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Development of Employee Incentive Programmes with Regard to Risks Taken and Individual Performance

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ABSTRACT

The article considers the issues of the development of incentive programmes for risk taking employees taking into account the financial institution. The mechanisms for the formation of long-term employee incentive programmes with due regard to the requirements of the Basel Committee and regulatory requirements of the Bank of Russia are offered. The methods for the calculation and application of the deferral (installment) of bonuses for top managers and other risk taking employees are considered. The risk indicators of the credit institution are defined and methods for their calculation are offered. The key indicators for payment/adjustment of deferred bonuses are proposed. The notion of a materiality level for transactions that can be determined in the context of a single transaction/single customer/single product is introduced. The problems of tax registration of annual bonuses for key executives of an institution when calculating profit tax are considered. The recommendations on accounting treatment of deferrals at the bank are given. A possibility for using long-term employee incentive programmes in non-financial risk taking institutions is provided.

Keywords: Long-term incentive, bonus deferral, risks, institution stocks, business value, corporate culture, taxation.

1. INTRODUCTION

In 2008-2016, in the European and Russian banks the systems of remuneration were greatly changed. This was due not only to the need to trace requirements of the Basel Committee to incentive programmes but also to the change in our opinion about the corporate governance (Basel Committee on Banking Supervision, 2010).

The true transformation of corporate culture of institutions is not just a superficial adjustment of the corporate identity. It should include all aspects of the company activities, including the change in the incentive principles with regard to risk taking in institutions. In this connection, it is necessary to set the long-term tasks of efficient change in the corporate culture and to provide HR subdivisions (subdivisions of human resource management) with new management tools. The success of the corporate culture transformation depends not on the number of HR tools but on the degree of happening changes.

To ensure the desired nature and consistency of changes in the corporate culture an approach that would mention bases of motives of behavior, for example, common goals and meanings of institution activities, beliefs and values of personnel, is required.

The requirements of the Basel Committee change greatly the views on risks of institutions and impact of the risks on the existing system of remuneration for heads in institutions, top managers and other risk taking employees (Basel Committee on Banking Supervision, 2013).

The changes in the conceptual approaches to risk management lead to the changes in the design of the system of remuneration. Thus, the incentive system becomes more complete and complex, new types of remuneration appear, for example, in such forms as a non-cash reward, options and stocks. The deferred types of remuneration payment with regard to the risks of business appear. The bonuses for top managers and personnel are an incentive to high-performance activities, as well as growth of earnings and company results.

The analysis of the economic situation shows that in the economic insecurity the traditional long-term incentive programmes (LTIP) used for top managers in financial institutions that are designed for the medium term from 3 to 5 years require renewal and updating in accordance with new economic conditions.

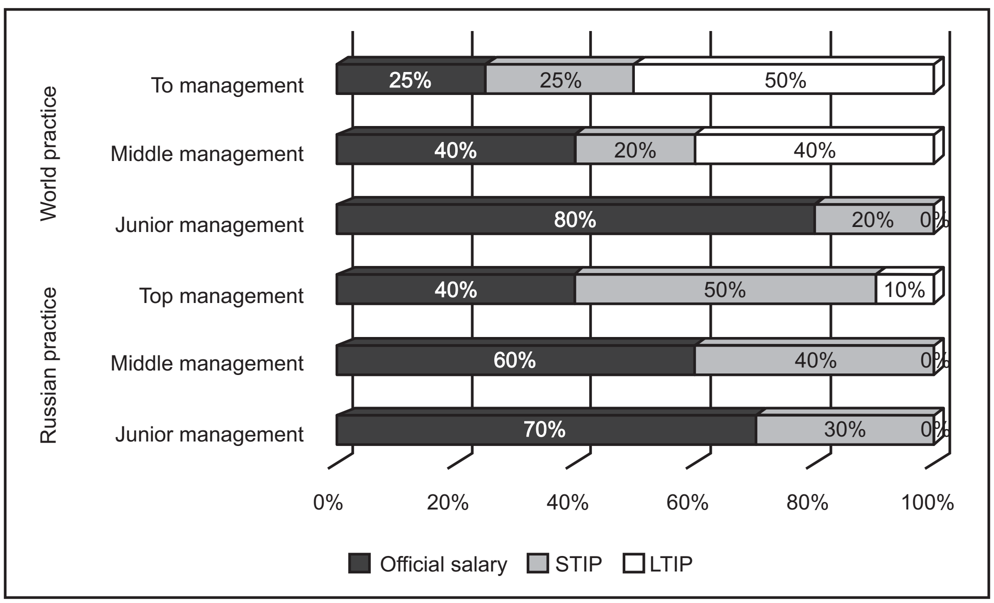

Figure 4.1: The structure of the annual income of top managers in Russia and abroad

In crisis, the management is focused on the achievement of short-term (operative) goals such as increasing sales, increasing profits, getting clients, etc. As the analysis shows, the share of short-term bonuses (short term incentive programmes – STIP) in the structure of income of management teams in companies is large enough (Figure 4.1). In these circumstances, it is important for companies to prevent the outflow of key heads, and the encouragement of achieving long-term results, such as the rise in the stock value, increase of company, profitability of stock capital, etc. takes the second place. Therefore, in these circumstances, it is important not to forget about the long-term incentive programmes that are characterized by significant advantages over the short-term incentive programmes (Golubev 2014; Bank of Russia Letter No. 105-T "On the Regulation of the Systems of Material Incentives in Credit Institutions", 2009).

The Financial Stability Board (FSB) has formulated 9 principles of terms of remuneration payment in financial institutions – Capital Requirements Directive III (CRD III). These principles are aimed at providing compensation in accordance with the achieved results with regard to risks of entrepreneurial activity (Chebotarev & Chebotarev 2008; *Key Attributes of Effective Resolution Regimes for Financial Institutions, 2014*).

The Committee on financial stability and CRD III have identified the following principles (Bank of Russia, 2016):

1. The system of remuneration itself should take into account the current and potential risks.
2. Not a fixed portion of the bonus should be reduced when receiving a negative performance.
3. For top managers the greater part of remunerations should be not fixed and should be tied to the overall performance of a financial institution; no less than 40% of the bonus should be deferred for a period of no less than 3 years.
4. The size of the deferred bonus should increase with the level growth of heads' posts.
5. At least 50% of non-fixed remuneration should be in the form of stocks or other derivative tools related to them.

The current labour legislation (Article 129 of the Labour Code) treats all incentives, including the annual bonuses, as an integral payroll component (part of salary). At the same time, incentive plans (the types of rewards, calculation and the decision-making procedures) are developed by each company internally and are included into employment contracts or collective agreements, as well as formalized in the corporate policies (*e.g.*, in Employee Incentive Policy).

It's worth paying attention to the fact that the "corporate governance code" ("Code") recommended by the Bank of Russia for application by joint-stock companies, the securities of which are admitted to on-exchange trading, enumerates the basic principles for incentive systems among which there are the following ones (Letter of the Central Bank of Russia No. 06-52/2463 "On Corporate Governance Code", 2014):

1. Bonuses for top managers should be managed to ensure a reasonable and justified balance between the fixed and the variable components.
2. The variable component should be based on the company's performance and on the individual contribution to the company's results.
3. The individual key performance indicators (KPIs) underlying the short-term motivation system should be relevant and aligned with the long-term strategy of the company.
4. The bonus system for key executive of institutions, the securities of which are admitted to on-exchange trading, should include the long-term motivation system using company share option plans.

The Code is not mandatory.

Thus, the Russian legislation currently sets no annual bonus caps.

On the contrary, in its Instruction of June 17, 2014 No. 154-I "On the procedure for assessing remuneration systems of credit institutions and the procedure for submitting to credit institutions orders to eliminate violations identified in their remuneration systems", which is mandatory, the Bank of Russia establishes that for risk taking institution's executive the target variable component of remuneration (provided the credit institution's performance targets are met) must be at least 40% of their total compensation. If the credit institution's performance targets or the ones in the respective direction of activities are not met the variable component of remuneration can be lower than 40% or not paid at all (Slepov 2015).

The similar approach to incentivising the risk-takers is recommended by the Bank of Russia in its guidance on payroll management and disclosure for certain non-credit financial institutions, aiming to prevent excessive exposure and maintain financial stability.

Although applying to a limited range of companies, these recommendations of the Central Bank of Russia illustrate its position that the annual bonuses of risk-takers should depend on their performance, *i.e.* on the company's financial results.

2. METHODS

The Bank of Russia does not offer the methods for calculation and application of the deferral of bonuses for top managers and other risk taking employees.

The most correct variant would be identifying material risks, indicators for these risks, permissible values on the basis of which the deferral for risk taking employees would be performed (Figure 3.2).

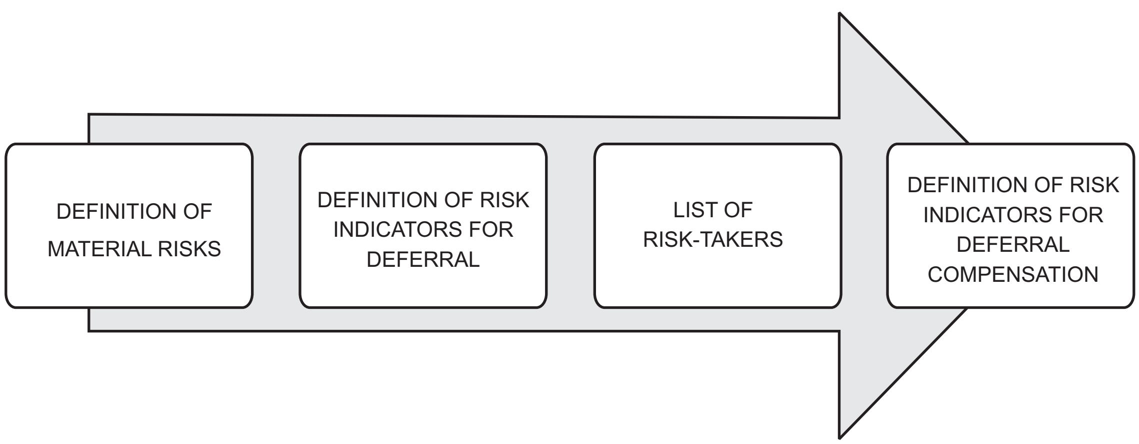

Figure 4.2: Procedure of deferral of the non-fixed component of remuneration

The risk indicators are defined by a credit institution. Their statutory value is set according to a business plan for institution development for 3 years (to calculate 40% of the deferred bonuses). The minimum Nmin and the maximum Nmax values of the statutory indicator are set.

If a risk-taker is a member of several taking various risks committees, 40% of the deferral (installment) is divided by these committees, as well as types of risks, in proportion to the risk exposure and risk materiality.

The deferral (installment) of bonuses for members of credit committees is applied to all of them, except for employees of risk management branches and the ones supervising the institution activities of the organization, regardless of the outcome of their vote at the committee meeting.

The amount of the deferral (installment) of bonuses for the executive body members and other risk taking employees is no less than 40% of the bonus size. Thus, 40% of the deferral is divided to 1 year, 2 year and 3 year periods proportionally to the share of average outstanding loans in the loan portfolio for the periods of under 1 year, from 1 year to 2 years and longer than 2 years respectively.

By the time of ending of the bonus payment deferral, the decision on the payment of the deferred part of the bonus is made based on finding the actual value of the risk indicator R act under the scale of statutory values (Nmax, Nmin). When the upper border of the statutory value of the risk indicator is gone beyond, the deferred bonus is not compensated. When the actual risk indicator is lower than the minimum statutory value of Nmin, the deferred bonus is compensated at full size (100%); and when the actual risk indicator is within the scale of statutory values, the rate of compensation of the deferred bonus C is calculated by the formula (Golubev 2014):

$$C = 100\% \times \frac{1 - (\mathrm{Ract} - \mathrm{Nmin})}{\mathrm{Nmax} - \mathrm{Nmin}},$$

where Ract is the actual value of the risk indicator,

Nmax, Nmin are respectively maximum and minimum values of the statutory ratio of the risk indicator.

However, this calculation can be quite time consuming. Therefore, many banks prefer to conduct the bonus deferral for all risk-takers (performing all kinds of risks) at once according to uniform bank performance indicators.

This is determined by the materiality level for bank transactions as monetary terms of transactions and other operations, the results of which may affect the bank's compliance with mandatory standards or occurrence of other situations challenging the interests of depositors and creditors, including the grounds for implementing measures to prevent financial insolvency (bankruptcy) of credit institutions.

The materiality level of transactions may be defined in the context of a single transaction/ single customer/ single product. Thus, the amount exceeding 1% of the bank's equity can be as monetary terms of the materiality level of transactions.

Compliance with the bank's practice and regulatory approaches is determined by the Department for methodology of risk management by the expert way, including on the basis of provisions of the Bank of Russia documents, within the banking risk management policies and practices in terms of risk taking sanctioning authority.

The deferral (installment) and subsequent adjustment of no less than 40% of the bonuses for taking risks employees for a 3 year period is performed by parts depending on the size of the loan portfolio by periods, for example:

1. A year after the reporting period in the amount of 35% of the deferred part of the bonus;
2. 2 years after the reporting period in the amount of 15% of the deferred part of the bonus;
3. 3 years after the reporting period in the amount of 50% of the deferred part of the bonus.

When receiving negative financial results over the bank in general, the bonus part divided into periods for a respective year may be reduced or cancelled.

The bonus calculation is performed proportionally to the amount of time worked in the status of a risk taking employee.

A list of key performance indicators for payment/adjustment of the deferred bonus for risk taking employees is set, for example, according to Table 4.1.

Table 4.1
Key performance indicators for payment/adjustment of the deferred bonus

The KPIs	*The weight of KPIs*	*Borders, min/max*	*Calculation of the KPIs values*	*Formula for calculating the indicator*
Net profit (Bank, International Financial Reporting Standards – IFRS)	80%	1.0	If the actual value by profit is < 0 the coefficient of KPIs performance is 0; If the actual value by profit is > 0 the coefficient of KPIs performance is 1	Net profit = operating result + non-operating income/expense – Selling, General and Administrative Expenses (SGA) (+) the amount of pre-setting up impairment allowance (restoring) +/- profit tax
Cost of risk (Bank, IFRS)	20%	0.8-0.1	If the actual /plan value is < 80%, the coefficient of KPIs performance is 1; If the actual/plan value is from 80% to 100% the coefficient of KPIs performance is calculated proportionally from 1.0 to 0.8; If the actual /plan value is > 100%, the coefficient of KPIs performance is 0	COR = the amount of pre-setting up impairment allowance (restoring) for 1 year (1) – average loan portfolio gross for 1 year (2), where (1) is the result of PL article “Provision for loan impairment”; (2) the average portfolio for the quarter = half sum of remains at the beginning and end of the quarter; The average portfolio for 1 year = the average weighted by the number of days portfolio for 4 quarters

The following bonus calculation formulas for payment of the deferred bonus (by the example of 2016 bonus) are used:

The part of the deferred bonus_2017

= Bonus for work results in 2016 × 40% × [35% × C tot_deferred __2017] × C adjust;

The part of the deferred bonus_2018

= Bonus for work results in 2016 × 40% × [15% × C tot_deferred __2018] × C adjust

The part of the deferred bonus_2019

= Bonus for work results in 2016 × 40% × [50% × C tot_deferred __2019] × C adjust

where: C tot_deferred_*i* is the coefficient of performance in the *i*-th year of the plan by KPIs that are used to adjust the deferred part of the bonus in accordance with the list of key performance indicators for payment/adjustment of the deferred bonus for risk taking employees, by their 1 year performance.

It is calculated by the formula:

C tot_deferred_*i*

= C KPIs_ net profit × Weight of KPIs net profit + C KPIs Cost of risk_*i*
× Weight of KPIs Cost of risk

Where C KPI*si* is the coefficient of performance in the *i*-th year of specific KPI*s* $.

The weight of the KPIs is the specific weight of specific KPIs in accordance with the list of key performance indicators for payment / adjustment of the deferred bonus for risk taking employees, by their 1 year performance $.

Cadjust – adjustment coefficient in the i-th year, equal to the ratio of the bank shares cost on the date of payment of the deferred bonus to the bank shares cost on the date of accruals of the deferred bonus.

Value of Ctot_deferred_*i* :

if Ctot_deferred_i <0.8 Ctot_deferred_i = 0;

if Ctot_deferred_i is from 0.8 to 1 Ctot_deferred_i is from 0.8 to 1;

if Ctot_deferred_i > 1 Ctot_deferred_i = 1.

Deferral accounting is conducted by the bank accounting staff using accounts of employees in terms of each deferral (without summation) for each year from the date of its establishment until their completion. In the case of employee dismissal, the deferrals are not paid, and when transferred between the bank branches, are kept.

3. DISCUSSION AND RESULTS

An example of remuneration payment to the employee of a corporate bank before and after CRD III is shown in Table 4.2.

Table 4.2
Example: payment of remuneration to the employee of a corporate bank thousand *e*

	A year	*+ 3months*	*+ 9months*	*+ 39 months*	*+ 45 months*
		TO CRD III			
Wages	250				
Bonus (cash)		2000			
		After CRD III			
Wages	250				
Bonus (cash)		400			
Bonus (stock 1)			400		
Deferred payment				600	
Deferred payment, stock 1					600
		After CRD IV (with the approval of the owner of limit 200%)			
Wages	750				
Bonus (cash)		300			
Bonus (stock 1)			300		
Deferred payment				450	
Deferred payment, stock 1					450

Source: 1. Stocks used delay after vesting, usually 6 months.

Recently, the taxpaying organizations more and more often deal with increasing attention of the tax authorities to the size of annual bonuses paid to employees (especially paid to key executive) and their deductibility reducing taxable profit.

At the same time, we can see how the tax authorities are paying more and more attention to the justification of bonus deductions of key institution's executive for profit tax purposes during tax audits (Deloitte CIS, 2016).

The tightening of control over bonus payments is evidenced by Draft Law No. 51799-74 pending in the Russian State Duma's Committee for Labour, Social Policy and Veterans Affairs. The draft is aimed at limiting the annual bonuses for top managers of state-owned institutions and companies to triple their average monthly pay. It runs contrary to the underlying economic essence and purpose of incentive payments, as the annual bonus size must depend solely on the company's financial performance and individual performance, therefore, may well exceed the triple monthly pay (Bill No. 51799-7 "On Introducing Changes in Article 145 of the Labour Code of the Russian Federation, 2016).

Given that various incentive payments set by the companies are treated by the Labour Code as part of employee's compensation, they can be deducted for labour expense purposes based on Item 2, Article 255 of the Russian Tax Code.

However, in order that the sums of paid annual bonuses could be taken into account as expenses reducing the taxable profits of institutions they must be simultaneously subject to the following criteria (The Central Bank of the Russian Federation, 2013; On Improvement of Organization of Supervision over Systemically Important Credit Institutions):

1. Payment of awards must be documented, i.e. envisaged in the employment contract and (or) collective agreement or other local corporate policies, and supported by an internal order.

2. The employer's bonus expenses must be justified. Justified expenses refer to economically justified costs with a value expressed in monetary terms. Thus, under the reasonable costs mean economically justified costs, which are expressed in monetary form.

3. The bonuses must not be paid out of special-purpose funds or special-purpose receipts.

While meeting the first and the third criteria is not a problem, the interpretation and the implementation of the second requirement is an issue due to the ambiguity of the concept of "expense justification" and its treatment by the tax and judicial authorities.

The annual bonus payments and its size must be economically justified, *i.e.* should correspond to the company's financial situation and the contribution to it by a bonus-given employee. Therefore, it is necessary to provide justification of economic feasibility of annual bonus payments should any questions from the tax authorities arise (*e.g.*, link the company's performance and respective employee's contribution/individual performance, make sure that there's no relation between the decision-makers and the bonus recipients, etc.).

The companies need to make sure that all paperwork underlying the payment of bonuses is in place (*e.g.* their regulation, including the bonus payment criteria, must be envisaged by the employment contracts, collective agreements or other local policies; bonus calculations must be documented, illustrating how the bonus is linked to the individual performance and the company's financial results; internal orders on payment of bonuses must be issued).

4. CONCLUSIONS

The long-term bonus plans are of interest not only for credit institutions in terms of accounting impact of risk factors on the remuneration size but for other institutions creating long-term incentive programmes to increase business value. Therefore, it is necessary to form long-term bonus plans not only for top managers and risk-takers but for more professional and talented company's personnel. This will "bind" employees to the company, make their relationship with it more strong and lasting which is favourable both for a company and employees.

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