Incentive schemes of banking institutions

As in earlier years, several financial sector regulators and market commentators have, once again, begun to question the appropriateness of incentive schemes that banking institutions employ.

There are usually two key concerns raised about banks' incentive schemes. First, the schemes are misaligned, that is, they are linked to short-term performance, rather than the long-run interests and objectives of the institution. Second, these schemes have significant upside with no or limited downside and therefore may influence behaviour that could encourage excessive risk-taking.

Misalignment between incentive schemes and the long-run objectives of banking institutions include mismatches between the timing of employees' bonus payments and the actual realisation of profits from their activities; inadequate recognition and remuneration of risk management professionals, that is, their 'exclusion' from incentive schemes; and the provision of funding to business units based on income potential, without considering the level of risk these units undertake.

It has been documented that the schemes are structured such that during years when employees meet their targets, 'high-flying' employees can earn bonuses running into millions of rands. In less-successful periods bonuses are lower. However, as a result of the abundance and competitiveness of these schemes, banking institutions appear to fear cutting bonuses by too much, since their employees may seek a 'better-rewarding' employer and resign. In the final instance, during periods where banks perform poorly, all employees face the threat of losing their jobs and there is no distinction between high risk takers and risk-averse employees.

The following remarks are deemed relevant to highlight the importance of an effective governance framework in respect of banks' incentive schemes:

> Since the fortunes of even the most technically sophisticated financial institutions ultimately depend on the decisions and judgments of individual managers and traders, senior management must ensure that the right incentives are in place so that risk-taking is appropriately captured in business-line performance evaluation and employee compensation. Senior management must understand the risks assumed by each individual business line and communicate the firm's strategy and risk appetite back down to those business lines. At the same time, senior management must send each business-line manager clear signals about which risk levels are tolerable and which practices are not acceptable. In this way, information and incentives are threads of sound risk management that must be woven into the fabric of each firm's management culture.
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> Any successful organization needs to develop appropriate mechanisms to ensure adherence to and sustainability of its risk management structures, and incentives structures are a key mechanism for this purpose. Appropriate incentives reward good behavior and penalize inappropriate behavior. Of course, incentives work best when they are known well in advance, that is, when they serve as *ex ante* signals of what should and should not be done. Naturally, in very large organizations it is difficult for senior management to monitor each individual, so incentives need to be consistent, permeate even the lowest levels of the organization, and remind each individual that his or her risk-taking affects the whole enterprise.
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In trading and certain other activities, there is a tendency for business-line heads or individual employees to focus on their short-term compensation and not think about the long-term risks that their activities create for the firm. But it is the responsibility of senior management to provide the proper incentives and controls to counter the potential for individuals within financial firms to discount risks to the broader institution, and of course to ensure that nefarious activity is promptly uncovered and stopped.

Clearly, it is up to financial institutions themselves – not bank supervisors – to decide how compensation should be structured, but managers and boards of directors should understand the consequences of providing too many short-term and one-sided incentives. They would benefit from thinking about compensation on more of a risk-adjusted basis. Accordingly, I encourage institutions to think about ways to alter existing compensation schemes to include some types of deferred compensation, since the risks of certain investments or trades may not manifest themselves in the near term. Thus, it makes sense to try to match the tenor of compensation with the tenor of the risk profile and thus explicitly to take into account the longer-run performance of the portfolio or division in which the employee operates. This type of compensation arrangement is already in use at many nonfinancial firms.

(Mr Randall S Kroszner, Governor: Board of Governors of the Federal Reserve System, United States of America, at the Global Association of Risk Management Professionals Annual Risk Convention, New York, 25 February 2008)