



Responsible rewards

Did bonuses bring down the global financial system?

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Responsible rewards

There is a common belief that extravagant incentives have encouraged reckless greed across the banking industry and tipped the world into recession. We disagree. Government and institutional policy drove the lending and borrowing practices that were to blame. Bonuses merely supported the business models behind this. In that sense they were efficient tools of strategy. It's the strategy which was the problem.

Of course, incentive plans that focus on the short term, that take no account of risk and that drown rational thought with life-changing sums of money cannot be considered particularly safe. They have increased the risks and perhaps prevented dangerous strategies from being questioned.

Whatever the causes, the consequences are here to stay. Organisations are used to evaluating their reward strategies from a number of angles: do they attract the talent they need? Are they cost effective? Do they guide the right behaviours? A new angle is needed. Every major institution – inside and outside the finance sector – will find its reward policies under intense scrutiny. Shareholders will want to know that managers are aligned to their interests. Governments – who may also be shareholders – will expect moderation

in return for assistance. Regulators worry about risk; the media sense a good controversy; and unions and employees will be watching for evidence of fair play.

Many companies may come to need sacrifices and savings from their workforce. It is possible to make the moral case for them – if the workforce has a sense of partnership.

Therefore it is a good time for all businesses to assess their reward policies for responsibility. There are benefits beyond pleasing stakeholders. Responsible reward policies will build a spirit of partnership to sustain the business; they will moderate excess; and they will be more firmly connected to business strategy.

Responsible reward is not about ending performance related pay. It is not about

capping earnings. It means, mostly, aligning the behaviours stimulated by rewards and incentives with the long term interests of all the organisation's stakeholders.

This has always been part of the theory of reward, but the practice has been more troublesome. Strategy should drive reward; but too often an alternative strategy 'in action' emerges from unforeseen effects of reward policies. Managers need to 'game' their incentives before their employees do. Given a particular structure of reward for a job, how would a rational decision maker maximise their gains and minimise their effort and risk, over the timescale of the average tenure in that role? What would be the effect on the organisation if every job holder did the same?

This brings out several contradictions between reward and strategy.

The first is the frequent disconnect between the timing of incentives and the timing of organisational performance. A big chunk of payments are often made before it is really clear whether performance has been delivered.

A second contradiction is between the risk borne by the individual and the business. Too often, individuals are rewarded on the results achieved, regardless of market conditions or the potential exposure on the downside of their strategy. Nor is the individual's downside (non-payment or redundancy) always comparable to the organisation's (bankruptcy).

A third contradiction is created when incentives focus on one or two measures of performance while the success of the business depends on multiple measures. It has long been recognised that any single indicator chosen to measure performance rapidly becomes useless. A final problem arises when incentive plans 'over-stimulate' individual achievement drive at the expense of the community and collaboration that truly reflect organisational life.

There is no such thing as a perfect reward system that can address every tension and meet every goal. But there are range of responsible practices that can limit risk and align interests.

A responsible reward strategy ...

Gets performance right

- It pays out over the same timescale that business value is created in. This implies that a big part of bonuses are deferred over periods greater than a single year.
- It includes an appropriate calculation of risk when assessing performance.
- It is linked to a bundle of performance measures, including behaviours, long term capacity building and results.
- It achieves a balance between individual, team and corporate performance.
- It is not sensitive to accidents of timing – probably by using a rolling average of results.

Helps the business meet its goals

- It is competitive enough to attract the talent the business needs.
- It is linked to firm individual accountability for the results of decisions and actions.
- Its effects are modelled under assumptions of individuals maximising their own benefit. The emergent strategy is tested against the desired strategy.

Encourages rational thinking

- It includes a fixed component large enough to meet essential financial needs of employees and their families.
- It is not so highly leveraged that a good year means you never need to work again or a bad year puts your family on the street.

Gets the point across

- It contains as few different schemes as possible and each scheme is designed for maximum simplicity.
- It is actively, effectively and repeatedly communicated to recipients and stakeholders. All recipients are absolutely clear how different actions on their part affect their possible payouts. This awareness is tested frequently.

Plays fair

- It provides a living wage to the least well paid throughout the supply chain.
- Its differentials between the highest and least well paid are fully justified by impact, workload, intensity and personal risk.
- It considers the messages and priorities it communicates to wider stakeholders.
- It recognises that reward is more than pay, that work is a community not just a transaction and that employees value and need a whole range of conditions and benefits, including leadership, progression, challenge, respect, flexibility and development.

How responsible are your reward policies on this scale?

Responsible reward is not just good public relations. It makes sound business sense. It supports a sustainable business model and aids execution. It helps with stakeholder management and it builds the community of interest necessary to sustain organisations through difficult times.