Performance-related pay and banking do not mix

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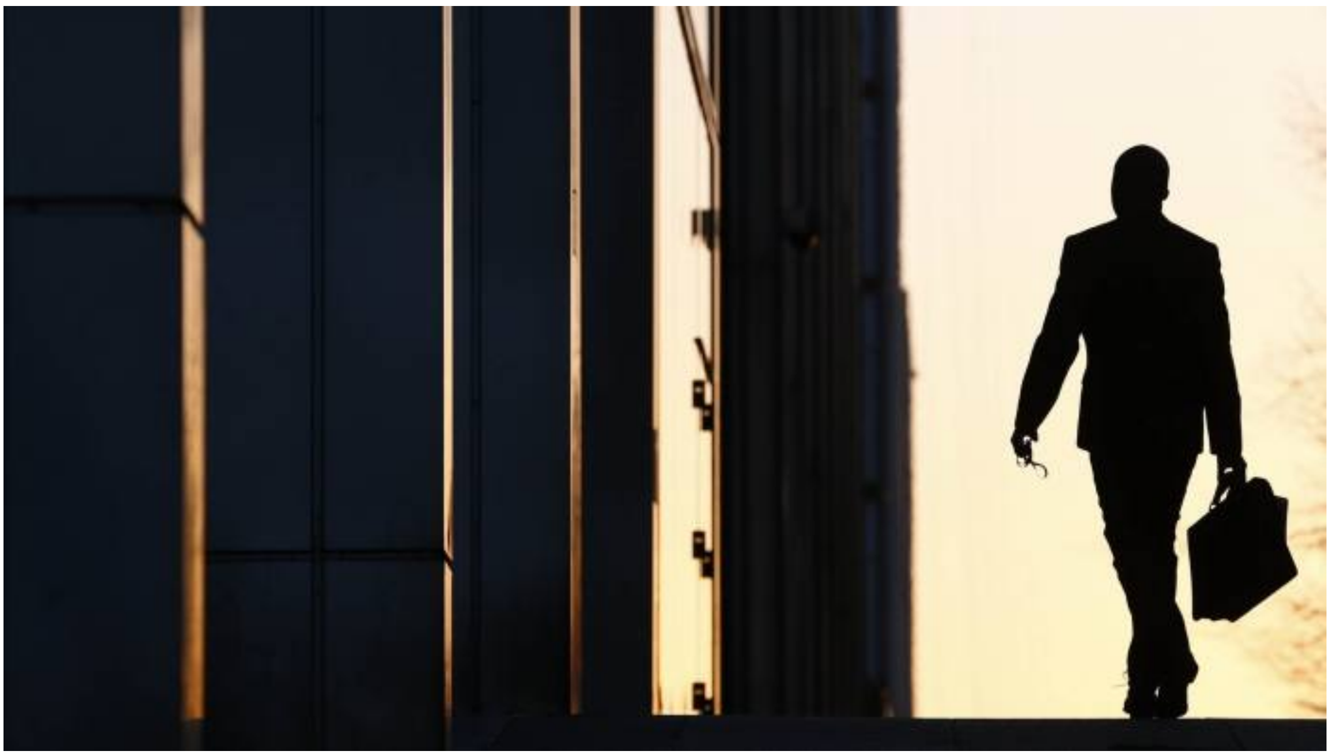

Bank bonuses are a comparatively novel innovation © Reuters

In the 10 years since the financial crisis, much of the debate about bankers' bonuses has fixated on the scale and structure of these controversial payments. What is less discussed is whether they serve any beneficial purpose and, indeed, whether commercial bankers should receive performance-related pay at all.

It is not such a silly question. Bonuses are a comparatively novel innovation.

So-called joint stock banks — the Big Four clearers and their smaller rivals — never used to pay them. Back in the days of Captain Mainwaring — the Dunkirk-era provincial bank manager portrayed in the TV comedy *Dad's Army* — bankers were expected to use their judgment and local knowledge in determining how to lend out the bank's capital.

If a manager made money, he might expect a nice letter from head office and an increase in his lending discretion. If he lost clients, or did not get his loans repaid, he might expect to see his freedoms fettered, or worse, be posted to some backwater where he could do less harm.

True, Mainwaring was shielded from competition by government intervention and the fact that the banks operated an informal cartel until the late 1960s. The system was not perfect: it could entrench snooty managers and make credit hard to come by.

But even after it ended, the banks continued to rely on generalists exercising judgment. Performance-based pay and sales targets only came later in the 1980s and 1990s, after the banks offered free current accounts for retail customers in credit, and the City of London's Big Bang reforms introduced investment bankers into the commercial banking bloodstream, thus normalising the idea of paying product specialists to generate deals.

It is now possible to form a judgment on this experiment, and it is not favourable. Many of the scandals we are still wading through stem from poor incentives. Take payment protection insurance, which has so far cost banks a staggering £35bn. For years, head offices offered financial inducements to staff to flog this frequently unnecessary product.

It was not only commissions that delivered perverse results or were gamed, but also incentives designed to achieve desired business outcomes. Before the financial crisis, for instance, HBOS rewarded lending bankers at its turnround unit if they could keep business customers out of insolvency. Yet this encouraged the rollover of debts at even hopeless cases, a practice that concealed huge losses that were only revealed after 2007.

Gillian Tett on banking sector pay

Similarly, when the credit crunch struck, incentives were proferred to employees in the banks' restructuring arms that dealt with riskier borrowers. Critics claim these encouraged banks such as Royal Bank of Scotland to treat restructuring as a "profit centre" activity, pitching potentially viable clients into insolvency and then seizing their assets — the so called "dash for cash" to restore overstretched bank balance sheets.

It is hard to imagine a more damaging claim, or one more calculated to make customers hold banks in contempt. RBS has admitted letting some small business customers down but denied it deliberately caused them to fail.

Nor is there much evidence to suggest that performance-based pay has improved performance. As Andy Haldane of the Bank of England points out, there are few ways for banks to bolster their returns to shareholders. One is to loosen underwriting standards and thus to increase the riskiness of the assets they invest in. The other is to squeeze the amount of regulatory capital they set against the investments they make.

The uplifts provided by either expedient are temporary, as puffed-up profits ultimately revert to the mean. Just look at Lloyds TSB, which went from the world's most valuable bank in 1998 to one requiring a state bailout a decade later. Offering incentives to encourage such volatility seems merely obtuse.

The banks of course claim that they have learnt their lessons since the crisis. Carnivorous pay practices designed to shift dodgy products have supposedly morphed into herbivorous bonuses based on fuzzy and uncontentious measures such as customer satisfaction. RBS has even withdrawn all such payments for frontline staff in its branches.

Yet that has not stopped substantial bonuses for product specialists and senior managers, all the way to the very well upholstered top. António Horta-Osório of Lloyds has, for instance, earned a thumping £38m since taking over as chief executive in 2011.

Banks want us to believe that they are more responsible; and competitive pressure will no longer force them into imprudent pay practices. So if employees' activities lead to future losses, for instance, they will claw bonuses back through mechanisms written into contracts.

Maybe they will. But there is of course a simpler way to avoid offering bad incentives. That is simply to pay employees a salary based on what the job is worth.