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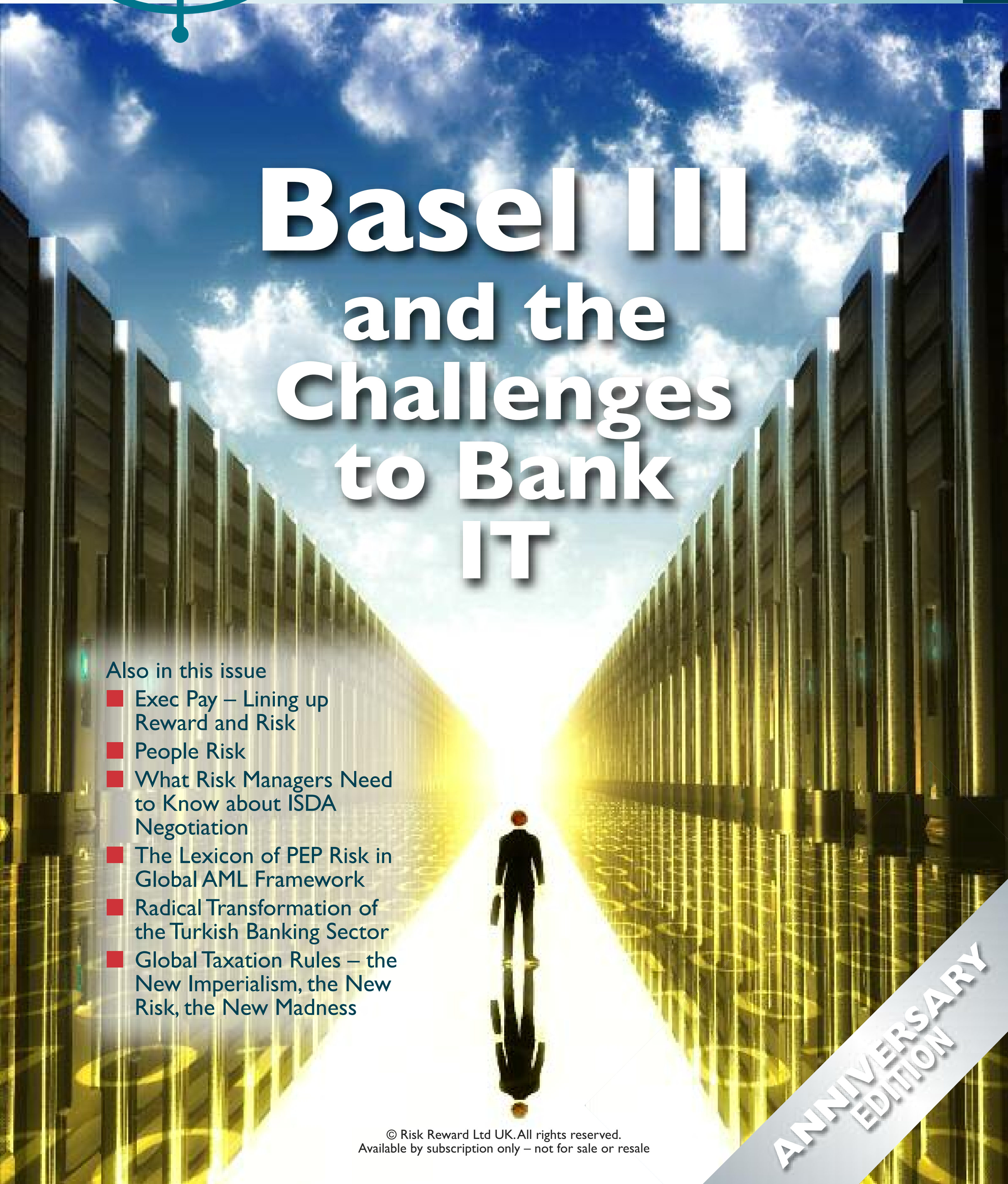

Basel III and the Challenges to Bank IT

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ANNIVERSARY EDITION

Exec Pay – Lining up Reward and Risk

Sandra Quinn is an independent consultant providing consultancy and contract support to businesses and public sector bodies looking to manage their business, people, conduct and ethical risks. A former UK Financial Services Authority regulator, Sandra created an innovative people risk framework for Lloyds Banking Group. As Interim CEO, she founded the National Fraud Authority. She has delivered business reviews for the Attorney General's Office and the FSA, and worked with the Prime Minister's Strategy Unit and the Independent Police Complaints Commission. In this article Sandra answers the questions where do you start when considering getting risk properly integrated into reward.

The Prime Minister's announcement on 8th January 2012 (http://www.bbc.co.uk/news/mobile/uk-16458570) that the UK Government would seek measures including legislating on executive pay raises a number of interesting issues. Subsequent Government proposals went little further than strengthening the hand of investors. But after EU Commissioner Michel Barnier's warning of EU legislation before the end of 2012 on pay and bonuses in banks, the European Parliament is now trying to insert remuneration provisions into the EU's implementation of Basel III.

This creates different challenges for legislators, companies, boards and shareholders. For legislators, how to make this workable. For companies, to have the infrastructure and culture to comply. And for boards and shareholders, to have the information enabling them to challenge and to ask whether mere compliance is enough or whether actually they should use this to contribute to better running of firms.

So what could all this be about in practice?
Let's assume it's right that pay should be about the right amount for the right job. But avoid getting into ethical arguments about relativities between shop floor and senior management or the relative social value of nurses and bosses.

It started with the bonuses
For a start, 'pay' in terms of packages is about salary, bonus, pension and benefits. To date a lot of the focus - especially in financial services - has been on bonuses.

Because bonuses are essentially about job done, the focus has traditionally been on past performance. How well have you and the firm done in the past year? That was established thinking until RBS and Lehmans forced regulators such as the FSA to require firms to ensure that reward was more aligned with risk and not just with short term financial results. After all, you may have made lots of money but did you create lots of risk which hasn't hit the company yet? The Financial Services Authority's Remuneration Code therefore forced first banks, now investment firms (and soon EU requirements will extend to insurance companies via the Solvency II EU directive) to look at the current/future risk profile as well as the financials in arriving at collective bonus pool and individual bonus decisions. After all, it's that risk profile which will impact on the future financials.

Think sub-prime mortgages and in the UK, Payment Protection Insurance. Lots of money made. Now lots of money lost or provisioned for settling losses, complaints and mis-selling. Which is now leaving HR Directors with tricky challenges about clawing back bonuses paid or holding back those awarded but not yet paid to the people responsible (and who in the good times were bullish about being the 'accountable executive').

Evaluating risk and showing you've evaluated risk
But 'risk aligned reward' is relevant to wider executive pay beyond bonus. You should have to look at the risk profile of the firm if you are going to judge performance 'success' or 'failure' for salary as well as for bonus. Because these roles are about the performance of the company is why there is such political, investor and public frustration with people paid for perceived failure. But that should mean the current and future risk profile and not just the past (past performance is after all no guide to the future ...) if you are not going to fall into the trap which sub prime and PPI exposed.

So what risk profile? Logically it's got to be more than about the financials. It's got to be about the key risks the organisation carries because that's where the hidden impact on financials is sitting. And that should cover financials, processes, compliance, people, its conduct and reputation. All of which are inextricably linked. See sub prime and PPI.

This has big implications for the way firms evaluate pay and the kind of information that Boards and investors should be seeing in terms of risk alignment and critically what they

Exec Pay – Lining up Reward and Risk

should be demanding and challenging. And big implications for firms to demonstrate their risk alignment, particularly where all their culture, decision-making, processes and information just haven't needed to before. It means HR, Risk, Compliance and Investor Relations working together in a way they won't have had to before. Even in banking where this has been most advanced to date, Investor Relations has not really been in the frame. Anyone in a company who knows any of these functions will confirm that they are often different beasts with divergent skillsets and cultures of their own so just 'working together' will itself take a lot of work. Some firms won't even have a central or strategic risk function to draw on, for example.

But returning to what has happened to date in relation to bonuses and financial services.

The law of unintended consequences

Focussing on one part of the 'pay' construct can have unintended consequences so companies and legislators will need to avoid that.

Feedback suggests that in financial services, restraint on variable pay had the unintended effect of sending employer and employed to look at what could compensate for the holding down of bonuses so the overall 'package' could be sustained. A bit like water looking for an alternative course when it's been frustrated. So salaries - which the Remuneration Code doesn't cover - have been driven up. And some at the non -public owned UK banks now perceive additional downward pressure on bonuses in the likes of Lloyds Banking Group and Royal Bank of Scotland as having resulted in their having to increase salaries to come up with packages to attract top talent with which the other banks have had to compete. Resulting in an upward spiral.

Does Risk stop at Exco?

And how far do you go through the firm? The impact of bonus requirements in financial services has affected the top couple of tiers of senior staff - those at senior levels and others in 'equivalent' roles in terms of their potential risk impact on the firm.

Currently the PM's thoughts seem to affect Board and Executive Committee type roles. But will it stay there? Should it stay there? Arguably that is where the FSA started with the Remuneration Code. If you are building risk into reward structures then why just stop at the Executive Committee? Why not look at other key roles which drive and impact on performance?

Preparing for the future

So what started in financial services is now showing signs of spreading to other industries.

Focus is likely to be on strengthening the role of RemCos and the challenge and role of investors who are the people and bodies (often our pension funds) who take the hit when it goes bad. Which means recalibrating pay decision making, tougher challenge, better MI and analysis which links risk to reward. And firms and their functions having to re-gear their thinking on all this.

So where do you start? A good place is to have a good tough look at how you evaluate risk in relation to pay and ask yourself if your decision making and the criteria you use really would stand up to external scrutiny. Chances are it won't. So how will you make it stand up and give it integrity. Look at what risk information you give your Remuneration Committees and what links you have between your Risk (if you have them) and your Remuneration Committees. Then project your primary investors and Investor Relations into the equation and ask how they would/should operate.

Inevitably a lot of busy firms are going to groan with this prospect. While potentially painful, it could be good management and good for the company. If you get it half-way right. And that will take preparation and not just waiting for the legislators to force you. That will be the trick.

But for legislators and parliamentarians, I would recommend they think through not just what they want but how they will achieve it and what they expect firms will actually do before they set out requirements. There have already been unintended consequences and getting risk properly integrated into reward is too big a prize for business to get this wrong if this is to strengthen business and not just window dress.

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