Is bonus banking the answer to banking bonuses?

Unfortunately, bonus banking is far from a complete answer to the issues surrounding incentives in financial services. While they can have many advantages, bonus banking structures are known to be difficult to implement, unpopular with employees, and ineffective at driving performance. They were pioneered by companies using economic profit (profit less risk-adjusted cost of capital) as the primary measure of corporate performance, and many have since quietly abandoned them. Why?

In theory, an appealing idea

Bonus banking describes an incentive scheme where part of the bonus earned is held back in a bonus account, to be paid out in subsequent years. It allows for the declaration of a negative bonus (or ‘malus’) where performance drops, or where the initial assessment of performance turns out to be wrong. It is closely related to a bonus clawback, but has the added benefit of providing the company with some security for repayment.

Bonus banking has an obvious appeal to compensation committees searching for an acceptable approach to incentivising their people. It reduces the much-criticised reliance on annual performance measures, creating stronger alignment of incentives with medium term or long term shareholder value creation. Depending on the measures used, it can lessen the opportunities for ‘gaming’ the scheme by focusing exclusively on meeting bonus targets at the expense of overall corporate performance. And it reassures stakeholders – shareholders, regulators and the wider community – that the company has some comeback against those who are seen to have caused current problems by their actions in previous years.
But in practice, it’s harder than it looks

The primary issue with bonus banking, in our experience, is the greater difficulty of managing and communicating the scheme while maintaining its effectiveness as a performance incentive. It’s a cardinal rule of reward that the more remote the payout becomes, the weaker the incentive. Employees – quite correctly – feel their bonus payouts are less secure, and are often unsure about the conditions for vesting or clawback of future payments. Complex multi-year performance measures can dilute the focus on maximising performance in the current year, without setting clear long term performance goals.

What’s more, bonus banking schemes often have an unintentionally punitive tone. Bonuses can usually only be adjusted down, which can lead employees to feel that failure will be punished, but sustained success not rewarded. This has led to them being highly unpopular, with the consequent risks to retention and performance.

Even where the company leadership succeeds in overcoming these issues, bonus banking is still far from a complete solution. Depending on how it is structured, the scheme can lead to bonuses being paid out in years where overall corporate performance is down, or to former employees who have not contributed to this year’s performance – unlikely to be a popular result in the current environment. Performance measures can be difficult to construct, and as a consequence schemes are often based on rolling annual targets, which are less effective in driving a focus on long term performance.

What’s the alternative?

We recommend that our clients avoid the ‘me too’ approach to incentives, and consider bonus banking to be one of the many options available to them.

We recommend that our clients avoid the ‘me too’ approach to incentives, and consider bonus banking to be one of the many options available to them. No one vehicle will ever provide a complete solution, and financial companies need to be clear about their goals and how incentives fit within the larger strategic programme before settling on a solution.

There are other options available which, depending on the circumstances, may be more effective than bonus banking. Deferring a part of the annual bonus into time-restricted shares ties the final value of the bonus to the share price – useful for focusing top executive attention on long term shareholder value, though less effective for those employees without a line of sight to the share price. Basing some incentives on two or three year timeframes – for example risk-adjusted returns based on cash returns, rather than profit estimates, can reduce the danger of short term focus.

By no means are we saying that bonus banking should never be adopted. Bonus banking can work, but only as part of an overall strategy that focuses the organisation on long term value creation. It won’t by itself guarantee the achievement of a responsible reward programme.

For more information or to discuss any of the issues raised in this Viewpoint, please contact:

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