CRASH COURSE?

Words: Tim Smedley
Illustration: Peter Crowther

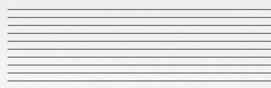
When it comes to **incentives**, you'd think we'd learnt our lesson from the **banking** crisis. But, although new **rules** will help, some City experts believe there is a **danger** the whole financial edifice could come **tumbling** down once more

The banking sector remains understandably defensive about the role bonuses played in the financial crisis of 2007-08. Take Tony Williams, HR director, global banking and markets, RBS, for example, who says: "You could argue that the outsized returns that many investment banks made for investors and stakeholders before the crash were positively motivated by bonuses." Similarly, Robert Potter, group head of HR at JLT, and head of the City HR Association, says: "If it's felt that remuneration may have contributed to the environment in which the financial crisis occurred, then it only contributed to a proportion of the crisis." However, Potter goes on to concede, "I think all recognise that it may have been a contributing factor."

The fact is: very few disagree with the Independent Commission on Banking's view that "prior to the crisis some bank employees were remunerated on the basis of reported profits that were neither time-adjusted nor risk-adjusted, and led to employee incentives that were not always aligned with the long-term interests of the bank". Or in the words of Nobel prize-winning economist Joseph Stiglitz, it was a system "... designed to encourage risk-taking – but it encouraged excessive risk-taking. In effect, it paid them to gamble."

Many on the outside have taken this to mean bonus payments and short-term risks are bad, and so fixed salary and long-term risks are good. Yet the actual story of how remuneration helped drive the City toward collapse is far murkier. And the way subsequent regulation has helped the sector back on its feet, even more so. Depending on who you believe, we are either entering much more sustainable economic times, or the opening lines to the next financial crisis have already been written.

'MONEY WILL ALWAYS FIND A WAY TO FLOW TO THE TOP, AND THE REGULATORS WILL NEVER BE AS CLEVER AS THE PEOPLE THEY ARE REGULATING'



BC (Before the Crash)

"This was all about instant profits, that's how people were measured. The risk element wasn't really in there." A former senior HR professional at an investment bank agreed to talk anonymously to *PM* – let's call him "Gordon". "Yes, the reward culture encouraged people to take risks, and that contributed to the crisis, for sure. If proper risk controls had been in place in terms of limits and management oversight, the crisis would not have happened." But he adds an important caveat: "That's what the management wanted – to encourage people to make money and take appropriate risks. That created the vast profits."

The key word is "appropriate". Prior to 2007 it was deemed appropriate to award cash bonuses many times larger than base pay, calculated on immediate financial success. If your trade made the bank money, you were paid accordingly. If the trade went bad years down the line, there were few, if any, consequences. Tony Williams says that before 2007, RBS paid bonuses "in cash, in full" every March. UBS told the Treasury Select Committee that it had been normal for senior investment bankers to earn "a multiple of between five and 10 times base pay". Gordon says, "I had guys I was paying £5 million a quarter, while their base pay would only be £100k, £150k a year. I heard of someone who didn't get paid their salary for six months by accident, and they didn't notice."

This is only problematic if there is a downside. Before 2007 there wasn't one – or, at least, not one that people were aware of. "Bonuses may have been a symptom rather than a cause," says Charles Cotton, the CIPD's adviser on reward. "While the salary and bonus may have seemed quite high for individuals, it wasn't an excessive drain on resources. They didn't get huge bonuses unless they brought in huge amounts of money. The problems occurred where they were mispricing the risk. And you could argue that a lot of people at board level did not understand the transactions that traders were carrying out on their behalf."

Nor did HR and reward. And even if they had understood, there was not much they could have done about it, explains Williams. Even when many firms saw employee reward begin to outstrip shareholder dividend, to reduce bonus payments would have been market suicide. That was exactly what happened in 2008 to RBS, now state run and harried by a public baying for bankers' blood. It went from cash bonus to fully deferred bonus way before the rest of the market. "Everybody realises what happens in those circumstances – you start losing your talent," says Williams. The bank's previous average of 7.5 to 8 per cent attrition doubled within 18 months, says Williams, "with hotspots far higher than that".

But it's a false notion that HR and reward professionals were sat timidly on the sidelines unable to warn of impending doom. No one recognised a problem with high-value reward for short-term risk-taking. It was how the City made money. As Vicky Wright, a former director at reward consultancy Towers Watson, and former CIPD president, says: "The risk wasn't necessarily a short-term transaction taking place, it was risky assets sitting on the books that someone had already been paid for." People were not incentivised to consider the long term. Deferred bonuses paid in shares existed but, says Gordon, "it was pointless, because the next employer would just buy it out, and we would do exactly the same for people coming to us".

You could say that the City needed saving from itself.

AD (After Disclosure)

Disclosure of remuneration in the banking and finance sector already existed prior to the crisis, not least in the Companies Act 2006 requirements for transparency in boardroom pay. But very little covered the remuneration of the traders and managers taking the biggest risks and earning the biggest bonuses. Now significant regulatory requirements have been put in place by the EU and UK on how pay should be structured and disclosed (*see panel, right, on the code*).

"It has had a significant operational impact on how remuneration is managed in the City," says Potter. The highlights include a rebalancing of fixed versus variable pay, bonuses to be paid at least half in shares, of which around half again should be deferred over three years, and making it harder for firms to "buy out" an individual's existing deferred bonus.

In May this year, Wright presided over a meeting of more than a hundred City remuneration professionals. She summarises, "deferment on remuneration is very much the order of the day now. As is a rebalancing between fixed and variable pay." The FSA code also enforces clawback – essentially allowing an employer to retrieve part or all of a bonus payment from an individual should their trade turn bad later on.

But pay was always only a contributing factor. "It's harder to talk about performance management and culture management; they are less tangible issues," says Cotton. It is these areas that Williams argues have seen the greatest changes, and are having the biggest impact.

"The first thing that RBS has spent a lot of time and money on is building better risk information systems," he says. "Once you understand what risks you're in, you can collectively

'DEFERMENT ON REMUNERATION IS VERY MUCH THE ORDER OF THE DAY NOW – AS IS A REBALANCING BETWEEN FIXED AND VARIABLE PAY'

make sure you are managing those risks robustly. There's a much more holistic view of risk across the organisation.

"From the HR perspective, once those areas of risk are defined, so are the roles that operate within them. There are a number of different risk metrics and financial metrics that we now set to roles... desk limits if you will. That is way more detailed and analytical than it used to be. You can define the KPIs for the individual, so performance reviews are much more systemic... risk is now measured and taken into account in the size of bonus pools." RBS also puts around 2,000 investment bank staff through 360 degree feedback, unheard of before the crisis.

All this would have been dismissed as "HR bureaucracy" in the past, says Williams. But now the need for robust performance management is understood and supported at board level.

And Wright says that, "HR people are thinking much more about how to have a good employment offer to ensure people aren't simply 'guns for hire'. Pay used to be the be-all and end-all of the employment contract... [but] we're seeing performance management and engagement more at the heart of banks now, and HR working more closely with Risk." This, says Potter, has caused many organisations to recognise, "the value that experienced reward consultants and HR professionals can bring. ⋙→

NEW REGULATIONS ON BANKERS' PAY

The following FSA *Remuneration Code* and CRD3 now apply to some 2,500 firms, including all banks and building societies and most other financial securities firms.

FSA Code
On 17 December 2010, the Financial Services Authority published the final version of its *Remuneration Code*. The code brings UK regulation broadly in line with the European and international guidance, CRD3 and Basel III (*see further down*). The overarching target is to align remuneration policy with sound risk management so that bonuses do not incentivise reckless conduct.

The majority of the code came into force on 1 January this year, with the remainder from July. The code requires:

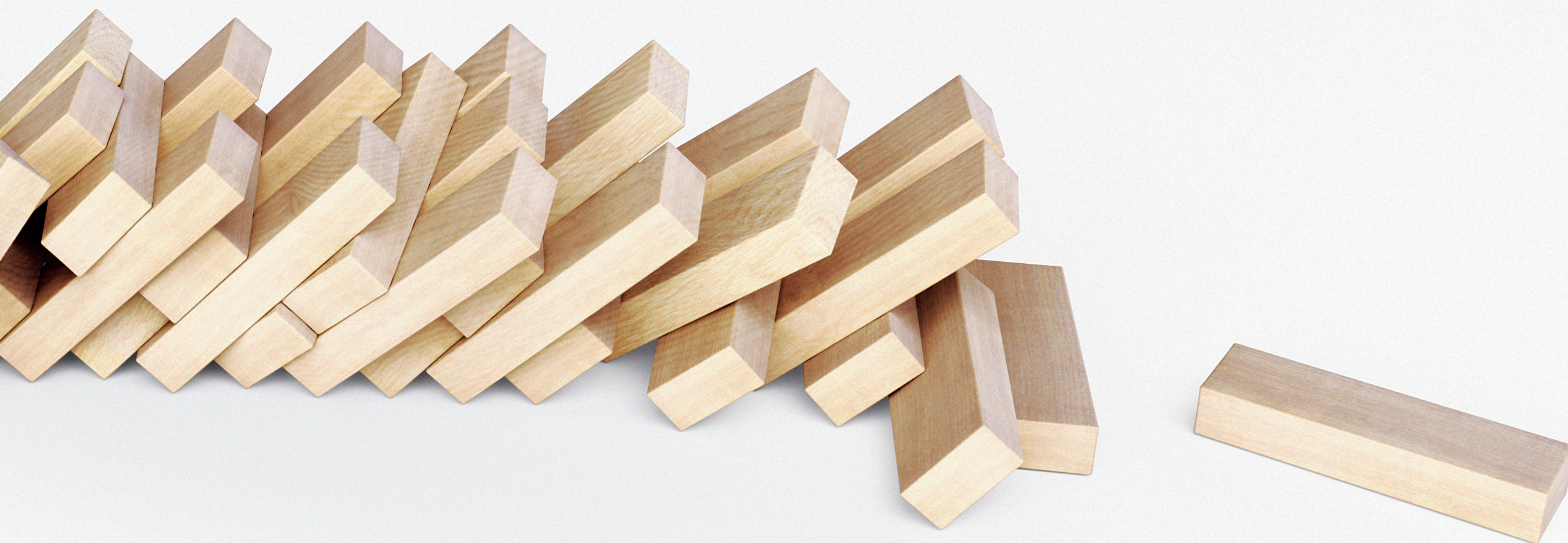
- At least 40 per cent of variable remuneration for code staff* to be deferred over a period of at least three years, rising to 60 per cent where annual total remuneration is more than £500,000.
- At least 50 per cent of variable remuneration to be paid in shares or other equivalent non-cash instruments.
- Firms not to offer guaranteed bonuses (or retention bonuses) of more than one year, and even then only in exceptional circumstances.
- A bigger role for remuneration committees, going beyond board remuneration to cover firm-wide remuneration policy, and a strengthening of their expertise.

*(*Remuneration code staff comprises categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management.)*

CRD3
The Capital Requirements Directive (CRD3) introduced EU requirements from the Committee of European Banking Supervisors for firms to make disclosures on remuneration. CRD3 covers the same staff as the FSA defined 'Code Staff'. Firms must now disclose information (usually in their annual report) in accordance with the 'Basel Pillar 3' framework, covering:

- the remuneration decision-making process;
- the design of the remuneration system;
- the link between pay and performance;
- performance criteria for assessing remuneration;
- parameters and rationale for variable compensation;
- total remuneration, variable remuneration, deferred remuneration, sign-on and severance payments in respect of senior management and risk takers.

Some additional wording by Simon Morris, partner, financial services, CMS Cameron McKenna LLP



There's been quite a lot of upgrading, specifically in respect to compensation," he says.

Similarly the remuneration committees (RemComs), in part through regulation and in part through natural progression, have moved on from simply looking at board-level compensation. "I have worked with two in the past couple of years," says Wright, "and they have a much broader brief than they used to have. They oversee, in effect, remuneration policy as a whole".

What will happen next?

Within the new banking regulations, however, you find a stipulation that is both comforting and troubling. Further to CRD3 are requirements for banks to hold a certain amount of equity capital, and to set at a 7 per cent baseline the ratio of equity to risk-weighted assets (expected to rise to 10 per cent). In essence this means that a bank must permanently retain more capital as a "cushion," to make government bail-outs less necessary. But, says Williams wryly, "regulators need to consider the law of unintended consequences".

Wright explains: "That banks need to hold more capital than they used to is very significant, because in order to produce a good rate of return on that they have to do better. So there will be increased pressure from shareholders about the return they are getting." As the pressure to perform increases, arguably so does the temptation to take short-term risks.

Added to that, "as base pay goes up, so the fixed costs of the bank go up", says Gordon. "If you pay most of your remuneration in variable pay, then in a bad cycle you would not pay much variable and you could survive. If you pay a large amount of salary, the only way you could recover from a bad cycle is to fire people. Which causes churn, which is actually a much higher risk. It could arguably cause more risk to be taken, because you have to work harder to get more return."

This, says Gordon, could create a City that is "truly mercenary", and where, "by the time you realise there's a problem, traders are two banks further on. The regulation is counter-productive."

If that seems a gloomy note to end on, the CIPD's Charles Cotton has a gloomier one: "The worry is that you always bring in regulation to deal with last year's problem. But what's the next financial crisis going to be about? And there will be one. But if it doesn't happen quickly, regulations tend to be weakened or ignored. Then a crisis does happen, and people say: what went wrong?" PM

LINKS & NOTES

- **FSA** Remuneration Code **https://fsahandbook.info/FSA/html/handbook**
- **FSA** paper on CRD3 rules **bit.ly/CRD3paper**
- **PM feature**, Nov 2009 "Mutiny on the bounty" **bit.ly/MutinyPM**

THE VIEW FROM THE INSIDE

A former senior HR professional at a City investment bank speaks candidly and incognito to *PM*:

"The reward system supported what the management wanted. They said: 'Go out and make us lots of money.'

"The problem was that management didn't understand the products their traders were selling. And if the traders were turning in very large profits, why would they look too closely at what was going on? With things like exotic derivatives, the trader was probably the only person that understood the product. I've heard of regulators looking at derivatives books with clearly no idea of what they were looking at, and still signing them off. So there was a lack of management control and a lack of supervisory knowledge.

"The whole raison d'etre of a reward professional is supporting the business model, and the business model was to make money in short-term bursts. It's not just that it would take a brave person to stand up and say 'This was wrong' – it wasn't wrong. It was a marketplace where people were paid for 'what you kill is what you eat'. If I'd done anything that caused a high-performing trader to leave, I would have been fired, and it didn't enter my mind, quite frankly.

"Pre-crash, those bringing in the biggest amount could act as they wanted. I remember one manager had four or five 'final' written warnings on his record, but no one was going to fire him because he made 10 per cent of the bank's profit. Some traders used to look at hardcore porn on their PCs, and no one said a word. I was described more than once by a trader as 'shit on his shoes', because he wanted to be paid offshore and we didn't do that.

"There was a high level of movement between the banks, and people didn't tend to stay more than three or four years. If you made a mistake, you were out; it was very cut-throat. If the particular product you were a specialist in ceased to be particularly profitable, your money fell away rapidly.

"The new FSA code won't make much difference. Giving RemComs, HR and Risk more power is fine until it affects shareholder value. No one wants to explain that they're not making as much money relative to the next bank because of remuneration decisions. Money will always find a way to flow to the top, and the regulators will never be as clever as the people they are regulating.

"Post-crash, people kept their heads down. Behaviour improved and the culture improved. But in two or three years' time, when things pick up again, we'll be back to the old ways. But before the crash, very large amounts of money were being made for an awful lot of people, including pensions funds. It was win-win. And we will get back there."