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New research by Macquarie University shows 'balanced scorecard' performance-based remuneration practices used in financial services sector are flawed

New research by Macquarie University's Department of Applied Finance released today showed some common industry remuneration practices are not as robust as many people thought with the balanced scorecard used to monitor variable remuneration significantly less effective than fixed remuneration when it comes to compliance outcomes.

The "Behaviour of Finance Professionals under the Balanced Scorecard" study is part of ongoing Macquarie University research into the balanced scorecard and was supported by Deloitte Australia, the Insurance Council of Australia, the Australian and New Zealand Institute of Insurance and Finance, and the Financial Services Institute of Australasia.

Macquarie University's Applied Finance Centre Associate Professor Elizabeth Sheedy said the study was ground-breaking investigating how various remuneration structures affect compliance with company policy. It focused specifically on how the balanced scorecard works to promote behaviour that is compliant with policy – a system that has come under scrutiny in the Royal Commission into Misconduct in Banking, Insurance and Financial Services.

According to the research, the highest rates (75%) of compliance were achieved under a fixed remuneration structure, whereas compliance rates fell significantly (62%) under a simplified balanced scorecard system. Dr Sheedy said the research showed under a compliance gateway, compliance rates fell further to 51% of participants.

"We began our experimental research on remuneration culture and compliance in 2017. This is the second such study. Interestingly, the balanced scorecard we tested did not lead to any significant uplift in productivity relative to fixed remuneration. This may be because the decision to breach, or not breach policy, slows participants down as they weigh up the chance of being caught and possible consequences. They must also consider issues such as moral identity and social standing, further slowing down the speed of mental processing. Under fixed remuneration, there is less need to consider such issues, and so the often-claimed loss in productivity is not observed," Dr Sheedy said.

"The aim of the study was to better understand the usefulness of the balanced scorecard for ensuring compliance with company policies. It was designed to mimic the typical financial services setting, where employees are under pressure to complete transactions for the benefit of shareholders. At times these aims of profit generation and compliance are in conflict, at least in the short-term; it is sometimes necessary to reject profitable opportunities to comply with company policy.

"The balanced scorecard is a system of performance measurement used when employees are expected to complete multiple, competing tasks. In a financial institution, employees are often expected to generate sales/profits while also complying with company policy. Policies could be designed to limit credit risk, underwriting risk, market risk and operational risks for the firm. This last category includes the possibility of legal/reputational costs flowing from, for example, misconduct toward customers."

Dr Sheedy said The Royal Commission has identified many examples of misconduct resulting in bad outcomes for customers and has refocused its attention on how remuneration practices influence behaviour. She further highlights the dearth of any other rigorous research to support the Balanced Scorecard.

"Based on this study, my previous research, the research of other academics, and the case studies presented by the Royal Commission, it is becoming increasingly difficult to justify the use of variable remuneration in financial services. I hope industry leaders and regulators will seriously consider this issue as we continue to do research in this crucial area of performance measurement and remuneration," Dr Sheedy said.

For more information

For interviews with Macquarie University Applied Finance Associate Professor Elizabeth Sheedy contact Karin Krueger on 0419 991 267 or karin.krueger@kdkmedia.com.au

For a copy of the research paper "Behaviour of Finance Professionals under the Balanced Scorecard" go to https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3283367

About the research

The "Behaviour of Finance Professionals under the Balanced Scorecard" study was authored by Macquarie University Applied Finance Associate Professor Elizabeth Sheedy (a specialist in financial risk management), Macquarie University Graduate School of Management Experimental Economist Dr Lyla Zhang, and visiting German scholar Dominik Steffan (enrolled in the elite Macquarie University Finance and Information Management program). To our knowledge, this is the first time that the balanced scorecard's impact on staff conduct has been tested under laboratory conditions. It is also the first research into 'Compliance Gateways' which are widely used in the financial services industry. Macquarie University recruited 318 finance professionals to participate in its second experimental study of variable remuneration. Members of ANZIIF (The Australian and New Zealand Institute of Insurance and Finance) made up 59% of the sample while 21% were members of FINSIA (Financial Services Institute of Australasia). The sole criterion for participation was employment in the financial services industry for a minimum of six months. Participants were required to spend approximately one hour in a temporary experimental laboratory located at Macquarie University's city campus at 123 Pitt St, Sydney. The initial design of the study was conducted in late 2017 - before the Royal Commission started. The scorecard used in this second study intentionally omits subjective criteria, such as managers ratings, as these have previously been shown to be affected by bias, and even collusion and extortion in extreme cases.

About the Balanced Scorecard

The concept of the Balanced Scorecard was introduced by Kaplan and Norton (1992). The original version expanded on mere financial performance measures and incorporated customer satisfaction, internal business processes and innovation and learning. Subsequently Kaplan and Norton emphasised that scorecard measures should depend on the organisation's strategy. In other words, the criteria chosen to measure performance should vary depending on what the organisation is trying to achieve. In an Australian financial institution, the typical Balanced Scorecard has multiple performance criteria of which some are financial (e.g. sales/profits) but others are non-financial (e.g. customer satisfaction, compliance with policy, behaviour consistent with company values), as shown in APRA (2018).

In 2016, the Australian Banking Association (ABA) commissioned Stephen Sedgwick to conduct a review of remuneration practices in retail banking. The final report, released in 2017, recommended that variable remuneration should not be based solely on financial measures, but on a broader set of measures (Sedgwick, 2017, see recommendation 3). This recommendation appears to be based primarily on guidance from the UK conduct regulator (FSA, 2013, at p. 20). The same FSA guidance, however, highlights that the success of the Balanced Scorecard is likely to depend on the importance given to non-sales criteria and whether those criteria reflect the fair treatment of customers.

Commonly used and simplistic measures of customer satisfaction, such as the net promoter score , may not achieve this. Further, a subsequent report from the UK conduct regulator documented that the increasing use of the Balanced Scorecard had not been as successful as had been hoped; this was attributed to the role of managerial discretion and biased ratings for some performance criteria (FCA, 2014, at p. 13).

When the Balanced Scorecard is implemented in a financial institution, it sometimes includes criteria that are difficult to judge objectively. An example of such a criterion would be 'Behaviour is consistent with organizational values' where the manager applies a rating. There is often doubt as to whether these ratings are credible; previous researchers have documented a range of problems with subjective management ratings. Centrality bias is the tendency to give all employees a similar rating, despite variation in performance, while leniency bias is the tendency to give higher performance ratings than are warranted. Bol (2011) shows that managers' own incentives and preferences can influence their ratings. Due to the large amount of managerial discretion in the ratings, and the desire to retain top performers in sales/profits, it is likely that managers may give a high rating to such staff despite poor behaviour. Even more worrying, subjective performance ratings can be prone to favouritism, collusion and extortion (Delfgaauw and Souverijn, 2016).

Not only is there a potential problem due to subjectivity, but bad behaviour often goes undetected (especially in the short-term) thus further limiting the usefulness of the rating. The difficulty of perfectly monitoring compliance behaviour, and hence the tendency for compliance ratings to be overstated, is a major challenge for the Balanced Scorecard.

If we have multiple performance criteria in a Balanced Scorecard, some objective and some subjective or measured imperfectly, what is the likely outcome? The economics literature suggests that in such a case staff will tend to focus on the objective criteria which are usually things like sales and profits (Holmstrom and Milgrom, 1991). In other words, the balance in the Balanced Scorecard goes out the window.

After reviewing more than 100 research studies on the topic, Danish scholars concluded that the "relevance" of the Balanced Scorecard system for remuneration remains unproven.