Regulating executive compensation in the financial service industry

Elin Komsi,
Julia Hakuli,
Jędrzej Bugowski,
Ronja Mäki-Leppilampi

Purpose of the presentation

The aim of our report is to ***identify problems regarding executive compensation in the financial sector****, present their* ***root causes*** *and describe* ***applicable post-crisis regulations****. We look at* ***the effects****, both* ***intended and unintended****, of implemented regulation, such as the UK Remuneration Code and EU bonus cap and* ***reflect on their beneficiality*** *in practice through financial theory and academic research.*

- Elin Komsi, Julia Hakuli, Jędrzej Bugowski and Ronja Mäki-Leppilampi

Global Financial Crisis of 2007-2012

Role of Financial Sector

Connecting households that are willing to invest their surplus money and those that seek additional funding - Adrian & Song Shin, 2010

Global Financial Crisis of 2007-2012

- Market panic of 2007 over health of financial sector in the US and European Union, involvement in Mortage Base Products
- Housing bubble burst; bankruptcy, bailout or nationalization of financial institutions: Fannie Mae, Freddie Mac, Lehman Brothers
- Extensive financial support utilizing taxpayer's money

Too Big To Fail Doctrine

- First view: size, internal complexity and economies of scale securing the stability of the entity
- Second view: collapse cannot be allowed, the void left would be catastrophic

Executive Compensation as a cause of the Crisis

- Causes of the crisis: increased borrowing, erroneous regulations and extensive risk-taking by bank managers
- Role of remuneration related to short-term performance with bonus cash-in before the realization of long-term effects

Resources: Helleiner E. (2011), ; Bebchuk, L. A. and Spamann, H. (2010).

Introduction to executive compensation schemes

Fixed pay

- The amount doesn't change despite of individual's or corporate's performance

Variable pay

- Often **performance-based** compensation
- Short-term vs long-term incentives
  - Long-term: generally, over 1-year time horizon
- Can be for example in the form of stock options or annual cash bonuses

Examples of compensation schemes from our case companies:

Deutsche Bank: CEO's target amount of base salary in 2021 was 3.6 million euros

- Variable pay's target was 5.4 million euros of which over half is based on long-term performance

Handelsbanken: CEO's fixed pay's portion of total pay was 100 % in 2021

- Total pay amount in 2021: 18.4 million SEK

Sources: Deutsche Bank, Compensation Report 2021; Handelsbanken, Remuneration report 2021

The role of executive compensation

- Mechanism internal to the firm that govern and control the actions of managers
- Alleviate the agency problem with the objective to reduce vertical governance problems

- Address the two-dimensional moral hazard problem

Incentivizing optimal effort

- Agency problem, the principal unable to monitor actions taken by the agents
- Shirking and extraction of private benefits
- Harming the value maximization from a shareholder perspective

Incentivizing optimal level of risk

- Underinvestment & excessive risk-taking at the expense of shareholders
- Overinvestment (benefit managers whose rewards are linked to equity and shareholders)
  - Increase in cost of debt

Source: Sepe S. (2011)

Regulation as corporate governance institution

The aim of regulation is to:

- **Govern** and **control** the executive compensation
- Affect to company's internal remuneration policies
- Have remuneration policies where possible losses to society are taken into account

And to prevent:

- Remuneration which encourages enormous risk-taking
- Excessive compensation
- New customs which would result in new crises (Johnston, 2014)

"Suboptimal regulation, if too loose, may result in excessive risk-taking and overly strict regulation can lead to risk avoidance ("credit freeze")." (Hilscher et al., 2021)

Few key points from the regulations

EU'S REGULATIONS

Bonus cap

- Restricts the variable pay amount
- One-to-one level or one-to-two level
    - 1-1: fixed pay is 1 million EUR and variable pay is 1 million EUR
    - 1-2: fixed pay is 1 million EUR and variable pay is 2 million EUR

Clawback arrangements

- 100 % of variable pay
- Means that if there would be e.g., restatements of financial statements, the bank has right to 'ask back' the bonus received due to the 'faulty' financials

UK'S REGULATIONS
(the UK Remuneration Code)

Changing the time horizon of compensation

- Minimum of 50 % of the bonus compensation is deferred at least for three years before payment

Sources: Kleymenova & Tuna, 2016; 2013/36/EU; Murphy & Jensen, 2018

The perceived value of regulation

Objectives of regulating compensation

- **Alignment of risk and remuneration**
    - **Decrease short-termism**
        - **Curb socially excessive risk-taking**
        - **Minimize perceived 'excesses'** in the level of:
            - Overall compensation and
            - Individual components, such as bonuses

Shareholder vs. Stakeholder viewpoint

Potential costs of regulating compensation

- **Constrained ability** to achieve the optimal level or structure of pay **to retain and attract talent**
    - Adverse selection problem
- Complexity and uncertainty of **compensation contracts**
- Restrained ability to align the interests of management and shareholders through compensation
    - Role of compensation: to incentivize effort
        - **Reduced executive incentive to create shareholder value**
- **Reduced competitiveness** of the sector relative to providers not subject to restrictions

Realized benefits – costs = value of regulation

Research provides differing results of regulation beneficiality in practice

Research on regulation

- Johnston (2014): **the cap is a vital addition** the the regulatory scheme
- Thanassoulis (2012): **optimal financial regulation would involve some intervention**
  - In particular weak caps on the proportion of the balance sheet used for bonus payments
    - **Stringent bonus caps** are value destroying and default risk enhancing
- Murphy (2013): **bonus caps** increase risk-taking incentives and **result in a loss of value** in the EU banking sector

If corporate governance is chosen optimally, constraints imposed by regulation can move companies out of equilibrium (Demsetz & Lehn, 1985)

Shareholder viewpoint – the capital market reaction (Kleymenova & Tuna, 2016)

- **Positive market reaction**
  - Regulation is perceived as **beneficial regulation for shareholders**
    - E.g. The UK Remuneration Code
- **Negative market reaction**
  - **Shareholders expect a loss of company value** due to imposed restrictions
    - E.g. The EU bonus cap
  - Expectation that in practice imposed restrictions:
    - Increase fixed costs
    - Gives executives incentive to take 'bad risks' and avoid 'good risks'
    - Ultimately do not decrease 'excess' pay
    - Lead to loss of talent

Source: Kleymenova, A. and Tuna, I, Regulation of Compensation and Systemic Risk. 2016.

What has changed in practice ?

Desired effects (achieved objectives)

- The UK Remuneration Code
  - Firms defer more bonuses
  - A decrease in measures of firm risk
  - Total compensation higher pre-2010
  - *Main objectives achieved*

Unintended effects (endogenous costs)

- UK and EU vs. US
  - Increase in unforced **CEO turnover** likelihood
- Overall
  - CEO **compensation contracts** more complex
  - Increase in overall informational requirement

Controversial effects

- The EU bonus cap
  - **Reduction of variable / fixed pay ratio**
    - Significant **increase in fixed remuneration**
      - *Objective achieved*
  - **No effect on financial stability and cost flexibility**
    - Fixed costs only accounted for minimal share of funds and overall administrative costs
  - **Change in the structure of fixed remuneration**
    - Significant share of fixed remuneration paid in **instruments other than cash**
      - Possibly a way to circumvent the ratio requirement
      - Instruments that in the end relate to performance
  - *Practices not sufficiently harmonized due to differences in national implementation*
    - *Full effects yet to be determined?*

Summary

The aim of our report is to identify problems regarding executive compensation in the financial sector

Problem: short-termism leading to socially excessive risk-taking

Presents their root causes and

Root causes of problem: unfavorable compensation schemes

Short-term oriented, performance driven pay schemes, possibly leading to excessive levels of pay

Applicable post-crisis regulations

Bonus caps, clawbacks, and bonus deferral

Effects of regulations

Intended and unintended, of implemented regulation, such as the UK Remuneration Code and EU bonus cap and reflect on their beneficiality in practice through financial theory and academic research

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