

# STRATEGIC RISK AND REWARD: INTEGRATING REWARD SYSTEMS AND BUSINESS STRATEGIES AFTER THE CREDIT CRISIS

BY PHILIP WHITELEY



**It is increasingly clear that banks' compensation strategies, in the words of Nobel prize-winning economist Joseph Stiglitz, "almost surely contributed in an important way to the [credit] crisis" by encouraging excessive risk-taking.**

A period of increasing innovation in financial instruments in the mid-2000s was accompanied by a war for talent in the market for the more gifted innovators and traders. Higher rewards and bonuses on offer to the top talent encouraged the pursuit of higher returns from more sophisticated, and often highly opaque, instruments that played a central role in precipitating the credit crunch.

So is there appetite for change in compensation practices among the banks and, if so, what is most

likely outcome? Perhaps more fundamentally, will banks be given the luxury to choose? With politicians feeling the heat from an electorate that views with suspicion the use – as they see it – of taxpayers' cash to 'prop up failing institutions', will any change come from within the industry or will it be imposed from above?

**Strategic Risk and Reward: Integrating reward systems and business strategies after the credit crisis** offers a timely insight into both the positive and negative implications of current compensation practices. Drawing on the views of some of the world's leading thinkers on reward strategy, as well as on a survey of bankers' views on compensation, the report should be essential reading for anyone with a stake in the sustainable profitability of the financial sector.

#### FEATURING THE CONTRIBUTIONS FROM:

**Vince Cable**, Treasury Spokesman, Liberal Democratic Party, UK

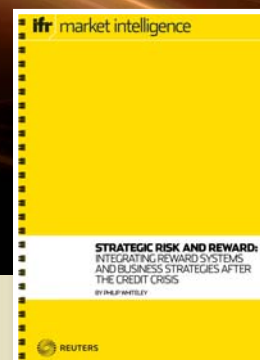
**Peter Christie**, Head of Reward, Hay Group

**Bimal Patel**, Manager of Corporate Governance and Policy for RiskMetrics Group

**Paul Aldrich**, Partner, CT Partners

# STRATEGIC RISK AND REWARD: INTEGRATING REWARD SYSTEMS AND BUSINESS STRATEGIES AFTER THE CREDIT CRISIS

BY PHILIP WHITELEY



**Compensation practices clearly play a vital role in maintaining competitiveness in any fiercely contested market, but in banking they differ in very significant ways. While bonuses in this sector dwarf those in almost any other, the industry is nonetheless implicitly underwritten by statutory authorities. These factors combine to generate asset bubbles which, when they inevitably burst, affect the entire economy.**

The absence of negative reward for operational failure is a feature of banking that is difficult to justify to those in other industries, who have to accept more fully the consequence of insolvency if a highly risky strategy fails, and whose taxes help to bail out failing banks.

By calling upon help from the statutory authorities following the credit crunch in mid-2007, banks have forfeited the right to protest at political interference into their operational management, including the reward system. If the industry wishes to avoid the more intrusive forms of regulation, to restore its reputation and repair its relationships with shareholders and customers, it has to address some crucial decisions. The publication in April 2008 of the Institute of International Finance's **Interim Report of the IIF Committee on Market Best Practice** showed there is now clear acceptance by banking leaders that they have to address perverse incentives within its reward system. But can such a fundamental change be brought about in a highly competitive market?

**Strategic Risk and Reward: Integrating reward systems and business strategies after the credit crisis** looks at the role that current compensation practices played in bringing about the credit crunch and gauges the mood for change among the banks and their regulators. It draws on the views of leading experts in the field of compensation – as well as a survey of bankers commissioned for the report - to assess the positive and

negative implication of a range of alternative reward systems, and to tackle major questions confronting the industry:

- Can the sector learn from other industries on linking reward and business strategy?
- Will it be possible to tackle the cultural attachment to the annual bonus cycle?
- Might there be short-term risks to performance, and recruitment for individual employers, if there is less reliance upon the annual bonus?
- How can business strategy, compensation policy, people management and corporate risk management be integrated?
- Does the industry have to move together, to prevent the first movers from suffering a brain-drain as more attractive short-term bonuses continue to be offered by rivals?

Questions of risk-taking, and the level of bonuses, are but two aspects to a complex narrative in the causes and consequences of the credit crisis. The objective of this report is not to argue for lower bonuses *per se*, but to examine ways to improve overall performance management, including performance measures that are adjusted for risk and measured over the longer term. To do this, it draws on lessons from other sectors, from the latest research on reward and on strategic management, and distils lessons from experienced bankers themselves on systemic weaknesses in these areas.

## ABOUT THE EDITOR

**Philip Whiteley** is an author and journalist, specialising in management, particularly the areas of leadership, reward and strategic human resources. He has written numerous articles for *The Times*, where for four years he contributed a weekly column on strategic reward, called *Packages*. He has also written for **Personnel Today**, **Director**, **CorpComms**, **Employee Benefits**, and many other titles, and has appeared on **BBC Newsnight** discussing the portrayal of the workplace in the media.

He is the author of five books, which have received commendations from leading management thinkers and commentators, including Daniel Goleman, Stephen Covey and Leif Edvinsson. He has highlighted the importance of introducing business measures to people management, and is chair of the Human Capital Forum ([www.humancapitalforum.com](http://www.humancapitalforum.com)).

His book **How to Manage in a Flat World**, published in the UK in September 2007, features interviews with 25 business leaders, including Miles Flint, President Sony Ericsson; Concetta Lanciaux, Vice President LVMH and Cynthia McCague, VP Human Resources at Coca Cola. Published by Financial Times Prentice Hall, it is co-authored with business coach Susan Bloch. In its first four months it sold over 2,000 copies, and agreement has been reached for five translations and for a US publication, due for launch spring 2009.



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