International Corporate Rescue
Chapter 4: Human behaviour

This paper will now go through the various areas of human behaviour and examine how they affect the actions of executives. The actions and activities of executives prior to the recession will be used to illustrate the negative effects of performance-based pay. The various regulations and rules concerning remuneration of executives in the UK will then be examined under each of the different areas of human behaviour to see whether they address the problems highlighted.

1. Incentives and behaviour

1.1. Crowding out

Psychological research has provided an interesting analysis on the effects of monetary incentives and has established the important motivational theory of crowding out. The theory postulates that providing monetary incentives to individuals in return for carrying out a particular task results in their ‘intrinsic motivation to perform the task well’ to be set aside by the extrinsic monetary incentive. The consequence of this is that monetary incentives become an overriding motivation for an individual to carry out the task required of them. Applying this to economic relations the crowding out effect is evident. There are various theories explaining the crowding out theory. However, the theory that appears the most plausible is that put forward by Harvey James. He acknowledges that an extrinsic monetary incentive can provide intrinsic motivation when it connotes the competence of the employee. However, if the incentive is deemed to be controlling in the sense that it is the primary source of the employee’s motivation to work then this has the effect of displacing the intrinsic motivation of a worker to perform his task. This is because he attributes his effort to the monetary incentive rather than to his personal preferences to complete the task. James also perceives large incentives to be controlling because they are more likely to have an impact on employees’ perception of work in that they are working for the reward rather than the satisfaction of completing the task well.

1.1.1. Crowding out in banking

The concept of crowding out has particular application to the banking sector due to it relying on high levels of variable ‘incentive based compensation’ as a means to attract talented individuals to work for them. The fact that they perceive monetary incentives as the primary means of attracting people to work for them results in creating a work culture that is based on monetary incentives and are in turn indicative of the crowding out process. The prevalence of this concept within banking has produced negative consequences. Indeed, the motivation of high levels of remuneration is said to have driven executives to engage in excessive risk taking that has been held to have been a contributory factor to the rise of the recession. Indeed, remuneration structures were fashioned in such a manner that executives received remuneration on the basis of short-term profits. Accordingly, they were encouraged to undertake large risks that would produce short-term

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6. Ibid.
proliferate and simply ignore the long-term performance of their activities which ultimately incurred loses for their employers. For example, cash bonuses were often paid out on the ‘immediate results of a transaction’ resulting in individuals paying ‘little or no regard to the overall long-term consequences and future profitability of those transactions’.8

1.1.2. Regulatory response

The contribution of remuneration practices to the excessive behaviour of bankers prior to the recession lead to the creation of the remuneration code under SYSC 19A. Examining the code itself, it appears to focus on the consequences of crowding out i.e. the excessive risk taking engaged by the bankers. It addresses these concerns by imposing requirements on the structure of remuneration so that it encourages all code staff,9 including executives, to work in the long-term interests of the firm10 and to give proper attention to the risk of their actions. It achieves this through a variety of criteria and rules that it imposes on firms to include in their remuneration policy.11 However, none of these provisions appear to remove the underlying motivation of monetary incentives for the workers that are so central to the practice of crowding out and to the excessive activities of bankers contributing to the recession. Indeed, the code retains the view that remuneration is the primary means of ‘attract[ing] qualified and experienced staff’.12 This illustrates that although the government tried to address the negative consequences of the crowding out process, the problem will remain because the underlying factor of high levels of monetary incentives continue to be used. This is reinforced by the fact that the code does not and has not prevented high levels of remuneration from being rewarded provided that remuneration is consistent with its provisions. This is illustrated by the recent round of bonuses that have been given out by the investment banks since SYSC 19A has come into force.13 Accordingly, the practice of crowding out is likely to remain.

Another illustration of the strength of monetary incentives to banking executives can be seen by the threats that many are making to move to other financial institutions in foreign jurisdictions in light of proposed caps to their pay. This is clearly surmised by Sir Fred Goodwin the former chief executive of the Royal Bank of Scotland, who notes that because banking is ‘an area [where] people and teams move around the market’, ‘if amounts are not paid and people do not feel they are appropriately remunerated they will move’.14 The fact remains that monetary incentives are ingrained within the culture of the banking sector even in light of new regulatory practices. Accordingly, by being slaves to the wage and being motivated by pay there is a danger similar to that experienced prior to the current recession that executives may engage in activities that maximise their pay but have adverse effects for the institutions they work for. Ultimately, this is because of the lack of loyalty that workers have to the financial institutions they work for. Their only loyalty is to the wage they receive and who can pay them the most. Consequently the practice of crowding out will remain and current attitudes of executives to pay will persist.

1.2. Narrowing of focus on monetary incentives

Moreover, a different strand of research indicates that monetary incentives can have a negative impact on the actual performance of a task. When a task is straightforward and mechanical, monetary incentives are an effective way to encourage greater performance.15 Indeed, the straightforward nature of the task means that only a mechanical application of effort is required. Thus when a monetary incentive is provided it increases the focus of the mind of the worker on that specific task so that its simple application is performed quicker and more effectively. However, when the task requires even a limited amount of ‘rudimentary cognitive skills’16 such as thinking and creativity so that it is not simply a fixed application of effort to the task, monetary incentives have been found to have a negative impact on the performance of the task. A classic illustration of this can be seen in the experiments carried out by Sam Glucksberg. He set a group of people a task to solve a

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7 Treasury Select Committee, note 4.
8 Ibid.
9 ‘Code staff comprises categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the firm’s risk profile’ as per SYSC 19A.3.4.
10 Includes banking institutions.
11 For example the deferral of variable payments as per SYSC 19A.3.49 and the adjustment of these payments according to the performance of the individual and the firm as per SYSC 19A.3.52 , which in turn encourages executives to undertake transactions that are less risky and more likely to perform over a longer period of time.
14 Examination of the Witness by the House of Common Treasury Committee.
15 Ibid.
problem that required creative thinking. He told half of the participants that they were being timed in order to see how fast the problem could be solved and to the other half of the participants he offered a monetary incentive to complete the task as quickly as possible. On comparing the results of the two groups he found that those that were not offered an incentive completed the task much quicker than those who were offered an incentive. These results are very much supported by recent research carried out by Dan Ariely at MIT. The explanation behind both these results is that monetary incentives produce a narrowing of focus of its recipients, which makes it more difficult for them to access their lateral thinking and ideas which are required in order to solve a non-mechanical task. In other words it makes it more difficult for people to think ‘outside of the box’, which is needed to complete these tasks. The work that is carried out by executives in banking institutions certainly requires a high level of cognitive ability that extends far beyond simple mechanicstic tasks, which are usually outsourced to other companies. Accordingly, the monetary incentives that are so widely used within the industry to motivate and attract workers are actually having a detrimental impact on the productivity of the executives.

Another major problem with this narrowing of focus on incentives is that people become so consumed by the incentive that they pay less attention to the lateral consequences such as the risks associated with their actions. Indeed, people are so focused on achieving their targets in order to attain incentives that people engage in behaviour that may appear risky to those viewing it externally but by those undertaking it, it is viewed as acceptable in light of gaining their incentives. This practice has particular application in investment banking where executives were so driven by their incentives of high remuneration that they did not acknowledge the lateral risks that their actions were running and the adverse impacts that they could incur. They only realised the detrimental consequences of their actions when the risks materialised and the recession that is gripping the world economy arose.

1.2.1. Regulatory response to the narrowing of focus on incentives

Although, SYSC 19A ensures that monetary incentives remain the primary means of motivating and attracting staff in the banking sector, it can also be interpreted as addressing the lateral consideration of risk that the narrowing of focus of monetary incentives has caused financial workers in banks to ignore. Indeed, the code seeks to align the interests of the bankers with that of the ‘long-term interests of the firm’ by ensuring that remuneration policies adopted by the firm are less risky and focus on the long-term performance. The regulation achieves this by setting requirements such as the deferral of ‘at least 40%’ of variable remuneration ‘over a period which is not less than three to five years’ and adjusting the level of these payments ‘according to the financial situation of the firm as a whole ... the performance of the firm, the business unit and the individual concerned’. These two provisions link remuneration to the long-term performance of the firm and in turn encourages executives of banks to engage in activities that are less risky and that are likely to produce long-term profits for the firm. This is reinforced by the fact that performance of the bankers is not only based on their financial performance but includes ‘adherence to effective risk management and compliance with the regulatory system’. The regulation goes further and holds that the lack of compliance with these non-financial assessment factors can actually ‘override metrics of financial performance’. The regulation’s emphasis on ensuring that staff at banking institutions secure long-term performances for their firm that is in compliance with risk management has the result of broadening the focus of bankers to acknowledge these lateral considerations.

However, the rigid nature of some of the provisions within the code that facilitates the broadening out of the focus of bankers, provide banking institutions with the means to circumvent the force of these provisions. For example, the code focuses on the variable component of remuneration and provides a number of rigid restrictions on them. Banking institutions can circumvent the effect of these restrictions on the level of remuneration by expanding the fixed component of pay to make up for the loss in variable remuneration. The consequence of this would be that executives

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17 Ibid.
19 Ibid.
20 SYSC 19A.3.8.
21 SYSC 19A.3.49.
22 Ibid.
23 SYSC 19A.3.51.
24 SYSC 19A.3.37.
25 Ibid.
would continue to receive high levels of remuneration which would narrow their focus and access to lateral considerations of risk but they would escape the provi- sions of the code that impose considerations of risk. The likelihood of this occurring is reinforced by the fact that there is evidence that financial institutions have actually increased the level of fixed remuneration that they award executives since SYSC 19A has come into force.26 Therefore, in reality the focus of the bankers will remain on the monetary incentives they receive and can even result in a return of the risk associated practices that contributed to the recession.

Therefore, although the current remuneration code broadens the focus of executives to lateral considerations of risks, its rigid nature enables banking institutions to circumvent its force and maintain the narrowing of focus on incentives. Consequently, the traditional problems such as crowding out, inefficient performance and engagement in risks can to a degree continue under the current regulatory scheme set out to police remuneration within financial institutions.

2. Performance targets

A significant part of the variable elements of executive remuneration is the setting of targets ‘in advance and measuring if and to what extent these targets have been met’.27 The extent of variable pay given out is then calculated according to the level of achievement in relation to the pre-determined targets. When performance indicators, especially those of the financial variety, are used as targets to determine potentially high levels of remuneration, they can corrupt its recipients.28 Indeed, the problem with such financial targets is that the smart people whose livelihoods are based on reaching these targets ‘figure out how to manipulate such numeric metrics’29 in order maximise the remuneration they receive. This phenomenon was very much prevalent within banking institutions prior to the recession where executives influenced the level of the targets that they were set and also engaged in destructive practices in order to achieve them.

2.1. The setting of performance targets by remuneration committees

In financial institutions, remuneration committees are largely given the responsibility of determining the performance targets and level of remuneration that executives receive.30 Corruption surrounding the setting of targets by the remuneration committee is illustrated by evidence from the Association of British Insurers,31 who reported that remuneration committees in banks had a ‘tendency … to give in to pressure from executives [and set] undemanding performance conditions’.32 One of the reasons behind why the remuneration committee succumbed to this pressure is the fact that the non-executives that represent the majority of these committees ‘are effectively chosen by, or only with the full agreement of, senior management’.33 Accordingly, pressure by executives to impose low performance targets would have to be complied with as there future employment may depend on it.34 Moreover, the non-executives were also committed to ensuring that this culture of setting low performance targets maintained so that non-executives in institutions which they were executives would set equally undemanding performance targets for them to satisfy.35

2.2. The actions of executives in achieving performance targets

Furthermore, the activities which executives in financial institutions engaged in, to achieve their performance targets, is indicative of the corruptive process of performance targets. Indeed, prior to the recession executives entered into transactions that generated large amount of short-term profit for the financial institutions that they worked for.36 This in turn satisfied both the performance targets set for the
individual executives and also contributed to the overall profits of the banks from which the general bonus pools were calculated. Consequently, executives were awarded very high levels of remuneration on account of achieving their targets. However, because executives were rewarded their variable remuneration on the basis of their yearly satisfaction of performance targets, they did not have to acknowledge the long-term performance of their transactions. As is well known these precarious transactions made huge losses once there was a downturn in the economy. Accordingly, the fact that executives repeatedly satisfied their performance targets and earned high levels of remuneration corrupted them from recognising the destructive long-term consequences of their actions.

What exacerbated and spread the extent of this behaviour in the industry was the fact that executives perceived that their actions were justified. They made self-serving rationalisations of their actions by pointing to the fact that their peers were engaging in similar transactions, which were generating large amount of profits for their institutions as well as high levels of remuneration for themselves. Accordingly, they felt that they were doing nothing wrong and as such continued to engage in increasingly risky activities. It is posited that what these executives lacked were clear principles of ethics, integrity and honesty. Indeed, if these executives had acknowledged such principles they would have more readily recognised the negative consequences of their actions and would not have sought to find naïve justifications for their behaviour. However, it is believed that the setting of performance targets that need to be achieved in order to attain high levels of remuneration is what clouded the executives ability to access these principles of ethics and integrity. As noted above it narrowed their focus and blocked out the very principles and considerations that would have enabled them to see the repercussions of their actions.

2.3. Regulatory response

The regulations set by the UK government in order to address remuneration policies attempt to address the issues noted above. In relation to the setting of performance targets and the level of remuneration that executives should achieve both SYSC 19A and the Combined Corporate Governance code 2010 requires banks to have independent committees undertaking these tasks. Indeed, SYSC 19A requires firms to have remuneration committees ‘constituted in a way that enables [them] to exercise competent and independent judgement on remuneration policies and practices’. The Combined code goes on to specify that the committee should have at least ‘three ... independent non-executive directors’. The emphasis on the independence of the committee with the inclusion of non-executive directors underlines a high level of impartiality that the regulations require of the committees. Accordingly, it is less likely for executives to be able to influence the specific targets set by the committee and the levels of remuneration which it recommends. However, this is debateable because of the fact that the Combined code (CC) requires the board to establish and appoint members to the remuneration committee. Accordingly, the members may set low performance targets as a form of reciprocation for the executives who appointed them. There is also the fact that one of the aims of remuneration that confront committees is to ‘adequately … attract qualified and experienced staff’. Consequently, remuneration committees may be inclined to set low performance targets in order for executives to more readily achieve their targets and receive higher levels of remuneration. This is in turn would ensure that the executives are not encouraged to move to other institutions that are offering higher levels of remuneration. This is especially prevalent in the current recession where high levels of profit as targets may be very difficult to achieve and therefore targets are lowered even further so as to ensure that executives receive a competitive level of remuneration.

The regulations have also tried to mitigate the irresponsible way in which executives sought to meet their performance targets. Indeed, SYSC 19A has sought to move away from assessing performance on the back of yearly performance and under SYSC 19A.3.39 actively requires the ‘assessment of performance to be in a multi-year framework’. This is specifically illustrated by the requirement of a deferral of at least 40% of any component of variable remuneration over a period not less than three to five years. In addition to this, the
level of this deferred portion of variable remuneration will also be adjusted according to the performance of the ‘firm, the business unit and the individual concerned’.

47 Accordingly, these provisions change the nature of the assessment of performance so that it is calculated over a longer period of time, which will encourage executives to engage in transactions that are more likely to provide long-term profits and in turn be less risky. However, it is believed that the regulation addresses only half of the problem through its changes to measuring performance on a long-term scale. This is because the human nature of the executives caused them to take advantage of the poorly designed performance targets and remuneration structures. Indeed, the fact that their peers in the industry were generating huge amounts of profit for their banks and earning very high levels of remuneration caused them to undertake similar transactions and narrow their focus away from the associated risks. Moreover, this narrowing of focus and self-serving rationalisations caused executives to ignore principles of ethics, integrity and honesty. If executives recognised these principles before they undertook risky transactions, it would have made them wary of the risks and negative consequences of what they were doing. These principles connote the difference between ‘what is legal and what is appropriate; what they were doing. These principles connote the difference between ‘what is legal and what is appropriate; what is the spirit of the rules’. These differences is what the regulation needs to achieve in that it needs to ensure that executives do not look to circumvent the regulation by finding loopholes but by abiding by the spirit of the regulation and the interests of those that they work for. Ultimately, that is the difficulty of using performance targets and remuneration to motivate staff. Indeed, they will be consumed with the targets and remuneration they receive rather than the purpose behind the work, which is to generate profit and revenue for the company and in turn its shareholders. The regulation in its current form does not recognise the problems behind the use of performance targets and incentives. It perceives that simply by ensuring that remuneration structures are designed better that it will prevent executives from undertaking risky activities that will be detrimental to the institutions they work for. This ignores the motivations and principles behind the actions of the executives and may result in detrimental consequences for financial institutions in the future.

3. Luck

3.1 Windfall profits

A related problem with performance based pay is that often it seems to reward windfall profits, increases in performance which are a consequence of general market developments rather than performance that can be attributed to executives. This can be illustrated by the manner in which executives were being remunerated in investment banking institutions during the period leading up to the recession. Indeed, during this period executives repeatedly engaged in risky investments, which would have incurred the banks major losses if the risks materialised. However, due to the buoyant state of the market these investments kept on producing huge amounts of profit and therefore encouraged executives to continue to undertake these investments.

In light of these profits executives were receiving very high levels of remuneration. Accordingly, the profits that were being generated by the banks can be attributed to the bullish state of the market rather than the individual performance of the executives. The solution would be to single out the individual performance of the company as compared to general market trends. But even if this was possible, the isolated performance of the company is not indicative of the performance of executives. Indeed, Nassim Taleb describes how people typically overestimate their own influence on success and ignore the factors which are often more relevant such as timing, circumstances and pure luck. Indeed, people are inclined to ‘create narratives’ to establish meaning for events and often do so in a ‘self-serving way’ that is not necessarily objectively accurate. The motive that underpins this tendency is the need that people have to assert their ‘self worth’. Conversely, people underestimate their contribution to failure and prefer to make more self-serving attributions that affirm their self worth and accord responsibility to factors outside of their control.
Changes in Regulations on Executive Remuneration in UK Banks Have Achieved Little in Remedying Frailties – Part Two

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this behaviour correlates to opportunistic shifts between what should be rewarded, value or merit.\textsuperscript{58} Indeed when times are good, the addition of value by the company is deemed as the performance that should be rewarded; executives assert their self-worth by attributing their performance to the increase of value regardless of how much value in reality was actually created by their specific performance. When times are bad, with little or no added value created by the firm, executives affirming their self worth will claim that they are merited a reward because of their hard work in a difficult economic environment and attribute the loses to the state of the market. Therefore, executives are able to benefit from the increase of value in the former scenario but in the latter receive a reward on the merit of their hard work notwithstanding the lack of value added. Evidence for the former can be seen in banking when executives were receiving high levels of remuneration prior to the recession despite their lack of individual contribution. As noted above the large amounts of profit that banks were generating could be attributed to the upturn in the markets which rewarded the executives irrespective of the risks they took. However, there is also evidence of the above approach shifting to the latter in light of the current recession where even though banks are making huge loses, executives are still receiving bonuses.\textsuperscript{59} Remuneration committees justify this by claiming that they need to reward executives for the hard work they are putting in during the downturn in order to prevent the talented individuals that make up their executive ranks from moving to other institutions.\textsuperscript{60} Therefore, executives are being rewarded for their efforts even though they are not adding any value in light of loses made. Accordingly, it can be seen that executive pay correlates to market performance when it is buoyant but to a much lesser degree when it is down.\textsuperscript{61} Executives are paid for the good luck they receive from an up-turn in market performance, but are evidently not punished for bad luck when the markets take a down-turn.\textsuperscript{62}

3.2. Regulatory response

There are elements within SYSC 19A that appear to give greater recognition to the individual performance of the executive in relation to the award of variable remuneration. Indeed, section 19A.3.36 holds that when calculating performance related remuneration that the individual’s performance should be taken into consideration as well as that of the business unit concerned and the overall results of the firm. These considerations are also taken into account under SYSC 19A.3.52 when adjusting variable remuneration that has been deferred. Accordingly, these provisions provide a commitment to ensuring that executives are rewarded for the value they add and not when they generate loses. Moreover, the restrictions placed on the award of guaranteed variable remuneration by SYSC 19A.3.40 also ensures that remuneration is not awarded irrespective of performance.

However, it should be noted that SYSC 19A does not specify how an individual’s financial performance will be assessed and whether his individual performance will and can be distinguished from the general upturn in the markets. Furthermore, there is a danger that the specificity of some of the requirements in SYSC 19A may enable the banks to circumvent the force of the measures by adopting practices that are not prevented by the code. Such measure may in turn place far less emphasis on the correlation between individual performance and remuneration. For example, SYSC 19A is largely devoted to the regulation of variable remuneration, with very little devoted to fixed levels of pay. Consequently, banking institutions could raise the proportion of fixed remuneration to displace the award of less variable remuneration as a result of the provisions in the code. There is nothing in the regulation to prevent this and would result in a lower proportion of pay that is linked to performance of executives. Accordingly, the current regulation may actually exacerbate the problem of executives receiving pay for windfall profits.

4. Benchmarking for fairness and status:

4.1. The impact of the mechanism of benchmarking on the ratcheting of pay

When remuneration of executives is calculated the practice of benchmarking is widely used. The process involves setting the level of an executive’s pay in light of what is paid for a similar position in a peer group of companies that the remuneration committee or human resource department has chosen. The reasoning behind the use of benchmarking can be attributed to it providing ‘a more objective standard’\textsuperscript{63} for determining

\textsuperscript{58} Winter, note 1 p. 10.
\textsuperscript{59} Ferrarini, note 5.
\textsuperscript{60} Treasury Select Committee, note 4.
\textsuperscript{61} Paul Gregg, Sarah Jewell and Ian Tonks, ‘Executive Pay and Performance in the UK’, AXA Working Paper Series No. 5 November 2010.
\textsuperscript{63} Winter, note 1, p. 8.
a company’s performance and also a way in which to prevent ‘windfall profits’.

However, in a similar fashion to performance targets, the composition of the peer groups that is chosen as a comparator has been greatly manipulated in order to maintain an increase in executive remuneration regardless of performance. This is substantiated by a study conducted by M. Faulkner and J. Yang on the peer groups compiled by a range of companies including investment banks such as J.P. Morgan and Merrill Lynch. They found that remuneration committees of these companies included companies in the peer groups that paid higher levels of executive remuneration than they did. These committees would then reward its executives’ remuneration above the ‘median or sometimes in the top quartile of the peer group’. The argument that investment banks and other companies use to defend this practice is the fact that they need to attract and retain talent within their institutions. Therefore they have to ensure that the pay their executives receive is consistent, if not better than their competitors so that executives do not move away. The result of this is a constant increase or ‘ratcheting’ in pay across the sector. For example, if one particular bank is not paying its executives in the upper half of the range of pay in its peer group, it will have to increase its executive remuneration to get above the median. Consequently another bank will drop from the upper half and will have to increase its pay to get back above the median.

The practice of benchmarking pay has the effect of increasing executive remuneration without any corresponding increase in performance by the executives or the companies that use them. This lack of correlation between performance and remuneration within financial institutions can be illustrated by a survey of financial institutions undertaken by Paul Gregg from 1996-2006. He found that while the level of remuneration of executives increased dramatically over the period of time, there was not a corresponding increase in the performance of the firms.

A number of academics have attributed this remuneration spiral to the increase of disclosures introduced by governments such as the UK through its remuneration code. However, even if there were no disclosures made by the banks themselves, this would not prevent the executives from disclosing their level of pay to each other or outsiders. Moreover, powerful remuneration consultants that facilitate remuneration committees in setting pay for employees, make it their business to know the level of remuneration that executives receive and would find ways of attaining this information.

4.2. Considerations of status and fairness

An element that is the driving force behind benchmarking and its inconsistencies is that the practice is a reflection of human nature in that people gauge the fairness of their income by comparing what they receive in pay to others in a similar occupation. This notion extends beyond the realm of executives in the banking sector and is applicable to all forms of employment. Indeed, if a person discovers that someone else carrying out similar work is remunerated more than they are, they perceive that they are being treated unfairly if they are not equally recompensed. However, the more logical approach that would prevent a remuneration spiral of simply paying the others less is not deemed as an appropriate way to eradicate the unfairness. In the area of banking executives this is reinforced by the correlation between the level of remuneration and social status. Indeed, in the ‘world of financial capitalism, pay has become the key measure for the status of executives’. Higher levels of pay correspond to a higher social status among peers. However, the problem with social status is that it is self-perpetuating. If one executive has a higher level of social status because he is receiving more remuneration, other executives will demand more remuneration in order to receive the equivalent social status. This though will lower the status of the initial executive and he will then demand more remuneration in order to maintain his higher social status. This phenomenon maps onto and explains why executives in banking continuously demand higher remuneration and view the fairness of the pay they receive in terms of what their peers are receiving.

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64 Ibid.
67 Ibid.
68 Ibid.
69 Gregg, note 61.
71 Winter, note 1, p. 9.
72 Ibid.
73 Winter, note 1, p. 10.
4.3. Regulatory response

Although, the practice of benchmarking is so central to the way in which remuneration is set. SYSC 19A does not directly refer to it. It does so indirectly by requiring firms to have regard to ‘guidelines produced by the Association of British Insurers (ABI) on executive contracts’, which recognises the use of ‘external comparisons’ by remuneration committees to determine levels of pay. However, the guideline does caution the use of this practice by acknowledging the ‘risk of an upward ratchet of remuneration levels with no corresponding improvement in performance’ and the avoidance of ‘paying more than necessary’. An almost identical caution can be found in the UK Corporate Governance Code (CGC) 2010 in respect of the practice of remuneration committees ‘positioning their company relative to other companies’ in light of rewarding remuneration. Therefore, there is a level of commitment from the regulations to prevent the spiral of remuneration arising from the practice of benchmarking.

However, this level of commitment is not particularly strong. Indeed, the initial fact that the primary source of regulation for the remuneration of executives in financial institutions does not directly refer to the practice of benchmarking and the detrimental consequences that arise from it, illustrates its lack of importance. Moreover, the principle itself included in the ABI guideline and the CCC is not a strong and clear affirmation of the risk of remuneration spiralling. The fact that the provisions ask for ‘caution’ and not anything more emphatic does not impress upon the remuneration committees the significance of avoiding such measures. There is also the fact that the remuneration committees could exploit the last clause in the ABI guideline, ‘avoid paying more than necessary’, to justify the use of external comparisons to increase the pay of executives even when it does not correlate to an upturn in performance. They can do so by saying that it is necessary to increase the pay in order to retain the services of executives, who otherwise in light of human nature will perceive their treatment as unfair and seek to move elsewhere.

Furthermore, the provision in the CGC has been in every version of the code since its inception. Accordingly, a decline in ratcheting and the spiralling of remuneration would be expected. However, the opposite has occurred and during the twelve year life span of the code the practice has maintained and if not increased. A reason for this can be attributed to the lack of guidance that the principle gives to the remuneration committees. It merely draws attention to the problems that can arise in relation to benchmarking, it does not give specific advice as to how it should be avoided. For example, by possibly requiring the level of executive remuneration to be set below the median of the peer group. This would remove the constant spiral in pay because the remuneration committee would be prevented from increasing pay to above the median and start the ratcheting process. However, the lack of guidance has enabled remuneration committees to continue the practice unabated.

Consequently the regulation of remuneration has done very little to prevent the spiralling of remuneration of executives within financial institutions.

Conclusion

Performance based pay continues to form an integral and dominant part of executive pay in financial institutions. Accordingly, the traditional assumptions – that executives will not be sufficiently motivated to work in the interests of their shareholders if they are not adequately remunerated, and that variable remuneration is the best way of mitigating moral hazard problems – continue to pertain. The UK regulatory response to remuneration policies very much support this and perceives that the problems associated with the remuneration of executives that contributed so significantly to the financial crisis can be addressed through enhanced supervision and better designed remuneration structures. However, these actions are only addressing half of the problem. They fail to acknowledge that executives took advantage of the failures in remuneration to benefit their own interests. Indeed, the use of variable incentives and performance targets to attract and motivate executives will continue to narrow their focus and fail to acknowledge lateral considerations of ethics, honesty, integrity and risks. It will preserve the practice of benchmarking and ‘ratcheting’ of pay as executives in light of fairness and status will continue to demand equal, if not more than their peers and will use the threat of quitting to ensure that they secure the necessary pay. Accordingly, there is a real possibility that executives may be drawn in the future to engage in activities that are detrimental to

Notes

75 SYSC 19A, 2.2(2).
77 Ibid.
78 ABI Guidelines on Remuneration, note 74.
79 Supporting principle in the remuneration section in the UK Corporate Governance Code 2010.
80 As per information noted above.
their employers because many of the negative elements of performance based remuneration that encouraged them to engage in their irresponsible behaviour are still there. There is also a danger that once the economy improves, regulators and financial institutions alike will relax regulation and supervision over executive remuneration in order to motivate executives to take advantage of the upturn in the markets. Consequently, there is a need for the FSA, EU commission and other supranational regulatory bodies to amend regulation in order to prevent the negative elements of performance based remuneration that were just as and if not more responsible for the financial crisis as the weaknesses in the remuneration structures themselves.
International Corporate Rescue

*International Corporate Rescue* addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists’ Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

*International Corporate Rescue* has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

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