

Reward: A new paradigm?





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Introduction

Shareholders, regulators, the media, even management teams themselves, say compensation systems in financial services are in need of reform. Current practices, it is observed, are not only too short-term oriented but also fail to adequately link rewards with risks. But even though executives believe change is essential, their range of available action is relatively limited: history shows that unless the industry moves as one, talent will move to where reform is least evident.

It is an era where the earnings of many firms are distressed, not to mention the prevalence of layoffs and restructurings. But think back to just a few years ago. Back then an extended bull market created pressure to attract and retain top talent. So banks and other financial services firms began to rely increasingly not only on higher pay levels in general but also on short-term-oriented 'eat what you kill' incentive structures.

Fast forward to today, where a broad range of market, political and regulatory forces are including such practices as one of the many factors that have led to the current market downturn. Commentators are criticising financial services firms for incentive practices

that they say encourage undesirable behaviours ranging from excessive risk taking to over-emphasis on short-term results. Bonuses still being paid to executives at underperforming or distressed companies are viewed with particular enmity.

None of this can be proven definitively and there are many voices to the contrary. Nonetheless, what is known for certain is that, largely in response to these pressures, compensation practices are receiving increased scrutiny across the financial services industry.

The outcry for reform

Though particularly vocal currently, calls for reform are nothing new. For example, in his April 2008 speech, the governor of the Bank of England told the Commons Treasury Committee, 'I intend the Bank to contribute to the design of regulatory and incentive structures... to try to curb the excessive build-up of risk-taking and credit creation... which was seen ahead of the recent crisis.'

In July 2008, the Institute of International Finance (IIF), a global association of financial institutions chaired by Josef Ackermann, Chief Executive of Deutsche Bank, published a report on

market best-practices in which compensation policies were seen as one among many factors requiring closer scrutiny and reform. 'Market changes that have both catalysed and resulted from the growth of the originate-to-distribute business model have created incentives for both firms and individual employees that have, in some cases, conflicted with sound underwriting practices, realisation of risk management goals, or the long-term interests of shareholders'.¹

Then in September 2008, talk of a massive US\$700 billion bailout for the US financial services industry ushered in still more calls for compensation reform.

Legislators in the US said that incentive models in financial services are too skewed towards short-term reward. Others added that incentive systems are too asymmetrical, providing tremendous upside potential but failing to materially limit or even reduce compensation in the event of poor performance.

In general, all said that executive compensation is just too high. Not surprisingly, as part of the US bailout, legislation was drafted that would materially tie the hands of financial institutions in terms of executive compensation. For example, at those

¹ Institute of International Finance (IIF) Report – 07.08.

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institutions where the federal government takes on equity, there would be limits on incentives, especially those that encourage excessive risk taking (as defined by the US Treasury Department). Similarly, the US government would expect to be able to recoup bonus or incentive payments based on earnings data that might later prove to be materially inaccurate. Finally, executives such as the attorney general in the State of New York are calling upon the most senior of financial services executives to voluntarily forego their bonuses. Whether as an act of selfless leadership or of contrition, many are complying.

The principal responses

In short, if the industry does not act on its own, it is becoming more likely that others will take matters into their own hands. So in addition to growing regulatory mandates, many elements of the financial services industry are responding of their own accord. Some of the most visible actions include:

- **A shift towards longer term incentives.** There is a widely held perception that the short-termism inherent in incentive plans contributed substantially to the current credit crisis. In particular, there is concern that risk and compensation are not always closely aligned. For example, an executive might be able

to take a bonus based on a mark-to-market profit in one year which becomes a loss in subsequent years.

The fundamental realisation is that bonuses should be driven not by an annual measure of performance but rather on performance measured over a period that is closer to, if not beyond, the life of the activity in question. Incentives should not require or encourage executives to execute a quick 'flip' when the potential for the most value creation is over the longer term.

So executives are taking steps to replace short-incentive payouts with long-term programs featuring higher degrees of equity or deferral. Many firms are also considering making the eventual receipt of deferred bonuses subject to longer term performance: so-called clawback. This is in fact a core feature of the sweeping remuneration reforms just announced by UBS, a major recipient of bailout funds from the Swiss government.

- **A more intensive focus on risk.** If nothing else, the credit crisis highlights both real and potential shortcomings in the alignment between risk management and compensation. But while firms realise it is important to try to align risks more closely with compensation, the implementation is rarely straightforward.

For example, one means of introducing more risk focus into compensation is through capital charges. But invariably, disagreements over the relative riskiness of any activity ensue. Although increasingly, firms can look to third-party assessments of risk such as the capital adequacy guidelines within Basel II, executives can disagree on the basis of special circumstances or additional steps for risk mitigation.

Ultimately, a firm communicates its risk tolerances to employees through capital allocations and bonus programs. Rewards most certainly need to guard against excessive risk taking. But equally, compensation systems need a means of discouraging the taking of insufficient risks. Striking the correct balance may be difficult, and no system is likely to be perfect, but it is essential that firms begin to do a better job of linking risk to performance.

- **A shift from individual to organisational.** Some companies are also attempting to shift their cultures towards a more group-wide performance orientation. In particular, senior executives need a more group-based compensation plan in order to spur broader collaboration between business units.



Introducing a broader percentage of pay based on group performance may seem simple enough. But in practice, there is likely to be considerable resistance. For example, executives whose actions and commitment are delivering strong returns will likely resent seeing their compensation diminished by loss-producing business units.

So again, as important as the concept may be, implementation remains challenging. As ever, it is a question of striking the right balance. While a degree of group performance in remuneration seems sensible, institutions should be careful to prevent too great a shift. The profits of many institutions are derived not just from teams, but also primarily from the vision and efforts of talented and motivated individuals. To go too far in the direction of group performance over individual rewards could potentially do more harm than good by removing the incentives that drive the top performers in the industry.

- **Striking a better balance between variable and fixed.**

If firms are paying too high a proportion of total compensation in the form of bonuses, then executives may need a portion of their bonuses to maintain their basic standard of living. That practice can drive executives to take on too much risk or to make

short-term-oriented decisions designed to deliver bonus, not long-term value.

More than one major investment bank has allowed its compensation costs as a percentage of net revenues to rise above the normal range in order to retain key staff. If part of the bonus pool really is fixed, perhaps this should be acknowledged explicitly in how pay is structured. In essence, financial institutions are recognising that the failure to accept a higher degree of fixed costs actually contributes to risk.

- **Introducing greater communication in remuneration issues.**

Financial institutions recognise that there are fences that need mending in terms of communication with employees as well as shareholders. Firms need to engage with employees to explain the issues and develop solutions. Collaboration will lead to cooperation; action without the consultation of those expected to obey it will lead to talent flight. At the same time, executives need to communicate with shareholders regarding the changes to come as well as the associated challenges. The ultimate goal is to create compensation systems that are fair to employees while still aligning with stakeholder needs and longer term outcomes.

Overcoming the barriers

Firms want to reform remuneration. But in addition to the complexities noted above, there is yet another critical barrier: the difficulty of going it alone.

Consider the following scenario. Imagine if one investment bank were immediately to halve or even suspend its annual bonuses, converting instead to long-term equity incentive structures. If no other firms were taking similar actions, the immediate effect would be that top performers would leave the firm for more familiar compensation schemes.

This underlines an important point about reform in compensation systems – without industry-wide support for change, it will be very difficult for individual institutions to implement significant reforms. The fear that they will lose key staff is simply too great.

One way such risks might be mitigated is through coordinated, industry-wide effort. But even in this ideal scenario, a number of firms would resist reforms, creating short-term disruption and slowing overall progress. Still, over the long term, this would be the most effective approach.

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Other risks also bear mentioning. Poorly implemented reforms to a remuneration system could reduce motivation or simply fail to provide adequate incentives. The danger here is that banks restructure their compensation systems simply to please shareholders or regulators, only to find that employees are no longer sufficiently incentivised to perform to the level that is required.

But in the end, the real risk is adopting an absolute 'wait and see' approach. Compensation programs are currently clearly out of alignment both with risk and with the goals of shareholders. Though there may be a degree of first-mover 'disadvantage' in terms of talent retention, it is essential that firms begin a triage designed to solve at least their most glaring misalignments. Progress by increments is better than no progress at all.

