Personnel Today
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Pay banker bonuses or count the cost

With bank shares in freefall, everyone is looking for someone or something to blame. City bonuses have become the target of renewed attention from the government and the FSA (Financial Services Authority). They say big bonuses encourage excessive risk taking, which has brought banks to their knees. But what does this focus on "excessive" bonuses mean for the banks?

The FSA is proposing to ask banks to explain their bonus structures. If it thinks a bank's bonus structure makes it a risky institution, the bank could be required to increase the amount of capital that it holds, which will cost the banks more, and sounds like a response to government pressure.

But the banks pay bonuses to reward good performance and to attract and retain talent, and while thousands of people work in the financial services sector, the number of those capable of generating significant profit is quite small.

The market is extremely competitive, with skilled bankers commanding big rewards and ready to move on to chase financial compensation. So if the government or the FSA interferes with the bonuses that banks can pay, banks will find it harder to incentivise excellent performance and keep their best people at the time when they need them most.

In the financial services sector, basic salaries tend to be relatively modest. Bonuses reward strong performance and are usually proportionate to the amount of profit generated. This aligns the interests of the bankers with the interests of the shareholders, which must be a good thing.

Ill-informed politicians argue that bankers take risks that pay-off in the short-term without regard for the long-term negative consequences for the business. The bankers get paid their big bonuses at the end of the financial year and it may not be until later that problems emerge.

But banks are alive to this criticism and most pay at least part of their bonuses in shares through long-term incentive schemes, often with claw-back arrangements. This encourages bankers to take a longer-term interest in the success of the business. These schemes usually provide that the individual will lose their entitlement to the reward payment if they leave the bank before the payment is actually made (which is often years later). This has the added advantage of encouraging the bankers who have performed well and earned the bonuses to stay with the bank.

Although long-term incentive schemes have clear advantages for the banks, they have recently become less popular with employees who have watched their hard-earned bonuses evaporate as share prices have crashed. It is said that more than $30bn of Lehman Brothers shares were held by its employees. A true sharing of risk. Bonuses paid in cold hard cash look more attractive than ever and the top talent will be going where the cash is. If the banks want them, they will have to be willing to pay.

In the current climate, financial institutions are under intense pressure from all sides. When it comes to paying bonuses, they will have tough decisions to make.

Some banks have bonus schemes that are totally discretionary. However, these banks could still face legal action from employees unless they can show that, when deciding on the size of bonuses they did not exercise their discretion in a way which was "irrational or perverse - ie, if no other reasonable bank would have exercised its discretion in the same way. If banks have contractual bonus schemes, then <u>they could face claims for breach of contract if they do not honour their commitments.</u>

Key Points

- The government says that big bonuses encourage risk taking
- Politicians do not understand that bonuses reflect performance
- Most bonus schemes are designed to protect medium- and long-term business interests
- Bonuses offer more flexibility in good and bad times
- Government interference with our financial systems poses a greater threat than the international market adjustments now taking place.

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