



Prudential Regulation Authority/Financial Conduct Authority: Strengthening the alignment of risk and reward - new remuneration rules

Consultation response from the ESRC Centre for Competition Policy

University of East Anglia, Norwich Research Park, Norwich NR4 7TJ

Date: 31 October 2014

Contributing authors:

- Prof Morten Hviid
- Dr David Deller

This document has been written by Prof Morten Hviid following discussions held in the Centre and it has the broad agreement of both contributors.

The support of the Economic and Social Research Council is gratefully acknowledged.



An ESRC funded Investment. The views and statements expressed are those of the authors and do not necessarily reflect the views of the ESRC.

● The ESRC Centre for Competition Policy (CCP)

CCP is an independent research centre, funded by the Economic and Social Research Council (ESRC), and established in 2004 as a Centre of Research Excellence. CCP's research programme explores competition and regulation policy from the perspective of economics, law, business and political science. CCP has close links with, but is independent of, regulatory authorities and private sector practitioners. The Centre produces a regular series of Working Papers, policy briefings and publications, and a bi-annual newsletter with short articles reflecting our recent research. An e-bulletin keeps academics and practitioners in touch with publications and events, and a lively programme of conferences, workshops and practitioner seminars takes place throughout the year. Further information about CCP is available at our website: www.competitionpolicy.ac.uk

Consultation Response

Although we have some concerns about other parts of the consultation document, we have for time reasons focused on the area where we see potential competition policy issues arising.

Individuals moving companies

The consultation document correctly identifies a significant problem arising from the mobility among rival firms of individuals covered by a clawback provision.

If the clawback provisions are cancelled or deferred compensation bought out when an individual moves firms, any incentive effects of these long-term incentive provisions will be severely limited. The question is whether anything can be done to ameliorate such problems without adding new problems. This is an area where we would urge the PRA/FCA to think again and to carry out more extensive analysis before proceeding.

- (1) Allowing cancellation or buy-out would affect either tenure or basic pay and possibly be open to abuse and would require costly monitoring. Deferring part of a bonus involves a risk which the individual may not be fully able to control through their own behaviour [if linking performance to pay perfectly was easy, there are simpler ways to achieve the desired outcome]. We would expect such staff to take steps either to reduce the risk they bear or to obtain compensation for taking the risk. If moving job achieves this, an artificially rapid turnover of individuals covered by a clawback provision may occur. To reduce this turnover, firms may well respond by offering higher basic pay. This may be desirable if it reduces risk-taking more than it reduces incentives to perform at a high level. However, to assess this requires more empirical evidence. More problematic from the point of view of the policy, would be an informal promise never to trigger the clawback in return for the individual staying with the firm. Where the number of individuals covered by a clawback provision is relatively small, there is an added risk that rapid turnover, and the implication that individuals are deliberately trying to avoid future clawback, may send a very negative signal to the capital markets regarding the health of the firm from which the individuals are departing.
- (2) The alternative of relying on current conflict of interest arrangements as sufficient to allow clawbacks/deferred compensation provisions to continue on from former employers appears equally problematic. There are three main issues:
 - (i) Firstly, suppose conflict of interest rules can be enforced effectively, the clawback provision lasts for seven years and the enforcement of malus/clawback provisions is linked to generic measures of performance at the former employer (e.g. profits/losses, share price and avoiding bankruptcy). If the enforcement of malus/clawback provisions is linked to these generic measures of performance the range of decisions at the new employer that could impact on the probability of clawback/malus at the former employer would be very large. In other words, the number and range of decisions where an executive may have to state a conflict of interest could be too large to be practical. In particular, several senior decision makers may have moved firms in the past seven years. This raises the question of whether in a typical decision making scenario there will be a sufficient pool of non-conflicted executives to make an informed decision? Each executive sidelined means a loss of knowledge, expertise and information.
 - (ii) Alternatively, suppose the conflict of interest rules are not possible to effectively enforce, but the characteristics of the clawback provisions remain the same. There are legitimate competition concerns. Linking the wealth of an individual with material influence on the behaviour of one firm to the outcome of a rival firm in such a way that it means the first firm is no longer competing as vigorously with its rival is clearly problematic from a competition policy perspective. These concerns are closely related to concerns about cross-shareholdings among rival firms.

(iii) The suggested solution to (i) of converting unvested compensation into cash where ‘conflicts of interest are significant’ would seem to be open to easy abuse and would not solve the problem of buy outs.

Neither of the two solutions to the issue of turnover among the individuals covered by a clawback provision appear attractive. The relative merit of the two may depend on very specific details of the remuneration package and the clawback triggers. We are not aware of existing evidence which would help determine when one or other solution would dominate.