HOW SHORT-TERM BONUSES CULTURE HAS LEAD TO INSTABILITY IN MANAGEMENT OF BANKS

Name

Course

Instructor

Date

1.0 INTRODUCTION

The global financial crisis which started last 2007 has brought vast devastation across the globe. During these turbulent years, the world has been rocked by news of mass layoffs of employees, closure of large financial institutions and companies, governments coming up with economic packages to bail out companies or financial institutions just to cushion the effect of the crisis, stock world market down and all of these things happening globally in the past two long years. These are the larger pictures of the global financial crisis. The other picture which is not much publicised is the day to day struggle of each and every ordinary person on the street trying to brace themselves, their families and their very lives from the horrors of the global financial meltdown. The urgency of the situation move the scholars to study and analyse what are the possible root cause or root causes of this financial meltdown that has a plunged the global economy into recession. (Dell'Arriccia et al, 2008; Persaud, 2008; Danielsson, 2008;Bordo, 2008; Reinhart, 2008). Recognising that the financial crisis is, indeed, multifactorial (Shutt, 2002; Wellink, 2009), there are still some details that seem to keep coming up in the discussion – short term bonuses and its connection, effects in the motivation of the performance of the roles and functions of managers in financial institutions.(Wellink, 2009)

Scholars are in agreement that short term bonus is one of the primordial reasons that cause the financial crunch. (Zalm, 2009; Buiter, 2008; Buchanan, 2009) The whole world seems to be caught in the world and web of greed and fear as played in the banking institution. And unfortunately, it is the ordinary persons who are paying the steepest price. Being such, it is claimed that more than the political and socio-economic reasons behind the financial crunch, there is a humongous psychological consideration that is fuelling the global financial crisis. (Shefrin, 2009)

The immensity of the financial crisis is undeniable and its repercussion very significant, there is an urgency in untangling the various ambiguous or even vague concepts that is behind short term bonuses in the banking system.

1.1 AIM

The primary aim of this paper is to understand the intricate connection between short term bonuses and instability with in the banking institution. And through this understanding, it is hoped that the clarification of the concept of short term bonus and the identification of the factors that makes it one of the principal aspects which contributed enormously in the current instability of the banking system and the global financial meltdown will, likewise, enable readers to explicate the manner with which short term bonuses culture has led to the instability of bank management and the first
financial crisis of the 21st century.

1.2 OBEJECTIVE

The major objectives of this dissertation proposal are:

1. To determine how the short-term culture in the banks has led to the near collapse of the entire banking system.

2. To determine the reasons because of which such a culture supporting short-term bonuses has been favoured in most banks even though it has caused the banks to become instable

3. To determine the reason for the instability in the management of certain banks that have a long standing culture of providing short-term bonuses to its employees and managerial staff members.

4. To determine the fact that even if an entity employee of a bank generated substantial short-term payback for the bank it does not in and of itself mean that the single member of staff is entitled to accept short-term bonuses.

5. To determine how the short-term bonus culture in banks has led to the first and biggest economic crisis of this century.

6. To enable the readers to be aware of some possible solutions to the problem of short term bonuses.

1.3 STATEMENT OF THE PROBLEM

The focal question that this paper intends to address is "*How short-term bonuses culture has led to instability in management of banks*?" In order to answer this particular query, the paper will tackle the following questions: first, what is shot term bonus? Second, why is it favoured over other forms of bonuses? Third, how short term bonuses are implemented in banks? Fourth, how short term bonuses have led to instability in the banking sector? And fifth, how short term bonus contributed to the global financial crisis?

1.4 SCOPE AND LIMITATION

The paper will principally look into short term bonuses, the concept and its effect to the banking system and how it has become one of the major causes of the biggest financial crunch of the century. The paper will not be discussing other factors such as politics, environment, socio-cultural factors, socio-cultural values and other similar aspects which have contributed to the global financial crisis. Likewise, the paper will not also discuss short term bonuses in other industries but will only zero-in on the banking industry. The paper will also not include in the discussions laws which deal with the issue at hand. Finally, the paper will not be doing a comparison of the varying approaches of different countries regarding the problem of short term bonuses as the leading of instability in the banking system.

1.5 SEARCH METHOD

In order to answer the questions raise in this paper, the database economics, EBSCO Premier were searched using the combination of the following key terms: *short term bonus, long term bonus, managers, banking system, global economic crisis, and financial crunch.* Articles written in English and published from the period of 1999 – 2009 were included in the selection. Likewise, articles that provided conceptual analysis, meta-analysis and empirical studies on short term bonuses in the banking system were selected. Correspondingly, excluded from the selection were editorials, opinions, laws and policies regarding short term bonuses in the banking system. The reference list of the articles was searched to identify additional relevant publications.

1.6 HYPOTHESIS

The current global financial crisis, which is the first in the 21st century, has tested the readiness and ability of the global community to respond to dire economic situations that afflict the whole world. In writing this paper certain assumptions or hypothesis are recognised by the researcher as influencing the manner with which the question is being approached. It is assumed that the managers or decision –makers are influenced by the environment, organizational goals and strategies, individual preferences and socio-political and economic dimensions which in turn influences the firm's performance. (Laverty, 1996). It is further hypothesised that incentives and remunerations are given to attract potential employees and to keep top calibre employees. However, short term bonus which is not part of the permanent remuneration creates a dynamic or mechanism that in the long run is detrimental to the quality of the performance of the job functions of the employee. Moreover, it can be impugned that short-term bonus cultures in banks have not only led to the instability in the management of banks but are perceived one of the root causes of the credit crunch which has devastated our economy.(Crotty & Epstein, 2009)

When it comes to risk, this research has been mostly based on the misconceptions pertinent to the type of financial risks that have been taken by most banks today. These misconceptions are due to an expanded observation of the efficiency of their existing risk models along with an inaccurate observation of the bonus culture and issues that are facing most of the financial institutions, i.e. banks, today. (Asaf 2004)

Of same importance, is the fact that short-term bonus culture which is perceptible in most banks today has encouraged the less experienced employees to take excessive risks disregarding R & D activities and investments necessary in attaining long term growth for the organization. This attitude of recklessness has hurt most banks leading to instability in their management and precipitating the financial crisis in the global economy. Thus, it can be said that short-term bonuses offered by most banks have proved to be drivers of irresponsibility, short-sighted behaviour, adventurism and most of all greed among the employees of the banks leading to total mismanagement in its working and disruption in the economies of the world. At the height of the financial crisis facing the world, it has become completely evident that short term bonuses are the main culprit behind the failure of most banks since they lure top bankers responsible for managing the big banks into publicly wasteful investments. (Regester 2007)

1.6 EXPECTED OUTCOME

The relevant and expected outcomes of this research are the following: first, it will provide a clearer conception of short term bonuses. And out from the presentation; deduce that short-term bonuses cause a drop in the quality of the performance of job functions of the employees in the banks. This is a result of the fact that banks are now becoming labour intensive (Nasir, 2009) and very competitive and short term bonus is best way to entice employees to work better and more. Thus, following this strategy, employees have to work very fast but the repercussion of which is that the output is of low quality. This paper also expects to show that short term bonuses changes the mentality or motivation of employees - their mentality changes as they know that if they increase or retain their level productivity they will still get a bonus, no matter what. (Berk 2007)

Furthermore, as short-term bonus oriented culture in major banks has caused banks to adopt excessive lending strategies and create and establish belligerent expansion policies which, definitely, have weakened their internal management policies, thereby, destabilizing the overall management of the banks. The sad news about this reality is that short term bonuses culture is one of the main culprits which led to the collapse of some well renowned banks like CITIGroup, BNP Paribas, Lehman Brothers, and UBS and which has plunged the global economy to a great recession of which the world has not yet been able to come out. (Pickett 2007)

There is a common agreement among scholars that short-term bonuses invite the managers and bankers to take high risks. (Abowd & Kaplan, 1999;Laverty, 1996;Griffith-Jones, 1999; Hope, 2009) because they have a very asymmetrical payment structure. The eventual outcome of such a situation is that if the high-risk investment made by the manager or banker becomes successful, then they are awarded with a generous compensation. But by chance if the high-risk investment fails even then the banker or manager involved enjoys his or hers fixed salary. Such a situation has caused a number of banks to become bankrupt since the bonus compensation culture in these banks failed to penalize critical recognitions of uncertain investments. (Robins & Krosinsky 2008)

In the next chapter, short term bonus will be discussed following the articulations of scholars as found in existing scholarly literatures.

CHAPTER II

LITERATURE REVIEW

2.1 INTRODUCTION

Understanding the nature of short term bonuses and its connection with the current instability in the banking system necessitates a re-look into two important aspects with which short term bonuses have been heavily connected. These two aspects being referred to are banks and remuneration.

The banking industry is separated from other industries in the society for its distinct characteristics. Nisar (2009) claims that the nature of banks are such that it is first, it is mainly a service industry and as a service industry it offers diverse, multi-products ranging from deposits to investments and mortgage. This aspect of the banking system is that which has greatly transformed in the past thirty years. This is maintained on the supposition that banking simple theory of banking is that banks act as the intermediaries between depositors and borrowers. (Acharya & Richardson, 2009) But, currently banks are acting more as intermediaries between *investors* (rather than depositors) and borrowers. (Acharya & Richardson, 2009; 5) Second, it is extremely labour intensive in the sense that it recognizes quality performance of job since it a service oriented industry and a low or high rate of customer satisfaction and relation becomes the parameter for quality assurance in the job. Third, it borrowed funds from the bulk of the capital employed and finally fourth, banks are subject to a considerable degree of control from regulatory authorities. But over and above these distinct characteristics of banks, it should be kept in mind that banks are primarily profit oriented just like any other members of the business sector.

The idea of remuneration, on the other hand, is always part of an organization it is the concrete form of the recognition of the competence and performance of the employees whether CEO or ordinary worker. In fact, it is acknowledged there is no one specific kind of remuneration for all types of companies or organizations. So much so, that each particular organization has to find the kind of remuneration that will “achieve balance and fit with their own organization and people.”(Jensen & Murphy, 2009; 3) Thus, in this context, the fundamental criteria for a good remuneration package for the CEO are the following: First, to attract the right executives at the lowest cost. Second, to retain the right executives at the lowest cost (and encourage the right executives to leave the firm at the appropriate time). And third, to motivate executives to take actions that create long-run shareholder value and avoid actions that destroy value. (Jensen & Murphy, 2009; Buchanan, 2009) However, in a study conducted by Jensen & Murphy (2009), they have found out that the trend in remuneration in the past thirty years shows that there is an increasing trend in the remuneration packages of CEOs that “In 1992, base salaries accounted for 38 percent of the $2.7 million average CEO pay package, while share options (valued at grant date using the Black- Scholes formula) accounted for 24 per cent. By the peak pay year 2000, base salaries accounted for only 17 percent of the average $14 million pay, while options accounted for half of pay. By 2002, average pay fell to $9.4 million, but options still comprised nearly half of the typical CEO’s pay package.”(31)

The increasing trend in the remuneration packages of the CEOs coupled with the changing nature of the banking system provide the framework with which the notion of short term culture flourish. What does this mean? What is short termism?

2.2 SHORT TERM BONUS: IN FOCUS

Firms and organizations for attracting and retaining their top performers, to motivate the behavior of the desired employees and for managing compensation costs, often offer short-term bonuses or incentives, just like salary, benefits, annual bonus. However, what differentiates short term bonus from other forms of remuneration is that short-term bonuses are not a permanent part of an employee's salary or basic pay and thus, it varies in quantity from time to time. This is possible because short termism, as a principle, is heavily oriented in short term profits disregarding long term research and development activities and investments. (Cescon,2002) One glaring logical repercussion of such a focus is that "the course of action that is best in the short term is not the same course of action that is best over the long run." (Laverty, 1996; 828) However, despite knowing this logical ramifications of short term bonus culture, the risks connected with it, apparently, is secondary only in consideration as there is a seeming emergence among banks in the UK of the concept of the bonus months which is claimed to be "the timings of bonus payouts (which) are designed to coincide with payments made by competitors to maximize a company's strategic goals. These may be, among other things, related to raising the company's profile among prospective employees and customers. Bonus schemes are also increasingly linked to wider business goals, thus replacing the traditional focus on output or profit measures."(Nisar, 2003; 32) These factors are important since it points to the fact that short term bonuses are basically used by companies as a way of enticing prospective employees and customers while at the same time attaining their corporate goals which moves beyond profit. The movement beyond profit provides a glimpse to the new dynamics of organizations in the global market, which is, incorporation of fast phase developments in technology, knowledge management, and globalization. Though the global market is confronted with new and distinct factors peculiar only to the contemporary period, what is amazing is the seeming recklessness in the handling of risk involve in financial institutions. The recklessness is deduced from the underlying principle of short term bonus which is *reward for a short term profit regardless of the repercussions of such an action in the future*. For example , supposing you have money and that you are very good in statistics but not a good poker play. But you know a good poker player. You have analyzed his results statistically and hire him to work for you. You pay him a fixed wage, accept occasional losses (that is all in the game) and as an incentive for playing well, you offer him 20% of the profits he makes for you. According to your analysis of his past results, this is a profitable contract for you. It is not difficult to understand that the expert poker player will play differently under this contract than he used to do. He will take more risks in the hope for big gains and he is not concerned about big losses because he will shift those to you and still has his fixed salary and possibly big gains from the past, which are not recouped. (Zalm, 2009) and this is what is seen in short term bonuses in banks. Transcribe this example in the banking system, the shareholder or stockholder hires an agent who will be doing business for him. This is commonly known as the *agency –relationship* which is defined as "contract under which one or more persons [the principal(s)] engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent' (Jensen and Meckling, 1976, p. 5).

The agency relationship is not without problem. The principal which is the stock holder hires an agent to do business for him. And in this scenario the executive or a bank agent is given lee way pertinent to decision –making. If their relation symmetrical, there is not much problem perceived since in a symmetrical relation the agent is pursuing the interests of the principal. On the other hand, if asymmetrical relation exists between the principal and the agent, it means that certain information is withheld thus resulting into inadequate disclosure of risk to the principal - example is the Citigroup.(Dash & Creswell 2008). The lack of transparency or non-full disclosure on the part of the agent leaves the principal not fully aware of the necessary information regarding the true mechanics and dynamics of his investments. Though, this makes the stakeholder appear to be not that much involve in the business and seems to leave everything to the agent (Windram, 2009) this does not mean that the agent has the license to do anything that he wants to the investments. In this kind of scenario, with no transparency in the transactions undertaken by the executives, there is a high probability that they will be more reckless in taking risk.(Windram, 2009; Gray & Canella, 1997; Abowd & Kaplan, 1999; Eccless, 1991)This is so because, win or lose, the executive will not be bearing the losses. This is possible since the agent will just be shifting the burden of lost to the principal anyway; he or she is paid regardless of the outcome of his management of risk. This contract binds them together. (Windram, 2005) As such, the banks pay their employees a huge incentive when they experience huge profits and also pay them when they have to go through horrendous loses. (Grosse 2008) Many traders, especially senior traders of banks, behave like this. If the employee gains a huge profit for year 1, she will be compensated well for that. And if in year 2 the company suffers losses out from the dealings that she makes in year 1, she is not compelled to return the huge compensation that she has received, even if they will be terminating her services. And astonishingly, “Financial institutions seem to be surprisingly willing to recruit individuals with losses on their resumes.”(Hull, 2007)

Another important consideration that should be considered when discussing short term bonus is the utility of short term bonus. When a company is in a financial distress meaning the company is facing financial adversity, short term bonus is given to CEO as a reward if they can stir the company away from financial distress. Thus, in such situations, CEO bonuses are often tied to short-term outcomes related to bringing the firm out of distress and successfully completing the restructuring. The ability to increase (short-run) cash flow, as well as other financial indicators of firm viability, is an important factor in the negotiations required to avoid the legal fees and other costs associated with financial restructuring or bankruptcy. “Thus, short-term financial measures should provide more informative signals of the managerial actions desired by shareholders in these situations, suggesting that firms will place less weight on non-financial performance measures when they are experiencing financial distress.”(Ittner et al,1997; 235)

The analysis of short term bonuses presents to us that short term bonus is a form of remuneration that is intended to attract and maintain top performers, to motivate employees to perform well and to acquire savings in compensation packages.

Moreover, it is also being used to entice both prospective employees and customers and to mark up the reputation of the company against competition. And lastly, short term bonus is utilised in saving a company undergoing financial distress. However, these characteristics of short term bonus are not without problems. Inherent in short term bonus is the fact that it focuses on short term profits not minding the long term repercussions of the action. Also, part of the concern with short term bonus, is the agency relation (which is problematic in itself) that is assumed by the two parties involved. And finally in all of these what should be kept in mind is that short term bonus is not part of the permanent part of the employee's salary, it is an incentive.

After gaining some conceptual clarification regarding short term bonus, it can now be ask, what went wrong?

2.4. SHORT TERM BONUSES: THE CHANGE NATURE OF RISK

The concept of risk is considered as a function of knowledge. The less the individual knows about the problem or the situation, the higher or greater the risk that the person is assuming. Thus, generally when individuals deal with risk, with its pros and cons, the common course of action is to reduce the risk. (Hodgetts, 1990) And basically, this is how banks are working.

Till 1970s the manner with which risks were taken by the banks included speculative trading and partnerships where the partners were allowed unlimited liabilities. Depending completely on the discretion of a partnership, the employees of a bank were awarded their bonuses. (Klein 2009) Only employees who produced a significant amount of profit were well paid and were entitled to bonuses. But, those who produced losses were not given any bonuses. In fact, they were blacklisted and often dismissed. During those tomes bankers possessed a keen sense of risk since the failure of a bank meant their own personal bankruptcy. There were no tax payers who could bail out the banks from their crisis situations and stop them from collapsing. However, things have changed.

Partnerships have almost disappeared and the principal institutional structures in banks nowadays have become their limited liability corporation. Banks “are now intermediaries between *investors* (rather than just depositors) and borrowers…bankers were increasingly paid through short-term cash bonuses based on volume and on marked-to-market profits, rather than on the long-term profitability of their bets.”(Acharya & Richardson, 2009;5,13) Such a transformation is one of the main reasons that has led to the culture of short-term bonuses in banks since it significantly cuts down the incentive of the bank’s senior management to supervise risk taking and management making it substantially instable. (MacCormack 2009) The banks that get engaged with speculative trading have to confront the inherent danger of its less experienced managers taking a lot of unnecessary risk which can even threaten the basic establishment of the firm. However, the other question that should be asked is what made the banks, the traders reckless in their estimation of risk?

In a study conducted by Avgoules (2009) he has cited several reasons which can be considered as factors that seem to have made banks little more reckless in their handling of risks compared with other industries. He claimed that various factors were acting as red flag signs but it was not given attention. He said that risk management were focused on failing credit, inability to properly value structured credit securities, excessive reliance on credit ratings, inadequate use of information when provided and ignorance of senior bank management regarding the true function of Special Investment. What aggravated this situation is the banking regulation and the resulting nature of banks after the deregulation of the banking industry.

Currently, banks enjoy public guarantees. Since the nature of the banking industry is such that the bankruptcy of a financial institution entails a weakening in the market particular and in the economy of the country in general. So, as much as possible, banks are not allowed to go bankrupt. And if there is a danger of it, taxpayers' money is used to bail them out. This strategy has created a strategy among banks which they call "interconnectedness". The bigger the bank, the more interconnected is it with other banks, the more the government will bail it out in case of bankruptcy. (Avguoleas 2009; Griffith- Jones, 2009; Tabellini, 2008; Cecchetti, 2008 a, 2008b) The government guarantee act as a "powerful perverse incentive to expand a banking institution's balance sheet obliterating the restraining power of market discipline". (Avgouleas, 2009; 22)

And within the circumstance of the changed nature of banks, of the changed perception of risk and risk management coupled with bank regulation and other socio-economic-political fact, the condition for the flourishing of short term bonus culture is entrenched.

2.3 PROBLEMS WITH SHORT TERM BONUSES

As stated before short-term bonuses have certain advantages, these are short term bonuses presents to us that short term bonus is a form of remuneration that is intended to attract and maintain top performers, to motivate employees to perform well and to acquire savings in compensation packages. Moreover, it is also being used to entice both prospective employees and customers and to mark up the reputation of the company against competition. And lastly, short term bonus is utilised in saving a company undergoing financial distress. Nevertheless, short term bonuses have created a whole gamut of problems that cause the instability in the banking system. These are:

First, banks belong to the service industry. Being such, the satisfaction and trust of the customer is of primary importance.(Wolf, 2007; Nisar 2009) However, in order to meet and exceed the productivity standards that have been set by the banks and receive the incentives; most bank employees work rapidly to meet their goals due to which a drop in their quality or performance is noticed. (Hutter & Power 2005) Furthermore, the moment that employees realize that they will get a short-term bonus at a regular interval, regardless of how they perform, an entitlement mentality gets set in their minds which indirectly affects the management of the banks as they tend to be lax and not highly motivated in the performance of their function. Now, if the quality and performance of the employees of a bank deteriorate then there will be instability in the management of the banks. (Robins & Krosinsky 2008) for as already mentioned banks belong to service industry and the satisfaction and trust of the customers are the buttress of the industry.

Second, as short-term bonus culture looks on short term profit, it has encouraged activities that involve high risks. And this behaviour has led to the instability in the management of banks. (Schotter & Weigelt, 1992) The banks take high risks to make spectacular profits. And since there are high profits, the management and employees gain their short-term bonuses. But if the banks have to go through losses then its employees and management staff do not have to shell out or forfeit from their own pockets and, at the same time, they do not lose any of their previous bonuses. (Chaudhry & Crick, 2007; Hull, 2007; Windram, 2009; Griffith-Jones, 2009)

Third, due to the stiffness of the competition in the banking industry, there is a strong tendency among the managerial staffs to define good performance in terms of high short term profit. This action or behaviour is detrimental for the banks since short term actions are taken without consideration of R & D activities and investments (Cescon, 2002). Looking only at the short term profits, they fail to realize is that most of the employees who are rewarded with bonuses produce those short-term gains by taking unnecessary risks at the expense of the bank. (Robins & Krosinsky 2008) Such short-term gains causes harm to the banks in the long run rather than bring profit since they amass longer term dangers. Due to such reckless actions of the employees and mistake on behalf of the banks in rewarding those reckless actions, a lot of problems have been created in not only managing the banks but also in global economy which
has led to the first complete economic depression of the 21st century. (Vishwanath 2007)

Fourth, once the management staffs realize that they are to receive bonuses they become indolent since they do not have to meet any performance targets set by the banks. As stated already, this is detrimental for the bank since the satisfaction, trust and keeping up with the good relation with the customers are the fundamental principles that drive the banking industry. Only those employees who have long term goals will want to stay in the banks and manage it properly. (Regester 2005)

Fifth, short-term bonus cultures and schemes in the banks instigate a pump-and-dump mentality due to which the banks encourage short-term profits as long as the economy and their management stay stable. The short-term bonus cultures in most banks are symptomatic of the shorter term strategies that most banks are opting for. This further leads to insufficient policies being integrated in their management systems causing their instability and sometimes even their collapse. (Robins & Krosinsky 2008) Most banks offer short-term bonuses with the intention of retaining their top managers but the attraction of instant remuneration and short-term growth has led to the movement of most executive managers of certain banks to other banks that offer higher bonuses. (Nottage 2009) Executives who have newly joined banks immediately try to find out ways of cost cutting, even if it hampers certain managerial decisions of the banks. This is done so that bank profits can be relatively increased and they, in turn, get instant rewards. Furthermore, due to cost cutting and implementation of newer strategies, the senior managers are not able to properly play their roles and the bank cannot pursue their coherent strategies intended for longer terms, especially in systems integration. (Pickett 2005)

Sixth, even in time of recession short-term remunerations have become unavoidable since they were previously guaranteed by the banks to their employees in response to profits that the employees had produced in the past. Thus, there is a need for bank managers and employees to ensure that the short-term bonus culture that they follow is consistent with the effective risk management schemes that have been designed especially for that particular bank. (Stern & Chew 2003) A number of economists have found that the culture of short-term bonuses followed by a number of banks is among the major reason that has contributed to the economic crisis facing our economy today. In order to re-establish the stability in the management of our banks today, they need to understand that senior managers need to be retained since they have much more experience than the junior ones. And for this, banks need to have long-term strategies which will discipline the risk takers. (Marar, Iyer & Brahme 2009)

Seventh, the short-term bonus culture has created a discrepancy between the interests of the banks and their management staffs which results into the instability in the management of banks. When a banker maximizes the bank's short-term remunerations the bank will be faced with the significant probability of having to incur huge future losses. For a short time the banks enjoy an attractive interest rate but are unable to repay the full principle in case a contingency takes place. Such short-term profits may appear to be remunerative for the bank but actually the ultimate consequence is that the bank has to suffer massive reputation damage, instability in its management and sometimes even lawsuits, eventually leading to its collapse. The central element of healthy banking gets destroyed along with people's investment in their trust and goodwill. (Suder 2008) The short-term bonus culture in banks has permeated into almost every banking activity. Certain basic banking activities, like the acquisition of long dated fixed income assets along with their funding and financing with the short-term low cost deposits have been subjected to the bonus compensation of most bankers. (Woodhead 2008)

Eight, unknown to many in good times, a large part of short term profit is paid out as bonuses. Because this profit is taken out of the banks, it is therefore not used to increase their capital, such that when crises come, banks are recapitalized by bailouts ultimately paid by tax-payers. It can be argued that taxpayers are paying after the fact for excessive bonuses. (Griffith-Jones 2009)

And indeed, the boom-bust is short lived. Greenspan (2009) claims that even during the 'golden era' of the financial industry during the 80's up to the first few years of the 21st century the crisis is just around the corner waiting to burst. Since, big short-term bonuses during good times and especially during time of economic crisis have proved to be nothing more than the perfect formula for the instability of the banks.(Griffith-Jones 2009)

Undebiably, short-term bonus culture has been established by the structural changes within most banks over the last 3 decades and it has directly contributed to the current financial difficulties, meltdown experience worldwide.(Marar, Iyer & Brahme 2009)

2.4 SHORT TERM BONUS: ITS CONSEQUENCES

Short term bonus culture that has been at play and considered as a viable strategy adopted in gaining short term profit has now shown its venom. As the world is reeling from the wave of economic depression brought about by the recklessness of risk managers in banks and other financial institutions, people have seen that one of the major perpetrators of the financial meltdown is short term bonuses itself.

With the real colour of short term bonus unmask, short term bonus culture has two very dire consequences – *instability in the banks and global financial meltdown in the world.*

2.4. a. INSTABILITY IN THE BANKS

There is a common sentiment among ordinary people in the street that banks are responsible for the consequences of all their transactions. (Missbach 2004) This simple trust that they have on banks is in fact the very lifeblood that drives and supports banks and financial institutions. The idea that banks will get your money and then run away with it is never part of a banks' image. But times have changed...

Short term bonus has greatly affected and influenced the behaviour of senior managers.(Shefrin, 2007) Observing the current financial situation, one can clearly see that the decision-making of senior traders and managers have been greatly influenced by the huge short term bonuses that they personally received as a guarantee for their services. "Executives in the financial sector are paid in large part in bonuses that are based on hitting profit targets or stock options, the value of which was hugely responsive to short-term profits. In both cases, there is an enormous incentive to show short-term profits. The same dynamic applies with hedge funds, where managers typically receive 20 percent of the gains. If the cost of the gains for a hedge fund in the current year are losses in future years, this poses little problem, since the managers do not share in the losses. " (Baker, 2008;78) The irrationality of the recklessness in taking high risk is in fact not irrational but driven by greed. That is why it is common in our time to see the concentration of wealth in the hands of financial executives. (Griffith –Jones 2009; Baker 2008) Unfortunately for the common people, the impact of short-term bonuses is far more controversial and ideologically charged than just their effect on the behaviour of senior managers. The compensation packages that have been designed for these bankers are such that they actually take advantage of the short-term bonuses that are given to them which in turn becomes detrimental for the bank. (Robins & Krosinsky 2008) Although bonuses and incentives are actually intended for retaining and motivating the top performers at the banks, it has been found that the reason why short-term bonuses pose such a huge problem is because the employees and less experienced managers of banks do not view short-term bonuses to be a part of their work and business. Rather, it has become the job. (Graham et al, 2006) This structure of compensation has given managers little incentive to plan for the long-term health of their own companies and encouraged all forms of risky behavior. The biggest incomes flow from generating large fees, even if there will be losses from the assets being sold. (Baker, 2008) Thus, for some bank managers and employees short term bonuses have become the business itself and not a mere remuneration for a job which they have done well. (Crouhy 2000)

Short term bonuses have caused instability in the banks because it has become the business itself (Crouch 2000). Managers have focused more on gaining short term bonus rather than securing the long term stability of their banks.(Baker, 2008) Their behaviour motivated by greed (Shefrin 2007) has secured only their interest and not the interest of the principal and the people. But more than that, they have designed the short term bonus packages so that they will gain a lot from the transactions. (Robins &

Krosinsky 2008) All of these factors combined together eroded the trust of the people to banks, which as mentioned earlier, is the lifeblood of the banking industry. Moreover, when people learned that bank regulations guarantee bailouts making the people the real payers of those excessive short term bonuses (Avgouleas, 2009; Griffith-Jones 2009; Wellink, 2009), the ire of the people on the recklessness and irresponsible actions of bank managers and senior traders is fanned because the people are the ones who are bearing the brunt heavily. This ire, in turn, redound to distrust in the banks, distrust in the banking system, thereby, resulting into instability in the banking system.

2.4.b GLOBAL FINANCIAL CRISIS

Though the global financial crisis is multifactorial (Shutt, 2002; Wellink, 2009), the 'interconnected nature' (Avgouleas 2009) of banks has brought to the fore the big role that short term bonus plays in the global financial meltdown. The whole process is intricate and complicated because of the multifarious aspects involve and the extent of the damage. However, what is surprising is that at the center of everything is short term bonus. What does this mean?

When trying to understand the role of short term bonus in the global financial meltdown, focus should be directed on two important aspects it. First, is the recklessness taken by managers and senior traders in entering into high risks transactions. Second, since banks are interconnected, the larger the group, the higher the probability that the government will bail it out if it experience bankruptcy. Thus in the end, it is the people's money that is used to pay the excessive short term bonus paid to the few executives, directors or managers of banks and financial institutions. How do these aspects of short term bonus contribute to the global financial meltdown?

In terms of risks, the high risks that are taken by most banks result in their high default probability along with a high proximity to bankruptcy. (Robins & Krosinsky 2008) Short-term bonuses of banks need to be supervised specially in such a crisis situation so that risky investments that have led to the instability of banks can be discouraged. Banks which have been ravaged by religiously following a short-term bonus culture need to review their proposals and policies so as to stop such a devastating practice. They need to come up with advanced ideas focusing on the central element of risk sensitivity. They should choose the appropriate technique for adjusting the capital for risk and profit which is most suitable for their existing circumstances. (Suder 2009) By doing this they can adjust their expectation to the risks taken. The problem here is that banks can gain very little knowledge from the outcomes about the risks which they have incurred in order to achieve the outcome itself. (Marar, Iyer & Brahme 2009)

In terms of bail outs, the problem with the ongoing payment of short-term bonuses in most banks is that they have been receiving the support of the public. This support comes in terms of what they call bail out- bail the banks out from their current financial crisis. It is completely absurd that the banks have to retain the services promised to its employees in the form of short-term bonuses even when the banks are facing financial crisis and already receiving public support. As the banks are losing money, it leaves no room for the justifications of payment of short-term bonuses. (Suder 2009) The recent economic crisis brutally reminds us how fragile the internal working of banks is. The managers of the banks need to acquire insurance in times of systemic crisis so that incentives are created for them. As a result of which they show concern about the stability of their banks. (Timber 2007) In the United States of America, the Wall Street Banks were paid a total of $18 billion in the last year during which the financial sector required almost $1 trillion, for its bailout, from the US taxpayers. (Marar, Iyer & Brahme 2009) This is absolutely alarming and also shameful. There appears to be a consensus where such an asymmetric payment structure often makes bonuses to be like a vehicle of private profits for the bankers and socialized loss for the bank itself. Such a view neglects to consider the fact that bonuses should be based on an employee's performance criterion which is ideally and typically outside the control of management. (Rath 2008)

The bonus culture in the banks has led to the instability in the management of the banks which has further caused the first and biggest economic crisis of this century.

2.5 IS THERE A WAY OUT?

The immensity of the situation prompted an immediate response from all people – from the academe, the policy-makers, economists, politicians and people from all walks of life. This is so because everybody is a stakeholder in this situation. Various frameworks or solutions have been forwarded with the primary intention of curbing the current financial meltdown so as to reduce the impact of the economic depression across the globe. It is also the intention of many scholars and stakeholders to formulate policies and strategies that will prevent similar events from happening again in the future. (Hamel, 2006; Hope, 2009, Griffith- Jones, 2009;Jensen & Murphy, 2009; Tosi et al, 2000;Wellink, 2009;Calomiris, 2009; Crotty, 2007)

Some of the solutions that they have given are:

1. Suspension of the bonus incentive. This move is a temporary, stop gap remedy intended to address the situation right now. Likewise, it can be viewed as a temporary measure of crisis management of banks which are technically bankrupt. As it is recognised that bonus culture cannot be completely dispensed in a day, senior managers need to realize how to effectively use bonuses as an instrument for guiding those under them in order to bring back the stability of banks.
2. There is a need for the thorough evaluation of management systems. Since their management systems are extremely profit oriented and, thus, short-sighted, they need to try and reward the employees based on their sustainable performances and other criterions like volume gathered across a longer and steadier sampling period and their average rate of growth. (Suder 2008) But in order to establish a culture favouring long term growth and stability, banks need to design compensation and bonus packages that are sustainable and stability oriented in order to reinforce their stable management and financial architecture.
3. The regulations to be imposed on banks explicitly needs to consider the impact it will have on the employees of the bank, both on the senior managers who will be monitoring the inexperienced risk takers as well as the junior and less experienced managers who are directly associated with risk taking. Senior managers who are more responsible for the stability of the banks need to defer a

significant part of the short-term bonus promised to them over a longer time period so that the amount can be directly related to the long-term fortunes and profits of the banks. (Suder 2009)

4. There is a need to review and rectify internal incentives and compensation policies so that the short-term incentives can be adjusted based on longer terms. (Frynas & Pigman 2008) in order to bring back the stability in the management of banks, senior managers who are getting public assistance must drop all of their remitted bonuses. (Marar, Iyer & Brahme 2009) Even the short-term bonuses of the junior employees need to be regulated so that the management can check the incentives for any gaming. The banks need to revise their structures since a bonus driven payoff structure will result in the instability in the management of the banks. Since, it possesses the lethal combination of excessive and reckless risk taking by the employees of the banks. The clear failure of the remuneration committee in the banks becomes evident where the non-executive directors are more than willing to authorize the ratcheting of most of the senior managers' incentives; while at the same time they are setting a comparatively unchallenging performance target. (Adams 2006) Thus, according to Magnan and Tebourbi (2009) "boards have to step up to the challenge and create new compensation programs that restore shareholder trust. Moreover, boards need to find a balance between the accountability provided by objective standards and their vulnerability to "gaming" by managers. Companies have to consider the simplicity, accuracy and reliability of these measures to ensure they are appropriate and contribute to the creation of shareholder value. At the same time, companies need to balance

long-term perspective with the requirement to evaluate managers each year.” (52)

5. Better transparency between the principal and the agent (Wellink 2009). Since the experience of CitiGroup (Dash & Creswell, 2008) has shown the world that lack of transparency and inadequate flow of necessary information is detrimental to the creation of a stable long term growth in the banking industry.
6. Since, bonuses are entrenched in the banking system already and the complicatedness of removing it from the system is next to impossible, it is suggested that there should be a regulating body that is going to over look and monitor the amount of bonuses that managers are receiving. (Griffith- Jones, 2009)
7. There is a need for the creation of a global financial institution that will act as overseer for the creation and development of a sound financial system across every country to ensure that financial meltdown can be avoided in the future. This is necessary, in fact, urgent in developing countries as a further collapse in the economy of these countries entails actual starvation, poverty even death for real living people.
8. Follow the lead of Toyota and Google, use lean management. As lean management (Womack et al, 1990) recognises the importance, intelligence and creativity of each employee and that these becomes fully manifest as everybody recognises the significance of teamwork in attaining the goals of the organization, of the centrality of cooperation among members of the team or group, the manager acting as a moderator egging her team to come up with better ideas or

strategies is perhaps a better incentive. This is working and true as experience in Toyota and Goolgle.

2.6 Conclusion

In order for banks to improve their situation, they need to take drastic steps. They need to review and rectify the errors which have been brought by adopting short term actions which yields high short term profits and short term bonuses as a strategy. Short term bonus when use as an incentive for managers to bring companies and firms out of financial distress and successfully complete the restructuring to save the company is a legitimate move. However, what the world has experienced is that the recklessness, adventurism and greed of some people have made them blind regarding the social responsibilities of banks. The instability of bank and the financial meltdown which is largely caused by excessive short term bonuses of some executives clearly show the failure of the equator principle which is supposed to be the beacon that will affirm and guide banking institutions to take responsibility for the consequences of their transactions. Perhaps, it can be claimed that the only good thing that results from all of these financial difficulties is that the whole situation opens up the urgency for the creation of a regulatory body that will ensure that similar events may be avoided in the future.

Due to the greed of some people, the whole world has been plunged into financial crisis. But through the concerted effort of everyone to rise up from the shackles of economic depression, the horizon for everybody may be bright and clear.

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