Policy Exchange

The Balanced Incentive Scheme

Changing the Bonus Culture for Senior Banking Executives

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Executive Summary

Executive compensation has stormed onto the political stage and into the consciousness of voters. Taxpayer anger is growing at the payment of bonuses to bailed-out bankers, and there is confusion over bonuses paid for the previous year's poor performance.

The dramatic downturn in the economy since the collapse of Lehman Brothers has left little time to identify what has actually happened. The distinction between cause and effect has become blurred: given that the recession came from a banking crisis, wasn't it the overpaid bankers that caused it? There is an understandable search for a scapegoat, and to find the crack in the dam which caused the tsunami. Unfortunately, this hunt obfuscates the issues. Yes, banks, and some bankers, took too much risk; and yes, their compensation played a part in that process. But regulators and central banks failed to police the system as they should. Bonuses didn't cause the current crisis, but the structure of compensation packages clearly contributed towards the general build up of risk in the system.

Now that we are considering how to prevent such a crisis from happening again, it is natural to assess how risks were created, and the structure of bonuses should form part of that re-evaluation. But what can or should be done? On the one hand we need to avoid a knee-jerk response which might undermine incentives, encourage talented individuals to work elsewhere and make Britain less competitive. On the other hand senior executives' incentive structures *can* be improved, and there is now a golden opportunity for reform.

In this note, we will focus on remuneration for senior executives within the banking world. It is in the banks that the incentive structure became overly skewed towards a short-term outlook. This is only in part due to bonus packages; it is also to do with the business model of investment banking activities.

We focus on senior executives because the buck ultimately stops with them. Our recommendations for a new kind of bonus can of course be applied to employees, such as traders. The board and shareholders must decide how, for example, star traders should be incentivised; in some cases, shorter-term performance targets are more applicable than long-term ones. (Traders in liquid short-dated investments such as currencies need not be concerned with the long-term balance sheet impact, unlike sellers of illiquid structured 30 year mortgage-backed securities.) The executive board must understand the risks being taken by various parts of the bank, and adjust rewards appropriately.

We propose the following reforms to the remuneration system:

1) Companies should introduce Redeemable Convertible Preference Shares (RCPS) to remuneration packages
2) The Combined Code should be amended to include shareholder approval for remuneration advisers and their fees

Current compensation structures

Remuneration packages are usually composed of a mixture of the following…

Short-Term Incentives

The most common short-term incentive is paid in **Cash**. It is based on a one-year performance period, and it is usually immediately available, with no deferred element.

e.g. Executive X receives £1 million cash on bonus day – receiving significantly less once tax has been deducted

Long-Term Incentives

Share-based schemes represent the long-term element. Executives receive **Shares** in the company instead of cash: if the share price goes up, then their bonus goes up; if it goes down, then their bonus goes down. This was thought to align executive incentives with those of ordinary shareholders. Usually the shares will only be received once a performance period has passed and a performance target has been met, such as a high TSR (Total Shareholder Return) relative to comparable companies.

e.g. Executive X, working for Company A, is granted £1 million worth of Company A shares on bonus day. If after a performance period of 3 years, they have met their targets, they will receive the shares. If the share price then doubles, Executive X can sell for £2 million, pay capital gains tax at approximately 20%, and receive a bonus of ~£1.6 million. If the share price falls after they have been received, leaving them worth less than the original £1 million, then the Executive will likely wait until share prices go back up before selling the shares.

Executives can also receive **Options**. These are options on a share, which give the holder the right to buy the share at some point in the future. They only become active when a certain share price (known as the exercise price) is reached. As the share price moves above the exercise price, they gain in value; if the share price collapses then they can lose most of their value.

Other Incentives: Executives also receive external benefits, such as housing or car allowances, and pension benefits.

It is clear that each of these schemes creates different motivations. Some will encourage more aggressive behaviour than others, as executives look to increase their payouts in the shortest time possible.

At the moment many commentators are recommending a higher percentage of banking executives' awards should be tied to equity shares, rather than paid in cash. It should be noted, however, that many banking executives already receive a share-based component: Lehman Brothers had a large number of

employees on its shareholder list.

Furthermore, increasing the share-based component would not necessarily solve the problem of how compensation packages for banking executives are structured, for two main reasons:-

1) Performance measurement revolves around short-term goals. Banks are in some respects more short-term businesses than, say, a construction company. There are few tangible assets, little long-term investment, and the focus is on how much money is generated each quarter.
2) Base salaries have remained relatively stable throughout the boom years. Rising through the ranks did not translate into larger salaries, but rather into larger bonuses. A House of Commons Library Note, "*Executive Remuneration in UK Banking*"[1], shows that salaries increased 20% between 2003 and 2007, whereas cash bonuses went up by over 100%. This focused executives into gaining as much reward in the short-term as possible, to compensate for a salary that was falling in relation to asset prices. Constrained base salary growth is preferred by firms because it means they pay lower fixed costs in terms of pension contributions.

Given these considerations, it is clear that banking pay will retain a short-term element as long as banks focus on their short-term objectives. The current crisis is likely to force a reassessment of the banking business model. In addition there is a question around whether base salaries should increase relative to bonuses (as has now been put forward at Bank of America and UBS) or whether deferred incentives should release a cash flow component to augment the annual salary and reduce reliance on the bonus.

Simply arguing for a higher share-based component risks a resuscitation of the same old cycle. This is because it places even more emphasis on the whim of the stock markets, rather than on the input of the executive on the output of their company.

Pure cash bonuses with no deferred component clearly incentivise short term thinking. But on the other hand, pure equity doesn't tie rewards closely enough to individual performance – much of the reward will depend on the overall performance of the stock market. Bonuses become prey to market forces: some lucky executives can sell their shares at the top of the market, whereas others who sell later realise a smaller profit due to stock market fluctuations. The goal for executives then becomes to receive as many shares as possible and then get lucky over when to trade them in. This uncertainty is exacerbated by the timescale of share schemes: they can be sold at any time after the performance period (usually 3 years) up until 10 years, a very generous period in which to time the market right.

[1] "*Executive Remuneration in UK Banking*", 24 March 2009, House of Commons Library
http://www.parliament.uk/commons/lib/research/briefings/snbt-04970.pdf

Pure option based schemes skew incentives further, with executives tempted to push the share price higher to trigger the option value. This can affect the company's strategy. Consider a take-over bid: if completed, these usually create a sharp increase in equity value, while at the same time triggering encashment of the executive's options. With directors keen to take the money while they have the chance, they may press ahead with a risky merger, even if the long-term benefits are not clear.

However, the current collapse in share prices has meant that holders of shares and options are now just as disillusioned with them as investors and politicians. Lehman executives, for instance, saw their personal wealth disappear overnight; many other executives hold share options that are now at a significant discount to their issue price and unlikely to recover in the medium term. This means option based schemes provide a positive disincentive in the current environment. Executives are more likely to move to another company where they can receive options at a current market strike price rather than remain with their existing employer, where their incentives have lost all value and are far from recovery.

To help resolve these tensions we propose a new **Balanced Incentive Scheme** for senior banking executives, which would involve two key changes to the remuneration system:

1) Introduce Redeemable Convertible Preference Shares (RCPS) to bonus packages, rather than relying on common equity. These provide a truly balanced incentive: they pay a fixed annual dividend, and are not as volatile as the underlying equity;
2) Shareholders must approve the appointment of the remuneration advisers, and their fees, at the annual general meeting, by amendment to The Combined Code. This would balance any conflict of interest between the Executive Directors, Non-Executive Directors, and shareholders.

These relatively simple changes would help re-align executive incentives with those of their shareholders. They would also harness crucial free-market forces—the delicate balance between greed and fear—without destabilising the system, or reducing the competitiveness of the UK economy.

Proposed changes to the system

The current consensus seems to be that executives should continue to receive the largest part of their bonus in shares. It has also been argued that there should be "malus" provisions: if a department or trader loses money then this can be clawed back from previous bonuses.

These suggestions however fail to address the underlying problem of executives' incentives

misalignment with shareholders' interests, and potentially create more distortions to the system. The current share-based component of compensation packages distorts incentives due to its volatility, and lack of flexibility.

Equity is volatile and so using it as a larger part of compensation packages ultimately disenfranchises the executive. They need to see their annual input rewarded, even if they also recognise that a long-term, 10 year increase in the share price is in their interests. The movements in the share price in the short-term are unlikely to be due to their individual contribution. Knowing that stock markets can be volatile also encourages executives to keep one eye on timing the market, rather than focusing on doing their job and letting the share price take care of itself.

Putting restrictions on when executives can access their shares creates a problem of flexibility. The 21st century economy no longer offers a job for life; it is not unusual or indeed undesirable if an executive wishes to leave their company after a number of years. If they are leaving on a positive note, then they will bargain for a generous remuneration package at their next job to compensate for their unvested shares. If they want to leave due to poor performance, then being tied in to a share-based scheme might deter them, and retaining an unmotivated employee is unlikely to be in the company's best interest. Either way, being bound by vesting schedules once again disenfranchises the executive, creating perverse incentives.

Indeed, the "malus" provisions could further exacerbate the situation, with executives likely to jump from job to job in order to maintain their bonus pot – and use it to leverage a more favourable remuneration package from their next place of work. Despite current recommendations to extend share-based schemes, executives will be nervous about accepting shares in the current environment, and key personnel will bargain for cash. This would be a retrograde step.

The key problem with the current debate is that it is based on a misunderstanding about the way to align incentives. As equities represent the bulk of institutions' investments in commercial companies, they naturally think that equity ownership will align the interest of employees and management with their own.

The problem is that equity means different things to the two parties. An investor is looking for company growth; an employee is looking for an annual reward that reflects their contribution to the business.

The future for share-based schemes

The current furore over bonus payouts has created the perfect opportunity to reform the system.

We recommend the following: share-based schemes should include **Redeemable Convertible Preference Shares (RCPS)** as an alternative to equity. These provide a truly balanced incentive.

> The difference between common equity and RCPS is that the latter:
>
> - Pays a fixed dividend
> - Is not as volatile as the underlying equity
> - Has more attractive flexibility in terms of encashment, due to the fixed realisation date

The fixed dividend provides annual cash flow as compensation for the deferral of the bonus. The fixed realisation date would help to set up the secondary market and rebalance flexibility back towards the company, rather than the employee. Simple share-based schemes put all the power in the hands of the executive; the RCPS component encourages a dialogue between the company and the executive. The executive can only sell them back to the company if the company agrees to buy them. This flexibility, combined with lower volatility, would reduce the distortions to incentives that occur within purely common equity based schemes.

As the RCPS are convertible to equity, rather than just being redeemed for cash, they would mirror the performance of the underlying equity share – but without as much volatility, due to the guarantee of redemption. Their conversion rights into ordinary shares need not be set on a 1:1 basis; if it were 1 ordinary share for every 2 preference shares, then holders would only benefit from 50 per cent or less of the equity holder's profit/(loss) when equity prices rose/(fell).

For example:

As an alternative to a £100,000 cash bonus, you are awarded £100,000 worth of 2014 RCPS, paying a dividend of 1.5 %. On one day per quarter in 2014 the shares must either be converted into equity on a 2 for 1 basis (½ equity value for one RCPS share) or redeemed for cash. The conversion ratio is set when the RCPS are issued.

If you want to redeem early you can request the company to do so but they are not obliged to redeem, and the price would be set by negotiation.

Until then you receive £1,500 in pre-tax income, which gives you some reward for the delayed payment of the bonus.

If in 2014 the equity has trebled in value, the RCPS would have increased pro rata so you would on redemption convert into common shares valued at £150,000[2], which you can sell or hold.

If the equity price had crashed by 50%, the redemption value would reflect this, cushioned by the 2:1 ratio. The value of the RCPS would fall by 25%, leaving a redemption value of £75,000. This would track the loss of 50% suffered by investors who owned the shares over this period of time.

If the RCPS conversion ratio was 1 for 1 rather than ½ for 1, both upside profit and downside loss would be doubled.

If there was a change of control via a takeover, the RCPS would not (unless both parties agreed) be redeemed immediately. However, the price per share paid by the acquirer would then form the basis of the redemption terms in 2014.

Appointment of remuneration consultants

Above and beyond the structure of remuneration schemes, it is important to have a system of checks and balances in place. Remuneration consultants are expected to play this role.

The oversight system has not worked well, however, with most remuneration consultant recommendations waved through by the remuneration committee. It is unusual for the committee – dominated by non-executive directors – to appoint consultants that would not meet with full board approval, and it is in the interests of the remuneration consultants to retain their fees by proposing remuneration that is beneficial to the Board.

[2] We have assumed the tax status of the RCPS would be the same as current equity issues. Therefore capital gains tax would normally be payable on redemption of the RCPS or the eventual sale of the equity shares.

To remove this conflict of interest, we suggest that the appointment of remuneration consultants needs to be voted on by shareholders. At the moment, a shareholder vote is necessary to re-appoint the auditors, so it would be simple to add on the further requirement to re-appoint the remuneration consultants. It is true, however, that shareholder votes in these matters are usually dictated by board recommendation – but in the current environment it is likely that shareholders will develop a more activist stance.

We also recommend that remuneration consultants should be approved for at least a 2 year period, as some of their work is not based upon one year's results: many directors receive multi-year payment packages. Shareholders need them in place for some time to help implement and justify policies created for the long term.

Furthermore, shareholders must approve the fees charged by the remuneration consultants. It is not difficult to see that if the board pays the consultants, then their independence in recommending remuneration for board executives is severely compromised.

Conclusion

The current crisis has created the ideal opportunity to reform incentive structures for executives. Taxpayers and politicians can now see how short-term the previous structure was; and executives themselves see the disadvantage in relying on volatile equity schemes.

The politicians are currently looking at potentially more destabilising solutions. It wasn't cash bonuses that created the high-risk incentive structure: but rather, an over-reliance on common equity based schemes. The answer, therefore, lies in removing volatility and inflexibility from bonus structures, to remove the incentive to "go for the home run".

Our recommendations should be simple and quick to implement. They would not undermine the competitiveness of doing business in the UK: in fact, they should form a blueprint for boardrooms across the globe.

About the authors

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Peter has seen quoted and private company remuneration from both sides of the table. He has or does chair three fully quoted, one AIM group and four private trading companies. In 1977, he co-founded Reward Regional Surveys and has since founded and chaired Top Pay Research Group specialising in independent director remuneration and in 2003 Independent Remuneration Solutions and has advised hundreds of UK quoted companies. He wrote and published the annual Independent Chairman and Non-Executive Director Salary survey from 1990-2007 and is a well known commentator on remuneration issues.

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Work on Financial Markets at Policy Exchange

Our Financial Markets programme will develop a plan of action by analysing how the financial framework should develop. We have already explained why the credit crunch happened and debated how banking regulation should change. We now focus on questions such as how to rebuild trust in the savings industry? How can corporate governance be improved? What is the role of banks during a downturn? Are Central Banks to blame for the current crisis and how can they restore financial stability? And what is the long-term political risk premium for UK investments now the government is a key part of the financial system?

For further information about this new programme please contact **Helen Thomas CFA**, Economics Research Fellow, on **helen.thomas@policyexchange.org.uk**.

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