Practical steps to take the heat out of City bonuses

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Hardly a week goes by without a City representative weighing in with a view on the folly of current bonus structures in the banking sector and fingering financial sector compensation as one of the main culprits behind the credit crunch. Mervyn King, Governor of the Bank of England, says that he intends the Bank to extend its regulatory reach to include the design of incentive structures in an effort to 'curb the excessive build-up of risk-taking ... which was seen ahead of the recent crisis'. Hector Sants, Chair of the Financial Services Authority (FSA), has pledged to consider with 'increasing intensity' the implications of reward structures when judging the overall risk of individual institutions.

City executives seem to accept that something needs to change. The fact that the excesses of the credit boom have had repercussions far beyond the banking sector has ensured this. Earlier this year, John Thain, Chief Executive of Merrill Lynch, said that he intends to tackle excessive risk-taking by implementing a bonus structure that will be based on first the overall performance of the firm, then the unit an employee is working in, and finally the individual's own performance. Speaking at a financial markets regulation conference recently, Josef Ackermann, Deutsche Bank CEO, acknowledged that compensation structures were now firmly on the agendas of regulatory organisations. A recent report from the Institute of International Finance (IIF), chaired by Ackermann, said that bonuses should be deferred and pay should be set "on a risk-adjusted basis".

At this point it is useful to reflect on typical bonus practice in financial institutions. City bonuses not only tend to be substantially higher than in other industries, they are generally much more complex in the way that the bonus is delivered to the individual. Payment of some of the bonus is often deferred for anything between one and five years in order to encourage the individual to stay with the organisation. Part of the bonus may be paid in the form of shares to provide a link between the performance of the business as a whole and the individual's reward. Most employees are eligible to receive discretionary payments from a pool which is determined by the performance against financial targets. In sales and trading environments however, it is quite common to see bonuses driven by the performance of a team or an individual.

The criticism now being levelled at City institutions is that bonuses have been too much influenced by pure profit or revenue, and not enough account has been taken of the level of risk incurred in generating that profit or revenue. Take for example the case of Jerome Kerviel, the Societe Generale derivatives trader who built up high-risk trading positions that far exceeded his employer's market

capitalisation. Unwinding the exposure led to €4.9bn of losses in a four-day fire sale by the bank, and cost the chief executive his job. Kerviel had been expecting a bonus of €300,000 for his performance during the year - by no means exceptional by finance sector standards - and it is easy to speculate that his behaviour was influenced by this prospect.

The challenge for financial sector employers is how to incentivise their employees to take calculated risks (which will mean potentially larger bonuses for them), yet make sure that they are acting at all times in the best interests of the firm. Scrapping bonuses altogether is simply not an option. Financial institutions must find ways to make bonus plans safer, without taking away their power to channel employee behaviour in the right direction. There are a number of practical steps that they can take to help them achieve this:

1) Weight revenue or profit for bonus purposes according to the riskiness of the underlying transactions.

Increasingly finance sector firms are adjusting their bonus plans to reflect risk-adjusted return on capital, or Raroc, a measure which put simply tracks the expected return from a transaction against the maximum amount that could be lost as a result of making the transaction. Raroc clearly has the potential to weight employee reward towards less risky transactions, and is surely one of the factors that the FSA and the IIF expect to see incorporated into bonus plans in future. However there are problems to be worked through, notably in deciding where the risk should be measured. Charging for risk at the divisional level could disguise the higher risk associated with some products that make up the divisional portfolio. At the other end, considering Raroc for individual transactions, as bank lending divisions often do, is more problematic in a trading environment, as it may not be possible to assess the risk impact before a trader commits to a trade. However it should be possible to do so shortly afterwards, and if a trader knows the parameters he or she will understand the risk of the trade and the likely impact on their bonus.

2) Claw back bonus payments if positions taken during one financial year turn out to be loss-making in subsequent years.

This is feature that regulators and shareholders may expect to see in the future. Realistically this is only likely to be feasible where a deferred element of the bonus has not yet been paid to the individual. And even then it is fraught with difficulties. Reporting systems will have to be agile enough to keep track of transactions against individuals or teams responsible for them, and to ensure that employees' bonuses do not suffer twice - once through claw-back and once through impact on current year performance - as a result. And what happens if responsibility for a position passes onto to someone else in a subsequent year?

3) Maintain a strong link with the overall performance of the business
As John Thain of Merrill Lynch has already identified, bonus plans which depend on the overall performance of the business or team are less likely to encourage individual employees to take excessive risks in what they do to generate profit or revenue. It also encourages employees to take an interest in the activities of colleagues as colleagues' performance will also impact their own compensation - this should increase transparency and reduce risk-taking. There will still be areas where it is appropriate to retain bonus plans which focus on the results of a team or an individual, especially in sales and trading environments. Here it will be important to lay down clear guidelines as to the circumstances where this kind of plan is suitable, and on how the plans should be structured to prevent unnecessary risk-taking.

4) Defer a portion of bonus payments over a certain threshold, wherever practical into stock
Deferral remains an effective way of encouraging employees to remain with their employer. This in turn, as well as having many positive benefits in terms of employee effectiveness, makes it much less likely that an employee who incurs excessive risks will succeed in hiding this from his or her employer. Deferral into stock means that the eventual value of the deferred portion of the bonus is linked via the share price to the overall performance of the business, so that employees' have a continuing interest in their employer's financial success.

5) Benchmark bonus plans robustly so that payout levels remain competitive without being excessive
There is nowadays a wealth of pay benchmarking information available to finance sector employers that can be used to set bonus levels not only for on-target performance, but also above and below-target performance. A relatively new development though is the increase in the amount of business performance benchmarking information available. This new breed of survey tracks metrics such as headcount and total compensation cost against financial revenue. Overlaying this information on benchmark levels of bonus means that employers can set bonus parameters that are comparable on a like-for-like basis with market practice.

These are all ways in which some of the heat can be taken out of the current debate on City bonuses. Implementing them is likely to require the collective willpower on the part of the finance sector, as individual institutions are unlikely to make changes to bonus plan structure unless they know that their competitors are doing likewise. However there is now a momentum for change that hasn't been seen before, and if finance sector employers do not act themselves, they risk having change imposed on them through a mix of regulatory and shareholder action.

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