Mini-Review on the Relationship between Cash Compensation of Senior Executives and Bank Performance in China

Aihua Shi1, *, Jiaolong He1 and Mengyuan Chen2

1School of Economics and Management, Hebei College of Science and Technology, China
2School of Tourism and Hospitality, Management Development Institute of Singapore, Singapore

*Corresponding author e-mail: 1522621455@qq.com

Abstract. Employee compensation is the reward that reflects its value in providing services to the enterprise, including monetary compensation and non-monetary compensation. Monetary compensation refers to the economic income measured in currency obtained by employees by completing the work in their own positions, while non-monetary benefits are those that cannot be measured in currency, such as the distribution of self-produced products and provision of benefits such as health care services. Therefore, remuneration is a measure and manifestation of the value that employees bring to the company for their services. In this paper, reviews on the relationship between cash compensation of senior executives and bank performance are conducted from the aspects of definition of compensation requirement and bank performance, worldwide theoretical reviews, and empirical reviews. Based on the analysis of relationship between compensation and bank performance as well as managerial discretion and pay-performance sensitivity in different literatures, the laggings in China’s studies are discussed in the end.

Keywords: Cash Compensation; Senior Executives; Bank Performance; Managerial Discretion.

1. Introduction

1.1 Executive Compensation

Chinese listed bank typically implements the annual salary system to executives, which mainly includes basic remuneration, performance remuneration, and various welfare incomes. Basic remuneration is mainly determined by the nature of the work of the manager, the length of service, the responsibilities in the bank and the risk of assuming the responsibility. Performance remuneration is the part of remuneration that commercial banks pay to managers based on the manager’s annual performance appraisal results and the increase in revenue and expenditures that the manager brings to the bank. In other words, managers can use their own efforts to improve the level of performance appraisal indicators in the year to obtain an increase in performance compensation (Liang and Song, 2020). According to the relevant regulations of the China Banking Regulatory Commission, when designing performance-based compensation, commercial banks in China need to fully consider the bank’s risk and cost deductions. At the same time, they should also follow the bank’s sustainable development incentives and constraints. Welfare income is the various social insurance premiums and housing provident fund that commercial banks provide to managers in accordance with the relevant regulations of the country to ensure that senior executives are fully engaged in work. In addition, general executive compensation also includes some non-economic remuneration, such as the opportunities for political promotion (Cao et al., 2009) and the sense of accomplishment that work brings to them (Harvey, 1993), which cannot be directly measured by money. Therefore, the salary studied in this dissertation is only the part of salary that can be measured in currency in a narrow sense.

1.2 Bank Performance

Different scholars have their own views on the understanding and definition of the concept of performance. Drucker’s view of performance as explained in the book People and Performance: The
best of Peter Drucker on management believes that the synonym for performance is achievement, and the manager is the person who achieves this result (Drucker, 1995). Some scholars believe that performance is the efficiency and performance of completing the work (Robbins, 1987; Cherrington, 1989; Lebans and Euske, 2006).

The operating performance of an enterprise is the operating efficiency and performance achieved by an enterprise during a certain operating period, and it can reflect the profitability, solvency, and capital operation level of the enterprise. In empirical research, several indicators are used to express the performance, as conducted by The Balanced Scorecard Model (Kaplan and Norton, 1992). The most common are financial performance indicators and market performance indicators. Financial performance indicators mainly include actual accounting profit, earnings per share, return on total assets and return on equity. Market performance indicators include Tobin’s Q value, total stock value and stock return (Schneider et al., 2003; Gabčanová, 2012).

Commercial banks are different from ordinary enterprises. When measuring their comprehensive performance, profitability indicators as well as growth ability, risk tolerance and the liquidity of bank assets should be considered. It is a difficult problem whether to choose financial performance indicators or market performance indicators to represent the company’s performance. Market indicators can actually hardly represent the real situation of the company in China. Conyon and He (2012) shows that the correlation between executive compensation and accounting performance is stronger than that of market performance in China. At the same time, Firth and Fung (2007) found that Chinese listed companies rely heavily on accounting data related to profitability to determine executive compensation (Sorauren, 2000).

2. Review on Related Theoretical Studies

2.1 Agent Theory

In the theoretical literature, agency theory is widely used to justify the existence of executive compensation and its relation with firm performance. Initially in 1976, Jensen and Meckling recognized the relationship between the stockholders and top management within the corporation as a pure principal-agent relationship, and the two parties have divergences and conflicts in goals and interests and substantially suffer a struggle for the residual claims (Fama & Jensen, 1983), which is called the ‘agency problem’, as long as the corporation is not wholly-owned and managed by the owner. In general, this agency relationship can be regarded as a contractual relationship, and the compensation policy established can be seen as a constituent of an efficient contract for the alignment of interests and risks (Jensen & Meckling, 1976; Fama & Jensen, 1983; Eisenhardt, 1989; Jensen & Murphy, 1990). From the perspective of agency problem between outside equity holders (i.e. shareholders) and management, the design of compensation scheme should be closely related to what the shareholders are concern about, normally the corporate performance and its value, such as involving performance-based remuneration (Fama, 1980; Jensen & Murphy, 1990) and equity incentives (Jensen & Meckling, 1976).

Meanwhile, considering the existence of creditors or lenders in the agency problem, Jensen and Meckling (1976) propose that compensating executives in the form of partial debts is an effective way to reduce the conflict of interest between shareholders and creditors, such as pension and deferred payment of remuneration, which is called ‘inside debt’. It was after nearly three decades when the predominant focus was on the equity-based compensation in the literature, that Sundaram and Yermack (2007) draw the attention to the prevalence of ‘inside debt’ in the form of pensions or deferred compensation in the compensation package of CEOs in reality, and reemphasize its significance in reduce overall firm risk and thus the agency cost of debt. And this significance was highlighted further after the financial crisis in 2008 when the substantial bondholders had suffered losses, indicating that equity instrument alone in executive compensation is inadequate to play the role in solving the agency cost of debt (Edmans & Liu, 2011; Tung & Wang, 2012; Bennett, Güntay and Unal, 2015). In particular, Edmans and Liu (2011) point out the sensitivity of inside debt to
liquidation value and therefore considered it a superior solution and a substantial component in an efficient compensation scheme.

2.2 Corporate Governance Perspective

Apart from those related to the agency theory, Hambrick and Finkelstein (1987) contribute to the theory by formally introducing the concept of managerial discretion and suggesting that it can play an essential role in explaining some phenomena in companies, including compensation. Hambrick and Finkelstein (1987) defined managerial discretion as “the latitude of managerial action available to a decision maker”, and argue that it can play an essential role in explaining some phenomena in companies, including executive compensation, which in line with the point of view from Hambrick and Abrahamson (1995) and Mueller and Yun (1997). The issue that is related to this research is the impact of managerial discretion on performance-based compensation, which has been illustrated by considerable empirical studies. For example, Gomze-mejia, Tosi and Hinkin (1987) find executives in externally controlled firms, namely with less managerial discretion, receive more performance-based compensation than counterparts, because the outside dominant stockholders have more power to align the compensation of executives with the firm performance in their best interests; Finkelstein and Boyd (1998), Wright and Kroll (2002), Jing, Wan and Gao (2010), and Xia, Runian and Yuanyuan (2012) even suggest that CEO compensation is positively related to managerial discretion, which can justify the involvement of managerial discretion in the key variables in the compensation models later.

With regard to the construct of ‘managerial discretion’, Hambrick and Finkelstein (1987) focused on three determinants: the task environment (e.g. external industrial characteristics), internal organizational factors, and managerial characteristics. Since then, sufficient studies have been conducted on the measurement of managerial discretion, but mainly focus on the factor of industry task environment and the organization (Wangrow, Schepker & Barker, 2015), which will be discussed later in the empirical review.

3. Reviews on Empirical Studies of Executive and Bank Industry

3.1 The Particularity of Capital Structure

Compared with other enterprises, the proportion of equity of commercial banks is significantly lower. Under Basel III, the minimum capital adequacy ratio that banks must maintain is 85%. Because of this high-leverage capital structure, the funds of commercial banks mainly come from depositors and other creditors, among which deposits are the important source. The characteristics of high debt ratio implies that the operation risk of commercial banks is higher than that of ordinary enterprises (Al-Musalli and Ismail, 2012). Since creditors generally do not actively participate in the supervision and management of commercial banks, although commercial banks are always in a status of high leverage operations, they lack the supervision and control of general corporate governance, which makes the creditor governance mechanism of commercial banks invalid (De Andres and Valledado, 2008).

3.2 The Problem of Information Asymmetry

The problem of information asymmetry in commercial bank is concluded as two aspects. First, there is information asymmetry among depositors, supervisors and bank executives (Arun and Turner, 2004). Corporate governance theories generally analyze the information asymmetry between shareholders, directors and senior management. Creditors and small shareholders of commercial banks are at an information disadvantage and cannot effectively restrict large shareholders and senior management. The information asymmetry of the products provided by banks is more serious than that of ordinary tangible products. This puts depositors and regulators at an information disadvantage, and the role of external supervision is significantly weakened (Mullineux, 2006). The second is the asymmetry of information in the product market (Dell'Ariccia, 2001). The quality of monetary
products such as credit is difficult to observe in the short term, making the operating performance of commercial banks more difficult to evaluate than ordinary enterprises. This makes the external governance mechanism of commercial banks weaker than the governance mechanism of ordinary enterprises (Neuberger, 1998).

3.3 The Strict Supervision of the Industry

The financial sector is the core sector of the economic system, while commercial banks are the core of the financial system. The risks of the banking industry are contagious, which can affect the entire economic system. Once the banking industry has a crisis, it will cause very serious damage to the economy. The 1997 Asian financial crisis and the 2007 global financial crisis are good examples. Although the scope and intensity of the supervision of commercial banks in different countries are different during different periods, governments of all countries actively and strictly supervise commercial banks due to the fragility of bank operation and the particularity of the industry (Cihak et al., 2012). The purpose of bank supervision is to protect the interests of depositors as well as to prevent the risk of the banking system. The regulations on commercial banks have replaced and weakened the corporate governance mechanism of banks to a certain extent (Hopt, 2013).

4. Relationship between Executive Compensation and Bank Performance

Due to the distinctiveness of the operation of the banking industry and its pivotal position in the economic system, there are some previous researches on the salary of bank senior executives. Houston and James (1995) studied the characteristics of executive compensation in the banking industry. Due to the government’s strict supervision of the banking industry, bank executives are unwilling to increase bank operating performance and make themselves too risky. Therefore, executive compensation and operating performance is insensitive. Crawford, Ezzel, and Miles (1995) found that with the deregulation of banks’ cross-border operations, the sensitivity of bank executives’ compensation and performance has increased significantly. In addition, the sensitivity of salaries and bonuses, stock options, and common stock holdings has increased significantly, which indicated that the salary of financial corporate executives is related to corporate performance.

Marshall (2009) selects seven British retail banks, aggregates their information reflecting company performance and executive pay, and concludes a very weak positive association between the performance and pay, which even become weakly negative for the largest five banks. This conclusion does not conflict with Shiyyab et al. (2013), which shows executives are paid independent of performance with a sample of 65 EU banks. Likewise, in Korea, executive pay in banks is not linked to performance and the base salary is the main component of the compensation structure (Choe and Lee, 2003).

In China, Yang (2013) studied the relationship between bank executive compensation and performance. Considering that the executive compensation of the five major state-owned banks is not completely market-oriented and is subject to greater interference from the government, nine joint-stock commercial banks were selected for her research. The results found that the performance of the bank has a greater positive effect on the executive compensation, but the relationship between the executive compensation and the bank risk is not significant. Wang and Zhao (2015) conducted empirical analysis and found that executive compensation has a significant positive correlation with earnings per share, while a significant negative correlation with return on assets. Dong (2016) studied the relationship between executive compensation and bank performance, and found that executive compensation incentives of listed banks have a significant positive impact on company performance, whereas executives are more concerned about improving the absolute performance of the company in the market. Performance is insufficient to improve the bank’s return on assets. Jiang (2016) used the data of listed banks in China from 2010 to 2014 to conduct research, and found that the executive compensation incentive system of large state-owned banks was basically invalid. Although the executive compensation of joint-stock banks and city commercial banks had a positive effect on bank
performance. But the effect is not significant. In contrast, after the bank reforms in China, compensation of bank director seems to be associated with the bank performance (Zhou et al., 2011).

5. Managerial Discretion and Pay-Performance Sensitivity

Finkelstein and Hambrick (1989) pointed out that in reality, there are many factors that affect executive compensation. Ultimately however, it is determined by the effectiveness of corporate governance mechanism. The arrangement of managerial discretion is the most direct and comprehensive factor to reflect the effectiveness of corporate governance. A few scholars have studied the related factors of corporate governance structure. It is found that ownership concentration, ownership structure, proportion of external directors and other governance factors also have a significant impact on the sensitivity of managers’ compensation performance (Thompson, 1967; Tosi and Hinkin, 1987; Gerhart and Milkovich, 1990). Although managerial discretion belongs to the category of corporate governance, the concept is more comprehensive and has a more direct impact on various organizational outcome of the company. In fact, whether it is to change the ownership structure or the board system, the essence is to change the action space and behavior mode of managers. These governance mechanisms affect the managerial discretion, and are ultimately reflected in the company’s decision-making.

In the empirical works considering managerial discretion, there are some preliminary researches on the direct consequences of managerial discretion primarily focuses on executive compensation and firm performance. For instance, Finkelstein and Boyd (1998) found that managerial discretion is positively related to CEO compensation and this relationship is much stronger for high performers versus low performers. Boyd and Salamin (2001) found that strategic orientation affects the pay of all employees, not just top managers. Base pay is higher with change-oriented strategies. Bonus pay and bonus pay-to-base pay ratio are also higher with changed-oriented strategies but only at upper levels of hierarchy. Demsetz and Sidenberg (1999) suggest that pay-performance sensitivities in financial institutions vary with executive stature, which is somehow tied with the managerial discretion. In particular, in a study conducted by Magnan and Stonge (1997) based on the context of US commercial banking, they explicitly conclude that the level of managerial discretion moderates this pay-performance relationship.

In the banking industry, Crawford, Ezzell and Miles (1995) test the deregulation hypothesis that posits that bank CEO compensation became more sensitive to performance as bank management became less regulated. They observed a significant increase in pay-performance sensitivities from 1976-81 regulation subsample to 1982-88 deregulation subsample. These increases in pay sensitivities after deregulation are observed for salary and bonus, stock options, and common stock holdings. In the context of China, Zhang and Xie (2008) applied the data of 784 Chinese listed firms both of Shanghai Stock Exchange and Shenzhen Stock Exchange in 2004 and showed empirically proved delete proved that managerial discretion can negatively manipulate affect not manipulate CEO pay-performance sensitivity significantly and high managerial discretion without effective monitoring is the critical factor of persistent low CEO pay-performance sensitivity.

6. Executive Pay Restriction and Corporate Performance

Dittmann, Maug, and Zhang (2011) analyzed the impact of CEO compensation restrictions and found that compensation restriction makes managers increase the on-the-job consumption as an alternative to compensation. They believe that the degree of executive compensation restriction is positively related to the probability of executive corruption, which indirectly proves the impact of salary restriction on corporate performance. Thanassoulis (2012) discussed the theoretical foundation for compensation restrictions of bankers by analyzing the default risk of banks generated by investment and remuneration pressures. Regulators should introduce appropriate structural restrictions on the balance sheet ratio used for bonuses. Meanwhile, a strict bonus ceiling can destroy
value, increase the risk of default, and is not the best choice for a regulator as well. Dhole et al. (2015) studied the impact of the California Non-Profit Integrity Act of 2004 on CEO compensation, and found that despite the purpose of the Act was to ensure a just and reasonable executive compensation, the CEO compensation costs for affected nonprofits during the post-regulation periods have increased by about 6.3% when compared with a control group of comparable unaffected nonprofits. Kleymenova and Tuna (2018) found that the regulation of executive compensation in UK financial institutions has an ideal effect on motivating risk-taking motives, but it also brings unexpected consequences of increased executive turnover.

As a means of administrative power to interfere with the economy, salary restriction is widespread in Chinese state-owned enterprises. In order to strengthen the remuneration management of the senior executives of state-owned enterprises and make the remuneration structure of the senior executives of state-owned enterprises reasonable, appropriate and standardized, the government has issued a series of remuneration control policies. Some scholars have carried out relevant research on the issue of state-owned enterprise executive compensation control. Bae et al. (2017) used the data of listed companies in China from 2005 to 2015 and found that the salary restriction policy of 2009 is counterproductive. The monetary compensation of executives decreased, but executives compensated for the decrease in monetary compensation by increasing on-the-job consumption and encroaching on company resources, resulting in a decrease in company value. Shen and Li (2010) found that after the government promulgated the salary restriction policy in 2009, the salary level of state-owned enterprise executives rose instead of falling, and the effect of the salary restriction policy was limited. Tian and Zhang (2015) believed that the actual salary of executives is determined by both the executive’s formal contract and the relationship contract. The salary restriction policy only limits the salary that the executives receive from the formal contract, and has limited restriction on the benefits that the executives obtain from the relationship contract. Yang, Wang and Tang (2017) conducted research on the Remuneration System Reform Plan for Heads of Centrally Managed Enterprises issued in 2014, and found that the introduction of the salary restriction policy has distorted the original effective salary incentives, leading to the corporate value of competitive central enterprises reduction without significantly affecting the corporate value of monopolistic central enterprises.

7. Conclusion

In summary, this review suggests that there have been considerable studies on this topic across the world outside China regarding the relationship between cash compensation of senior executives and bank performance worldwide. Still, such research under Chinese background is somewhat limited, and in particular, the concept of managerial discretion has not covered at all, which brings some reference value to our research. In addition, the existing study on the effect of salary restriction policy in Chinese banks does not distinguish the level of managerial discretion, which may inspire further research in this dissertation.

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