HOW BANKERS SHOULD BE PAID

The following article by Cliff Weight, of MM&K remuneration consultants appeared in Financial World in May 2008

The way bankers are paid does not work. In most cases the expected value of an executive's pay package will increase if his actions increase tail risk, tracking error and share price volatility. Executives receive asymmetric returns: they are not aligned with shareholders.

Most banks operate a simple rule that no more than 50% of net revenue should be paid out as pay. This is fine in theory, but most banks break their rule when income does not meet expectations.

Another typical rule is that a team/unit will share 20% of the profits between the team. The exact percentage will vary between the type of business, the particular skills of the team and their leverage in negotiation.

The banking pay problem is complex. A good start is to consider these ten issues:

1. Not enough bonus is deferred. The lack of handcuffs means that executives can move elsewhere and have too much leverage in their pay negotiations.
2. No "claw-back" if losses occur next year. Deferred pay should be contingent on future profits. A particularly case is when bonus is paid on "paper" profits, which may not recur in future years, or which fail to generate cash. MM&K do a lot of work with private equity companies, whose executives receive their incentive pay based on "cash on cash" returns – so aligning their interests with investors. Their incentives are also usually based on whole fund returns, rather than on a share of each investment, thus if one project fails the others need to make up for it before the executives receive any incentive pay.
3. No link to risk. "Profits" are not worth so much if there is a higher risk of losses.
4. No cost of capital. If a team/unit needs capital (or trades off the parent bank's credit rating) then the cost of capital (risk adjusted) should be charged prior to sharing profits.
5. It is also very difficult in some areas to identify whether the financials have been due to good performance or to luck. Some will argue that it does not matter. It is a question of culture whether you pay for financial measures, behavioural measures under the control of management, or take account of both. The affordability argument drives companies to link rewards to financial measures. Making pay a variable cost rather than a fixed cost makes strategic sense when it is a large part of the cost base. But when guaranteed bonuses are awarded, the "variable" cost becomes semi-fixed and the company loses both ways. Employees whose pay is based on financial measures may perceive higher levels of personal risk and demand a higher expected value of pay to compensate.
6. Does Tiger Woods' manager get paid more than Tiger? Of course not. Not by a long way. Yet many banks assume the manager has to be paid more than those in his/her team. I am not saying the star culture is wrong, just remember that the team manager is not (always) the "star".
7. Banking is a people business. Banks cannot grow without the people. If banks see an opportunity and wish to exploit it, they have to redeploy existing people or recruit externally. External recruits demand guaranteed bonuses. Hiring people is risky – at least 25% of senior recruits fail. Banks' HR strategy should be to recruit very few senior people: and instead to grow their own. Banks need to be tremendously effective in hiring high quality graduates/MBAs and growing them into partners/directors. Goldman Sachs do this very well.
8. The pay problem starts at the top. The US model of CEO pay is broken. It has been for years. Enron, WorldCom, Tyco, NYSE and Hollander are examples of the CEO having too much influence in setting their own pay. This is still the case as is shown by the large payoffs to the CEOs of Citigroup, Merrill Lynch, etc. [1]
9. Executives do not think and act like owners, because their pay does not encourage them to.
10. The Turnbull Report asked Boards to consider: "*Do the company's culture, code of conduct, human resource policies, and performance reward systems support the business objectives and risk management and internal control systems?*" Did the Board's of Northern Rock, Citigroup, Merrill Lynch and UBS consider this question? Boards need to pay more attention to Turnbull and establish ways to check that the incentives and pay arrangements support the culture the company wants.

[1] Next month Cliff Weight will write an article on CEO pay and how it should be structured.

Will things change? Will they get better?

There are 4 stages in change >>> 1. DENIAL>>> 2. ACCEPTANCE>>> 3. PLANNING>>> 4. IMPLEMENTATION.

I doubt much will change quickly. Most bankers are just about moving from Denial to Acceptance. This article is evidence of change. If you want to create value for your shareholders in the long term, it is time to move to the planning stage and start looking at better ways to pay people.

Cliff Weight is a director of MM&K, the leading firm of independent remuneration consultants. MM&K's roots are in banking, having been founded 35 years' ago by Morgan Grenfell. Our up to date expertise and long-term perspective means we are well suited to advise on bankers' pay.

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