

## **Is the Central Bank Gone Mad: Executive Compensation with Reference to the Nepalese Banking Industry <sup>1</sup>**

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### **ABSTRACT**

With the global financial crisis that showed up a couple of years back, the debate of executive compensation once again was brought into the stage by the media and become the hot issue for academicians, researchers, regulators, policy-makers, and the public.

The major reason for the financial meltdown is attributed to the large portion of performance-based salary that the executives in the financial sector were paid. Since, the performance indicators are linked with the asset accumulation and short-term profit generation of these institutions, it encouraged executives to take high risk to gain immediate returns so that their performance is positively appraised and hence their paycheck gets bigger. This excessive risk-taking behavior, without due consideration for long-term sustainability of the organization gave rise to excessive defaults and brought about a systemic crisis in the financial sector, which spread to a number of countries by their inter-linkages. Although, this is only a part of the greater problem, it encouraged the regulatory authorities to formulate some sort of regulations for executive compensation. The Financial Stability Board came up with guiding principles for effective executive compensation. Several countries emphasized these principles and regulated executive compensation in line with the basic principles stipulated therein. The major focuses of all these provisions was to discourage the excessive risk-taking behavior of the bank's executive by especially targeting the performance-based remuneration of the executives in the financial institutions. The essence of the regulation is to align the risk with payments such that provisions of payments through non-cash instruments, deferring of variable payments for several years, provision of claw-backs, etc were made.

Nepalese scenario also updated through a series of developments regarding the executive compensation, especially in the financial sector. The changes in the management structure of the central bank, the Nepal Rastra Bank (NRB), also changed its policy regarding free-market-economy and executive compensation is one of the primary and important targets in this process. Although, the central bank's policy should have been uniform and predictable, the political and vested interest played its role. The regulation for executive compensation is brought in the way that not only affected the variable payment but also the fixed payments, which are numerically specified. Nowhere in the world, has regulators targeted the fixed portion of the compensation. Even the institutions that received taxpayers' money for bailout has been exempted from limiting the basic annual compensation. Nepalese regulators, on the other hand, does neither considered this simple fact nor the fact that it will bring about several ills to the only sector performing

professionally and transparently. Corporate governance is the one issue that will have the most effect. Besides, the major blunder was to link the fixed salary with Asset Size and/or Staff Expenses of the bank. The very reason that gave rise to the whole debate of executive compensation regulation has been overlooked. The basic principle that linking compensation with performance will encourage excessive risk-taking in pursuit of increasing asset size that may lead to financial crash has instead been encouraged by the Nepalese regulator, the Nepal Rastra Bank.

## **1. INTRODUCTION**

### **1.1. Global Financial Crisis & the Executive Compensation**

Since at least as early as the 1950s, the press, general public, politicians, and academic researchers have remarked on the high levels of executive (CEO or Chief Executive Officer, Management/Manager, and Executive are used interchangeably throughout this research and implies the same thing) pay in the US (United States of America), especially in the bank (the term Bank/s has been used to infer all the players in the financial sector, that is, all the banks and financial institutions, and is used interchangeably with terms like financial institutions/organizations), and questioned whether these levels are fair and appropriate, as well as whether executive compensation provides proper incentives. Undoubtedly, executive compensation and incentives will continue to be a hotly debated issue for years to come (Core and Guay, 2010).

First, it is indisputable that we have reached excesses over the last two decades in managerial compensation levels (Gibson, 2004). Even in the developing countries the executive pay is very high and comparable to their counterparts in the developed countries (Waweru et al., 2009). Executive compensation is so closely linked to cultural values and perceptions of how much pay is simply too much (Barney, 2009). The rise in executive compensation has triggered a large amount of public controversy and academic research (Gabaix and Landier, 2006). It appears that culture is the ultimate determinant of overall levels of executive pay and approaches to compensation regulation (Barney, 2009). The worldwide financial meltdown fueled an unprecedented level of outrage and activism regarding executive compensation on multiple fronts. Investors, politicians, and regulators are calling on corporate leaders to redesign executive compensation programs to better focus on long-term value creation (PMP, 2009). There is widespread concern that inappropriate remuneration schemes may have contributed to the present market crisis (FSA, 2008).

The crisis has triggered a flood of proposals from various sources to regulate executive compensation, particularly within the financial services industry (Core and Guay, 2010). The system surrounding executive compensation should be reformed in order to correct the excesses reached over last two decades (Chesney, 2004). Policy analysts have decried the role of bank executive compensation in promoting excessive risk-taking leading up to the financial crisis, and regulators have imposed constraints on banker pay. Academics have likewise proposed banker pay reforms (Tung, 2010). The global financial crisis has increased the focus on the compensation policies of financial institutions. This has led to the creation of a large

variety of legislation and guidelines, both by international and national institutions, as well as initiatives by individual financial institutions (EBF, 2010).

It is one thing, however, to say that corporate compensation systems are flawed and it is quite another thing to say that this flaw caused the financial crisis (Friedman and Kraus, 2010). There seems to be a link between a community's values and compensation levels in that community that result in a level of public emotion, often negative, which does not truly attach to any other facet of corporate law (Barney, 2009). Bhagat and Romano (2009: as cited in Core and Guay, 2010), in their proposal to regulate bankers' pay, in the essence, agree that there is no relation between pay and the financial crisis, but note that pay bothers a lot of people and politicians, and that therefore they will propose a way of regulating it. Few if any observers and respondents believe that compensation was the sole cause of the crisis, nor do they believe that changes limited to compensation practice will be enough to limit the chance of future systemic crises. However, absent such changes, other reforms are likely to be less effective (FSF, 2009). Most rhetoric favoring additional executive compensation regulation does not rely on evidence or careful analysis as to why existing compensation practices are flawed, since there is little clear evidence that arrangements are systematically flawed (Core and Guay, 2010). Friedman and Kraus (2010) provided an example: bond investors always trade risk against returns and a high rating connotes safety and, therefore, always pays lower returns and if bankers were being lured by compensation system into acquiring risky but lucrative assets, then they should never have bought AAA-bonds instead always opted lower rated but higher-paying bonds but they did so only seven percent of the time. This also shows that the debate has been turned towards the unjustified path based on vested political interest.

Banks are special institutions and very different from other businesses. First, they are highly leveraged. With leverage, shareholders and their agents prefer riskier bets than if the firm had no debt, because the payoffs from leveraged bets are asymmetric. Shareholders enjoy unlimited payoffs from a successful high-risk bet with borrowed money, but limited liability assures that they lose only the amount of their investment in the firm should the high-risk bet turn out badly. Remaining losses are born by the firm's creditors. In addition to high leverage, bank assets and liabilities are mismatched. Most of their liabilities are volatile, taking the form of customer deposits that must be repaid upon demand. Banks are to some extent always dealing with uncertainty regarding their cash outlays. Banks' assets, on the other hand, primarily take the form of longer-term loans (promises of regular periodic payments from their borrowers). Because of this mismatch of relatively illiquid assets with extremely liquid liabilities, banks are vulnerable to runs, which may cause even a solvent bank to fail (Tung, 2010). Financial sector booms and busts create gigantic losses for society (Wolf, 2010). Analysis suggests that the combination of high-powered incentives and the pretense of high-growth firms will lead eventually to the firm's crash (Benmelech et al., 2008). It would appear that in many cases the remuneration structures of firms may have been inconsistent with sound risk management (FSA, 2008).

### **1.2. Executive Compensation, Risk-Taking, & Financial Crisis**

Based on the long-standing, preferred political idea that certain individuals are paid too much or improperly, one uses the argument that flawed compensation practices must have been partly responsible for the financial crisis (Core and Guay, 2010).

It is assumed that the rise in executive compensation was due to the excessive risk-taking by the executives to generate short-term profits of a firm and its linkage to their compensation levels, but without reference to the underlying risk horizon of that profit (Institute of International Finance, 2009: as cited in Sheehan, 2009). Friedman and Kraus (2010) also affirmed it to be true that many publicly held corporations, including banks, pay performance bonuses that may encourage excessive risk-taking. These perverse incentives amplified the excessive risk-taking that severely threatened the global financial system and left firms with fewer resources to absorb losses as risk materialized (FSF, 2009). ABA (2009) also stated that misaligned incentives associated with some compensation practices appear to have contributed, in part, to the financial crisis by rewarding short-term performance while allowing long-term risks to accumulate. Institutions take synchronized risks, they increase the likelihood and severity of such crises, by creating the conditions in which ultimately ruinous bets are rewarded, at least for a while (Wolf, 2010). Tung (2010) elaborated it by stating that the bank managers' risk-taking incentives intensify as the bank nears insolvency, only more so. By raising deposit interest rates, banks can continue to attract cash because of the government insurance. Sheehan (2009) states that in devising and promulgating principles and rules on executive remuneration, institutional investors have encouraged performance-based pay without setting any meaningful limits on what quantum of remuneration is acceptable, given firm performance, and what amount is excessive, given strong firm performance. For instance, in a US study as of the end of 2006, less than ten percent of executive pays was in the form of fixed salary. The rest was performance-based. Over two-third received equity compensation, and among them, equity compensation accounted for almost half of their total pay on average. The average executive's equity portfolio was over ten times larger than the total annual compensation, and over twenty times larger than the value of annual equity-based compensation (Tung, 2010). The empirical literature, thus, indicates an increased dependence of bank management compensation on equity returns since the movement towards banking deregulation began in the 1980s (VanHoose, 2010). However, theoretical research suggests that the effects of performance-based pay on risk depend on a number of other factors (VanHoose, 2010). Interestingly, yet some argue that executive pay levels are too high due to absence of component for pay-for-performance from executive compensation plans and these arguments appear to stem in part from the observation that executives typically receive a substantial amount of annual pay even in years when earnings and stock returns are poor (Core and Guay, 2010). Increasing share of stock-based pay of total compensation is a major trend in executive compensation in the last decade (Murphy, 2004). However, there is a growing body of empirical evidence that shows that it leads to earnings management, misreporting, and outright fraudulent accounting (Benmelech et al., 2008). Equity-based awards, coupled with the capital structure of banks, tie executives' compensation to a highly levered bet on the value of banks' assets and

executives have incentives to give insufficient weight to the downside of risky strategies (Bebchuk and Spamann, 2010; Tung, 2010).

One approach argues that the pay-setting process for executives is flawed due to various problems with corporate governance. And, if the pay-setting process is flawed, one can readily extrapolate that executive pay levels and incentives are also expected to be flawed (Core and Guay, 2010). It is argued that that excessive level of compensation can be explained by the dynamics of boards of directors. Executive compensation is determined by the board of directors of firms, and that boards at many companies do not function the way they should due to the group dynamics of boards (Widmer, 2004). Since markets are driving forces in decisions on executive pay, it is important to remember that in small countries personal relationships between executives and board members can play a significant role in deciding about compensation levels, particularly when they reciprocate in sitting on each other's boards (Zufferey, 2004). Falk et al. (2004) added that existing conflicts of interest for members of the board of directors or, in particular, members of the compensation committee of a board of directors, seem to be an important factor to explain recent cases of excessive executive pay. For example, executives that equally serve as board chairman, large boards that consist of a great fraction of outside directors that are directly appointed by the executive, or boards whose agenda is set by the executive, may well have an inflationary effect on the level of executive compensation. Besides, the problem with conflicts of interest within the board is generally difficult to manage and the boards often fail to negotiate at arm's length with the executives they are meant to oversee. Furthermore, the remuneration committee of the board is often incompetent when it comes to negotiating executive compensation. However, it might be overly simplistic to conclude that high levels of executive compensation are always the result of Board-Capture (Barney, 2009). Shareholders, on the other hand, lack the capacity to monitor risks in complex institutions. Worse, in highly leveraged limited liability companies, they also lack the interest to monitor such risks properly (Wolf, 2010). Core and Guay (2010) added that it is a well known fact that shareholders can have incentives to take risks at the expense of creditors, particularly when the corporation is distressed. Sheehan (2009) added that as monitors of executive remuneration, institutional investors collectively would appear to have a poor record when it comes to ensuring good executive remuneration practices in investee companies.

Standard Incentive Theory suggests that managerial incentive pay should depend on events exclusively under the manager's control, and not on events exogenous to her efforts or decisions. To the extent that significant components of a executive's pay are directly or indirectly related to her own firm's stock returns, this theory advocates compensation mechanisms that reward the executive only to the extent that her own firm's stock outperforms a chosen sectoral or broad based market index. Accordingly, such considerations mandate Relative Performance Evaluation (RPE), that is, a negative relationship between the executive's compensation and the chosen comparative benchmark. Surprisingly, RPE contracts are not commonly observed: large components of the average executive's compensation appear to be positively related to factors totally beyond her control. Besides, it is observed that

there is a stronger link of executive pay to market returns when returns are positive than when they are negative: executives enjoy good luck and appear to be insulated from bad luck, a practice referred to as one-sided RPE (Danthine and Donaldson, 2010). Falk et al. (2004) also argued that by simply looking at the development of stock prices in order to set the level of executive compensation, it is implicitly assumed that the executive is responsible for creating any volatility of a company's share-price.

Although, there is little evidence that deregulation of banks' compensation caused the financial crisis (Friedman and Kraus, 2010), yet the other reason relates to the regulation of the financial sector. Due to highly leveraged nature of business, presence of deposit insurance, and concept of too-big-to-fail, regulators are left with the task of constraining risk-taking at banks (Core and Guay, 2010). The government as creditor has an economic interest in constraining managerial slack and excessive risk-taking. Regulatory agencies and their bank-examiners represent the government in this endeavor. Unlike private creditors of nonfinancial firms, however, regulators do not have their own money on the line. So, while they possess significant expertise and enjoy important regulatory powers, they may lack the strong incentive of private lenders toward efficient monitoring. The extent of their monitoring is also politically determined. In some cases, their regulation and supervision may be excessive and in others it may be insufficient, hence regulation could never be perfect (Tung, 2010). Bebchuk and Spamann (2010) also observed that given the complexities of modern finance and the limited information and resources of regulators, such prudential regulation is necessarily imperfect. The combination of asymmetric information with the complexity of such institutions makes it effectively impossible for regulators to monitor the risks being taken (Wolf, 2010).

Friedman and Kraus (2010), however, argued that the capital regulations imposed on banks across the world caused the financial crisis. These regulations explain why bankers, who are commonly seen as having recklessly bought risky mortgage-backed bonds in order to boost earnings, and bonuses, actually bought the least-risky, least-lucrative bonds available: those that were guaranteed by government or were rated the most (AAA). These securities were decisively favored by capital regulations, raising the question of whether regulation actually increases systemic risk. By definition, regulations aim to homogenize the otherwise heterogeneous behavior of competing firms. Since one set of regulations has the force of law, it homogenizes the entire economy in that jurisdiction. But regulators are fallible, and if their ideas turn out to be wrong, as they appear to have been in the capital regulations that caused the global financial crisis, the entire system is put at risk. Thus, with the genesis of global financial crisis, it turns out to have been caused by the very device, Regulation, to which most people now look for the reform of capitalism. Regulation, by their very nature, aligns the behavior of those being regulated with the ideas of those doing the regulating. Whether by forbidding one activity or encouraging a different one, the whole point of regulation is, after all, to change the behavior of those being regulated. And the direction of change is, obviously, the one the regulators think is wise. Since regulators ideas are imposed on the whole economy at once, they could not be put to the competitive test and if

it happen to be good one, all will gain but if it happen to be bad one, all will lose. Hence, regulations that is like mandatory instructions for herd behavior, automatically increases system risk. The whole system crashed when the financial regulators' idea about prudent banking backfired.

Since, capitalism is so heavily regulated, it will probably always be prone to asset bubbles and other manifestation of these homogenous behaviors. This is a risk that can be mitigated but not eliminated. But capitalism has a unique feature, competition, which does mitigate it by both encouraging and taking advantage of heterogeneous behavior, that is, innovation. Thus, if one is looking for the cause of a systemic failure in the highly regulated economy, it makes more sense, at least initially, to look to the laws that govern the whole system, rather than reflexively blaming what has now become "capitalism" in name only. The theories that seem so obviously true to regulators may turn out to be disastrously false, unless regulators are infallible. The question raised by the ongoing intellectual contest between socialism and capitalism, and the ongoing practical battle between regulation and competition, is how best to guard against human frailties: by putting all our eggs in one politically decided basket or by spreading our bets through the only practical means available, the competition (Friedman and Kraus, 2010).

A greater managerial focus on improving shareholder returns means riskier investment strategies that place more risk on creditors. Whether pay-for-performance has been generally good for shareholders is the subject of some debate. Nonetheless, compensation for bank officers before the financial crisis tracked the same basic shareholder-based incentive framework, and managers' equity stakes have been shown to be significantly correlated with bank returns and risk. Standard corporate governance arrangements such as fiduciary duties and shareholder voting are generally designed to align managers' decision-making with the interests of the firm's equity-holders, who are generally viewed as the firm's owner. Similarly, performance-based pay (typically in the form of equity or equity-based options) intends to overcome managers' shrinking and risk aversion in order to align their incentives with shareholders' more risk-preferring interests (Tung, 2010). For the managers, standard equity-based incentive pay may encourage excessive risk-taking that is inimical to the public interest in bank safety and soundness. Aligning managers' interests more closely with those of bank equity holders exacerbates the moral hazards that accompany deposit insurance. It gives bankers a direct personal stake in the unlimited upside they might potentially enjoy from high-risk high-return strategies, an approach that bank regulators typically wish to discourage (Bolton et al., 2006).

The major reasons explained for the high executive compensations are linked with the scarcity of executive talents in the market (Gabaix and Landier, 2006). Waweru et al. (2004: as cited in Waweru et al., 2009) also reported that even a developing country like South Africa suffers from the problem of shortage of skilled human resources (Waweru, Hoque and Uliana, 2004). Such shortage of skilled manpower is expected to lead to higher demand for executives which would result to higher compensation levels (Waweru et al., 2009). Decision making is especially difficult among poor-performers, as the importance of differentiating pay based on

contribution and perceived fairness increases even as the award pool shrinks. While executives expect pay-for-performance, a no-payout result that is perceived to be linked primarily with external market factors is de-motivational, and top talent is always a retention risk (PMP, 2009).

Moreover, the role of average firm size provides a novel explanation of the rapid surge in executive pay. Gabaix and Landier (2006) showed that the increase in firm size gave rise to proportional increase in executives pay (Gabaix and Landier, 2006). While executive pay at large firms has grown considerably over time, so has the size of the large firms that these executives manage (Core and Guay, 2010). Economic theory predicts that larger firms are more difficult to manage and will demand more talented executives (Gabaix and Landier, 2008). The study found a significant positive relationship between the executives' compensation and the value of the firm. There was also a significant positive relationship between the executives' compensation and growth opportunities, an indication that executives in firms with higher growth opportunities receive more compensation (Waweru et al., 2009). Thus, growth in executive compensation may, at least in part, stem from the fact that, not surprisingly, large firms are much larger, and arguably more complex, today than they were decades ago (Core and Guay, 2010).

Other explanations relates to hiring of foreign executives, labor law, Board's role, and corporate governance. One explanation for the excessive increase in executive pay is the fact that in the last decade the ratio of outside hires to total executive hires increased significantly. Usually, hiring executives externally requires a premium (Murphy, 2004). Also, to compensate executives for the increased likelihood of being fired, their pay must increase (Gabaix and Landier, 2006). Besides, in the recent years the connection between corporate governance and executive compensation has undergone a fundamental redefinition. The view of executive compensation through the governance lens has gone from that of a problem (the possibility for executive self-dealing) to a solution or at least an opportunity (that of aligning management's interest with those of shareholders). In that sense, executive compensation also emerges as a partial solution to the ownership-control separation. Of course, this solution was at least in part dependent upon corporate directors who were willing to deal with executives on an arm's length basis in pay-setting process (an ideal which is perhaps rarely observed in reality). When this ideal is not observed, excessive executive compensation, which can be defined as compensation which exceeds the amount necessary to minimize shareholder value, is often the result (Barney, 2009). Bebchuk and Spamann (2010) also attributed high executive compensation, at least partly, due to corporate governance problems in banks that may lead to the adoption of pay arrangements that do not serve the interests of common shareholders.

The product market discipline that affects nonfinancial firms also does not operate well on banks. In a competitive market for deposit-taking and other financial services, customers selecting a bank would care about bank solvency and would channel their deposits accordingly. But a significant group of creditors (insured depositors) does not monitor banks' risk-taking because deposits are insured by the government and are indifferent to it. Moreover, deposit insurance premiums are not



finely calibrated to account for the particular risks posed by individual banks, so absent perfect regulatory oversight, bankers have incentive to externalize losses to the insurance pool, and indirectly to the healthy banks that contribute to the pool and the taxpayers that ultimately stand behind the insurance pool. Regulators are therefore left with the task of constraining risk-taking at banks. And regulation is imperfect (Tung, 2010). Bebchuk and Spamann (2010) also were of the same view. They stated that there is a fundamental, and now well understood, moral hazard problem in banks. Those who provide equity capital have an excessive incentive to take risk. They will capture the full upside, while some of the downside will be borne by the government as insurer of deposits if the bank goes bankrupt. Besides, not only shareholders but also creditors lack the interest to price properly the risks being assumed, since they enjoy a high probability of rescue in the event of failure, this is the operational core of the idea of too-big-to-fail (Wolf, 2010).

Although it is reasonable for regulators to be concerned about risk-taking incentives of executives, there is often confusion over what constitutes risk-taking incentives of executives (Core and Guay, 2010). In principle, if risk management and control systems were strong and highly effective, the risk-taking incentives provided by compensation systems would not matter because risk would stay within the firm's appetite (FSF, 2009). Also, one-size-does-not-fit-all and financial firms differ in goals, activities, and culture. Regulators fail to recognize that taking on the right amount of investment and operating risk is essential to successfully compete within any industry, and that even creditors want firms to prudently take on some risk (Core and Guay, 2010). However, any compensation system must work in concert with other management tools in pursuit of prudent risk-taking (FSF, 2009).

## **2. DISCUSSION**

### **2.1. Principles**

Financial Stability Forum (FSF) publicized its basic principles for sound compensation practices which are enlisted below (FSF, 2009): The FSF Principles for Sound Compensation Practices aim to ensure effective governance of compensation, alignment of compensation with prudent risk-taking and effective supervisory oversight and stakeholder engagement in compensation. The benefits of sound compensation practices will be achieved only if there is determined and coordinated action by national regulators, facilitated if necessary by suitable legislative powers and supported by national governments.

The board of directors of major financial firms should exercise good stewardship of their firms' compensation practices and ensure that compensation works in harmony with other practices to implement balanced risk postures. The Principles need to become ingrained over time into the culture of the entire organization. An employee's compensation should take account of the risks that the employee takes on behalf of the firm. Compensation should take into consideration prospective risks and risk outcomes that are already realized. Firms should demonstrate to the satisfaction of their regulators and other stakeholders that their compensation policies are sound. As with other aspects of risk management and governance supervisors should take rigorous action when deficiencies are discovered.

## **2.2. Institutional Arrangement in Other Jurisdictions**

Treasury Committee Report (US) specifies some features of remuneration structures as follows (FBD, 2009):

- No upper limits on pay but disclosure of pay structure for senior managers and those in the highest pay bands;
- FSA to impose higher capital requirements on institutions with inappropriate pay structures or to use other appropriate sanctions;
- FSA to report on any action it has taken over pay policy in banks; and
- Greater use of deferral and claw-back.

Financial Services Authority (FSA) of the United Kingdom provides the key features of the code for executive compensation regulation as follows (FBD, 2009):

- Current year results should not be the only measure of performance;
- Poor risk management should, if necessary, override financial performance measures;
- Fixed pay should be sufficient to leave a loss making firm able to pay no bonus at all;
- Two-thirds of bonus should be deferred and subject to performance criteria if the bonus is significant relative to fixed remuneration;
- Deferred bonuses should be adjusted depending on future performance; and
- Good practice to include an extra-statutory supplement to the annual report and accounts, covering remuneration policies for the whole company.

The recommendation by European Commission on the same covers the following (FBD, 2009):

- Remuneration policy should promote sound risk management and not encourage excessive risk-taking;
- There should be an appropriate balance of fixed and variable pay-with a requirement for institutions to set an upper limit on variable pay;
- Base pay should be sufficiently high to allow no bonus to be paid;
- Performance conditions should be based on business and individual performance;
- Those setting pay should be independent and have appropriate expertise; and
- Financial institutions should disclose remuneration policy to stakeholders in a clear and easily understandable way.

The European Banking Federation supports a principles-based approach towards remuneration policies with the aim of aligning remuneration policies to sound risk management (EBF, 2010).

## **2.3. Executive Compensation Regulation in India**

RBI issued a guidelines on compensation (RBI, 2010), which also emphasized FSB's principles of sound compensation practices.

Related to Effective Governance of Compensation it emphasized formulation of Compensation Policy and a Remuneration Committee by the Bank's Board.

Related to Effective Alignment of Compensation with Prudent Risk Taking, it emphasized compensation to be risk-adjusted, compensation outcomes to be symmetric with risk outcomes, and compensation payouts to be sensitive to time horizon. It again broke down some issues: Fixed Pay, which should be reasonable and which should increase in the range of 10-15% annually; existence of variable pay composition and deferral (40-60% deferred) system, if it is substantial compared to total pay, over a minimum period of three years; provision of clawback should exist; guaranteed bonus should be avoided; and hedging should be discouraged. Besides, emphasis was given for the independence and proper compensation for risk-control and compliance staff.

Related to Disclosure and Engagement by Stakeholders, it emphasized to disclose the decision-making process, design characteristics, aggregate quantitative information on compensation of senior employees.

#### **2.4. Nepalese Scenario**

In 2011 (October 26), NRB issued a directives with a Guidelines related with Executive Compensation. This was unusual in several stances; has reviewed two international studies; was released after careful consideration of several factors; and pre-answering those issues including legal, moral, and possibly controversial. Despite of this, it will be evident later on that this is issued intentionally, with vested personal interest, and without considering its overall implications. Reviewed literature and data were also presented intentionally to create confusion and misconception and to favor the provisions made therein. Theoretically/principally the document is a total blunder. The background (preface) and guidelines are contrasting each other and is totally against the internationally accepted theory, principle, practice, and norms. Practically, it is wrong as well as difficult to implement besides having several errors, some of which has been revoked later by NRB itself.

The first paragraph of the document states that: one of the reasons behind the global financial crisis was the structure of executive compensation, which encourages excessive risk-taking for increasing short-term profitability but which brought the long-term systematic risk. The second paragraph states that: due to lack of proper regulation of executive's salary, allowances, and other financial benefits they are inclined to show their efficiency by taking more risk by lending to the low-quality borrowers and investing on bet-like (casino) businesses with the objective of making high profits that make the task of controlling financial instability more challenging. In the Nepalese context it said that: Nepal also saw an inequitable and unbalanced development of banking system due to excessive increase in pledging against share and real estate lending in the last half-decade. From these three statements it could be interpreted that due to performance-based compensation portion of the executive, they are inclined to take excessive risk, since their only objective is to increase the asset of the bank so that their compensation level will also increase accordingly. This shows that NRB accepted that performance-based compensation may be one of the reason of financial crisis that we witnessed globally.

The NRB's document referred two studies (Bebchuk and Spamann, 2010; Core and Guay, 2010). The author is convinced that not only these two but several other research discussed the issue of executive compensation and the need for its regulation. However, the NRB has misled everyone referring these literatures.

In case of Bebchuk and Spamann (2010) some statements were quoted by NRB. NRB argued that the research proved direct relation between executive's salary and the current financial crisis, but this research (that is, Bebchuk and Spamann, 2010) does not undertake any empirical study in this regard, as well as the focus of this research was not on finding the reason for financial crisis rather the research objective was to find out the best option for monitoring and regulation of compensation level of senior executives of the bank. Because in the background, this research cited some previous literature, it might have encouraged NRB to use these statements in its favor. Besides, not the compensation but the structure of compensation, especially performance-based payments, has been discussed as one of the possible cause of the crisis, which is also evident from the NRB's same document which states that "executive's are inclined to take more risk in lending/investing to show more profits and increase own compensation", which implies variable or performance-based compensation. Finally, with the detail study of the literature it could be evident that the authors has stated that there is not lack of legal provisions rather that worldwide regulators have enough legal powers but the methodology adopted for monitoring, supervision, and regulation might be faulty due to which assessing the level of risk-taking behavior and/or risk-taking interests of lenders could be difficult through the old techniques/procedures, and depending on these traditional approaches may not be appropriate and effective. Finally, everyone has accepted that some sort of regular assessment is necessary, and needless to say it is the important function of the regulatory authority. On the whole, the research (Bebchuk and Spamann, 2010) emphasized that the structure of executive's compensation that encourages a executive to take excessive risk needs to be assessed by the regulatory authority by the use of mixture of old as well as new techniques and methodology so that the chances of promoters/shareholders to influence excessive risk-taking that is not socially acceptable could be minimized and the concept that by involving the directors and handing over the bank to them will stop excessive risk-taking might be changed.

In the second literature cited by NRB (Core and Guay, 2010), it has referred the following statement in favor of the new provisions it has introduced: the validity of statement that executive's compensation is not appropriate and justifiable raised by American media, public, politicians, researchers in the 1950s has proved true now; the research agrees with the view of regulatory authority's regarding the need of fixing the remuneration of executive, which has been a hot and popular topic globally at present; and that the fixing of executive's salary will be a controversial issue for years to come. The reference of above quotes from this research is more confusing and may have been used by NRB to convince its Board on its proposal. The translation of the meaning has also been intentionally misinterpreted. Also, the statement has been quoted without its relevance, that is, the statement written in different context has been used without referring the context of its use. The literature has no reference to the statement that "the validity of statement that

executive's compensation is not appropriate and justifiable raised by American media, public, politicians, researchers in the 1950s has proved true now". This has never been stated nor the statement made therein even have meant (implies near to) it. Besides, the research stated that since this issue has been raised first in 1950s and since the issue was highlighted at present too, it means that this issue will always be a topic of debate. However, the interpretation has been done so that it implies that the executives will always be making controversies regarding this issue and oppose any regulation for compensation, which is not the essence of the same literature NRB referred. Finally, the research has not accepted the regulatory authorities view to fix the remuneration of executive rather the research agreed with the "general principles", especially the procedures to be followed to scientifically address the issue of executive's compensation regulation.

In the main text of the NRB guidelines, in the beginning it is written that the Bank's Board will be responsible for making the policy regarding compensation of its executive. However, the second sentence was in total contrast to the first and states that: the compensation shall not be higher than that fixed under the same Guidelines. This is totally against the liberal economic and free market principles. With regard to the NRB provision of executive's compensation, first component is Fixed Annual Compensation or Base Salary. A unique formula has been invented that is rare anywhere in the world. In fact, no regulators have said anything about the fixed salary. But NRB has derived a formula even for it. First formula states: 5% of the 3-years average salary expenses for all the staff. Although, it looks like that this provision has been introduced to reduce difference and hence inequality in employee payments but the other aspects has been totally ignored. Although, the endeavor is good to increase the overall salary levels, it seems that increasing expenses is an indicator of efficiency and NRB wants to promote it. Reducing the Management Efficiency Ratio, that checks the performance of bank, will now be beneficial for the executive. May be, the epidemic of public enterprises will now enter the private enterprises too: increase the number of unnecessary human resources, increase average salary, and increase your own salary.

Second formula to derive the executive's fixed annual salary relates to banks' assets, specifically 0.025% of bank's assets as of last Fiscal Year-end (FY). This is a real blunder made by NRB. This is a U-Turn from the globally accepted principle and against the background of the very debate on executive compensation. Linking assets with executive salary will only encourage the executive to take more risks so as to increase short-term profits visible by the FY-end, which will move the banking sector towards the swamp of crisis. Increasing the bank asset will be the only objective of executive leading to financial non-prudence and hence instability. There is a high chance that this will bring about a disaster in the financial sector. This is not only against the well-accepted international principle but against the main spirit that raised this very same debate of executive's compensation, excessive risk-taking by the executives for increasing financial benefits they receive. The NRB provision thus seems to bring about instability in the national economy instead of stabilizing it. This provision, if realized will surely increase the loan defaults (non-performing loans, NPL) of the banks and currently stable banking sector will see a turmoil leading to increased bankruptcy and ultimately the financial crisis.

Besides, since the above two formula relates the salary with some sort of performance of bank, it means that this is not supposed to be fixed-salary rather is a type of performance-based-salary and could not be considered as a formula for fixed or base salary. Again, if a new executive is appointed, the ambiguity about the method of calculation of compensation arises, since the bank's assets in the last FY or average salary have no relation with the new executive. Moreover, it is also not justifiable if by joining a large (small) bank the salary of a new executive becomes considerably higher (lower). This formula, therefore, does not gives due consideration to the executive's qualifications, experiences, achievements, professionalism, and efficiency. One-size-fits-all policy is neither scientific nor justifiable, in this regard. Without looking at the chances of brain-drain of talents from this sector, the new provision brought by NRB could only serve their vested interest: to secure the retired life of their current senior employees who could be brought as executives of the private banks since they may be willing to accept relatively lower pay for their retired life; or Board/Directors be involved directly as a executive since this will be their side job and hence they can work for minimal pay. NRB should be clear in this respect.

This provision will also create market distortion in several aspects. First, the professionally managed but low-asset banks cannot afford talented executives rather high-asset banks and/or banks with huge expenses but less professionally managed could attract talents due to the amount they are able to offer. Well! If NRB wish to attract talented professional to run the government-managed banks like Rastriya Banijya Bank and Nepal Bank Ltd., which have large assets, then the case is different, since these banks are unable to attract qualified persons at present even after repeated attempts (advertisement and announcement for vacancy). Besides, for a new bank the calculation of market average will be difficult since there is no data regarding average executive salary. How the new bank compensates its executive will be difficult to understand. Besides, since being new they have relatively less assets, they could not attract talented professionals. The presence of "minimum average market salary" also shows the neglect of the central bank, since if it is average there is no question of being minimum, and vice versa. Again, the provision of continuation of current compensation package will force the executives to try their best to remain in the same bank since otherwise there is a risk of reduction of the compensation package from the current level enjoyed by them, hence they will have to accept undue pressure and proposal from their banks' Board. The corporate governance will be severely affected by this provision, too. This will increase corruption and informal financial transactions and hence decrease transparency. The only sector cherished for its openness then will also follow the fate of other sectors. Besides, even if the executive adheres to the same bank, the provision ruled out the chances of increment in the salary, which would hamper full potential performance of the executive since there is the lack of motivation. Keeping in mind the annual inflation and price rise also this becomes impractical. Besides, if the performance of an executive has no means of judgment and encouragement, it is difficult for him to remain in the same organization and increase the chances of movement, even outside the sector or country. This will create havoc in the already panicking industry due to global crisis and other

financial disturbances and political instability. There may also be some instances when the current second-senior most management staff may be drawing higher salary than that calculated for the executive (since the NRB directive applies only for CEO) and if actually the executive was to get the salary based on NRB guidelines, it may fall short of that compared to the deputy.

NRB, on the one hand, says that the current level of executive salary is indigestible for the society whereas it itself allowed continuance of the current salary structure, and excluded foreign banks and joint ventures. What will be the status of government owned or managed banks are also not clear. Even at present when there is a widespread claim of unfair treatment between public and private banks, the new provision is sure to increase this debate (government banks are allowed discount on not following the CAR). Some other issues like counting bonuses as a "performance-based salary" is also wrong since even the international labor standard established labor's claim on company's profit. Explicit mentioning of performance-based payments in the bank's regulation makes it more difficult even for the release of bonuses. NRB also intervened in petty issues like mobile bills, newspaper subscription, vehicle repair and fuel, internet bills, and some other miscellaneous issues. The provision that new vehicle could not be bought brings a practical issue if the vehicle become totally not-workable. Newspaper and internet may also become out of reach of executive since the limit for these is set at 0.5% of executive's salary and most executives will have to resort for a few and/or low quality services. International books, newspapers, and journals will be totally out of reach of banks' executives. In this way, trivial issues that have no relation with the systemic risk or even risk to the bank has been *sensationalized* and the central bank resorted to the micromanagement of the banks taking undue advantage of the power it was vested for good purpose. Instead of using its limited resources of skilled human capital in the macroeconomic, pertinent, and important issues of national level, the central bank will now open the records of bank to go through the expenses made in fuel, newspaper, internet, phone, teas, coffees, snacks, and so on. It also opened the door for nepotism and favoritism requiring executives to submit to them (NRB Officials) since NRB could suspend some of these provisions (in the Directives for regulating executive compensation), if requested.

## **2.5. Way Forward: Global Perspective**

### **2.5.1. Regulation of Executive Compensation**

Recently, the bank regulators have added evaluations of bank management compensation packages to the list of factors taken into account in supervisory safety and soundness examinations (VanHoose, 2010). Constraining bank risk-taking is unending task for bank regulators, even outside the crisis context. Banks are highly leveraged and bank executives typically enjoy high levels of equity-based incentive pay. These two factors would encourage risky strategies in any firm (Tung, 2010). Broadly speaking, there seem to exist two strategies. The first is to restructure the financial industry in such a way that the risk-taking parts will never need public bailouts, in which case one could leave the monitoring of pay structures to shareholders, themselves monitored by creditors fully aware of the risks they are running. The second strategy is to assume that the public sector will always be the risk-taker-of-last-resort, and so intervene in the structure, but not the level of pay,

to ensure that the interest of the public are reflected in those incentives (Wolf, 2010). The approach used by different countries could vary based on several factors. The financial services industry operates in a global and competitive environment, therefore, a global solution is needed. The failure to align practices between different jurisdictions may lead to arbitrage and the loss of business, as well as some practical problem may also arise due to highly globalized nature of financial businesses (EBF, 2010).

However, some researchers argue against the direct/indirect regulation of bankers' pay based on empirical evidences. As they did in this case, regulations may tend to increase systemic risk by homogenizing otherwise heterogeneous competitive economic behavior (Friedman and Kraus, 2010). VanHosse (2010) emphasized that there is neither persuasive empirical evidence nor an unambiguous theoretical argument in favor of either direct or indirect regulation of bankers' pay. Core and Guay (2010) added that it is important to recognize the difference between a two-sided social and economic debate, and policy-setting based on only one side of the debate. It appears that current regulations are based on arguments from the side of the debate that asserts executive pay is too high and performance incentives are too low. Consequently, the available empirical evidence fails to provide strong support for government management of compensation regulation aimed at limiting bank risk-taking behavior (VanHoose, 2010). Core and Guay (2010) further added that they have serious reservations about whether several of the regulatory proposals would achieve their stated objectives. Nevertheless, the case for regulating bankers' pay is not very strong. Empirical findings to date provide mixed conclusions regarding the relationship between the structure of bank management compensation and risk-taking behavior. Although there has been an increase in the sensitivity of bank managers' pay to performance in recent years, there is very mixed evidence regarding the effect of this development on banks' risk-taking behavior (VanHoose, 2010). Friedman and Kraus (2010) even went forward saying that two familiar scapegoats for the financial crisis (deregulation and bankers' bonuses), do not, in fact, appear to have been responsible for the disaster. Rather, powerful evidence suggests that the recourse rule, and other variants of the Basel regulations on commercial banks' capital, caused the crisis. American Bankers' Association (ABA) also recognized that smaller firms do not necessarily require the formal committees and structures envisioned in some of the proposed principles (ABA, 2009). As a general proposition, inequality should be dealt with by general taxation, not by interference in pay levels, least of all interference in pay levels in individual industries. Thus, regulators should not be concerned with the level of pay, though there is also a strong case for investigating the degree of competition in the sector and exploring remedies if significant monopolies are discovered. Some other literatures also argued in favor of indirect regulation such that regulatory principles on remuneration should focus on outcomes in order to avoid prescription on structures and other issues where firms can reasonably adopt different approaches (Wolf, 2010).

However, there is a large mass of literatures that emphasized the need of regulation. But they also pre-warned for the adoption of principle-based approach for regulation of bankers' pay. Many national legislators and supervisors have



already addressed remuneration issues. This has been done in various forms (guidelines, principles, regulations, codes of conduct), however, the initiatives also have things in common: most proposals take into account the guideline of the FSB (EBF, 2010). The Task Force (formed by the American Bankers' Association) recommends the adoption of interagency regulatory best practices for compensation (ABA, 2009). Despite the prevailing disagreement, there is certainly a strong argument that in the realm of executive compensation, the proper legal framework can provide a level of shareholder protection that market-based forces might be unable ( or, perhaps more accurately, unwilling) to provide (Barney, 2009). Bank regulators should monitor the incentives of the bank's top management teams. Such monitoring and assessment is important for evaluating the risks posed by the bank (Bebchuk and Spamann, 2010). For this, regulators could focus on the menu of choices available to banks and on the incentives influencing the choices from that menu. Regulators may be able to bond bankers to more prudent banking practices with pay-performance incentives that include instruments that are sensitive to risk. At the same time, regular attention to the structure of management incentives may offer an important tool to enable better tradeoffs between risk-taking and regulation (Tung, 2010). There is a possibility of directly regulating executive pay arrangements, or at least, encouraging or discouraging certain arrangements. Such regulation should seek to limit the extent to which bank executives face asymmetric payoffs when considering options that have both an upside and a downside (Bebchuk and Spamann, 2010). Tung (2010) also proposed substantive constraints on pay-structure, including prohibitions on compensation that encourages excessive risks. Wolf (2010) also supported that regulators do have a vital interest in the structure of pay. Structural reforms, including much higher capital requirements, would help. But, so long as anything like the present situation prevails, in terms of the structure of the financial industry, it is vital to prevent management of systematically significant institutions from benefiting directly from decisions that make failure likely. The answer is to make decision-makers bear substantial personal liability, in the event of such failures. Combining traditional direct regulation of banks' actions and activities with regulation of bank executives' pay structures may well improve the overall effectiveness of banking regulation. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation of activities could be less tight than it should otherwise be (Bebchuk and Spamann, 2010).

Another tool available for bank regulation to the regulators and for the benefit of other stakeholders is the disclosure regime. It has sometimes also being advocated that more disclosures are required, even to the extent of segregating payment structure, and not only the levels of total compensation. But it is found that these disclosures have largely emphasized the level of executive pay rather than the incentives embedded in executive pay. For, example, existing disclosures do not allow one to easily determine the overall sensitivity of executive compensation to firm's performance (Core and Guay, 2010). At a time when executives' salaries are several hundred times higher than that of an average worker, and knowing that motivation is one of the key problems in any company, disclosure might negatively affect the motivation and performance of other workers. With enforced disclosure of executive pay, one could expect that not only may performance go up but so will

compensation levels. One of the best natural experiments is the case of Canada. Thus, while government disclosures rules may improve the pay-performance relationship by increasing shareholder scrutiny of managerial pay contracts, it might also affect workers' motivation and performance negatively (Falk et al., 2004). Core and Guay (2010) also argued that the time it would take an outsider using public disclosures to assess whether or not a specific compensation plan was appropriate for a specific firm at specific point in time reduces any benefit of such regulation practices and hence is not worth much.

There are other indirect approaches of compensation regulation. For example, in US the Federal Deposit Insurance Corporation has proposed conditioning deposit insurance premiums on the structure of bank management compensation, both to take into account the risk implications of alternative pay-plans and to try to influence the pay-structures that banks select so as to reduce risks. Research suggests that effect of the relative shares of shareholders, debt-holders, and managers in bank risk-taking decisions depend considerably on factors such as the magnitude of the moral hazard problem created by deposit insurance and the governance structure in place at banks. Conditioning deposit insurance premiums on a bank's pay structure might alter risk-shifting incentives created by moral hazard arising from deposit insurance (VanHoose, 2010).

Finally, there are several things to consider before implementing any kind of regulatory practices. First, it is essential that firms are given the opportunity, as well as sufficient time, to implement changes to their reward practices that have been reviewed and evaluated over time, and which are appropriate to their business models, rather than implementing any short-term changes that may inadvertently caused unintended consequences in the long-term (EBF, 2010). Second, the best practices should also consider compensation and authority of back-office, risk-control, and compliance employees (ABA, 2009). Third, if the remuneration policies of banks become subject to stricter regulation, then the same should apply for other financial and/or non-financial institutions. Besides, any rules regarding remuneration should be neutral towards a bank's business model. Hence, remuneration principles should not be directed towards a certain type of bank. In addition, remuneration principles should not encourage banks towards a particular business model. Different business model have been developed to serve the different needs of customers, so supervisors should not encourage banks to move away from models (EBF, 2010). Fourth, regulators should act as a facilitator and give due consideration to some of the practical problems faced by these institutions. For instance, for many banks the new initiatives alter the bank's existing remuneration policies. Their former remuneration regimes can either be included in individual contracts, in collective labor agreements or in the firm's internal rules. In the new situation, these differences could be problematic from a legal perspective (EBF, 2010). Also regulators should not be involved in micro-management of any firms. This approach likely imposes costs on the subordinates and on the firms (Core and Guay, 2010). Regulators should also keep in mind that while voluntary action is desirable (FSF, 2009).

### **2.5.2. Changes Sought from Inside the Institution**

This approach argues that if the debate that executive's pay is high is true than it could be argued safely that the pay-setting process is flawed. And, if the pay-setting process is flawed, one can readily extrapolate that executive pay levels and incentives are also expected to be flawed. If one believes that executive compensation practices are flawed, a natural first step would be to direct attention toward those responsible for the pay-setting process, that is, the board of directors and its compensation/remuneration committee, rather than to indirectly attack the problem by regulating the outcomes of the board's decision-making process, that is, the executive compensation. And, further to this point, if one was to determine that the decision-makers in the compensation setting process were competent and aligned with shareholders, this would tend to call into question whether, in fact, executive compensation practices were indeed flawed (Core and Guay, 2010).

Financial Service Authority (FSA) clearly emphasized the role of bank's Board by stating that it has no wish to become involved in setting remuneration levels: that is a matter for Boards, which should ensure that they have effective structures in place to set remuneration policies and monitor remuneration levels throughout the firm (FSA, 2008). American Bankers' Association also argued that the principles-based approach to regulating executive compensation has two significant benefits. First, it places responsibility for executive compensation squarely where it belongs with: directors who are elected by and responsible to shareholders. Second, it gives company boards and compensation committees sufficient flexibility to design executive compensation programs appropriate and in the best interest of their shareholders (ABA, 2009). Thus, the approach envisages to ensure that firms follow remuneration policies which are aligned with sound risk management systems and controls and with the firm's stated risk appetite, rather than direct control of Boards' role by the regulators (FSA, 2008). Literatures also suggested that the remuneration committee must take control of process, policies, and practices with regards to executive recruitment and compensation, in this regard (Murphy, 2004; Jensen, 2004). Remuneration and audit committees should pay careful attention to ensuring that their managers cannot benefit from short-term increases in stock prices that are achieved at the expense of long-term value destruction (Jensen, 2004).

Boards should design rules that give appropriate incentives to the executive to act in the best interest of the shareholder (Falk et al., 2004). It is generally accepted that delegating the management of the firm to the executives creates an agency problem, since, absent the right incentives, executives could base their decisions on short-term or personal objectives, which imply immediate reward, rather than trying to serve the interests of the stockholders by increasing the long-term value of the firm (Jarque, 2008). While it is clear that no solution will eliminate the agency problems between managers and shareholders, and between board members and shareholders, the objectives should be to mitigate these problems by well-designed pay-packages on one side and well-designed corporate governance policies and processes on the other (Jensen, 2004). Internal incentive considerations imply that the manager's compensation must be tied to the performance of her own firm.

Performance-based compensation ensures that her interests are appropriately aligned with the goals of the firm's owners (Danthine and Donaldson, 2010).

However, there are several problems within the Board and in the Corporate Governance of banks. Major issue of concern is the conflict of interest. But the governance problems can be reduced by separating the chairman and executive (Falk et al., 2004). Researchers proposed several other measures to improve the functioning of banks' boards. For instance, companies should change the structural, social, and psychological environment of the board so that the directors are no longer governed by the executive (Jensen, 2004). Most importantly, directors should not see themselves as employee of the executive (Murphy, 2004). In this regard, Widmer (2004) proposed that first a board should constitute itself, that board members meet extensively, and that board members meet regularly without management. Second, the agenda of a board meeting be set by the chairman. Third, the board should manage the executive, and not vice versa, that is, the board sets the executive's objectives, assesses his strategies, and monitors performance. Furthermore, the chairman of a board be employed part-time and act as a representative of shareholders, not of the company. That is, the chairman should focus on controlling management. Such changes in board structure would remedy current problems with executive compensation. In plain language, it would be geared to expectations of the executive's role, to what the candidate is required to deliver, and to how he ultimately performs. However, for any such successful role of Board, all the Directors should be highly qualified and trained to act professionally.

Corporate governance reforms aimed at aligning executive pay arrangements with the interests of banks' common shareholders (such as advisory shareholder votes on compensation arrangements, use of restricted stock awards, and increased director oversight and independence) cannot eliminate the identified problem. In fact, the interest of common shareholders could be served by more risk-taking than is socially desirable. Thus, governance reforms cannot be relied on to eliminate excessive risk-taking because they cannot be expected to eliminate incentives to take risks that would be excessive from a social perspective but not from shareholders' perspectives (Bebchuk and Spamann, 2010). Besides, although the creation of shareholder wealth is the most important measure of top executive performance, some companies do not consider shareholder as a sufficient measure of top executives' performance (Zufferey, 2004). If managers and shareholders are equally risk averse, managers' decisions will be correct from the shareholders' perspective if and only if managers' and shareholders' consumption streams are in direct proportion to one another (Danthine and Donaldson, 2010). Optimal compensation design is not sufficient to achieve long-term value maximization and we need to rethink corporate governance. Indeed, the responsibilities and the incentives of the board of directors need to be revisited. Moreover, the shareholder-monitoring of managers need to be reexamined (Gibson, 2004). Tung (2010) also proposed rules to be imposed on corporate governance. For instance, although shareholder say-on-pay voting might on the surface appear to be a valuable corporate governance mechanism, it seems difficult to envision a shareholder vote

on pay leading to more efficient executive compensation packages (Core and Guay, 2010).

It is being argued that executive compensation be tied with several performance indicators. Falk et al. (2004) stated that some authors argued share-price currently represents the best measure for evaluating the contribution of top executives. Benmelech et al. (2008) also argued that stock-based compensation is more effective than dividends-based compensations to provide the managers with the incentive to exercise costly effort, and thus increase the firms' investment opportunities. Tung (2010) also added that since bank executives typically enjoy high levels of equity-based incentive pay, this would encourage risky strategies in any firm. Equity-based awards, coupled with the capital structure of banks, tie executives' compensation to a highly levered bet on the value of banks' assets. Because bank executives expect to share in any gains that might flow to common shareholders, but are insulated from losses that the realization of risks could impose on preferred shareholders, bondholders, depositors, and taxpayers, executives have incentives to give insufficient weight to the downside of risky strategies (Bebchuk and Spamann, 2010).

A performance-based contract that is based on cash-flows or earnings (but not stocks) always achieves truth telling, and thus an optimal investment strategy. Stock-based compensation, however, is much more effective than cash-flow-based compensation in inducing the manager to exert costly effort and constantly seek additional investment opportunities for the firm. That is, stock-based compensation does in fact align the manager's objective with the shareholders' (Benmelech et al., 2008). Core and Guay (2010), therefore, preferred that all aspects of top executive pay be closely tied to future stock price performance. Since, by simply looking at the development of stock prices in order to set the level of executive compensation, it is implicitly assumed that the executive is responsible for creating any volatility of a company's share-price. By taking the share-price as a reference, executive compensation might be determined to a large extent by luck or external events rather than by pure measure of individual performance (Falk et al., 2004). While a large theoretical literature views stock-based compensation as a solution to an agency problem between shareholders and managers, there is also a growing body of empirical evidence that shows that it leads to earnings management, misreporting, and outright fraudulent accounting (Benmelech et al., 2008). Thus, some authors propose long-term equity pay for bankers. Bankers would be paid with stock they could not sell until several years after they retired from their firms, on the theory that this lengthy holding-period would induce bankers to adopt a long-term perspective in their decision-making (Tung, 2010).

It is difficult to assess the performance of the executive in a year or two because it will only be realized in five or ten years (Biedermann et al., 2004). So, the systemically important financial institutions should withhold a significant share of each senior manager's total annual compensation for several years (Wolf, 2010). Stock ownership and retention requirements are among the tools that help companies to maintain a long-term view of performance and reduce the likelihood that executives will take undue risks. Companies should also consider the full range

of upside/downside payouts under incentive payouts, which requires that LTI (Long-Term Incentive) awards be calculated under best, realistic, and worst case stock price/payout scenarios (PMP, 2009). Thus, many new initiatives state that a large part of deferred remuneration has to be paid out in shares or share-linked instruments. This may, however, have some negative effects, because it gives the firm the possibility to influence the size of their employees' bonuses and can dilute the share-ownership (EBF, 2010). Wolf (2010) added that the withheld compensation should not take the form of stock or stock option. Rather, each holdback should be for a fixed-dollar-amount and employees would forfeit their hold back if their firm goes bankrupt or receives extraordinary assistance. Effectively, this would mean that management would bear substantial personal liability, in the event of failure. It would be crucial that such obligations could not be expunged by leaving the firm, but would be in place for a significant and fixed period of time (Wolf, 2010).

Some authors propose to pay bankers with a representative slice of all their firm's securities (preferred stock and bonds, as well as common equity). This enterprise value approach would hopefully reduce risk-taking, since preferred stockholders and bondholders generally prefer less risk than common shareholders (Tung, 2010). Benmelech et al. (2008) proposed that different types of firms need to put in place a different composition of dividends and stocks in the compensation packages (Benmelech et al., 2008). But Murphy (2004) highlighted the idea of "perceived cost hypothesis". Board members and managers perceive the cost of stock options as being low. However, stock options do give rise to economic costs, most importantly in the form of dilution. In fact, the economic cost of an option is typically higher than the value of an option to the employees which in turn is higher than the perceived cost of the option. As decisions are supposedly based on perceived cost rather than on economic cost, too many options were granted to too many people. Tung (2010) therefore proposed paying bankers with debt.

Paying bankers with debt may curb bankers' appetite for risk, consistent with regulators' goal of assuring bank safety and soundness. Since, unlike equity, debt is sensitive to the firm's liquidation value, debt compensation can improve managerial effort and firm value in distress situations. Thus, in addition to equity, bank executives should receive some portion of their compensation in the form of their bank's publicly traded subordinated debt securities. Recent theoretical and empirical research shows that as an executive's holdings of her firm's debt increases relative to the value of her equity holdings, that is, as her inside debt-equity ratio increases, the firm's risk-taking declines. Such inside debt holdings help to align managers' interests with those of their firms' creditors, who are more risk averse than equity holders. Publicly traded subordinated bank debt may be an ideal form of debt compensation for bankers because market pricing of this debt will offer a continuing referendum on risk-taking at bank. If the bank were to fail, its subordinated debt would be repaid only after all depositors and general creditors were paid in full. And subordinated debt does not enjoy the unlimited upside from the bank's risky bets that equity does, since subordinated debt claims are fixed. Market pricing of the debt will therefore be particularly sensitive to downside risk, much more so than equity. These risk-related price fluctuations will directly affect banker's wealth,

giving bankers useful feedback and important incentives with respect to excessive risk-taking (Tung, 2010).

It is also suggested to include criteria other than financial ones in the evaluation of executive performance, for example, job creation, company reputation, etc. When jobs are being destroyed, higher remuneration of the executive seems to be a reward for failure (Biedermann et al., 2004). Beyond pure financial performance, firms should attach high value to qualitative criteria such as customer loyalty, service quality, employee satisfaction, operational stability, and sustainable growth. These criteria should play an increasing role in executive compensation strategies (Zufferey, 2004). Again, it has been criticized that peer-groups and performance benchmarking in setting executive compensation levels has so far rarely been used and that there exists a strong opposition against this approach within the industry. But this policy provides two very strong signals: first, executives only receive a bonus when they achieve something outstanding; and second, it conveys a signal of confidence to the investor community that the company was able to beat its competitors (Falk et al., 2004).

Some authors also highlighted the issue of comparative loss to the executive in case of failure of his/her institution. Since managers' consumption is not tightly constraint by their compensation package, the latter indicates to them how the principles want them to view the world and in which light they should make the firm relevant decisions (Danthine and Donaldson, 2010). Bebchuk and Spamann (2010) added that to the extent that the ownership of common shares in the bank holding company represents a substantial fraction of an executive's wealth, such a large stake might lead the executive to be more averse than shareholders who are more diversified. In addition, a failure of the bank might impose significant personal costs on the bank's managers that would not be borne by other common shareholders. Empirical studies have documented that executives who are insulated from shareholder pressure and do not receive high-powered pay are less prone to engage in risk-taking. The fact that managers are privately wealthy implies that they should be almost risk-neutral at the margin. Although shareholders are supposed to be well diversified, they are not, however, risk-neutral. At the opposite extreme, since compared to shareholders managers are excessively invested in their own firm they are insufficiently diversified. This, it is argued, suggests that they are likely to be excessively prudent (Danthine and Donaldson, 2010). Friedman and Kraus (2010) also showed that the banks whose executives held the most stock in the banks lost the most money in the crisis, indicating that the executives did not engage in deliberate risk-taking motivated by a quest for higher bonuses, as they would have been risking their own money. Thus, there is decisive evidence against the theory that incentives to take risks caused the financial crisis.

Current trend showed some banks have shifted towards greater emphasis on salary over bonuses in management-compensation package (VanHoose, 2010). Some initial empirical evidence in Europe shows that not only new remuneration concepts have been implemented but the structure of variable/fix remuneration has already started to change, thus setting strong incentives towards sustainable business and affecting actual behavior (EBF, 2010).

## **2.6. Regulating Fix or Base Salary**

In absolute terms, bank executives are highly paid. However, many types of individuals are highly paid, for example, doctors, lawyers, athletes, players, musicians, actors, and so on. Thus, one needs to provide more than just net amounts of pay to make a convincing argument against existing pay practices (Core and Guay, 2010). A key problem in determining the right levels of pay resides in the difficulty to assess the marginal contribution of the executive to firm value (Falk et al., 2004). Bank executives received about thirty-five percent less annual pay in 2006 than executives of matched non-financial firms. Further, bank executive performance and risk-taking incentives are slightly smaller than that of the matched non-financial firm executives. The analysis suggests that the compensation and incentives structures of bank executives are not much significantly different to that of executives of non-financial firms (Core and Guay, 2010).

Any government regulation of executive compensation should encourage compensation practices that will contribute to the sustainable long-term value of business as we emerge from this crisis, rather than simply “fixing” specific compensation practices which are seen as having contributed to the crisis. What is needed is a set of principles to guide the design and operation of any responsible executive compensation program (ABA, 2009). The principles should be intended to reduce incentives towards excessive risk-taking that may arise from the structure of compensation schemes. They should not be intended to prescribe particular designs or levels of individual compensation (FSF, 2009). Several researchers argued that focusing simply on the level of pay is the wrong way of looking at the problem. It might well be acceptable for a company to give the executive two percent of the increase in wealth that the executive creates for its shareholders. It cannot be viewed as excessive, when executive pay is correlated with the long-term wealth that he creates for shareholders. Hence, instead of discussing how much you should pay executives (the right level of compensation relative to some benchmark salary), it is how remuneration is structured that really matters. The focus should be on the structure of pay leading to practices that do not distort managers’ incentives (Falk et al., 2004). Regulators should not be concerned with the level of pay, which should be left to tax policy (Wolf, 2010). Such pay regulation should focus on the structure of compensation (not the amount) with the aim of avoiding incentives for excessive risk-taking. Regulators should attempt to make executive incentives work for, rather than against, the goals of financial regulation (Bebchuk and Spamann, 2010).

Perhaps the most important difficulty, however, is that any restriction likely would push overall compensation levels for banks executives below market levels. Effective ceilings on bankers’ pay would push the quantity of executive talent demanded by banks above the quantity supplied, resulting in a shortage of qualified managers. The reduction in the pool of available executive talent if this eventually were to arise likely would contribute to higher rather than lower risks in the banking industry (VanHoose, 2010). Since, opponents may argue that pay regulation will drive talent away, and that financial firms will lose valuable employees, it is stressed that regulation of pay in financial firms should focus on pay structures and



should not limit compensation levels (Bebchuk and Spamann, 2010). Experience has also found that direct government control of pay creates a host of perverse and unintended consequences (Wolf, 2010). Many researchers cast serious doubt on the recent discussion about the appropriate level of executive compensation. One of the suggestions that repeatedly arises in the media and that has been criticized by the researchers is some legislated maximum of executive compensation relative to some benchmark, such as the lowest paid employee in a firm or the average worker pay. Recent discussions in Switzerland and Germany to limit executive compensation schemes to deliberate multiple of a non-executive average salary, led to the question of what should be regarded as excessive and what level would be appropriate (Falk et al., 2004).

As of yet, the most important forms of executive compensation regulation in the US in response to the global financial crisis affect only those firms who are participating in the TARP program. Emergency Economic Stabilization Act of 2008 (EESA) of US requires financial institutions in which the treasury "receives a meaningful debt or equity position" through TARP to "meet appropriate standards for executive compensation and corporate governance". These standards might include the exclusion of incentives for senior executives that would encourage excessive risk-taking; clawback provisions, or bonus recovery provisions; and a prohibition on golden parachute payments. The American Recovery and Reinvestment Act of 2009 (ARRA) overhauled the executive compensation regime established under EESA. ARRA imposes "appropriate standards for executive compensation" on all companies receiving TARP funds, as opposed to the optional imposition of such standards under the original EESA. ARRA also prevents the payments of any bonus (or incentive) based compensation to certain executive of firms receiving TARP funds (Barney, 2009). Thus, even in the US, the TARP restrictions to the bailed out institutions do not appear to place strict limits on the overall level of executive pay (which is an important degree of freedom to maintain if these institutions are to compete in the market for executive talent). Rather, the majority of compensation is encouraged to be conveyed through salary paid in the form of restricted stock, which is vested at grant date, but cannot be sold for several years and the cash salary is limited to US\$ 500,000 or less for most executives (Core and Guay, 2010). Economic staffs of bank supervisory agencies are well aware of three basic economic pitfalls associated with pay restrictions that might effectively impose ceilings on managers' wages. This recognition is surely the reason that bank regulators are always careful to state that, aside from the statutory restrictions imposed on a few bailout recipients, there is no intention to subtly redistribute the forms of compensation received by bank executives (VanHoose, 2010).

At the most basic level, economic theory identifies three potential pitfalls of regulations aimed specifically at restraining bank management compensation. One pitfall is that explicit ceilings that constrain executive pay below market clearing levels, which already show signs of adjusting to altered perceptions of risks are likely to prove to be counterproductive in relation to the overriding objective of producing a safe and sound banking industry. The second pitfall is the danger of assuming that the effects of bank-pay regulation can be evaluated without reference to the rest of the economy. A shortage of executive talent would not

result because a number of people possessing risk-management skills would not usefully employ them. Instead, a number of these people would opt to provide those skills to other industries, including firms in other financial industries as well as companies in nonfinancial industries seeking financial officers that would be able to offer higher, unregulated wages. Thus, a predictable effect of restraining executive compensation in the banking industry to a "below market" level would be the departure of the most productive managers to other industries. Among these executives would be people with the best skills in managing risks. The loss of this talent pool would hardly promote improved risk-management capabilities within the banking industry. The third pitfall is a failure to account for feedback effects of wage regulations. The potential for a labor shortage within the management ranks and the impending loss of some of the most talented managers to other industries would give banking firms a strong incentive to engage in regulatory avoidance behaviors. Undoubtedly, some institutions likely would respond to regulations on explicit executive compensation by developing implicit forms of compensation, improved benefit packages, and miscellaneous forms of executive perks, not covered by laws or regulatory rules. Other banks might respond by leaving the "banking" business and reconstituting themselves as an alternative form of uninsured financial institution not subject to compensation restrictions (VanHoose, 2010).

In addition to arguing that executive pay levels are too high, critics of current executive compensation practices also argue that pay-for-performance is largely absent in executive compensation plans. These arguments appear to stem in part from the observation that executives typically receive a substantial amount of annual pay even in years when earnings and stock returns are poor (Core and Guay, 2010). Some researchers even proposed that additional incentives are necessary in executive pay because of the presence of potential for manipulation, in spite that they lead to manipulation as a side effect (Sun, 2009) and that some banks even shifted towards greater emphasis on salary over bonuses in management compensation package (VanHoose, 2010).

### **3. CONCLUSION**

Global financial crisis initiated, once again, a heated debate for the need of executive compensation regulation in the financial sector. The outcry from public, policy-makers, and regulators were based on one-sided view that the payments (in absolute terms) are very high and have widened inequality in the society widening the gap between rich and poor and hence increasing social tension. Empirical data, however, could not validate that the current financial crisis is due to the high levels of executive payments. However, due to the linkage between executive compensation and risk-taking, some researchers pointed out the need for regulating executive compensation since absent this other reforms will be less effective. Researchers, who stated that executive compensation could be one of the factors contributing to the global financial crisis, argued that performance-based compensation led to high risk-taking by the executives in pursuit of enhancing the short-term profits of the bank to enhance their compensation level, disregarding long-term perspective of the firms' performance. They, therefore, argued that the variable payments made to the banks' executives need to be regulated.

Financial sector booms and busts create gigantic losses for society, not only via the direct costs of bailouts, but still more via the indirect costs of economic instability on the economy. Analysis suggests that the combination of high-powered incentives and the pretense of high-growth firms will lead eventually to the firm's crash. It would appear that in many cases the remuneration structures of firms may have been inconsistent with sound risk management. It is possible that they frequently gave incentives to staff to pursue risky policies, undermining the impact of systems designed to control risk, to the detriment of shareholders and other stakeholders, including depositors, creditors, and ultimately taxpayers.

Bankers' pay immediately before the crisis was found to be substantially high and performance-based, which may be several times higher than the base-salary in some cases. It may also be based on stock and equity payments, which are looked as free by the shareholders disregarding the economic cost. Corporate governance and the Banks' Board also were not working satisfactorily. Even the creditors lack incentive to monitor their banks due to schemes like deposit guarantees. Regulation was imperfect. In the name of alignment, managers are inclined to take more risk to the mutual benefit of shareholders and they themselves. Lack of talents in the market, increasing firm size and complexity, labor laws like hire-and-fire, also contributed to increased executive paychecks.

FSF/FSB highlighted some basic principles for executive compensation regulation. The principles emphasized the effective governance of compensation; effective alignment of compensation with prudent risk-taking; and effective supervisory oversight and engagement of stakeholders. The principles stressed on Board's role; functioning of independent authority to look after compensation process; focus on risk and compliance staff along with the top executives; compensation adjusted for risk (symmetric with risk outcomes as well as sensitive to time horizon of risk); and the mix of cash, equity, and other forms of compensation. The deferral of variable payments and claw backs arrangement were also emphasized. Supervisory practices to include compensation assessment; increased disclosure requirement on compensation practices; and involvement of other stakeholders in the pay-setting process is also the main focus of the principle-based compensation regulation. Based on these principles, several jurisdictions initiated/reformed the executive compensation regulation. The major attributes of these regulatory practices are: assess banks' compensation levels, processes, and practices; increased reporting requirement; directly/indirectly regulate variable payments including, but not limited to, focus on greater time-horizon for payments, deferral, and claw backs; appropriate balance of fixed and variable pay: no upper limits on pay (fixed/base), fixed pay should be increased in relation to variable payments, variable pay should not be substantially higher compared to fix pay; risk-management to override financial performance; say-on-pay vote by shareholders; and so on. Indian Regulators also followed this principle-based regulation. Some important highlights besides those mentioned above were: fixed pay should increase in the range of 10-15% annually; 40-60% of variable pay deferred over a minimum period of three years; etc.

On October 26, 2011, the NRB issued a Directive with a Guideline for Executive Compensation Regulation. This was, in many ways, different than earlier directives. The background and the main text are contrasting and not only contradicts with internationally acceptable principles but also proved impractical later on (NRB has already revoked some of the provisions made therein). The literatures cited in this document was falsely presented to create confusions and misled. Misinterpretation of data and facts, confusing and misleading statements, out of context elaboration of the statements, are some of the intentional mis-presentation. There are also some statements cited from other sources, but which does not exist in the same literature, that is, arbitrary statements has been made citing literature. The guideline also was a blunder from theoretical point of view. It set the fix salary based on certain percentage of banks' asset and/or total expenses on staff salary. This is not only against the well-accepted international principle but against the main spirit that raised this very same debate of executive's compensation regulation, that is, excessive risk-taking by the executives for increasing financial benefits they receive. The NRB provision thus seems to bring about instability in the national economy instead of stabilizing it. This provision could have a far-reaching effect, if realized and will surely give rise to several problems and the currently stable banking sector will see a turmoil leading to increased bankruptcy and ultimately the financial crisis. Add to it, the level of micromanagement sought by the central bank could not be a welcome move.

Nepal made a totally opposite case out of the current crisis and vested interest of some government officials and politicians. Instead of discouraging risk-taking for short-term profit generation disregarding long-term performance of the firm, the central bank tied the fixed salary to the bank's asset, which is alarmingly dangerous. Besides, if a payment is based on some sort of performance, it could not be regarded as fixed-payment. Second, the very debate for the executive compensation has been disregarded by the Nepalese Regulator. The situation of Nepal and other countries is different and the debate should not have entered Nepal, since Nepal has very limited, if any, performance-based pay that may have given rise to increased risk-taking behavior of the executives. *It should be noted that analysis of all the commercial banks of Nepal showed no existence of performance-indicator-linked<sup>2</sup> payments.* But sooner or later it would have been an issue, however, the solution should have been searched very carefully or otherwise stable financial sector could also plunge into the crisis that the Nepalese central bank should be responsible of. On the other hand, looking at the history it does not seems that high executive salary is the reason banking sector has not progressed so quickly rather the low levels of salary may be the real cause. The high levels of corruption, lack of corporate governance, lack of transparency, in the government-managed banks may be some good examples to look after. Doesn't the inability of government to find suitable candidate for executive despite repeated advertisement indicates that low levels of compensation offered by these institution has distracted talents from joining these institutions. The provision is not possible to be implemented in the long run due to innumerable impractical possibilities. NRB, itself, has relaxed this provision for some types of institutions, which also shows that their decision was faulty. Besides, this type of bias and unequal playing field is counterproductive for the whole sector.

To understand the current debate, it would be better to look at the background. Why the question on compensation did arise? From where does it started? What is happening there? What solutions are being proposed? What are the underlying principles for this debate and solution? Are some of the million dollar questions that needed to be answered. Looking at the provisions made by different countries around the world, looking at the extensive literature available in this issue at present, looking at the reports from international organization like FSB, looking from the Indian and American provisions no one has raised question on the fixed or base salary, since the cause of current financial crisis, if any, was attributed to the variable component of the payments that are specially based on performance and that triggers the risk-taking behavior of the executives. Not a single jurisdiction has fingered the issue of fix payments, not even the TARP recipient banks in the US.

From the global perspective, two approaches could be useful to tackle this tricky situation. First, some sort of regulation of executive compensation. However, the second and the desirable solution for this problem is to sought changes from inside the institution. But due to first mover disadvantage voluntary changes could not be expected to fully rely upon. Due to globally interlinked nature of financial businesses, the global approach should be sought. First, indirect regulation is to be preferred such as tax, deposit insurance premium, capital requirements, increased disclosure, constraining risk-taking, increased reporting requirement, and other such policies. Direct regulation should be principle-based, those based on internationally accepted principle. Substantive constraint on pay-structure and arrangements could be done along with restricting asymmetric payoffs. However, there are several side-effects of any such regulations and regulators should take precaution in order not to bring about undesirable outcomes. On top of these, regulators should keep in mind that they are there to play as a facilitator and guardian and not as a market-maker with a direct role. Again, one need to provide more than just net amounts of pay to make a convincing argument against existing pay practices. A key issue is the exact answer does not exist for the question of what excessive payment refers to and to assess the marginal contribution of the executive. Any government regulation of executive compensation should encourage compensation practices that will contribute to the sustainable long-term value of business. The principles should be intended to reduce incentives towards excessive risk-taking that may arise from the structure of compensation schemes. They should not be intended to prescribe particular designs or levels of individual compensation. Instead of discussing how much pay executives should be paid, it is how remuneration is structured that really matters.

The best way to solve this problem, however, is to seek changes from within the institution. Researchers have proposed several solutions in this regard. First, the banks' board should take charge of all the processes in pay-setting process and work in line with the broader goal of the institution and in favor of the common shareholders. Shareholder also needs more voice and scrutiny of the payment levels and pay-setting procedures. The compensation practices should incorporate a best mix of both performance-based and fixed portion of the salary, which takes into account of long-term performance of the institution. In this regard, non-cash

payment through the mixture of representative slice of all firms' securities, stock/equity options, long-term debt instruments, deferred bonuses in cash or in-kind are the possible options. Executive performance should also be tied to several indicators besides financial, that is, like customer loyalty, service quality, employee satisfaction, job creation, company reputation, operational stability, sustainable growth prospects, and so on. In the end, it is also to be noted that if a bank fails, executives are the one who suffers the most.

Worldwide, even the researchers who argue that there is no case for the executive compensation regulation has accepted that absent it other reforms will not work for the benefit of economic sustainability. Hence, this shows the need of some sort of regulation. However, the Nepalese regulations, in this regard, are totally absurd. First, putting a ceiling in fixed salary could not be justified. Second, linking salary with some sort of performance of the firm means that it is variable form of payment. Third, linking the payments to some sort of performance is not desirable since it will encourage excessive risk-taking in pursuit of short-term performance enhancement. The only ways forward for Nepal is thus to regulate it based on principles or even better to deregulate it, since it is an opportunity that Nepal lacks significant portion of performance-based payments, which has been presented as the main culprit of the global financial crisis. Hence, it would be better to deregulate executive compensation, in the Nepalese context. If, however, NRB wants some sort of regulation, then the second option could be indirect regulation of executive compensation. First, since critics of current executive compensation practices also argue that pay-for-performance is largely absent in executive compensation plans, it should be introduced in Nepal. There should be a fixed level of salary that was decided by the individual banks, specifically Board or Remuneration Committee of banks. A provision of gradual growth in it should also be there, like in India. There should also be some sort of performance-based payment so that despite of firm's performance executives should not be able to draw significant incomes. However, precaution should be given not to link performance-based payment to anything that will trigger risk-taking. In all other aspects, principles from FSF/FSB could be *copied and pasted* in the new NRB Directive on Executive Compensation. Sooner or later, the central bank (NRB) ought to withdraw the current Directive (Guidelines for Executive Compensation Regulation), since it is sure to fail. The sooner it revokes it, the better will be for the economy and the NRB itself.

#### **4. NOTE**

<sup>1</sup> For details please go through the elaboration found on the book on the same topic written by the same author (Bhatta, K. P. 2012. Executive compensation: review of global financial crisis and the ongoing debate. Lambert Academic Publishing, Germany. ISBN Number 978-3-659-15081-4).

<sup>2</sup> Performance-indicator-linked payments, here, refers to the payment based on some sort of performance indicator. The concept could be simplified by an example. Suppose, if with every increase in 1% of dividend the payment made to the executive increases by X%, it could be termed as performance-indicator-linked payment, since it has some linkage with the level of dividend. For example, a CEO is provided Rs. 100 (as a base salary; along with other standard benefits and perks like allowance, insurance, bonuses) and the variable salary is linked to dividend as 5X, that is 5% for each increase of 1% in dividend. If the firm distributes 15% dividend than the variable salary of CEO will be (15\*5%) of Rs. 100, that is, Rs. 75. In some firms in US, it has been found that while the basic salary is Rs. 100

(plus benefits), the variable salary could shoot up to Rs. 2000 or more (20 times or 2000%). But Nepal lacks any such performance-indicator-linked payments to the CEOs.

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