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Participating in opportunities and risks. Long live the bonus bank!

The re-birth of an old, but strikingly simple idea

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Executive Summary

There have been very few topics lately that have stirred up as many emotions as managers' compensation – not entirely without reason, as causal research of the current economic crisis has exposed.

However, the understandable anger has not led to meaningful solutions. Capping salaries means that management cannot participate fully in the upside of their company's success. It cannot be the goal of compensation systems to reduce management's incentive to make entrepreneurial decisions in this way, especially in times of crisis.

There is no doubt that the "standard compensation model" that was predominant – not only in banking, but also in many other industries – does not meet the requirements of today's reality.

Truly entrepreneurial compensation systems need to fulfill four essential criteria:

- Create clarity about the definition and measurement of success
- Reward sustainable and long-term value creation
- Ensure participation in entrepreneurial opportunities and risks
- Include all employees in the scheme to ensure congruity of purpose between management and other employees

The sheer enormity of today's crisis allows companies the opportunity to bid farewell to traditional and outdated compensation schemes and implement real and sustainable management participation in the opportunities and risks they face.

Why today's compensation systems are not working

Almost all companies pay their managers not only a fixed salary, but also a variable bonus. The size of the bonus should, according to theory, reflect the value the manager is creating for the company. Today's crisis shows that in many companies the reality is different. No sooner had record profits been reported and bonuses in the millions paid out to individual managers, than companies are back in the red with some even facing bankruptcy. How can this be? Were bonuses paid out too quickly and without ensuring that performance had reached a sustainable level? And more importantly, how can such mistakes be avoided in the future without eliminating variable pay altogether?

The four cardinal sins of today's compensation systems are:

- The performance measures used are incomplete and do not capture value creation.
- Achieved success is rewarded immediately, even if it is not sustainable.
- Managers are participating in the opportunities but not in the risks.
- Non-management employees are excluded from the scheme, hence alienated, leading to a "them and us" mentality.

Each of these systemic mistakes creates the wrong incentives. Together, they can even lead to the opposite of what was originally intended – compensation systems that actually reward value destruction and penalize sustainable value creation. In order to motivate employees to think and act in the right way, entrepreneurial compensation schemes must be simple and need to fulfill a few elementary requirements.

Clarity about defining and measuring success

A uniform definition of success and how it can be measured does not exist in practice. However, some common performance measures are used over and over again, despite being, at best, inadequate for guiding a company down a value maximizing path and, at worst, counterproductive.

The trouble with commonly used absolute performance measures

The majority of companies are using financial performance measures like EBIT, EBITDA or Net Income. The advantage of these measures is that they are included in every P&L statement and can be calculated for single divisions or operating units. These advantages, however, do not change the fact that they are suboptimal for true performance measurement. By using EBIT or EBITDA, capital costs remain totally unaccounted for. While Net Income at least takes cost of debt into account, the cost of equity is ignored.

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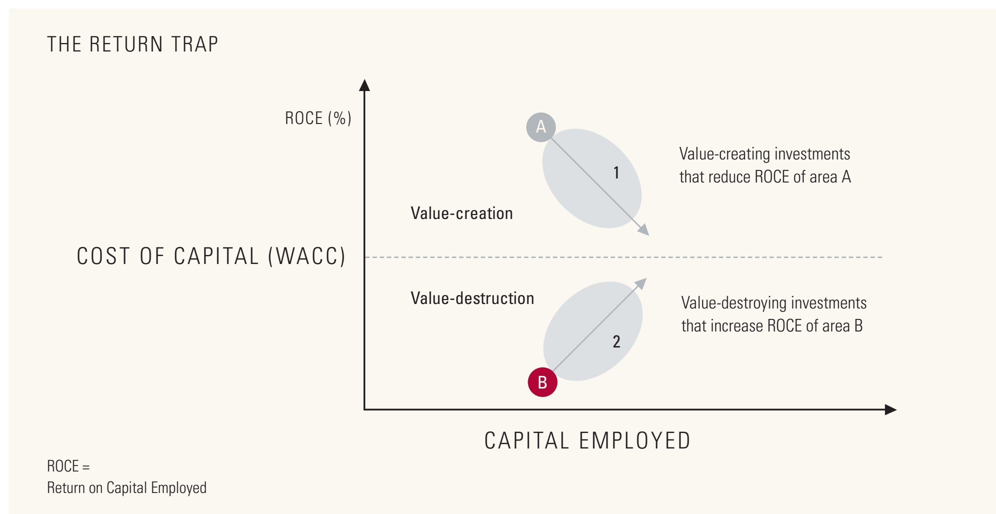
But entrepreneurial endeavors require capital – partly for investments and partly as a risk buffer for possible losses. The cost of this capital needs to be fully accounted for, otherwise, the risk for entrepreneurial actions will always be calculated as too low. In accounting terms, earnings – and, in parallel, bonuses – rise even if an investment is not earning the cost of capital. None of the mentioned earnings measures thus allow for the proper conclusion on whether or not an entrepreneurial action really creates value. The logical consequence of this is that these performance measures are suitable neither as indicators of value creation nor as a basis for awarding compensation.

The trouble with commonly used relative performance measures

In order to take into account the return on invested capital, many companies use additional measures such as ROI, ROCE and ROE. Such return measures are also recommended by several corporate governance codes. Business success, measured by an absolute measure like EBIT, EBITDA or Net Income, should also capture the full cost of invested capital. However, as much as it sounds plausible that, with combined EBIT and ROI measurements, it should be possible to correctly evaluate performance, this is not the case. The reason is that relative performance figures have the disadvantage that actual current performance becomes the hurdle rate for evaluating future investments: the "Return Trap."

THE RETURN TRAP



ROCE =
Return on Capital Employed

Returns will improve if a new investment has a higher return than the existing business. The more profitable the current business, the more difficult it is to further increase returns, and the higher the hurdle rate becomes for future investments (area 1 of graph). The more unprofitable the current business, the easier it is to improve performance (area 2 of graph). In this scenario, investments do not even need to earn their cost of capital as long as they just achieve a higher return than the existing business. In an extreme case, this could mean that in a loss-making business an investment that does not achieve any

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returns is having a positive effect on the overall return, since a zero return is better than a negative one. Compensation schemes that are strictly geared to whether the overall return is improving are in effect preventing profitable business units from further investments and growth while at the same time promoting investments in unprofitable, value-destroying units.

The strong focus on return measures was responsible for dramatic developments at many companies in the past few years. The incentive to maximize return ratios mainly through reducing the denominator (the invested capital) was widespread – especially in banking. In order to achieve ambitious ROE targets of 25% or more, many companies bought back shares. Having bought back shares, equity is reduced and the same business is attached to less capital. In this way a bank can improve its return on equity, but automatically the risk of bankruptcy increases. In other industries this trend continues and is often supported under the notion of active balance sheet management. This means for example that certain balance sheet items are kept as far away from the balance sheet as possible. Many forms of off-balance sheet financing, such as securitization, leasing, factoring and others, are being used to stretch current accounting rules to the limit. Instead it is preferable to depict economic realities as accurately as possible, to include entrepreneurial risks on the balance sheet and to incorporate the true economic capital base in the performance measures used to manage the business.

Economic profit figures are the solution

The true hurdle rate for evaluating an investment should be its cost of capital and not the profitability of the current business. Thus, only absolute excess profit figures such as economic profit, where the costs of both debt and equity are taken into account, are suitable for measuring success.

Ensure sustainability of success

The problem with current variable compensation lies less in its absolute size and more in the fact that bonuses are being paid out for average performance and are based on short-term earnings improvements, even if they prove to be unsustainable in the longer term.

Two components are responsible for this problematic situation: first, performance is typically assessed against the annual plan or budget, and, second, bonuses are often paid out based on single-period results without ensuring the sustainability of the achieved success.

The trouble with performance assessment against the budget

In order to evaluate a given performance, it is typically compared with a target based on the annual plan or budget. In this case, target bonus is achieved if plan or budget is met. If the result is better than the

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plan, the bonus will be higher; if not, it will be lower. By connecting performance to the annual plan, a political negotiating process is instigated. Management loses every incentive to set ambitious targets for itself and for its area of responsibility. This is one of the main reasons for the long and arduous planning processes in which managers try to set targets that are as easy to reach as possible in order to secure their own compensation. This dilemma can only be solved by separating compensation targets from the planning and budgeting process.

Targets for compensation systems need to be derived from the long-term strategy and should not be re-negotiated annually. The overall goal for each compensation system must be participation in true value creation; for example, measured by improvement in economic profit. Targets should be set in a top-down manner for each division and annual targets should be derived from the company's long-term target.

The annual planning process should therefore be independent of the target-setting process. However, it should be based on ambitious, albeit achievable, goals for the next year. These annual planning goals can be above or below targets for the compensation scheme. Through this strict separation, managers are motivated to set ambitious goals in the annual planning process, since their bonus is oriented to the long-term target of the compensation scheme which is not adjusted on an annual basis.

The trouble with immediately paying out the full bonus

Whichever performance measures are used, one cannot eliminate the possibility that a given performance increase proves not to be sustainable over future periods. For this reason, compensation systems should avoid paying out high bonuses to management who cannot be made accountable for a decline in performance in subsequent years.

However, if performance is measured on an annual basis (or even on a bi-annual or quarterly basis), unsustainability of performance only starts to surface when the bonuses have already been paid out. If there is a decline in performance in subsequent years, managers search for reasons that are outside their sphere of influence and argue to reduce their targets.

How can one ensure that high bonuses are only paid out for sustainable value creation and not for short-term optimizations?

The solution lies less in performance measurement itself and more in the structure of bonus pay-outs. High bonuses can be awarded but they should not be fully paid out immediately. If a part of the bonus is kept in reserve and subjected to business risk, this part of the bonus can also be reduced or removed in the following years in the case of poor performance. To address this, we have developed a comprehensive framework called the "bonus bank."

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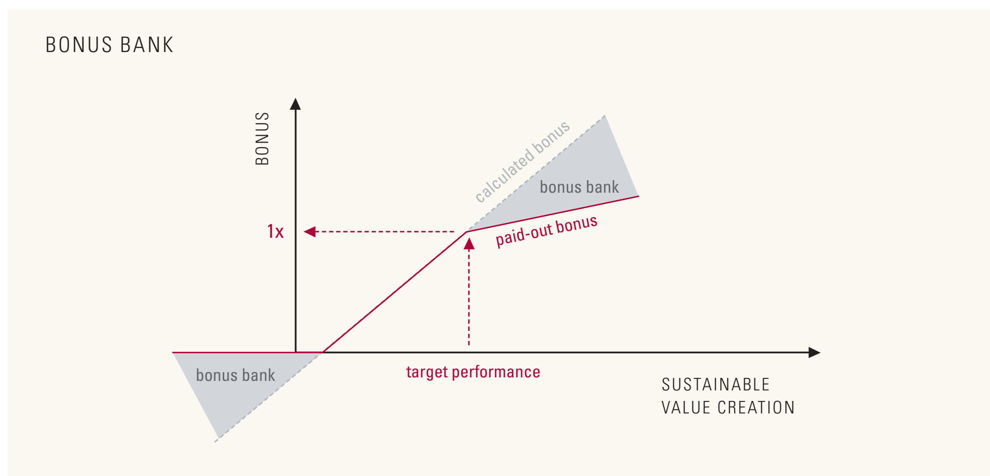
The bonus bank is not a bank in the proper sense of the word, but something closer to a "performance-memory mechanism." Under the bonus bank framework, the bonus awarded for performance in a specific year is not fully paid out immediately; rather a part is credited into the employee's individual bonus bank. A fixed percentage of the bonus bank balance is then paid out in each subsequent year while the remainder is carried over to the following year. In this way the compensation scheme is expanded to include a mid-term component, which even makes the declaration of negative bonuses possible. Through the bonus bank, a significant part of the bonus is subjected to future business risk, which is a form of active capital participation by employees. Only long-term and sustainable value creation is rewarded with high bonuses.



Anyone wanting to participate in the opportunities of entrepreneurial activities also has to be willing to be subjected to parts of the risk. However, this is exactly what is not happening in most traditional compensation schemes. After a good year, managers receive high bonuses and even in bad years bonuses are still paid out. However, participation in losses is never an issue, even if company owners (shareholders) have to endure significant losses in their investment.

Moreover, the bonus bank model can be used to aid employee retention. If the scheme is set up so that on leaving the company the employee only receives what is due from the bonus bank in that year, and future years' payouts are forfeited, then employees have a strong incentive to stay with the company. If they stay, they retain the potential to receive the full pay-out of large bonuses awarded in previous years. If they leave, they forfeit the amounts payable in future years. In companies in which bonuses are paid out in full immediately, like in many banks, we often see an annual flood of resignations after each bonus round.

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True sharing of risks

The bonus bank concept opens up the possibility of letting employees share not only in the opportunities, but also in the risks of the company. One part of the bonus is thus not distributed immediately and remains in the bonus bank and is exposed to entrepreneurial risk. If the company displays a very bad performance in a single year, the calculated bonus can even turn negative. A negative bonus is offset against a positive bonus bank balance. Managers whose bonuses are exposed to this kind of risk are operating with more foresight and do not have an incentive for short-term optimizations, as motivated by many traditional compensation systems.

EXEMPLARY BONUS BANK MODEL

			year 1	year 2	year 3
		achieved bonus	100	260	-40
1)	-	direct pay-out (target bonus)	100	100	0
	=	credit into bonus bank	0	160	-40
	+	bonus bank balance (beginning of year)	0	0	120
	=	total bonus bank balance	0	160	80
	x	% pay-out of bonus bank	25%	25%	25%
2)	=	absolute pay-out of bonus bank	0	40	20
1)+2)		total bonus payment	100	140	20

The illustration shows how the bonus can develop over a three-year period and what payments are made to an employee. In this example the target bonus is assumed to be 100. Because of the smoothing effect of the bonus bank, it is possible to gear the compensation system toward more entrepreneurship and allow for more success participation than traditional systems. Despite the calculated bonus varying between +260 (year 2) and -40 (year 3), the paid-out bonus remains relatively stable (140 in year 2 and 20 in year 3). In the second year, 120 from the calculated bonus of 260 is credited into the bonus bank and is exposed to entrepreneurial risk in the following years. In the third year the company achieves such a bad result that the calculated bonus is negative. However, with the bonus bank, this effect is moderated. The -40 from the calculated bonus is added to the 120 credit in the bonus bank balance. From the remaining 80, the employee is paid out 25%, which in this case is 20. Irrespective of losses in year 3, the employee receives a small bonus, but at the same time effectively loses money, as the bonus bank balance is reduced from 120 to 60.

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Continuity in success participation creates trust

One of the main problems of current compensation schemes lies in their very conception. Before designing the scheme, it is not explicitly defined whether employees should only be rewarded for their performance (i.e., results) or for effort as well. Many companies confuse performance and effort and speak of "success participation," but really mean rewarding "effort." This manifests itself when bonuses are paid out on the grounds that even though the results were bad "everyone made a great effort" or "the market environment was exceptionally tough." If under these circumstances a very small bonus (or even a zero bonus) seems to be unreasonably low, targets are adjusted downward so that a larger bonus can be justified. Especially in the current financial crisis, it is very often said that when designing the compensation system, "such market developments were not taken into account" and thus the system needed to be adjusted. What about the proclaimed participation in opportunities and risks? Is it not part of the entrepreneurial risk that things can also get tough and that despite great efforts results can decline?

Frequent changes in the compensation scheme diminish the credibility of the entire compensation scheme, not only within the company itself, but also from an external perspective. For this reason, the compensation system needs to be designed in such a way that even in unexpectedly difficult times the incentive to improve performance is still present. At the same time, it must be clear from the onset which part of the bonus should depend on expected long-term performance development. In most cases, it is better not to make that part too large, while also to refrain from constantly adjusting it.

A company-wide scheme ensures consistency of purpose and better collaboration

It is also important to extend the compensation scheme across and up and down throughout the organization to ensure that all employees are incentivized to behave in ways that lead to the desired strategic and financial outcomes for the company. This transparency and consistency contributes to alignment of purpose and trust between management and other employees, which enables better relationships and better communication. Such a scheme helps all employees to make choices on a day-to-day basis that drive economic profit within their own individual spheres of responsibility, and in a coordinated way with other employees and units.

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Conclusion

The current practice regarding variable compensation schemes has been strongly discredited in recent times and requires an adjustment. Management participation in the success of the company is one of the elements, though, that needs to be retained. However, it must be ensured that economic success – after consideration of the cost of all invested capital – is used as the basis for the calculation of the bonus. In addition, great success should lead to high bonuses only if the results are sustainable.

With a well-designed compensation scheme, such mishaps can be avoided and management can be given the proper incentives to pursue economically sound and sustainable value-creating strategies. The current financial crisis offers managers and boards a great opportunity to recalibrate their compensation schemes. The most important steps for this are:

- Use performance measures that take into account the full costs of invested capital in absolute terms
- Set multi-year compensation targets that are distinct from the yearly planning and budget process
- Use the bonus bank in order to let employees share in the opportunities and risks of the business
- Deploy the scheme widely to ensure individual incentives are aligned

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