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Health warning

Overgenerous or unmanaged bonuses, it is now clear, can damage an organisation's wealth and credibility. And while the initial panic over bonuses has run its course, the damage it has done will last for a long time and many bystanders, people not involved in the financial services world, will suffer from it for some years to come.

Although the reasons for the various financial crises are complex, it is generally accepted that the combination of unmanaged risks, greed and recklessness was made worse by seriously flawed bonus systems. Why were they so enormously generous? They were considerably more generous than required to provide firm incentives to inspiring leaders and diligent professionals. Frankly, it is hard to believe that there were quite so many outstandingly talented people in financial services, although many people have certainly been part of a successful business. Competition between institutions for the best talent led to ever higher promises of remuneration for those who appeared to be outstanding performers.

"Appeared to be"? Well, that's exactly what it was: the standards for judging high performance took too little account of the potential for performance in a job always difficult to assess. And the measure of performance took too little account of the quality of the output. There were, and still are, lessons to be learnt from the unfashionable world of manufacturing.

USEFUL BUT DANGEROUS Bonus schemes, where an individual or team is rewarded for some aspect of the results achieved, have been around for many years. And for many years employers have been anxious to have some link between results and what the producers of those results get paid as an incentive to perform highly.

There is nothing new about bonus schemes and concerns about their effect on performance, or more pertinently behaviours and attitudes. In the manufacturing industries there was a long debate on the use and value of such schemes; the debate ran from the 1930s to the 1970s and was pretty fierce at times. There were many studies, and Wilfred Brown's book, Piecework Abandoned, had a great influence on the way managers thought about schemes and how dangerous they could be if they got out of control.

In 1967, before most of today's dealers were born, the National Board for Prices and Incomes conducted a very substantial survey of such schemes and repeated the dangers. The board also recommended safeguards, which many of those who had been concerned with such schemes in manufacturing knew well. The principles are fairly simple even though they are not always easy to apply, and are listed in Box 1.

Even in simple manufacturing it is difficult to stick to these principles. The board found few schemes over three years old which had not become distorted, and only a few schemes that were maintained regularly; most schemes had drifted away from their original principles.

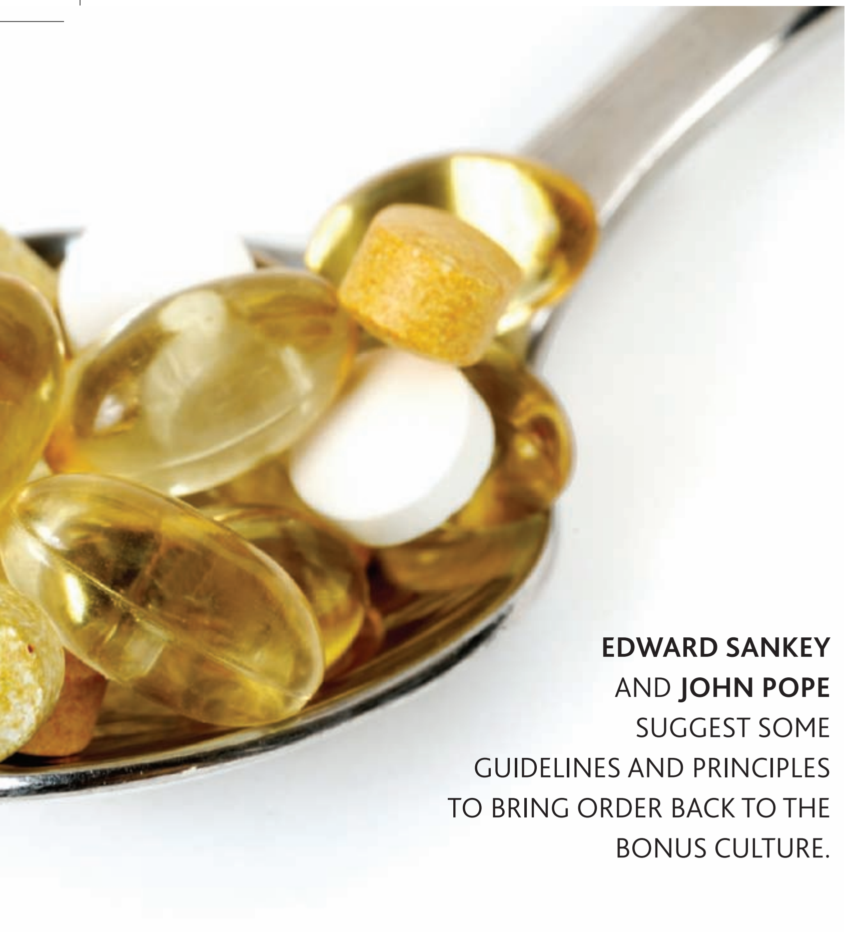
Above all, it is crucial to check regularly that the scheme is not abused, or misused, that managers do not get sloppy and make unwarranted concessions, and in particular that managers are managing their people, not concentrating on their personal bonus.

APPLYING THE PRINCIPLES TO KNOWLEDGE JOBS It is much easier to apply those principles to manufacturing, where output can be physically measured, than to knowledge jobs. It is also important not to destroy the animal spirits and entrepreneurial skills of dealers and traders. However, a bonus scheme that encourages cheating, error and undue risk-taking with client or shareholder funds is extremely dangerous. And where the results of some investment or other piece of business may not be realised for years, too strong an incentive can be catastrophic.

Hector Sants of the FSA has written to the UK's chief executives emphasising they must take fully into account the consequences of remuneration polices for a firm's risk profile. This is certainly good operational risk management practice. However, the FSA has said this before. This time the price of ignoring the linkage between incentives and risks is too clear and too high to be ignored.

Executive summary

- **Much criticism has accompanied the payment of bonuses during the present financial crisis. There is nothing new about paying bonuses to improve performance and the risks of such schemes are also well understood. By following sound principles and regularly monitoring the working of bonus schemes it should be possible to establish a real and sustainable link between performance and pay.**



EDWARD SANKEY AND **JOHN POPE** SUGGEST SOME GUIDELINES AND PRINCIPLES TO BRING ORDER BACK TO THE BONUS CULTURE.

FRAUD AND ULTRA-SHARP PRACTICE Incentive scheme fraud and sharp practice are never easy for any organisation to control. Even in a manufacturing business where an individual's bonus depends on jobs completed it is possible to find workers banking job tickets so that they count towards their bonus for payment in a particular week, variously called a bull-week or a pudding week. To prevent this, periodically a junior manager has to go around and verify job records and locate documentation, and periodically check the paperwork when the shop clerk is on holiday, just in case they're in on some racket. The same principles of independent and respected verification must apply in knowledge jobs. It is essential that organisations check for reckless behaviour, sharp practice, exceeding the limits, covering up losses, and fraud.

ALL SCHEMES DECAY Employees, whether in the manufacturing or banking sector, will typically attempt to make a scheme pay out more than it should, and when times are difficult and bonus levels fall, they will try to get round the restrictions and safeguards. This is very likely to happen if the bonus is very high by comparison with basic pay. If their managers are weak, not given a clear and enforced framework in which to plan bonuses, or are themselves benefiting from the apparent success of their staff, they will quietly condone bad practice to avoid trouble and the loss of key staff or simply out of self-interest.

Bonus schemes decay faster when they are not regularly reviewed or audited. They are corrupted when people have to be dissuaded from leaving the company, or need to be attracted to join the organisation by secret concessions that no one else is supposed to know about. And these problems are usually the result of a sloppy (not "flexible") remuneration policy, domineering managers, inattentive human resources departments or line managers keen to avoid having to handle a vacancy and recruitment problem. These problems are undoubtedly the responsibility of senior management to prevent.

The distortion and self-deception becomes evident in oxymorons such as "guaranteed bonus", which is a contradiction in terms. It shows that there is some practice that will not bear scrutiny.

INCENTIVES AND BEHAVIOUR Organisations use incentives to encourage staff to adopt behaviours they believe are profitable. Those behaviours include attitudes to risk, to competitiveness, to trusting judgement, to assessing and grasping opportunities, to winning business from others, and more beside.

The key questions to ask about an organisation's present or planned incentive scheme are:

- Are you clear on the behaviours you want?
- Do your present arrangements encourage the right behaviours?
- Do they also encourage harmful or dangerous behaviours?
- How do you design your scheme to control the inherent risks?
- How do you limit the external risks?

Strong incentives that encourage people to make ever greater efforts to build revenues and trading margins also tempt them to find increasingly complex ways of earning them. But using controls to help prevent this will only create an unstable situation. If there are two strong and opposing forces, it will not take much for the balance to break down. Sooner or later forceful managers in money-making businesses and highly ambitious staff will overcome the controls, as was seen at Barings, Société Générale and in many investment banking businesses engaged in sub-prime and other derivatives.

It is important that any reward scheme aligns, both in short term and long term, the interests of shareholders, managers and staff. Nowhere is this more important than in the volatile world of the financial sector. In recent years, these interests have seen seriously out of balance, and reward systems have tilted strongly towards the workforce and away from owners and investors.

WHAT CAN BE DONE? Incentives can create – or should be designed to do so – mutually profitable behaviours. And there are some principles which stem from this. For the investment manager and trader, exposure should be treated as if it were their own; limits and controls must be adhered to, there must be enough evaluation

Box 1: Principles

- Pay a flat, basic rate for normal performance that you expect regularly from those with the skills needed for the work and the opportunities to get good results.
- Pay an incentive for performance improvements achieved through the recipient's own extra skill and effort.
- If individuals' performance depends substantially on others in a group, pay the incentive to the group, not the individuals.
- Pay incentive only for good work. Don't pay for scrap and don't count work until it proves to be good.
- Limit incentives to a reasonable amount. A bonus is an extra and people need to be able to live on the basic. In the manufacturing sector, bonuses are conventionally one-third of basic pay.
- Share out equally the good and poor opportunities to earn. That way you avoid breeding greedy superstars who disrupt the team.
- Have a rational means of measuring or valuing independently work done.
- Keep good records so you know who has produced what.
- Do not corrupt the scheme to fix a short-term problem.

Box 2: Recognise the flags

The green flags to collect

- Align the bonus scheme with the shareholders' fortunes and corporate objectives. In good times employees and the organisation's owners share the gain; in bad times both share the pain. Don't pay advance bonuses on the assumption that performances will be good.
- Relate the bonus scheme and employee benefits to the exposures the individual and the business unit are responsible for managing, as well as to the rewards. Assess how exposure to undue risk will be affected by the bonus scheme.
- Make the scheme transparent. Ensure the scheme arrangements are set out at the start of the year and extra performance is measurable and independently verifiable. Design the system to be stable and so your people can understand in advance the link between what they do, how well they do it and what they get. Frequent changes or bonus period decisions are seen as arbitrary, unfair or oppressive.
- Ensure that controls and limits to market operations and other activities are adhered to. Monitor employees' integrity as well as business performance. Check regularly for abuse or fiddles.
- Ensure supervision and reporting are timely and accurate, especially for new products and services.

The red flags to avoid

- Measures of performance that are not compatible with corporate aims and realised profitability.
- Not disciplining breaches of controls and principles.
- Ad hoc bonus decisions and scope for managers to make special awards, higher or lower than par, to individuals.

modelling and assessment of any proposition, and the speed of action must not exceed the speed of thought and diligent analysis.

One way of aligning the aims of the workforce with those of investors is, of course, to pay bonuses in stock, realisable only after some delay, but even this is not enough.

Make sure managers encourage the right approach and ensure it is followed. Many managers turned a blind eye to taking undue risks and cutting corners while the business appeared to be successful. But since the value of some deals cannot be quickly assessed, any breaches of procedure can ultimately turn into enormous problems.

Take a cold-eyed view of whether the success of a business unit really depends on particular individuals, or on a combined performance by a team, possibly including staff outside your own unit. Don't be afraid to drop someone's bonus if they do not repeat their success according to the criteria set out.

You want a sound business that reliably makes above-average profits without being put recklessly into danger; one where there are limits to risk and a few individuals cannot bring down the business.

TIME FOR ACTION There probably won't be much bonus paid for some time to come, so this could be a good time to establish schemes on the principles set out here. Review your existing schemes and consider how to restore the link between real performance and reward without running the risks which have contributed to so much loss and trouble.

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