Bijlage 2: Performance pay and financial stability

Non Paper by the Netherlands

1. Introduction

Both public and private entities regard compensation policies to have played an important role in provoking the current financial crisis. One of the reasons why compensation schemes are viewed as a contributing factor to the current crisis is that the most sizeable losses were incurred in business areas in which the compensation components based on short term results had been substantial in the run-up to the crisis. Explicit absolute volume targets in mortgage markets are a second example, where remuneration policies might have played a role in originating excessive risks. Ex post, it could be argued that compensation was not adjusted adequately for the risks that were taken, be it by traders or by executive management. Moreover, misaligned incentives on different levels (individual, business unit, board of directors) have proved to be mutually enforcing in the current crisis.

The FSF members agreed that compensation arrangements often encouraged disproportionate risk-taking with insufficient regard to longer-term risks[1]. They recommended that the financial industry should align compensation models with long-term, firm-wide profitability and that regulators and supervisors should work with market participants to mitigate the risks arising from inappropriate incentive structures. Private sector participants, such as the IIF or individual banks[2], note the role compensation policies played in the current crisis as well. This memorandum is written to support this ongoing process. This note has a strict focus on incentives stemming from compensation policy and practices. It does not discuss other misaligned incentives in the financial sector that also need further attention in line with the recommendations of the FSF and the 15 November Summit in Washington, such as an implicit government guarantee for large banks that could create moral hazard, or credit rating agencies being paid by the issuers of securities they rate and the way these conflicts of interest are managed.

2. Setting out the issue

Within firms there are a number of well-known conflicts of interest. First, there is the choice of effort: additional effort from the employee, manager or executive generally increases the residual value of the firm (to which shareholders have a title) but reduces the utility of the manager. Second, there is risk exposure: managers typically have substantial levels of human capital (and personal wealth) invested in

[1] Recommendation II.19, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, FSF, 7 April 2008, p. 20.

[2] The UBS shareholder report of April 18 explaining the write downs describes (p.41) “insufficient incentives to protect the UBS franchise long term” where essentially “bonuses were measured against gross revenue after personnel costs, with no formal account taken of the quality or sustainability of those earnings” and notes the existence of “asymmetric risk / reward compensation” where for example, mezzanine CDOs had a higher fee structure, than high grade CDOs.

the firm. This can make them overly risk averse from the standpoint of the shareholders, who are able to diversify specific risk. Third, different time horizons: managers' claims on the corporation are generally limited to their tenure with the firm. Therefore, managers have limited incentives to care about the cash flows beyond their tenure. Owners, on the other hand, are interested in the value of the entire future stream of cash flows, since it determines the value of the firm. Fourth and finally, managers generally have a preference to empire-building: they are reluctant to reduce the size of a firm even if it has no profitable investment projects.

Well designed contracts can resolve these types of incentive problems at low costs. The use of variable pay (including bonuses) is probably the most efficient – and certainly the most common - way to address many of the above mentioned conflicts of interest. In the private sector, this type of performance pay has become standard: compensation usually varies from year to year based on some measure of revenue or profit that the employee has contributed to or generated on behalf of the financial firm in the past year.

Strengthened incentives for performance have come with a potential cost: it may lead to an asymmetric return profile. That is, an employee may gain a high bonus by engaging in a risky trade, but the employee is not held liable if, over time, his actions turn into a loss. Limited liability for downside risks creates moral hazard, which may promote excessive risk-taking. While limited liability in general is a great social invention[3], at the present juncture, the relevant question for the shareholder is at what point asymmetric compensation schemes generate excessive risk taking that ultimately undermines the performance of the firm.

If financial stability is at stake, or where potentially excessive risk taking affects the real economy and the interest of non-shareholding stakeholders such as depositors and taxpayers, public authorities and regulators have a legitimate cause to be concerned about compensation practices
These incentives could equally well be non-financial, for example resulting from the corporate culture[4].

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[3] Asymmetric incentive structures are not confined to modern day compensation systems. They have played an important role in economic history. In fact, limited liability facilitates the creation of enterprises and has as such proved to be of great importance for economic growth and welfare. Many important economic developments (e.g. railroads) were only backed by private investors because their liabilities were limited.

[4] See for an inside viewpoint of the Salomon Brothers (now Citigroup) trading room "Liar's poker" by Michael Lewis (1989), Norton Press: New York.

3. Private sector proposals

In summer 2008 two industry groups have publicly addressed compensation issues and underscored the need for improvement. The International Institute of Finance (IIF)[5] has issued seven Principles of Conduct on compensation policies:

- 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.
- 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 achievements of risk-management and other general goals.
- Severance pay should take into account realized performance for shareholders over time.
- The approach, principles, and objectives of compensation incentives should be transparent to stakeholders.

The IIF does not give detailed recommendations as compensation policy is an important recruitment instrument for attracting highly qualified labour. Compensation policy should therefore not be uniform across financial institutions. Some banks are in the process of adapting their compensation structure[6]. Next to the IIF, the Counterparty Risk Management Policy Group (CRMPG III[7]) has identified compensation schemes as one of five factors that were the primary driving forces of the current credit market crisis. The Policy Group states that "compensation practices as they apply to senior and executive management should be 1) based heavily on the performance of the bank as a whole and 2) heavily stock-based with such stock-based compensation vesting over an extended period of time."

Also in the broader sphere of corporate governance in private sector, there is increased attention to conduct on the part of management and supervisory board members. For instance, the recently updated Dutch corporate governance code has strengthened the role of the supervisory board, for example in relation to management board remuneration. Main adjustments include (among others) risk

[5] IIF, Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, July 17, 2008, p.49.
[6] UBS for example will adopt a new compensation model for the Board of Directors and the Group Executive Board in 2009, in order to focus more on the long-term and to align compensation more closely with the value creation of the firm. The fundamental changes are: The Chairman of the Board of Directors is no longer bound to the same incentive system as the Group Executive Board and will no longer receive variable compensation components. Variable cash compensation for the Group Executive Board is based on a bonus / malus system. A similar concept to the above-mentioned bonus / malus system is effective for variable equity compensation
[7] CRMPG III, Containing Systemic Risk: The Road to Reform, August 6, 2008, p. 5.

management and executive pay. Regarding the latter, the Committee[8] recommends that when executive pay is determined, pay differentials within the company must be taken into account. In addition, it recommends that the ratio of variable to fixed remuneration should be appropriate and that variable remuneration should be based on long term objectives, while non financial indicators relevant to the company should also be taken into account. Remuneration policy must also be in line with the company's risk profile.

4. The public policy reaction

While the IIF proposals can be considered as valuable steps forward, several national supervisors and regulators considered that these proposals alone do not sufficiently address the issue at hand and are (in the process of) developing policy-initiatives. The reason is firstly that as the issued IIF principles are voluntary, compliance is not guaranteed. Secondly, none of the principles really addresses the fundamentally asymmetric risk-return profile that investment managers or traders face. Examples of authorities who have called for increased surveillance or measures are Banca d'Italia (which has included a number of principles in relation to compensation as part of its corporate governance principles), the Financial Services Authority (FSA) in the UK (which has sent a letter to the CEOs of 40 high impact firms, explaining bad practices and good practises while urging management to implement good practices[9]), and the Dutch Central Bank and Financial Markets Authority (who are in the process of developing principles and have announced that it will monitor more closely the risks resulting from compensation practices).

We support the initiatives already underway within international committees of supervisors. An FSF working group on compensation is established and plans to develop a set of sound practice guidelines for compensation schemes and we understand the Joint Forum is planning on a similar initiative. We encourage that the results will be taken forward by its members (BCSB, IAIS and IOSCO). On an EU level the Committee of European Banking Supervisors (CEBS) has formed a task force to develop principles for sound remuneration. The European 3L3 committees (CEBS, CEIOPS and CESR) have delegated this task to CEBS, while acknowledging that the topic is not only relevant to the banking industry. CEIOPS and the European Commission are observer in this task force.

A bank's compensation scheme should be explicitly and openly discussed with supervisors under pillar 2 of Basel II. The supervisory review process should ensure the prudential supervisor that the applied compensation scheme does not give rise to excessive risk taking. This is complemented ex post by considering the implication of compensation structures for the overall risk profile of individual firms

[8] The Corporate Governance Code Monitoring Committee, which was established by the Minister of Finance, the State Secretary for Economic Affairs and the Minister of Justice in December 2004 to promote the use of the Code and to monitor compliance and application. The Monitoring Committee's term of office ended on 14 December 2008.

[9] Downloadable at http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf

and ensuring that firms retain reserves that are commensurate to such. The development of sound principals or best practices via the Basel Committee on Banking Supervision (BCBS) might prove to be a sensible next step to maintain a level playing field as it would dampen ex ante the risk-taking incentives embedded in compensation practices on a harmonised international coordinated basis.

5. Draft compensation principles by Dutch financial supervisors

The Dutch Central Bank (De Nederlandsche Bank, DNB) and the Dutch Financial Markets Authority (AFM) are in the process of developing principles for sound performance-related pay. The principles – currently in draft - focus on the governance aspect of compensation, the measurement of performance as a basis for compensation and on the composition of performance-related compensation.

With respect to governance, financial institutions should ensure that its compensation policy fits within a formulated risk profile, with a larger and well described role for risk management (at the level of firm wide compensation policy) and compliance (at the individual level). Compensation systems should be designed in such a way that employees' risk acceptance is in line with the risk profile of the institution. Performance based compensation can only be paid out, if employees have followed the code of conduct (a possibility could be to introduce claw back-like features if variable compensation is awarded on the basis of incorrect data, or if employees verifiably did not follow the code of conduct). Responsibility for the remuneration policy and the level of the allocated remuneration lies with the institution's Executive Board. The Supervisory Board (or a similar internal supervisory body) determines the individual remuneration packages for executives and supervises the remuneration policy for executives and employees and any individual employee remunerations that exceed a certain level or amount.

With respect to the assessment of performances as a basis for performance related compensation, the financial results underpinning the allocation of performance pay should be adjusted for risks and costs, should be partly based on non financial criteria and business unit or firm wide results. Earning high profits via a high risk strategy is not a performance, but a gamble. Therefore risk-adjustment is crucial in determining performance pay. Moreover performance should include non-financial criteria relevant to the company, and should be based on group- and institution performance as well, as to increase the individual responsibility.

The amount of compensation pay should be in proportion to the fixed salary and be dependent on the results over several years. Different proportions between fixed and variable salary may by appropriate for different functions. For example, a variable salary of 50% of total remuneration could be suitable for transaction-oriented commercial functions, whereas that percentage could be considerably lower for back-office employees (such as in risk management or compliance). Where performance-related

remunerations make up a substantial part of the total remuneration package, the (final) level of the performance-related remunerations paid is dependent on the results over several years. This can be achieved by paying allocated bonuses in tranches over a multi-year period, with the unpaid portion subject to risk (in other words, liable for adjustment for weaker or unexpected results). The institution could also choose to only determine and grant a bonus after it can assess performance over a number of years, possibly using a moving average of the results over the relevant period.

6. Conclusions

Organizational architecture learns that by designing compensation contracts that maximize the value of employees' output net of costs, firm value is maximized and both the owners of the firm and their employees can be made better off. Compensation schemes (level and structure) have several functions: to reward past performance, to promote future performance, to retain and attract staff as well as to minimize taxes. Employers compete for talent and their compensation instrument is their most important tool. Within these borders a sustainable compensation policy has to be formulated, that guarantees a proper and comprehensible relationship between performance and pay.

Incentive pay has important pro's, but it also has con's. Some say it is ineffective, since money alone is not a motivator (other factors, such as the nature of the work or quality of the colleagues are equally important for making a job attractive). A second type of criticism is that incentive pay does not work because it is impossible to design an effective incentive compensation scheme, let alone measure skill since performance depends on many other factors as well (organisational architecture, management). However, recent events give new impetus to George Baker's conclusion: "the problem is not that incentives can't work but that they work all too well"[10].

If financial stability is at stake, there is a clear justification for government intervention. The Financial Supervisor is best placed to perform this role. It should include compensation schemes in its regular supervision activities. At the international level, an agreement on best practices and good principles would be instrumental to this.

[10] G.Baker (1993), "Rethinking Rewards" *Harvard Busniess Review*, November-December, 44-45.