Macrothink Institute™

Business Management and Strategy
ISSN 2157-6068
2018, Vol. 9, No. 1

Clawback Rule – The Ground of Managers Responsible. Model of Remuneration

Paweł Dec, PhD

Institute of Corporate Finance and Investment, Warsaw School of Economics

E-mail: pawel.dec@sgh.waw.pl

Prof. Piotr Masiukiewicz, PhD

Institute of Value Management, Warsaw School of Economics

Received: January 30, 2018 Accepted: February 28, 2018 Published: March 8, 2018

doi:10.5296/bms.v9i1.12560 URL: https://doi.org/10.5296/bms.v9i1.12560

Abstract

The paper concerns the duties and responsibilities of managers using the principle of clawback. The authors proposed their own model of financial model of construction of remuneration for managers. There are in practice ethical problems concerning the level of requirements and qualifications versus salary and the level of legal and financial liability, especially against top-managers of the largest enterprises; often in a situation of extensive economic and social impact of their decisions. The problem of a manager's responsibility has a dual nature. On the one hand the manager is charged with overall responsibility for all financial and PR losses of a company, on the other hand the manager takes moral, legal and financial responsibility for particular decisions. This article considers the financial responsibility area. The subprime financial crisis has sparked a discussion about the responsibility of top management in the context of disclosure of large bonuses paid to the senior managers and lack of consequences for bankruptcies. Very high salaries the executives were paid, were not sufficiently related to the system of contractual and administrative responsibility.

Keywords: clawback, model of remuneration, manager responsibility, motivation system
JEL: G32, M14, J53

1. Introduction

After the international financial crisis, subprime was taken discussion among researchers and practitioners on the responsibilities of managers; including financial responsibility. The discussion in the context of disclosures of large bonuses and bonuses paid to top-managers and in many cases not suffered the consequences of the bankruptcy. Very high level of wages and bonuses was not sufficiently linked to the system of civil liability, contractual and administrative. Moreover, many managers do not meet the challenge and in the face of the crisis, their management skills proved to be overvalued. In practice, there are ethical problems of the level of requirements and qualifications versus wages and the level of legal and financial consequences, especially against top-managers of major enterprises; in a situation sometimes extensive social and economic consequences of their decisions. The problem of responsibility manager has a dual nature; on the one hand he is charged with overall responsibility for all financial losses and image of the company, on the other hand, should bear personal responsibility ethical, legal and financial responsibility for specific decisions. The principle of clawback as the basis of financial responsibility is the subject of discussion in this article. The thesis of the article is as follows: criticism of high bonuses and the rule of law to errors caused the change in the approach of governments and business owners to the problem of the financial responsibility of top-managers and wider implementation of the principle of clawback as part of financial responsibility. The research methods used in this work: literature analysis, analysis of the regulation and case study.

2. Literature Review

Legal liability stems from certain regulations and contract can be in formal terms to distinguish the code, the responsibility (civil, criminal, labor, administrative - eg. Fines Financial Supervision Commission) and contractual (due to agreements and contracts managers) (Gregg et al. 2013, Crilly 2013, Ketola 2012). Any legal sanctions are allowed to use on the basis of the laws and regulations of work, while sanctions moral define the most common codes of ethics. Models financial responsibility of top managers for decisions in practice may have the following nature: (Dec, Masiukiewicz 2016)

1. Model of civil liability - is a model of limiting the responsibility of the manager to the company proven guilty by the court at the request of the injured person or institution (enterprise). You can significantly reduce the responsibility through the use of liability insurance.
2. Model administrative responsibility - a model widely used in the practice of the functioning of financial markets includes a system of administrative penalties imposed on managers for non-adjustment.
3. Model contractual liability - is a model of voluntary compliance to rules within the framework of corporate governance. The use of this model requires the determination of detailed rules of liability for loss of the company in the conditions of remuneration of managers and contract (employment contract), the manager (including the principle of clawback).

4. Model criminal liability is incurred liability requires proof of fault here before a criminal court. Processes criminal presidents and board members of companies are quite rare.

In the literature there are many studies and proposals for indicators to measure the effectiveness of the work of managers (Hosie, Nankervis 2016), but it is important to find a specific measure, which will be neutral to the specifics of the behavior of managers. According to analysis in large institutions can distinguish the following types of pejorative behavioral preferences of top-managers (Masiukiewicz, 2014):

- Appetite for high risk to satisfy ambition, high bonuses, etc.
- Abuse of the right to errors in the parallel civil insurance (liability for decisions) - giving a sense of impunity,
- A sense of confidence and infallibility of the ineffective functioning of corporate governance and supervision of the state,
- The tendency to circumvent the law in the name of higher goals of business,
- Low business ethics,
- Aware of the strength of support for the manager (from the owners, politicians, etc.), Instead of the requirements for professional qualifications and ethical standards.

Depending on the industry, size of operations and the internationalization of the company, models of responsibility should be diversified (Dec, Masiukiewicz, 2018). Many managers (including the recent financial crisis) managed to avoid responsibility. Usually, the only consequence was the loss of positions without giving reasons appeal. The members of the supervisory board for decision were sometimes linked with the management and share responsibility for wrong decisions. In this model, solving the problem of ethics was lost and created the conditions for subsequent precedents of avoiding responsibility. An example of a bank president, who did not suffer the consequences of the loss is Ch. Prince, the former CEO of Citigroup Incorporation, who was appointed in 2003. When the share price was 47 dollars. Later, the bank has created a highly risky portfolio of assets and entered into the zone of losses in 2007., And the share price fell to 0.72 USD. President paid 138 million dollars for his efforts in a good period. For the disaster in the bank did not suffer any responsibility and resigned in November 2007. (Masiukiewicz, 2014). In the EU and US in the light of published guidelines and directives as well as in the light of the practice of financial supervisors. It is a kind of revolution in the approach to responsibility managers. The US government introduced restrictions on the payment of dividends and salaries for managers of enterprises and banks benefiting from state aid based on the TARP program as a result of the crisis, and the law Dodd-Frank m. In. He forbade the granting of bonuses, which encourage to take a large, short-term risk (McGrane, Lucchetti, 2011).

The European Commission has issued a number of documents regulating the remuneration system and the accountability of managers. They recommend, among others, bond premium long-term results, and check in case of early termination of the contract shall not exceed two years' basic salaries, and in the case of termination due to unsatisfactory results briefing in general should not be paid. The Directive on the supervisory review of remuneration policies committed credit institutions, remuneration policy was in line with the business strategy, objectives, values and long-term interests of the institution (Directive, 2010).

The most important provisions of the directive, which was implemented in the European Union are:

- The management body (supervisory) should take the general principles of the remuneration policy and make periodic assessments of the implementation of the remuneration policy.
- In large institutions should be set up committees, remuneration.
- Fixed and variable components of remuneration should be properly balanced so that it was possible to conduct a flexible policy in this area, including pay no variable remuneration components.
- Payments for early termination of a contract must reflect performance achieved over time and adopted principles should not reward failure.
- At least 50% of the variable remuneration should consist of shares or similar titles or related instruments or equivalent non-cash instruments in the case of a non-listed credit institution.
- At least 40% of the variable remuneration component should be distributed (for payments) for a period of not less than three to five years.
- Variable remuneration is paid or acquire the right to it, if it is sustainable according to the financial situation of the institution and the results of the worker concerned, m. In. previously paid bonuses in case of deterioration of the results can be received.
- Employees in managerial positions are required to undertake not to use personal hedging strategies or insurance related to remuneration and responsibility.

Consequently, the implementation of the above. policies in financial institutions already established procedures clawback indicating the return of bonuses and bonuses received in the framework of contractual liability. Clawback procedures used in 2013. for example, Lloyds Bank - 13 executives bonuses withdrawn in the amount of 1.45 million pounds too risky sale of insurance policies; which produced 3.2 billion loss. They are also used in the HSBC Bank in Mexico due to money laundering, drug cartels and terrorist organizations. When the shares of his company JC Penney lost enormously in value, Ron Johnson, the former Director General (CEO) salary was reduced by 97 percent. And workers' wages have not fallen (and rightly so, because they should not). (Edmans 2016) Subsequent proposals for more stringent sanctions for top-managers of banks are discussed in the EU in light of the Report (High-level…). Special tests in the selection of the management board and the supervisory board, the legal framework motivation systems in conjunction with the financial responsibility of the Management Board, sanctions in the form of a ban on working in any financial institutions, and reimbursement received salaries.

3. Research Method and Proposed Model

Incentive systems - as a function of management - are there tended to specific behaviors and actions. If the cause of action reverse or other harmful effects, that is, they are wrong. Model remuneration must be coherent with the long-term growth of the company but also the contribution of labor and skills manager. In Britain, Theresa May launched a campaign crowned with success for Prime Minister speech, which promised to introduce restrictions wages managers at the highest levels. (Edmans 2016) It should be emphasized that the existing motivation systems of managers and decision-makers of very different financial institutions, especially during the subprime mortgage crisis that was not so distant, were not sufficient enough to impose work, as well as liability resulting from employment and civil liability (Schaefer-Munoz, 2010). It was significant that the majority of CEOs of large enterprises or financial institutions, as well as their management board members, practically did not carry any legal or even financial consequences of the temptation of abuse, in particular losses and bankruptcies. It is not obvious to confirm, let alone to prove that it was the incomplete or even wrong motivation system that caused the recent financial crisis in the world. All the more, it should be noted that the existing models of remuneration contributed once to the exac- tion of the crisis, and two to its greater negative consequences. That is why the boards have the main responsibility for this situation, which is to set up such incentive systems for top-level managers as well as decision-makers that will limit such threats described above. (Dec, Masiukiewicz, 2013). Enterprises take many more decisions - a much greater impact on society. This applies to hiring, restructuring or huge investments, which nevertheless rarely covers the regulations. It is therefore apparent that the call for regulation of wages may be due to jealousy, not that wages are social decision critical. (Murphy 2012) For motivation model's construction in a particular enterprise defining functions' aims to combine remuneration's elements is crucial. Dobbs, Huyett and Koller point that in most enterprises in financial sector remunerating for total return for shareholders (TRS) is no longer practised, however there are some companies that still practise this method (Dobbs et al., 2010). The authors imply, for example, underrated or overrated investors' expectations and factors which influence stock market courses regardless of managers. However, as a study of 500 managers has shown, building a model based on real achievements of managers is hard to do (Dobbs et al., 2010).

Features of a good motivation system for top-level managers can be varied depending on the culture of organization. To the broadest features there can be included:

- bright general aims and operational aims of the system of motivation,
- clarity of the system,
- perceptibility of the financial connected with professional status and competences,

- remuneration structure adequate for goals,
- precise rules of payment or forfeiture of changeable elements of remuneration (bonuses etc.),
- clearly defined forms of pay of particular remuneration elements (e.g. securities),
- rules of imposing financial penalties,
- criteria of losing right to severance pay and other gratifications at dissolving a contract, also at manager's fault.

Nowadays, in motivation models there are constant and changing remuneration elements, financial and non-financial elements, including securities and statutory or discretionary bonuses. Also important issues are terms of pays, amount of remuneration in relation to responsibility and temporal ban on selling securities obtained as bonuses. A financial model of construction of remuneration composed of regular and shirting elements is presented below [Masiukiewicz, 2011].

$$\sum Wr = \sum WP_{12} + \left[nxWP_{12}(f:C) + \Delta Kpw \right] + Pm(f:C) + SNF - Pdr - Pow - K - Ob$$

Where: Wr = annual income altogether, WP_{12} = monthly basic salary, nWP = bonuses including securities as n-times salary, Pm = discretionary bonuses, number m of bonuses awarded, Kpw = changes of market rates of bonuses paid in securities, SNF = non-financial benefits (paid in nature), Pdr = annual income tax, Pow = high remunerations tax, K = fines imposed by financial supervision authorities (banking law and stock exchange and securities trading regulations), Ob = postponed and conditional due to payment bonuses (depending on long-term f:C), (f:C) = function of particular motivation instrument's goal.

Elements of model which can significantly diversify this model in particular enterprises are: relations of constant elements of remuneration and bonuses (n and m parameters), national customs of paying benefits in kind (SNF parameter) and regulations standardizing penalizing managers (K parameter). Other additional bans, for example maximum ceiling of remunerations or time limits of sale of securities obtained as bonuses, they are also factors that differentiate a specific model employed in a bank.

4. Research Results and Discussion

Delphi survey method, carried out in Poland showed that most experts believe the application of the principle of clawback is right (Table. 1).

Table 1. Rating rules clawback

No.	Are introduced in the banks clawback rule (refund of all or part of bonuses and bonuses for managers in case of loss or intentional loss of profits) is: (1 reply)	Answers N=76	
		Number	%
1.	Very good option	30	39,5
2.	Good option	41	53,9

3.	Bad option	7	3,9
4.	No opinion	5	2,7

Source: own study.

Model of clawback liability besides advantages also has disadvantages, and among other things:

- can cause fear managers before making financial decisions,
- may cause postponement decision-making time,
- will be possible pressure on the supervisory boards of the increasing value of bonuses for managers to compensate potential financial penalties,
- will be possible civil proceedings dissatisfied / managers of victims before the court.

Penalties administration offices can play an important role as part of a system of financial responsibility. In practice, there are financial penalties for financial supervision, the state labor inspection, environmental inspection, sanitary inspection, etc. In connection with the punishment given to the directors of the bank Northern Rock - M. Cole, chairman of the FSA in the UK, said that this is also a message for the financial market, as they are meant action against top-managers in the sector, if they exceed acceptable standards of functioning (Enrich, 2010). Below are examples of the use of administrative penalties for managers in Poland (Table 2).

Table. 2. The penalties Imposed by the PFSA for the members of governing bodies, public companies and financial Institutions

Year	Number of penalties imposed	Net value of the penalties in m PLN
2006	12	0.70
2007	30	2.08
2008	55	4.03
2009	50	2.61
2010	51	5.40
2011	53	7.17
2012	53	5.09
2013	48	22.27
Including: penalties for management and supervisory boards over l. 2006-2013	50	-

Source: *Komisja Nadzoru Finansowego. Pięć lat działalności.* KNF. Warszawa. Retrieved from www.knf.gov.pl

Severe legal-organization sanction is the suspension of the president or a board member of a financial institution supervised by the PFSA. [Dec, Masiukiewicz 2016] Financial penalties imposed by the PFSA on both public companies and financial institutions and their managers are constantly increasing (Table 3).

The second example is the punishment for the destruction of the environment.

Table 3. Mandates for non-environmental laws

No.	Item	2011	2012	2013	2014	Change %
1.	The number of penalties imposed	1997	2353	1570	1 333	66,8
2.	The amount of penalties in the thousands PLN	575,1	734,7	531,7	464,4	80,7

Source: Informacja o realizacji zadań Inspekcji Ochrony Środowiska w 2011, 2012, 2013 i 2014 roku, masz. pow.

Chief Inspector of Environmental Protection has the power to impose penalties on companies that violate environmental regulations and mandates to managers (entrepreneurs). (Dec, Masiukiewicz 2016). In 2014, it imposed a total of 1 333 fines for environmental damage totaling 464.4 thousand PLN (Table 3). For several years, the number and amount of fines imposed decreases. When controlled refused to accept the mandate, the provincial environmental protection inspectors performed with the application to the district court.

6. Conclusions

The principle of unrestricted right to mistakes managers should no longer be applied in practice. High salaries of top-managers justify their financial responsibility and committed culpable errors. Forms of contractual liability and administrative may be different, for example, the principle of clawback entered into a contract, financial penalties of financial supervision, the supervisory power or state environmental inspection. These issues require further international research. Equalization of wage disparities broadly it should serve the tax measure. The financial liability of managers should suppress appetite for high risk activities - at the expense of society, the environment and employees. According to the authors, there is one more important conclusion from the last subprime crisis and the behavior of managers (or more strongly said: taking responsibility from them for making mistakes) - lack of proper education of top-level managers. And the lack of continuous and effective training during their professional life. It cannot be that after graduating from university, some managers completely ignore the need to expand their knowledge, while being careful that their previous professional achievements are their best guarantee and a certificate of high qualifications. Such thinking can only be considered and can work in the short term, because in the long run there will be shortages or misunderstandings of phenomena appearing in a turbulent environment. Hence the need to raise (and often also maintain) your qualifications by senior managers throughout your career, just as it is in the case of other professions, first of all with doctors at the forefront.

References

Crilly, D. (2013). Corporate Social Responsibility: A Multilevel Explanation of Why Managers do Good, in Peer C. Fiss, Bart Cambré, Axel Marx (ed.) Configurational Theory and Methods in Organizational Research. *Research in the Sociology of Organizations, 38,* 181-204.

Dec, P., & Masiukiewicz, P. (2013). Dysfunctions and Risks of Big Financial Institutions. *Business Systems and Economics, Research Journal, 3,* https://doi.org/10.13165/vse-13-3-2-06

Dec, P., & Masiukiewicz, P. (2018). Sharing Economy – New Phenomenon. *Business and Economic Research, 8*(2), 1. https://doi.org/10.5296/ber.v8i2.12522

Dec, P., & Masiukiewicz P. (2016). *Odpowiedzialność menedżerów*, Warszawa: Wydawnictwo Orgmasz.

Dobb, R., Huyett, B., & Koller, T. (2010). The CEO's Guide to Corporate Finance, *McKinsey Quarterly*, *4.*

Dyrektywa (2010). Parlamentu Europejskiego i Rady 2010/76/UE z dn. 24.11.2010 r.

w sprawie zmiany dyrektyw 2006/48/WE oraz 2006/49/WE w zakresie wymogów kapitałowych dotyczących portfela handlowego i resekurytyzacji oraz przeglądu nadzorczego polityki wynagrodzeń (Dz. Urz. U E, nr L 329 z dn. 14.12.2010).

Edmans, A. (2016). *Wynagrodzenia prezesów powinny ustalać rady nadzorcze, a nie politycy*. Retrieved from www.obserwatorfinansowy.pl.

Enrich, D. (2010). Northern Rock Pair Penalized by the FSA. *The Wall Street Journal*, 14.04.

Gregg, P., Jewell, S., & Tonks, I. (2013). *Executive Pay and Performance: Did Banker's Bonuses Cause the Crisis*. Retrieved from http://www.papers.ssrn.com.sol3-papers.cfm_abstract?id=1815210.

High-level Expert Group on the Reforming the Structure of the EU Banking Sector (2012). Final Report, Brussels, 2 October.

Hosie, P., & Nankervis, A. (2016). A multidimensional measure of managers' contextual and task performance. *Personnel Review, 45*(2), 419-447, https://doi.org/10.1108/pr-02-2014-0038

Informacja o realizacji zadań Inspekcji Ochrony Środowiska w 2011, 2012, 2013, 2014.

Ketola, T. (2012). Losing yourself: managerial persona and shadow pressures killing responsible leadership. *Journal of Management Development*, *31*(5), 470-487, https://doi.org/10.1108/02621711211226051

Komisja Nadzoru Finansowego. Pięć lat działalności. (2012). KNF.Warszawa. Retrieved from http://www.knf.gov.pl

Kujala, J., Lamsa, A. M., & Penttila, K. (2011), Managers' Moral Decision – Making Patterns Over Time: A Multidimensional Approach. *Journal of Business Ethics*, *100.*

McGrane, V., & Lucchetti, A. (2011). U.S. Wants More Pay Deferred. *The Wall Street Journal*, *7*(2).

Masiukiewicz, P. (2014). Responsibility of Bank Managers. *Krakowskie Studia Małopolskie*, *19*.

Masiukiewicz, P. (2015). Models of Financial Responsibility of Managers. *Journal of Applied Management and* Investments, *4*(4).

Murphy, K. J. (2012). *The politics of pay: A legislative history of executive compensation*. Research handbook on executive pay. Edward Elgar Publishers.

Schaefer-Munoz, S. (2010). EU Holds Hard Line on Banker Bonuses. *The Wall Street Journal*, *13*(12).