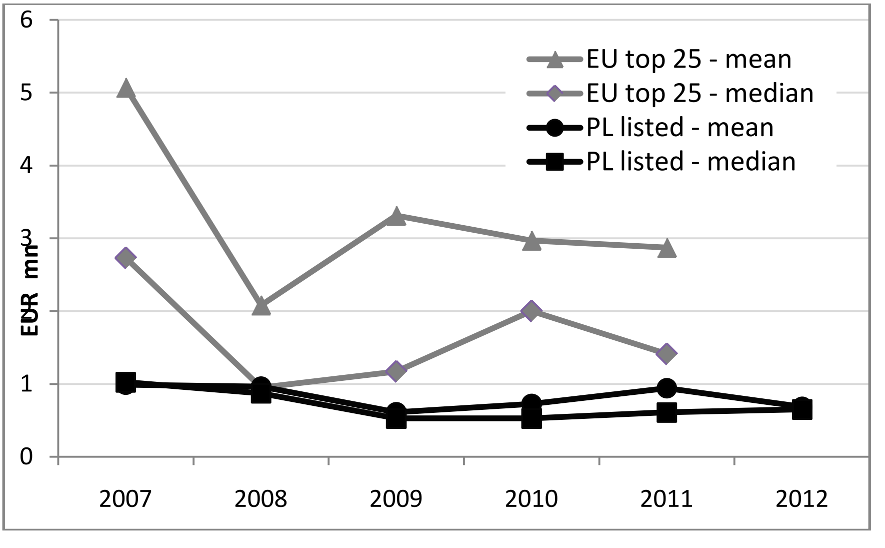

Figure 1. CEO total annual remuneration: the biggest 25 European banks and Polish listed banks

Source: Khalilulina, Nestor, 2012 and banks reports

The structure of remuneration of CEOs is very different in the analyzed European banks (see Figure 2)[3]. Some of the banks rely mainly (and

[2] See Nestor Advisors report (Khalilulina, Nestor, 2012) for details.
[3] Polish banks generally disclose less information and the reports of the majority of banks do not allow for the detailed analysis of remuneration structure.

sometimes exclusively) on base salary, the majority of banks give high bonus opportunities. In recent years the incentives for bank managers rely more on long-term performance, though many banks still strongly reward for annual outcomes.

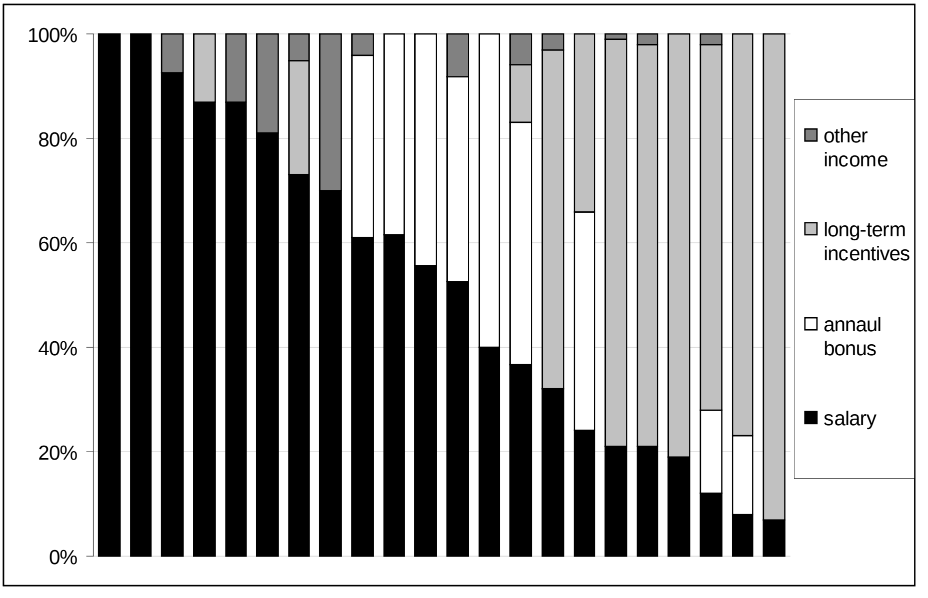

Figure 2. Structure of remuneration of the largest European banks' CEOs

Source*:* based on Nestor Advisors 2010

High growth and the level of total remuneration (due to high bonuses) in the banking sector has been criticized, especially in the context of the financial crisis and the weak performance of banks. The extremely high level of many bank managers pay, and the lack of linkage of the pay with the financial situation of those institutions has led to a discussion regarding the issue of remuneration schemes. The issue of managers' remuneration is an important aspect of corporate governance and the failure of forming an adequate system of incentives for managers can lead to serious problems with the functioning of banking institutions. Analysis of the deficiencies of the remuneration systems (see Section 3) has led to formulation of certain principles and regulation within this area (see Section 4).

3. THE PROBLEMS OF MANAGEMENT COMPENSATION IN THE BANKING SECTOR

A well-designed executive compensation package can serve as a key mechanism for corporate governance. It has the potential to align managerial incentives with those of shareholders in the decision-making process. But flawed compensation schemes can lead to value destruction (Faulkender et al, 2010).

When corporate governance mechanisms are weak, managers tend to have a greater influence on the process that determines their own compensation; they extract fees and protect themselves from the consequences of bad performance. The huge increase of bank managers' remuneration therefore reflects the inefficient transfers of wealth from shareholders to executives who enjoy too much discretion over their own pay (Faulkender et al, 2010).

As the Basel Committee on Banking Supervision (BCBS) stresses, the task of the supervisory board is to ensure that the system of remuneration of the management of a bank is consistent with its corporate culture, its long-term objectives and strategy and environment control (BCBS, 2006). The board should actively oversee the compensation system's design and operation, and should monitor and review the compensation system to ensure that it operates as intended (BCBS, 2010b).

It is difficult to deny the validity of this principle. However, it is the issue of remuneration of the management of the banks that is indicated as one of the fundamental problems of corporate governance and is pointed out as one of the irregularities which led to the financial crisis.

The key issues discussed in the analysis of problems connected with bank managers remuneration are:

- overcompensation (too high amounts of total salaries),
- incentives for excessive risk taking,
- short time horizon,
- lack of pay-performance link,
- manipulation of data (to increase pay),
- poor disclosure,
- the role of the supervisory board.

To the extent that compensation packages deviate materially from the sustainable competitive performance of the firm and the long-term financial interest of shareholders, the **overcompensation** problem is an apparent result of governance failures. Specifically the severance packages of many senior executives fired as a result of the recent financial crisis suggest the extreme level of agency costs imposed on shareholders in the banking industry (Clementi et al 2009, p. 201). Bebchuk and Fried (2006) demonstrate that managers have a strong influence over supervisory board members over their compensation and therefore their pay has increased enormously and – even more importantly – those practices have led to the dilution and distortion of managers' incentives.

However, some authors argue that managers' remuneration has not grown substantially. Specifically Jensen and Murphy (1990) showed that executive pay was surprisingly insensitive to shareholder wealth[4]. Gabaix and Landier (2008) strengthened that view, arguing that the six-fold increase of U.S. CEO pay between the years 1980-2003 was fully attributed to the six-fold increase in the market capitalization of large companies during that period.

With regard to the banking industry, DeYoung, Peng and Yan (2010) proved that the level of top managers remuneration at major U.S. banks did not significantly differ from the level at non-financial firms. At the same time they prove that the "vega" (sensitivity to volatility) of top management compensation in banks is higher than in non-banks after 1999, leading to the increase of risk.

Bebchuk and Fried (2010) also point out that the incentives generated by executive compensation programs led to excessive risk-taking by banks leading to the global financial crisis. The construction and structure of CEOs remuneration can stimulate **excessive risk taking** – if the bonuses are tied with short term results (e.g. one year profits or profitability ratios) and the incentive structure is skewed (executive's pay sensitivity is asymmetric: a huge upside in remuneration for making a profitable bet without any corresponding downside in the case of a loss), the managers are willing to concentrate on generating higher returns (even on one-time events) and tend to neglect the risk (Bebchuk, Cohen, Spamann 2010; Bhattad, Kanchan 2011). Chen, Steiner and Whyte (2006) show that following deregulation the structure of executive remuneration in banks induces risk-taking due to the wide employment of stock option-based compensation. The analysis of banks' acquisitions (Hagendorff, Vallascas 2011) proves that those CEOs who have a remuneration package eligible to higher pay-risk sensitivity tend to engage in risk-inducing mergers. Bolton, Mehran and Shapiro (2011)

[4] The authors estimated that during 1974-1986 the remuneration of top managers increased only by $3,25 for every $1000 increase in shareholder value.

quote recent empirical studies evidencing the positive relationship between equity compensation and risk-taking.

Bebchuk, Cohen and Spamann (2010), by analyzing the case of Bear Stearns and Lehman Brothers, give arguments for the thesis that executives' pay arrangements provided them with excessive risk-taking incentives[5]. However, Acrey, McCumber and Nguyen (2011) found only modest evidence that CEO remuneration structures promote significant firm-specific heterogeneity in bank risk measures or risky activities[6].

Faulkender et al (2010) highlighted the important issue of bank managers' remuneration, arguing that not only the level, but also the structure of compensation, and the process of setting compensation in financial institutions might have caused the problems. The issue of the structure of compensation concerns the instruments used. Many executives receive a portion of their pay in the form of equity or options. As the shareholders of levered institutions benefit from high risk, paying executives with stock or options and aligning them with shareholders could have the unwanted effect of pushing executives to take on excessive risk.

The boards of the banks – willing to generate high profits in the shortest possible time – take excessive risks. Studies have confirmed that excessive risk taking (and treating risk more as a possibility of achieving profits than losses) is stimulated by the application of higher premiums and financial objectives for the management (Erkens, Hung, Matos 2009; Bechmann, Raaballe 2009; Harman, Slapnicar 2007).

Bhattad and Kanchan (2011) explained that excessive risk is induced by the incorrect alignment of short-term incentives with long-term value creation. The instruments used and their structure in managers' total remuneration makes an important difference: Fortin, Goldberg and Roth (2010) prove that if CEOs are paid high base salaries, bank holding companies take less risk, if CEOs are granted more in stock options or are paid higher bonuses, bank holding companies take more risk. Balachandran, Kogut and Harnal (2010) also prove that equity-based pay (i.e. restricted stock and options) increases the probability of default, while non-equity pay (i.e. cash bonuses) decreases it. On the contrary, Ayadi, Arbak and De Groen

[5] The article shows that during the 2000-2008 period, managers of those institutions were able to cash in large amounts of bonus compensation that was not clawed back when the firms collapsed, as well as to pocket large amounts from selling shares.

[6] In their study the riskiest remuneration components – vested options and bonuses – were either insignificant or negatively correlated with risk variables, and only positively significant in predicting the level of trading assets and securitization income.

(2012) showed that the presence of option plans at large European banks did not have a significant impact on risk-taking in banking. However they made an important additional observation: long-term performance bonus plans have a deteriorating impact on the likelihood of failure.

As already noted, at present, although the total remuneration of bank CEOs has been decreasing since the financial crisis, short term bonuses (being blamed for the rise of risk) still play an important role in many banks, as the Nestor Advisors (2010) analysis proves.

Erkens, Hung and Matos (2012) and Cheng, Hong and Scheinkman (2010) state that excessive risk-taking was a result of pressure for short-term profits from institutions and outside directors, led to banks stressing that such traditionally good governance measures as institutional ownership and board independence, were in fact positively related to losses.

The inadequacy of the mechanisms of corporate governance in this area largely stems from the fact that the **short time horizon**, in which the results of the companies (including banks) are assessed, and the pressure to generate a high return on equity (which requires banks to generate high profits). The impatience and greed of investors is therefore a key factor provoking banks to more aggressive financial behaviour (the greed of which banks and bankers were blamed by the media was only an indirect consequence). Not without significance is also the fact of making the managers into owners of their banks (through the payment of their wages in the form of stocks or stock options) – designed to motivate managements to care for the interests of the owners; the effect was achieved in a multiple way.

A study performed among banks by Hirschey (1999) evidenced that managerial ownership in banking is inversely related to accounting profits and market values for commercial banks, but he observed that the high level of managerial stock ownership is typical only for small banks. He suggested therefore that inferior performance by closely-controlled banks may simply reflect the diseconomies of the small scale of the operation. Fahlenbrach and Stulz (2011) indicated that those banks where executives' remuneration was better aligned with the interests of shareholders performed worse during the recent financial crisis[7].

It should be however mentioned that Gregg, Jewell and Tonks (2011) found that – although the pay in the financial services sector was high – the

[7] They also point out that bank CEOs did not reduce their holdings of shares in anticipation of the crisis or during the crisis and consequently they suffered extremely large wealth losses in the wake of the crisis.

cash-plus-bonus pay-performance sensitivity of financial firms was not significantly higher than in other sectors; they concluded that it is unlikely that incentive structures could be held responsible for inducing bank executives to focus on short-term results.

The problems of incentives for excessive risk-taking and short-time horizon are parts of the bigger issue of the **link between the remuneration level and the financial performance of banks**. It was often criticism that bank managers' compensation was not aligned with the financial outcomes of their institutions. As was already stated, this issue is more complicated, as this link in fact usually existed, but was opaque (the linkage concerned only short-term performance, e.g. annual income).

Generally, research proves that managers' remuneration is mainly explained by company size – namely the amount of assets or market capitalization (Jensen and Murphy, 1990; McKnight, 1996; Gabaix and Landier, 2008; Frydman and Saks, 2008; Clementi and Cooley, 2009). Many studies prove the no pay-performance linkage or the weak pay-to-performance relation (Sykes, 2002; Kubo 2005; Shiwakoti, Ashton and Keasey, 2004; McKnight, 1996; Banghřj et al, 2010).

Harris and Helfat (1997) stress that companies reward their executives not only for the outputs (firm performance), but also the inputs, such as their skills and abilities. This is proved by the declarations of many companies that their managers remuneration is based not only on performance evaluation but also on the individual executive's appraisal.

John and Qian (2003) stressed that pay-performance sensitivity actually should be lower for regulated firms (and they empirically prove that for banks, comparing them with manufacturing firms).

Another problem arising from managers compensation formulas is that the schemes construction can lead to **manipulation** to earn higher premiums. Faulkender et al (2010) pointed out four kinds of such manipulation:

- risk manipulation – managers can pursue inefficient hedging activities against the risks of exposure in a high-powered contract,
- earnings manipulation – the structure of executive pay creates incentives for executives to manage earnings,
- peer group manipulation – highly paid peers‘ over-representation in remuneration peer groups influences the median pay resulting in the ratcheting up of CEO pay,
- disclosure manipulation – executives manage disclosure around the time of option and equity grants.

Jensen and Zimmerman (1985) also pointed out that managers choose accounting accruals in such ways that increase the value of their bonus awards (they tend to increase or decrease accounting profits depending on the bounds of their bonus plans). Hallock and Oyer (1999) showed the potential of income-smoothing (mainly by moving sales revenue among quarters) for the purpose of determining rewards. Weber (2006) also suggested that CEO wealth sensitivity is positively associated with abnormal accrual usage and the relation is consistent with income-smoothing (the author also finds that governance does not significantly influence the association between CEO stock-based wealth sensitivity and earnings-smoothing).

To some extent, the problems caused by managerial pay are connected with **poor disclosure**. Although some recommendations and regulations (e.g. some corporate governance codes, European Union regulations, International Accounting Standards) require listed companies to disclose in the annual report and accounts information about the compensation of company directors (both executive and non-executive), in practice the quality of disclosure is poor. Moreover, some research proves that a loophole still exists regarding the disclosure of specific remuneration packages for each executive director (Ward 1998). Chizema (2008) links the quality of individual pay with the company's characteristics (ownership structure, company size, supervisory board size)[8].

The last of the problems identified concerns the **role of the supervisory board**. Bebchuck and Fried (2006) argued that social and psychological factors (mainly friendship, loyalty, collegiality and team spirit) are the means by which the directors establish favourable remuneration systems for top executives.

Mayers and Smith (2010), in a study among insurance companies, document the relation between the board structure and the extent of the link between executive remuneration and performance. They proved that compensation changes are significantly more sensitive to changes in return on assets when the fraction of outsiders on the board is high. In contrast, Gregory-Smith (2012) – based on the analysis of FTSE 350 companies between 1996 and 2008 – showed that no evidence of a relationship between

[8] Institutional ownership, dispersed ownership, state ownership, prior adoption of shareholder value-oriented practices, and firm size are positively and significantly associated with the disclosure of individual executive compensation; the size of the supervisory board and firm's age are negatively and significantly associated with the individual disclosure of executive compensation.

CEO pay and director independence exists. The Walker review (2009) pointed out that a lack of remuneration committee independence contributed to failings in the financial service sector.

4. REGULATORY RECOMMENDATIONS FOR REMUNERATION POLICIES

4.1. Reform Proposals

As executive remuneration can cause serious corporate governance problems, some reform proposals are formulated. The proposals and recommendations include (Larker, Tayan 2011, p. 274-278; Faulkender et al 2010):

- improvements in board governance – compensation should be determined by a remuneration committee composed of independent directors having sufficient financial expertise,
- increase proxy disclosure – improved disclosure about executive compensation in notes to financial statements and Management Commentary,
- say-on-pay – shareholders are given an advisory (non-binding) vote on executive and director compensation,
- set strict limits on compensation – proposal for regulatory bodies to place explicit restrictions on compensation to reduce aggregate pay[9],
- take into account cumulative pay before setting future compensation – setting limits for the cumulative pay awarded to executives during their tenure with the company,
- decrease flexibility of executives to cash in on an earned or accrued long-term incentives – directors can restrict a portion of payouts until it is clear that they are truly merited.

Thus remedying the problems of senior management compensation in banking and finance is arguably not different than it is in non-financial firms (Clementi et al 2009, p. 202).

During the recent financial crisis, some recommendations concerning principles for remuneration of the managers were formulated, stating that (Institute of International Finance 2008):

[9] After the global financial crisis many legislations imposed compensation caps for those financial firms which received governmental aid.

- Compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital;
- Compensation incentives should not induce risk-taking in excess of the firm's risk appetite;
- Payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit[10];
- Incentive compensation should have a component reflecting the impact of business units' returns on the overall value of related business groups and the organization as a whole;
- Incentive compensation should have a component reflecting the firm's overall results and achievement of risk management and other general goals;
- Severance pay should take into account the realized performance for shareholders over time;
- The approach, principles, and objectives of compensation incentives should be transparent to stakeholders.

Broader recommendations relating to the whole system of remuneration in the bank are raised. The remuneration committee should be familiar with the conditions of employment and remuneration applied by the bank, to ensure that it is implementing a consistent approach to the remuneration of all staff. It is recommended that the supervision of the wage policy exercised by the Committee of the Council should be extended to all the best paid employees (and take into account the evaluation of the relationship with the objectives concerning the results and risk); it is also suggested that large quoted banks disclose the remuneration of such employees (as is the case for members of management). It is also stipulated that the banks have a deferred payment of the premium that includes a mechanism for corrections of risks, so as to provide for sustainable results. It is necessary to ensure that the system and structure of remuneration does not encourage the wrong bank exposure to risk – the remuneration policy must be consistent with effective risk management (Turner 2009, Walker 2009)[11]. As the Committee of European Banking Supervisors (CEBS) recommended, the remuneration policy should be transparent inside the bank and disclosed outside (CEBS, 2009).

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[10] This recommendation is the least implemented; some institutions do not plan to include it at all (Institute of International Finance 2009).

[11] Those recommendations are already included in guidelines issued by some regulators.

Transparency is perceived as a remedy, however Larker and Tayan (2010) pointed out that compensation disclosure has grown more extensive in length and detail, and yet the relationship between performance and compensation is perhaps less clear than it was in previous years. They argued that there seems to be a disclosure problem for companies and an understanding problem for shareholders.

4.2. Recommendations and Regulations

The issue of directors' remuneration has been of interest to corporate governance for a long time. The Greenbury report, issued in July 1995, stressed the importance of this topic and recommended a code of best practice, suggesting the fundamental principles of accountability, transparency, and linkage of rewards to performance. The Combined Code on Corporate Governance (published three years later) set out principles drawn from the Greenbury recommendations in relation to directors' pay. Since then corporate governance codes have included this area of good practice.

The formal rules were adapted by the European Commission (2004/913/EC) with regard to the remuneration of directors of listed companies and intended "fostering an appropriate regime for the remuneration of directors". In April 2009, the EC amended this recommendation (2009/385/EC) and issued a special recommendation addressed to the financial services sector (C(2009) 3159).

Remuneration Guidelines were issued by the International Corporate Governance Network (ICGN 2006). The guidelines are based on the same principles as Greenbury's recommendations: transparency, accountability and link to performance. It is mainly addressed to institutional investors who have both a fiduciary responsibility and an economic interest in ensuring that executive remuneration or compensation is well aligned with their interests. In 2010 the ICGN published further guidelines with regard to non-executive director remuneration (ICGN 2010).

After the financial crisis revealed problems with financial institutions corporate governance, in March 2009 at the Pittsburgh Summit the G-20 prepared a groundbreaking document: *Enhancing sound regulation and strengthening transparency*, that posed recommendations aimed at restoring the normal rules of functioning of the financial sector (G20, 2009). Three recommendations concerned compensation schemes. As a principle, *financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory* *action, to avoid compensation schemes which reward excessive short-term returns or risk taking*. The specific recommendations state that:

- *Large financial institutions should ensure that their compensation frameworks are consistent with their long-term goals and with prudent risk-taking. As such, the Boards of Directors of financial institutions should set clear lines of responsibility and accountability throughout their organizations to ensure that the design and operation of its remuneration system supports the firm's goals, including its overall risk tolerance. Shareholders may have a role in this process. Boards should also ensure there are appropriate mechanisms for monitoring remuneration schemes (Recommendation 19).*
- *In order to promote incentives for prudent risk-taking, each financial institution must review its compensation framework to ensure it follows the sound practice principles developed by the FSF. These include the need for remuneration systems to provide incentives consistent with the firm's long-term goals, to be adjusted for the risk taken by employees, and for the variable components of compensation to vary symmetrically according to performance (Recommendation 20).*
- *Prudential supervisors should enhance their oversight of compensation schemes by taking the design of remuneration systems into account when assessing risk management practices. The BCBS should more explicitly integrate this dimension in its guidance for the assessment of risk management practices by national prudential supervisors (Recommendation 21).*

In April 2009 the Financial Stability Forum (FSF, later: Financial Stability Board – FSB) issued specific *Principles for Sound Compensation Practices,* followed by *Implementation Standards,* issued in September 2009 (FSB 2009). The first document stated nine principles to improve remuneration practices concerning three groups of issues:

- effective governance of compensation,
- effective alignment of compensation with prudent risk-taking,
- effective supervisory oversight and engagement by stakeholders.

The implementation standards concern: governance, compensation and capital, pay structure and risk alignment, disclosure rules and supervisory oversight. Of special attention are the implementation standards regarding the required payout structure; they include the following requirements:

- deferral of bonus (40-60%), for at least 3 years,
- at least 50% of a bonus should be paid out in non-cash instruments.

- use of clawbacks and malus.

Table 2 summarizes those principles and standards.

Table 2

Summary of FSF/FSB compensation practices principles and implementation standards

Field of compensation practices	Key FSB principles	Implementation standards
Compensation governance	▪ Active Board involvement ▪ Involvement of the Risk function ▪ Independence of control functions ▪ Disclosure requirements	▪ Remuneration Committee should involve majority non executives and work closely with the Risk Committee ▪ Remuneration for control staff should be adequate and independent ▪ Remuneration Committee should submit compensation review annually (to the regulators and public) ▪ Detailed description of compensation framework ▪ Quantitative impact of current and deferred compensation assessment
Bonus pool calculation and funding	▪ Risk adjustments of compensation ▪ Link to Group performance ▪ Implications for capital position	▪ Risk adjustments should reflect the cost and quantity of capital consumptions as well as the liquidity risk ▪ Bank's financial performance should be reflected in bonus pool sizing ▪ Compensation payouts possible only in banks having sound capital base
Determination of individual compensation	▪ Risk adjustments in bonus allocation ▪ Accountability in performance measurement	▪ Thorough measurement and stress testing of risk positions ▪ Effective approach to capital allocation for the risk exposure ▪ Reliance on expert judgment to sufficiently incorporate opaque risks
Payout structures	▪ Link to business unit / individual performance ▪ Sensitivity of payouts to future performance ▪ Use of non-cash instruments ▪ No use of multi-year guaranteed bonuses	▪ Specific guidelines introduced to level the playing field globally - mandatory use of payout conditions (malus / clawbacks) - 40-60% of bonus should be deferred (% should increase with level of pay and seniority) - at least 3 years deferred (longer for businesses with higher risk holding periods) - >50% of bonus to be awarded in non-cash instruments; stock based instruments should be subject to an appropriate vesting policy

Source: based on Institute of International Finance 2010

The G-20 and FSB recommendations have formed a basis for guidelines and regulations with regard to the remuneration of financial institutions' management; they have become a set of *internationally agreed objectives, high-level principles and more specific benchmarks*.

The Basel Committee on Banking Supervision has included some of the issues in its capital standards framework: first, as an enhancement to the second pillar – "the supervisory process review", which defines principles regarding the internal management system of banks and of their supervisory review process (BCBS 2009), and later as an amendment to the third pillar, constituting the basis for market discipline, by defining the disclosure requirements (BCBS 2011b), and thus responding to the 8th recommendation of the FSB.

In the meantime, the compensation principles and standards assessment methodology (BCBS 2010a) and the range of methodologies for risk and performance alignment of remuneration (BCBS 2011a) were published.

The first of these documents defined 15 standards for the implementation within nine principles for sound compensation practices induced by FSB, and set the assessment methodology to guide supervisors in reviewing individual firms' compensation practices and assessing their compliance with those principles for sound compensation practices. BCBS stated that *the objective is to foster supervisory approaches that are effective in promoting sound compensation practices at significant financial firms and help support a level playing field.*

As FSB (2010, 2011) noted, good progress had been made in areas related to governance, oversight and disclosure, but further work was needed to raise the standard of risk adjustment to remuneration. The 7th recommendation was addressed to the BCBS *(the Basel Committee should develop for consultation … a report on the range of methodologies for risk and performance alignment of compensation schemes and their effectiveness in light of experience to date*). Mainly two specific issues were addressed:

- methods for incorporating risk and performance into bonus pool and individual compensation;
- the design of deferred compensation, such as adequate performance measures; the relation between performance measures and the ultimate value of deferred compensation instruments; malus triggers; the sensitivity of payout schedules to the time horizon of risks; and the funding of deferrals, supplemented by the proportionality in the application of rules (taking into account the size and complexity of the institutions, business models and risk tolerance etc.).

The second of the mentioned documents (BCBS 2011a) set the range of methodologies for risk and performance alignment of remuneration. The role of the document is to ensure that performance-based compensation is adjusted to account for potential risks (which is essential to the successful implementation of the FSB remuneration principles and standards).

As in the case of other BCBS recommendations, these documents formed the basis for the regulations and recommendations of the European Union. With regard to the amendments to the Basel capital accord (2nd and 3rd pillar), in October 2010 the changes to the Capital Requirements Directive (CRD III) were approved (effective January 1, 2011), and the changes were then transposed into national regulations of the member states.

The European Commission (2010b) also published a *Green Paper* concerning corporate governance in financial institutions. The document pointed out deficiencies and weaknesses in corporate governance within financial institutions and stated some required reforms in this area, also with regard to remuneration policies.

European bank supervisory authorities also issued their principle and guidance in this area. The CEBS (2009) formulated High-level Principles for Remuneration Policies; their aim was to address the most critical aspects to a properly functioning remuneration policy and to assist in remedying unsound remuneration policies (it was stressed that the responsibility for the policy rests ultimately with the institution itself and, where applicable, the shareholders). The document set the principles regarding:

- general,
- governance of remuneration,
- measurement of performance as a basis for remuneration,
- form of remuneration.

Later, the CEBS published its *Guidelines on Remuneration Policies and Practices* (CEBS 2010) concerning: outlines, governance of remuneration, general and specific requirements on risk alignment and disclosure issues.

The EBA (which replaced the CEBS and is an official banking supervision authority), issued *Guidelines on Internal Governance* (2011) which repealed some earlier CEBS documents (including High-level Principles for Remuneration Policies). It states that a remuneration framework that is in line with the risk strategies of the institution and the ultimate oversight of the remuneration policy are the key responsibilities of the institution’s management body. The document gives guidelines with special regard to the alignment of remuneration with risk profile and internal governance transparency (including the incentive and remuneration structure of the institution). The EBA will further assist in remuneration data collection and benchmarking (EBA 2012b).

The EBA (2012a) published the results of a survey on the implementation of the CEBS Guidelines on Remuneration Policies and Practices. The Authority assesses that the governance of remuneration has shown considerable progress, however it points out some problematic issues: the risk alignment of remuneration policies and practices remain underdeveloped, the use of instruments as part of variable remuneration suffers from a feasibility gap and the disclosure of remuneration policies and practices deserves greater attention.

5. ISSUES OF CONCERN – DISCUSSION OF THE REFORMS PROPOSAL

Many recommendations and formally binding rules regarding bank managers compensation have been implemented with the expectation that it will enable the creation of good remuneration systems, resulting in good incentives for risk reduction and managers caring about the results of the bank. It should however be noted that still not all of the problems have been taken care of. The European Banking Federation points out certain **practical challenges** that still need to be resolved (EBF 2010):

- Subsidiaries and branches' problem with the choice of norms to comply with (home, host or both countries' regulations?);
- Accounting and tax issues of executive remuneration deferral – should tax be levied on the sum at the time of the annual award or at the time of the actual payout?;
- Individual and collective labour agreements – the potential differences between the new and existing remuneration policies could be problematic from a legal perspective;
- Shareholder rights – some new initiatives suggest that a large part of deferred remuneration should be paid out in shares or share-linked instruments which can dilute the share ownership and cause negative effects for all shareholders (this problem however can be easily overcome by the use of phantom shares).

The Institute of International Finance in its progress reports (2009, 2010, 2011), pointed out those compensation issues that present the greatest implementation challenges to compensation reform; the most difficult issues were:

- measurement and incorporation of risk in the compensation process,
- alignment of deferrals with risk time horizon by business/roles,
- introduction of clawback clauses into the compensation framework (accounting treatment, legal/contractual issues etc.),
- the introduction of performance-linked deferrals into the compensation framework.

Regardless of the problems with the implementation of the rules, another fundamental issue is that the imposed **regulations may not achieve their goals**. It is therefore useful to assess the outcomes of previously enacted norms.

Vafeas, Waegelein, Papamichael (2003) assessed the changes in the executive compensation policy of 94 commercial banks following the ‘compensation reform’ (expanded compensation disclosure rules and revisions in the Internal Revenue Code regarding the deductibility of compensation expense). The results showed that during the period 1989–1997, banks substituted non-cash for cash compensation and exhibited a somewhat stronger pay-for-performance relationship. They concluded that compensation reform led commercial banks to change their governance structures and provided limited evidence of enhanced incentive effects of compensation contracts. As mentioned in the third section of this paper, the evidence shows that the reform did not work positively enough in all the banks.

Girma, Thompson, Wright (2007) gave evidence that the ‘Cadbury reforms’ have had disappointing results. They show that the relationship between pay and performance was still weak after the introduction of the code; the link to firm size – already strong – has been strengthened. Also Ozkan (2011) concludes from the research that the corporate governance reports (as for example the Greenbury Report, 1995) have not been totally effective. Chizema (2008) pointed out that a German Code of Corporate Governance recommendation of individual executive compensation disclosure has met with resistance in some firms.

Chalevas (2011) gives a good example of the positive impact of regulations. He shows that before the introduction of the first Greek Law on corporate governance, managers were not compensated in line with their performance. The author observed a significant link between executive compensation and company performance after the imposition of new rules.

Kostiander, Ikäheimo’s (2012) research showed that although most of the time the restrictive remuneration guidelines were followed to the letter, opportunities within the restrictions were used to maintain a competitive remuneration level. Their findings support the arguments of managerial entrenchment due to the strong involvement of CEOs in the design process and consultants engagement (consultants offer opportunistic benchmarks and introduce slack into the remuneration design[12]). They concluded that the restrictive remuneration guidelines do not lead to the intended consequences and that the same restrictions for all companies do not work properly.

The most important issue of concern is the fact that the recommendations were formulated based on the analysis of the biggest (usually global) banks, but they should be implemented by all institutions. Some of the norms are not adequate for small, unlisted banks operating in a local environment. It is however worth noticing that the principles and recommendations have forced banks' boards and owners[13] to deal with this topic – to analyse the issue of remuneration and to justify the level of compensation (ideally to link it with performance and risk).

6. DESIGNING A BANK MANAGERS' REMUNERATION MODEL

Analysis of the problems related to the remuneration of managers (in particular in the case of banks) has led to the formulation of certain postulates which are seen as a remedy for the problems diagnosed. They concern the following issues:

a) performance evaluation process,
b) linkage with risk,
c) instruments,
d) disclosure.

[12] This is consistent with Bebchuk, Fried and Walker‘s (2002) view that compensation consultants are part of the agency problem. In contrast, Voulgaris, Stathopoulos, and Walker (2010) find the positive effect of consultants on CEO pay levels, which mainly stems from an increase in equity-based compensation, as consultants exert a negative influence on basic (cash) pay.

[13] The say-on-pay mechanism was used several times by bank shareholders in recent years, giving stronger oversight over the remuneration system (strenghthening the oversight performed by supervisory board).

Performance evaluation process

Jensen, Murphy and Wruck (2004) formulated several recommendations with respect to remuneration systems. One crucial proposal puts an obligation on remuneration committees to *take the lead in seeing that Strategic Value Accountability is clearly assigned to those who have the unique combination of business judgment, financial knowledge, wisdom, and willingness to take on the critical task of managing the interface between the operating organization and the capital markets so as to create value*. The authors explain that SVA is the accountability for making the link between strategy choice and the value consequences of those choices (being the link between managers and capital markets). As it requires estimating the long-term value consequences of the alternative strategic choices, a key challenge in implementing Strategic Value Accountability is deciding how to measure and reward the performance of the person or entity that is guiding the formulation and execution of the firm's organizational and competitive strategy

Agency theory suggests the use of relative performance evaluation (RPE). As Murphy (1999) explains:

RPE is a direct implication of the informativeness principle with uni-dimensional executive actions: if the stochastic component of company performance contains an industry or market effect as well as an idiosyncratic effect, then "taking out the noise" through RPE is incrementally informative in assessing the actions taken by the CEO. Relative performance evaluation remains a strong prediction of the model after expanding the managerial action set, since pay based on relative performance provides essentially the same incentives as pay based on absolute performance, while insulating risk-averse managers from common shocks.

Compensation systems can use objective or subjective measures. The three broadly conceived types of measures used as performance criteria are: (i) accounts based measures, (ii) market-based measures and (iii) individual based measures. Some potential performance criteria are: profit measures, return on capital employed, earnings per share, shareholder return, share price (and other market based measures), individual director performance (Mallin 2007)[14]. Abowd and Kaplan (1999) argued that the remuneration package should include multiple pay-off criteria (relative performance incentives and individual incentives).

Rappaport (1999) postulated that the performance evaluation period should be extended (e.g. to a rolling 3-year cycle). His argument was that remuneration should motivate managers to create superior SVA and value creation is a long-term phenomenon – therefore performance should be evaluated beyond the current period. Nowadays the postulate remains up-to-date, but the rationale is deeper: (1) dependence on short-term results can motivate excessive risk taking, (2) short-term performance measures can be manipulated (earnings management, creative accounting etc.). Therefore the recommendations suggest including risk metrics in the performance evaluation in the remuneration system and to use such instruments and payout schemes that would support long-term performance appraisal.

The most important issue in determining the compensation package for CEOs is constructing the optimal level and structure of short and long-term incentives. Short-term incentives (usually paid in cash) offer payment for achieving predetermined performance objectives, usually being expressed as a financial measure (e.g. ROE, ROA, EPS) of a company performance in a short period of time (one year). Long-term incentives are to motivate managers to increase shareholder value and are usually expressed as a

[14] The analysis made by Murphy (1999) showed that in US financial firms the performance standards used in annual incentive plans were more often based on a single criterion than on multiple criteria. In the first group companies based their incentive plans mainly on peer group or budget (rarely on prior-year, sometimes were discretional); the vast majority of companies used earnings figure for performance evaluation (sometimes EBIT). The second group based the plans mainly on budgets, quite often on peer group; both: prior-year and discretional system were much more present than in the first group. These companies also used mainly earnings figures, but also specified operating objectives or sales targets; individual performance was often mentioned. Accounting measures were usually expressed as a margin (return, e.g. ROE), less often as per-share figures (e.g. EPS) or absolute figures (e.g. dollar value of income). Those studies tend to prove the pay-performance sensitivity, but also stress the short-termism built in the remuneration model in financial industry.

measure of the company's stock performance (e.g. total shareholder return, economic profit etc.) in a few years time.

In the case of banks, the possible performance measures for use in remuneration systems may include:

- net income or comprehensive income,
- economic profit,
- cost-income ratio, cost efficiency,
- changes in revenues and costs,
- return on equity,
- for listed banks: earnings per share (EPS), fully diluted earnings per share, EPS growth,
- for listed banks: total shareholder return (single and mutiple periods), relative total shareholder return (as compared to the market index or sub-index),
- for listed banks: price-earnings ratio,
- risk measures (see below),
- qualitative measures (for example: compliance, risk management effectiveness, internal control quality, supervisory asessement, processes effectiveness, quality asessment, customer satisfaction, brand reputation, employee satisfaction, corporate social performance) and
- individual objectives (individual executive's appraisal).

Some of those measures can however be subject to accounting manipulation, which stresses the importance of internal control and the long-term performance apprisal and deferral of a large portion of awarded bonuses.

Linkage with risk

Newly imposed regulations already take into account the necessity to link remuneration system with risk performance. As noted, this issue raises problems with implementation.

As Tarullo (2009) stressed, *to be fully effective, risk adjustments to compensation should take account of the full range of risks that the activities of employees may pose for the firm, including credit, market, compliance, reputational, and liquidity risks. Moreover, these adjustments need to be implemented in practice so that actual payments vary based on risks or risk outcomes. The second core principle is that incentive compensation* *arrangements should be compatible with effective risk management and controls.*

In the case of banks, the possible risk measures that could serve as key performance indicators in remuneration systems may include:

- non-performing loans amount, growth or ratio (non-performing loans as a percentage of total gross loans),
- value at risk (amount or number of times the bank exceeded the limit),
- liquidity ratios (asset-liability adequacy),
- leverage ratio (assets to equity or assets and off-balance sheet items to equity),
- risk-weighted assets and off-balance-sheet liabilities,
- capital adequacy (capital ratios: total, tier 1, common equity tier 1).

It can also be useful to use risk-adjusted performance measures, especially:

- economic capital,
- economic profit (risk included in the calculation of beta coeficient),
- risk adjusted profit,
- return on risk-weighted assets,
- risk-adjusted return on capital (RAROC) or risk on risk-adjusted capital (RORAC).

Instruments

The executive compensation package may consist of several elements and use a wide range of instruments: annual (basic) salary, annual cash bonus, long-term incentive plans, performance units (shares), stock options, restricted stock, contractual agreements (e.g. severance agreements, post-retirement consulting agreements, golden parachutes, etc.), other financial benefits (e.g. health insurance, life insurance, defined contribution retirement plans, supplemental executive retirement plans, reimbursement of taxes owed on taxable benefits etc) and perquisites (fringe benefits)[15]. The compensation package might be subject to certain contractual restrictions (Larker, Tayan 2011, p. 245):

- stock ownership guidelines – the minimum amount of stock that an executive is required to hold during employment (usually expressed as a multiple of base salary),

[15] See Larker, Tayan, 2011, p. 241-245; Murphy, 1999, p. 2485-2563, Urbanek, 2005, p. 147-165 for further description.

- clawback and deferred payouts – contractual provision that enables the company to reclaim compensation in future years if it becomes clear that the bonus should not have been awarded previously (for example, the Sarbanes-Oxley Act enables companies to reclaim bonuses from the CEO and CFO if it is later determined that the bonuses were awarded on the basis of manipulated earnings).

For many years the proposal of equity payments had many proponents; it was a solution to the problem of the conflict between managers and shareholders. However, as the already cited studies showed, the impact of stock ownership by executives on company performance is ambiguous. Now it is rather stressed that in the case of banks it may lead to the increase of risk (ultimately also systemic risk). Therefore nowadays new suggestions are being formulated as to the use of instruments of incentive compensation. Equity compensation is no longer perceived as a good solution (in fact it is rather a problem than a cure). The recommended instrument of remuneration payment in the case of bank managers is cash again or (to some extent) restricted equity instruments.

Some people suggests that the situation would be cured by longer term tenures for corporate management, truly independent non-executive directors, the cessation of stock options and the use of generous basic salary and five-year restricted shares (Sykes 2002).

Some authors even suggest that executive incentive compensation should include only restricted stock and restricted stock options. The restriction means that these instruments could not be sold or executed over a specified time after the end of executive's contract, for example two to four years (Bhagat, Bolton 2013). This however could have a negative effect on the managers' turnover and would shorten their tenure (or number of tenures), which could have destabilizing effects[16]. However, the notion of restrictions or deferrals is useful, and without doubt should be implemented in bank managers compensation schemes (with a resonable time frame of deferral).

A proposal of "bonus bank" system has been formulated. This is an arrangement that is intended to motivate executives to care for the long-term performance of the company – that is to induce the same patterns of the cumulative payouts as cumulative performance of a firm. In this concept, a large portion of the bonus should be retained in a bonus bank. After some

[16] In fact, the limitation of CEO's tenures is not necessarily bad. Ozkan (2011) proved the entrenchment effect of CEO tenure: longer CEO tenure was associated with lower pay-performance sensitivity of option grants.

specified time (2-5 years) partial sums of the retained bonus could be paid out provided that the company's actual performance is sustainable. If the profits (or other measures used) tend to be one-time and unusual (the performance worsens in subsequent years), the portion of bonus is eliminated. It is argued that this system – if employed consistently over multi-year periods – should exert a moderating effect on managerial risk preferences and lead to sustainable performance (McCormack, Weiker, 2010; Stewart, 1991).

Disclosure

It is necessary to increase disclosure scope and quality – company reports should give information of the compensation level and structure and most of all the remuneration system construction (the basis for remuneration setting, the instruments used and terms of the potential deferral).

Most international and national codes of corporate governance include recommendations to disclose remuneration policy that applies to executives: procedures of setting remuneration, its amount and structure (performance criteria on which variable components of remuneration are based, the relation between fixed and variable components of compensation, performance bonuses, the reasons why non-performance criteria have been applied, principles of supplementary pension schemes, information on compensation paid to directors in connection with the termination of their activities).

Gordon (2005) proposed the introduction of a "Compensation Discussion and Analysis" (CD&A) included in the company reports. Schiehll and Bellavance (2009) gave strong arguments for that, pointing out that disclosure of performance criteria and targets linked to CEO compensation would improve investor understanding of the alignment between executive pay and firm's performance, as their empirical study showed that non-financial information enhanced the board's proprietary information on CEO actions that are not fully reflected in financial and stock-price information.

Sheu, Chung and Liu (2010) suggested that transparency (the comprehensive disclosure of information on compensation) provides a signal that the firm has fewer agency problems and a better governance structure; poor disclosure can be perceived as camouflage for excess compensation and bargaining behaviour.

SUMMARY

The issue of bank managers performance is very controversial. This paper cites the researchers pointing out that the wrong compensation system was one of the causes of the recent global financial crisis, mainly due to short-termism and the resulting incentive for excessive risk-taking. Although research proved some regularities concerning the level and structure of remuneration of managers of the bank, but in many areas the results are inconclusive, making the issue even more complicated.

Banking authorities and market regulators are trying to heal the system by proposing new arrangements. However, it should be noted that their impact will depend on the financial system model and the level of the development of banking system. The recommendations and norms concerning bank managers' compensation should therefore be differentiated and adapted to the local conditions.

Irrespective of the legal issues, the accountability for the formulation and functioning of the remuneration system rests with the supervisory boards, but can (and should) also be strengthened by the bank's shareholders activity.

The optimally designed managerial compensation scheme should reflect the strategy of the bank and give incentives for achieving the institution's goals, concerning the stakeholder or shareholder value creation.

The proposals described in the last section of the article are the facilitation for banks to build their own remuneration system for managers. It should be kept in mind that there is no universal system, though the recommendations given and some pitfalls and limitations described can serve as a basis for the construction of the optimal system for each specific entity.

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