

Reward: A new paradigm?*





Contents

- 03 Introduction: Is reform essential?
- 05 Executive summary
- 09 Rewards: A call for reform
- 11 Beyond a compensation issue
- 15 Reform required
- 19 A change ahead?
- 23 Differing priorities
- 25 The willingness to change
- 32 Achieving change
- 33 The risks and rewards
- 36 A prospectus for reform
- 39 Conclusion
- 41 Appendix: Survey results
- 55 Contacts
- 59 PricewaterhouseCoopers Global Financial Services Briefing Programme

Welcome to the 17th report in our global financial services briefing programme, entitled **Reward: A new paradigm?**

Introduction: Is reform essential?

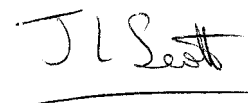
In the wake of the credit crisis, searching questions are being asked about whether compensation systems in financial services had a part to play in creating or fuelling the current situation. To some observers, rewards and the culture that created them are one of the most important factors, while to others, they play no substantive role at all.

What is beyond doubt is that recent events have, rightly or wrongly, generated significant scrutiny of compensation in the sector, from market participants, regulators and government officials. And while there is general agreement – even among industry participants themselves – that some degree of reform to reward systems would be beneficial, there is less consensus about the scale of the change required and about what, if anything, can be done to improve the current system in a way that benefits the industry as a whole.

In May 2008, the Economist Intelligence Unit (EIU) conducted a global survey on behalf of PricewaterhouseCoopers¹ to gain insight into these vital questions. The survey attracted 264 senior participants from across the financial services industry. The report that follows, presents the highlights of those survey findings, along with related additional insights drawn from a programme of interviews with prominent industry executives and commentators, including board members from large financial institutions.

Due to the controversial nature of the subject matter, some names and related details of specific interviewees are being withheld by request.

I am confident that you will find the briefing insightful and thought-provoking. If you would like to discuss any of the issues raised in this briefing in more detail, please speak with your usual contact at PricewaterhouseCoopers or one of the editorial board members listed at the end of this briefing. We would also appreciate your feedback on this briefing, as it helps us to ensure that we are addressing the issues that you are focusing on.



Jeremy Scott
Chairman, Global Financial Services
Leadership Team
PricewaterhouseCoopers (UK)

¹ PricewaterhouseCoopers refers to the global network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

There is overwhelming agreement
that there are problems with
current compensation systems
in financial services

Executive summary

Although there is divergence of opinion among participants in this study on the extent to which compensation was a cause or symptom of the credit crisis, there is widespread agreement that there are serious problems with the current approach to compensation. Asked about what they saw as the main problems with compensation systems, our survey respondents pointed to a number of issues. For example, they claim that there is a tendency for rewards to be skewed towards the short term; that they encourage excessive risk-taking in order to maximise short-term gains; and that they do not provide for sufficient clawback in the event of poor performance over the longer term. However, not all areas of financial services are viewed as equally in need of reform. Investment banking is generally perceived as being the most in need of changes. By contrast, the view in some sectors, such as insurance, is that the practices in other sectors have, unfairly, cast a shadow across the whole of financial services.

Despite support for reform, executives in the industry fear the ‘first-mover disadvantage.’

Although there is widespread recognition by survey respondents of the need for change, there are significant barriers that prevent wholesale reform. Respondents are particularly concerned that the implementation of changes to compensation systems would place them at a competitive disadvantage in terms of recruitment and retention, and could lead to an exodus of key talent. As a result, industry participants say that they are far more likely to support reform if it is an industrywide initiative, rather than one conducted single-handedly by their own organisation.

Change is already taking place in the industry, spurred on by pressure from compensation committees, shareholders and regulators.

Despite the problems associated with implementing reform to compensation, change is already under way in several areas within the industry. Significant proportions of respondents say that they have made adjustments to the use of long-term incentives, while growing numbers are using or investigating risk-adjusted performance metrics. Executive teams themselves have recognised that reform is necessary, and this is being reinforced by pressure from compensation committees and shareholders. Other than in isolated cases, regulators have not yet intervened, but they are likely to be a significant catalyst for change. There is recognition of the need for closer communication with stakeholders, including shareholders and regulators, in order to increase mutual understanding of the issue.

More change is coming, and the industry needs to pay attention to a number of key areas in the design of compensation arrangements.

The reform that is required in financial services organisations falls into three main categories. First, greater account needs to be taken of risk by using risk-adjusted performance metrics. Secondly, there needs to be a greater focus on longer term remuneration, beyond the deferral into stock that is already widespread. This means both wider use of incentive plans based on performance over several years, and revamped deferral schemes that create a closer alignment between bonuses and the long-term profitability of the business on which those bonuses are based. And thirdly, a better balance needs to be struck between the performance of the individual, business unit and overall group performance.

Compensation is a core business issue for many firms, which cannot simply be delegated to the human resources department.

In too many cases, the design of compensation programmes has been left to human resources functions, which by themselves are unlikely to be able to address all the implications, given the complexity of many financial services businesses. Much greater input from finance, risk and treasury is required to achieve a more joined-up approach to the design and management of compensation arrangements.

Fixing the problem is more than just a compensation issue.

Compensation did not cause the credit crisis and nor can it be used to solve the ensuing problems. Although reform in compensation is required, it needs to be combined with a consistent approach to risk management culture, management of performance and the development of talent.

A prospectus for reform

A one-size-fits-all approach to compensation design is clearly not appropriate. However, firms should consider how they would 'comply or explain' against the following principles.

- 1) Incentive payments should be based on performance measures that adequately account for the risk taken in producing profits.
- 2) Bonus pools should not be struck below the level at which cost and risk can be allocated.
- 3) Rewards should be aligned with the risk profile borne by the firm.
- 4) Deferrals should be linked to the realised profitability of the business on which the bonus was based.
- 5) Managers should have significant proportion of remuneration based on divisional or group-based bonuses.
- 6) Compensation design should be considered a key business competence and resourced as such.
- 7) Compensation design should be viewed in conjunction with wider people management practices in order to support a consistent approach to achieving the desired culture.



A convergence of market,
political and regulatory
forces over the last year
has brought into question
the compensation
practices of the financial
services industry.

Rewards: A call for reform

Commentators have criticised financial services firms for compensation practices that encourage undesirable behaviours ranging from excessive risk-taking to over emphasis on short-term results. None of this can be proven definitively. As can be seen from the survey results, there is a wide divergence of opinion as to the role compensation played in the credit crisis. What is known for certain is that in response to these market, political and regulatory pressures, compensation practices are receiving increased scrutiny across the financial services industry.

The compensation debate has seen a number of high-profile commentators express strong views on the subject. For example, in April 2008, Mervyn King, the governor of the Bank of England, launched a fierce attack against bonuses paid to City bankers. 'I intend the Bank to contribute to the design of regulatory and incentive structures... to try to curb the excessive build-up of risk-taking and credit creation..., which was seen ahead of the recent crisis', he said in a speech to the Commons Treasury Committee.

In July 2008, the Institute of International Finance (IIF), a global association of financial institutions chaired by Josef Ackermann, Chief Executive of Deutsche Bank, published a report on market best-practices, in which compensation policies were seen as one among many factors requiring closer scrutiny and reform. 'Market changes that have both catalysed and resulted from the growth of the originate-to-distribute business model have created incentives for both firms and individual employees that have, in some cases, conflicted with sound underwriting practices, realisation of risk management goals, or the long-term interests of shareholders', noted the report. It went on to outline principles of conduct for compensation policies and approaches by which firms can realign compensation incentives with shareholder interests and risk-adjusted returns (Table 1). These included the recommendation that incentives should be based on performance and long-term, firmwide profitability, taking into account overall risk and the cost of capital.

Table 1

Principles of Conduct:

Principle II.i: Compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firmwide profitability, taking into account overall risk and the cost of capital.

Principle II.ii: Compensation incentives should not induce risk-taking in excess of the firm's risk appetite.

Principle II.iii: Payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit.

Principle II.iv: Incentive compensation should have a component reflecting the impact of business units' returns on the overall value of related business groups and the organization as a whole.

Principle II.v: Incentive compensation should have a component reflecting the firm's overall results and achievement of risk management and other general goals.

Principle II.vi: Severance pay should take into account realized performance for shareholders over time.

Principle II.vii: The approach, principles, and objectives of compensation incentives should be transparent to stakeholders.

Source: Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, July 2008

Respondents to a survey conducted by the Economist Intelligence Unit (EIU) on behalf of PricewaterhouseCoopers would seem to agree with the findings from the IIF report.

Beyond a compensation issue

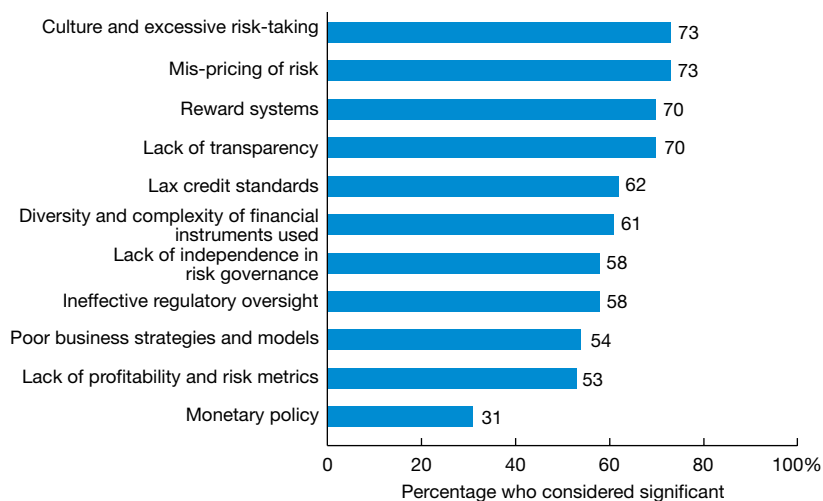
Seventy per cent cited rewards as a factor in the credit crisis, (in Figure 1). However, significantly, ahead of reward systems were cited culture and excessive risk-taking, and the mispricing of risk.

This suggests that, rather than being a cause of the credit crisis, compensation was just a by-product of other things that went wrong. And it has to be remembered that compensation is always an easy target for the press and other commentators, given the emotional resonance pay issues create among the public. In this context, pay provides a handy scapegoat for those seeking someone or something to blame for the current crisis.

Although remuneration may have played some part in the current situation, it would be wrong to pinpoint it as the main cause, according to a Non-Executive Director at a major UK bank. 'To make the case that remuneration caused the credit crisis, you have to prove that the system drove people to behave in ways that were materially different from what is prudent', he says. 'And that doesn't seem to be true. Instead, the problems in the credit market were something unanticipated and unprecedented and they cascaded into a larger issue.'

Figure 1

Question 4. What factors have created the conditions for the current credit/banking crisis?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

'I don't believe those banks with the greatest losses had the worst remuneration incentives or the least ethical people or traders', he continues. 'Instead, I feel it's a case that people made strategic choices which in retrospect they wish they hadn't.'

Other executives see larger issues. 'I think there's this unrealistic pressure to consistently outperform markets and the competition', says Richard Kearns, Chief Administrative Officer at Zurich Financial Services. 'You get into this "copy-cat mentality" where everyone chases the

Beyond a compensation issue continued

same returns, the same innovations – without thinking through both the medium- and the long-term. What is needed,’ says Mr Kearns, ‘are compensation systems that support doing right over the long term, aligned with shareholders and rewarding team efforts – not encouraging lone wolves.’

‘Remuneration is a problem but the main issue is the underlying culture that created it’, says Peter Montagnon, Head of Investment Affairs at the Association of British Insurers. ‘If the culture required banks to have a longer-term vision, then remuneration practice would change in keeping with that.’

The issue of underlying culture is one that also resonates with John Peace, Chairman of Experian Group and a Non-Executive Director

at Standard Chartered. ‘Pay can have a significant bearing on the culture of the organisation’, he explains. ‘Incentive programmes can provide a clear line of sight and clear motivation if correctly structured, and this subsequently has a direct effect on the culture and people in the organisation.’

This is not to say that incentives must always have a negative impact on culture, or vice versa. ‘Incentives can drive growth in a business and add to the culture’, he adds. ‘It is when you get them wrong and they get excessive that there are problems.’

This suggests that, rather than being a cause of undesirable behaviour, remuneration is a symptom of more fundamental problems, related to excessive risk-taking and a short-termist culture, and exacerbated by factors such as accounting rules, monetary policy and ineffective management oversight.

In an interesting comparison, The Banking Banana Skins 2008, an annual survey of bankers, observers and regulators conducted by the Centre for the Study of Financial Innovation on behalf of PricewaterhouseCoopers, finds management incentives at a relatively lowly 17th position in the risk rankings.



The argument over whether rewards are a cause or a symptom of the credit crisis is, to some extent, a rather philosophical one.

Reform required

Where there is a clear consensus among the executives questioned for our research is that there are significant problems with remuneration in financial services. 'Undoubtedly there are problems with the current system', says Sir Win Bischoff, Chairman of Citi. 'But the events of the past year will hopefully act as a catalyst whereby the rewards will be much more commensurate with knowing the outcome of the actions that people have taken.'

Sir Andrew Likierman, Professor of Management Practice at the London Business School, expresses a similar view. 'I've been talking to remuneration committee chairmen, remuneration consultants and City analysts,' he explains, 'and the consensus is that this is an area where considerable attention is needed.' Industry executives themselves – in overwhelming numbers – believe something should be done. Fully 95% of survey participants say that at least some degree of reform is necessary.

So what are the problems? Approximately 90% of survey respondents agreed with the following diagnosis. **First**, incentive models are skewed towards short-term reward. **Secondly**, there is little or no opportunity for clawback once a transaction has been made in the event that the trade turns out to be damaging over the long term. This creates an asymmetry between reward and performance. **Finally**, the current compensation systems encourage excessive risk-taking.

Tom Gosling, a partner at PricewaterhouseCoopers (UK), says that the alignment of risk and reward is central to the remuneration discussion and that too many firms have not properly factored risk into compensation.

'Retention pressures caused by the bull market led to banks paying key individuals on an 'eat what you kill basis', with rewards driven down to ever-more localised measures of performance', he says. 'In many cases, rewards were cascaded down to a level that went beyond their ability to measure risk. This led to situations where bonuses were based on profit without any allowance for the risk taken to generate that profit, or worse still, based just on revenues.' Such practices can clearly undermine the incentive to manage risk appropriately.

Although 95% of survey respondents agree that reform is required, a closer look at these numbers reveals that executives are evenly split between those who say that compensation systems in general need reform (45%) and those who believe that the problem is concentrated only in certain subsectors (50%).

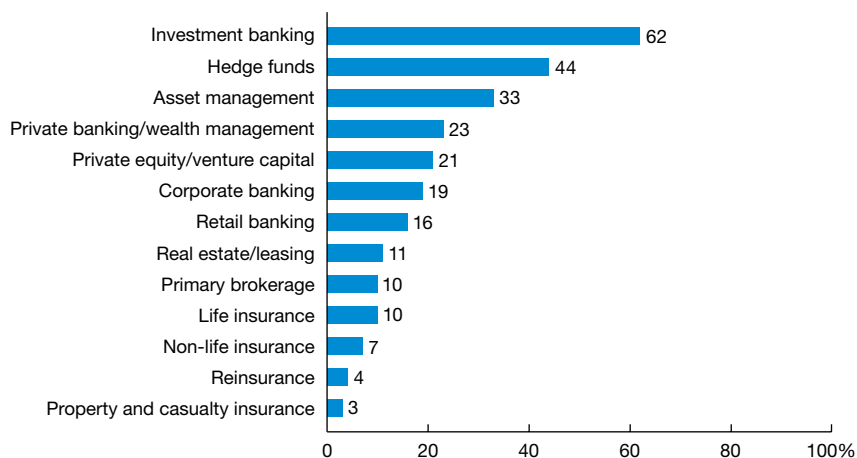
Asked about the areas of financial services that are most in need of reform, respondents point to investment banking first, followed by hedge funds and asset management. In a related finding, 52% of executives agree that problems with compensation systems are largely confined to investment banking.

Other sectors of the industry, such as retail banking and real estate, are perceived as being considerably less problematic. The insurance industry is seen as least problematic of all, a view that is echoed by Andrew Moss, Chief Executive of Aviva. 'Fundamentally,' he says, 'insurance companies, and particularly long-term life and pensions companies, are run for their shareholders and policy-holders and this is a very long-term business. We should not be motivated to take short-term risks and we don't.'

The perception that the problem is most acute in investment banking (see Figure 2 overleaf) is a view that is shared by a number of the interviewees questioned for this report. 'I find it irritating that the rest of us are left with an image that is completely wrong when it's the excesses of a very limited number of firms that caused all these credit market problems', says Michel Tilmant, Chairman of ING. 'Compensation is only part of these excesses, but it's still something that needs to be addressed by some sectors far more than others.'

Even investment banking executives questioned for our survey seem to hold the view that change is needed. Asked about the sectors within financial services that are most in need of reform, they were just as likely to choose their own industry as the overall set of respondents.

Figure 2
Question 2. In which of the following subsectors of financial services do you think reform is most needed?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

To an extent, the investment banking community seems to be taking ownership of its remuneration issues. As a financial executive from a US investment bank explains: 'I won't say remuneration was the root cause of what happened here, but I can tell you it's one of several pieces that is getting very close attention today.'

This is a trend that appears to be under way elsewhere. For example, in August 2008, UBS announced that as part of a repositioning of the

bank a new incentive plan would be introduced in the investment bank to balance risk and reward, and that staff and management would be rewarded for shareholder value creation in their division under a revised incentive plan. In May 2008, the *Financial Times* reported that Deutsche Bank was considering reform to its rewards structure, which would emphasise performance over several years. Josef Ackermann, Chief

Executive of the company, said at the bank's annual meeting that a 'multiyear' bonus scheme was under consideration.

In terms of the departments within institutions where reform is needed, respondents overwhelmingly say that it is the remuneration of front-office executives that is in need of attention (see Figure 3). A far smaller proportion point to the risk function as being in need of reform and fewer still view either back-office or middle-office compensation as a priority.

Although investment banking is seen as being most in need of reform, other sectors of financial services should not be complacent, according to Michael Rendell, a partner at PricewaterhouseCoopers (UK): 'First, many large retail banks and insurance companies have pockets of business where market pressures have led to reward models similar to those found in investment banking. They need to ensure that they are not repeating mistakes made elsewhere. Second, if, as seems increasingly likely, regulators start taking reward systems into account when assessing risk, then all financial services companies will potentially be affected and will need to prepare their response.'

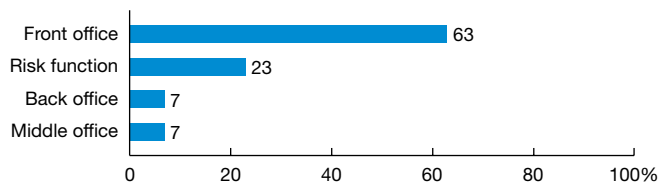
Furthermore, it is not just the investment banks that have been subjected to criticism over their remuneration arrangements. In May, for example, HSBC faced criticism from some shareholders over proposed changes to its pay packages for top

executives, which included placing a greater focus on short-term bonuses, while HBOS faced opposition over plans to place greater emphasis on short-term rewards and reduce hurdle rates on long-term incentives for top executives. Both proposals were eventually passed with more than 80% of shareholder support, but these levels of support were low by historic UK standards, and the associated press commentary reinforced the view that concerns about financial services remuneration are not limited to investment banking.

This view is also reflected in the survey responses. In many cases, respondents highlighted the need for remuneration reform within their own subsector to a greater extent than outside observers. For example, although only 16% of all survey respondents said that reform is needed in retail banking, this percentage rises to nearly 40% among retail banking respondents. Similarly, over 25% of life insurance respondents believe their subsector is in need of reform, compared with just 10% of all survey participants.

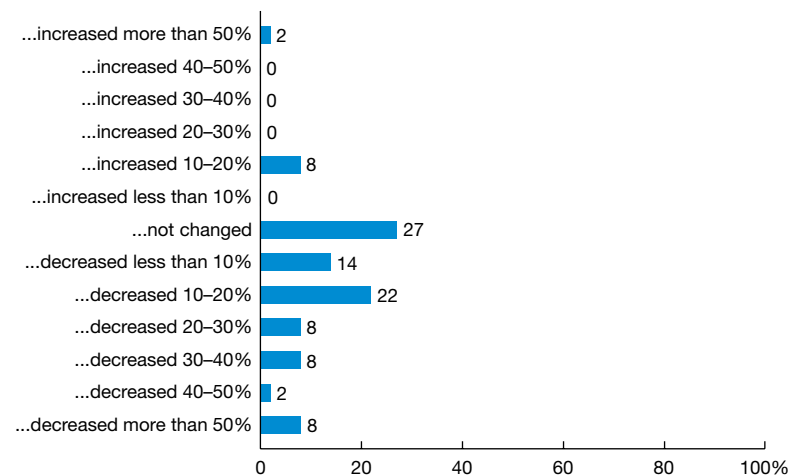
Nonetheless, while all sectors of financial services face remuneration challenges, none is as great as in investment banking, because of the key role that bonuses play in the compensation packages, and because of the consequent impact when those bonuses are no longer delivering the expected rewards. According to our research, 63% of respondents from investment banks report a decrease in bonuses as a result of the credit crisis, and 8% cite decreases of more than 50% (see Figure 4).

Figure 3
Question 3. In which of the following functions are the compensation systems most in need of reform?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

Figure 4
Question 12. Investment banks only – To what extent have bonuses at your organisation changed as a result of the current credit/banking crisis? Bonuses have...



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

A broad range of stakeholders is pressuring financial services companies to revamp their remuneration strategies and practices.

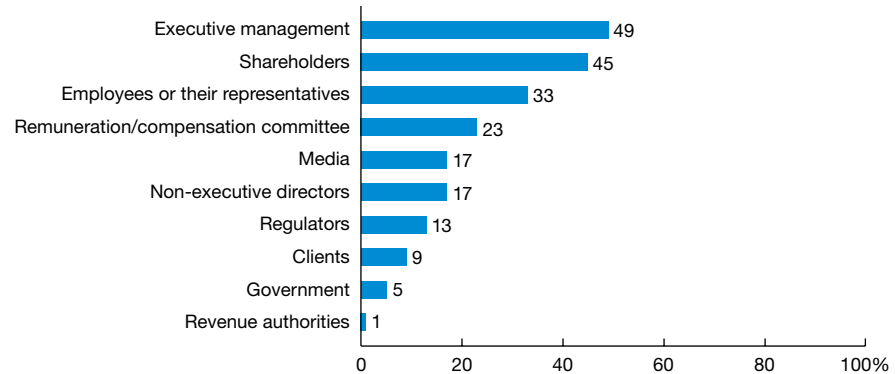
A change ahead?

Although the media, regulators, shareholders and even employees are making their voices heard, respondents to the survey say that it is their own executive management that is exerting the greatest pressure for reform. This appears to reflect a consensus that some form of change is required, and that it is best achieved pre-emptively, rather than waiting for pressure from shareholders, regulators or governments. Executive management is often spurred on to look at the issue by compensation committees. As Sean O'Hare, a partner at PricewaterhouseCoopers (UK) explains: 'Non-Executive Directors are increasingly concerned about their personal reputation in the eyes of shareholders. As a result, they are keen to be seen to be proactive in tackling the perceived problems with compensation in the sector.'

Although the greatest pressure for reform may come from within, shareholders are not far behind (see Figure 5). Growing numbers of investors can be expected to become more active in scrutinising remuneration practices. The institutional fund manager Hermes is one such organisation that is already looking for change. 'Significant losses from the credit crisis are forcing us to look at the reward issue more closely', explains Paul Lee, a Director at Hermes. 'For example, we are talking with major investment banks where we have a stake to see how they can improve in this area.'

Figure 5

Question 16. Which of the following stakeholders currently exert the greatest pressure on your organisation to change its compensation programmes?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

Mr Montagnon of the ABI makes the point that shareholders should scrutinise the underlying business, rather than focus exclusively on remuneration. 'Where shareholders should take interest is in the riskiness of the business model', he explains. 'It's legitimate for them to question that but if they're only going to look at pay, that's too narrow a focus. It's a more fundamental question about the business.'

Asked whether their shareholders have expressed concern over aspects of their compensation programmes, 32% of survey respondents reported that investors had expressed displeasure over an excessive focus on short-term measures and rewards, while 27% reported similar concerns over a lack of alignment between incentives and corporate performance (see Figure 6 overleaf).

A change ahead? continued

But how much change will shareholder pressure really bring about, when shareholder resolutions on pay continue to be passed with comfortable majorities in all but the most extreme cases? Since 2004, a vote on remuneration policies has been required at the annual general meetings of all UK-listed companies, but significant votes against these policies are rare. For example, in 2007, only one in ten UK companies had more than 15% of shareholders vote against or abstain on their remuneration report.

In that context, levels of dissent approaching the 20% level, which have been seen several times this year in the financial services industry, might

be seen as a significant issue. Mr Gosling of PricewaterhouseCoopers (UK) explains, however, that there is the potential for a disconnect here. 'On the one hand, we have shareholders thinking they have handed out significant warnings, but on the other we have companies thinking "80% – that's not so bad", and potentially being emboldened to push the envelope further.'

Regulators are another potential source of change. Survey respondents indicate that regulators currently exert little influence over their compensation programmes, and indeed, regulators themselves are clear that direct intervention in the design of compensation

arrangements should not be their role. For example, as a spokesperson for the UK's Financial Services Authority (FSA) explains: 'It is neither an appropriate role nor our desire to regulate compensation.'

This is not to say that regulators and governments have no interest in the subject. According to the FSA executive, there is too much asymmetry between the ways that individual employees and executives are receiving their rewards and the long-term interests of shareholders. 'There are too many institutions whose incentive structures have a tendency to encourage excessive short-term risk-taking. And in addition, quite a number of incentive payouts take place on mark-to-market profits, not ultimate profitability.' Firms should, says the spokesman, 'look carefully' into these key areas.

In terms of redress, the FSA executive suggests various means such as greater degrees of deferred compensation, clawback, or more medium- to long-term equity-like structures. But ultimately, while regulators may be vocal on these subjects, direct intervention in design is unlikely.

Figure 6
Question 17. In the past year, have shareholders expressed concern about any of the following aspects of your company's compensation programmes?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

Although regulators may be unable or unwilling to intervene in either the quantum or structure of remuneration, they are already looking at other ways of factoring in pay when considering the overall risk of the institution. In the UK, the FSA has signalled its intention to consider rewards and incentive frameworks as part of its overall assessment of a bank's capital requirements.

In a speech before the Investment Management Association on 20 May 2008, the FSA's Chief Executive, Hector Sants, told the audience that organisations need to do a better job of controlling risks that might result from inappropriate incentives. Moreover, he continued, the FSA 'will consider the implications of remuneration when judging the overall risk of individual institutions. We will do this with increased intensity.'

'This seems like a sensible idea', says Mr Montagnon of the Association of British Insurers (ABI). 'It doesn't mean that there is a direct intervention into remuneration and it doesn't stop banks being competitive. But it does mean that if they have a risky pay structure supporting a risky business model, then they will find that the regulators will come down more harshly and require that they hold more capital.'

Other regulators around the world are likely to follow the FSA's initiative. For example, in South Africa, banking regulator Errol Kruger has said that incentive schemes can produce potentially disastrous behaviour among top staff. In a Reserve Bank circular issued in July 2008, Mr Kruger said: 'I want to avoid a "heads I win, tails you lose" scenario where staff receive golden hellos, earn big bonuses, bet the house, do one deal too many and still get a golden handshake.'

Regulatory intervention is only supported by 20% of survey respondents, in sharp contrast to the 70% that support a voluntary code of conduct. But, according to Clare Thompson, a partner at PricewaterhouseCoopers (UK), an intelligently applied regulatory regime need not be all bad news.

'Many organisations see the need for reform,' she says, 'but are concerned about the risks of being a first mover in this area. This explains the widespread support we hear for a voluntary code of conduct. However, without some kind of regulatory teeth, I am skeptical as to whether by itself such a code could deliver change.'

Although some form of regulatory intervention into remuneration has been hotly debated, there are some significant challenges to overcome.

With regulators operating at a national level, or with control over only a limited part of the industry, a regulatory initiative over rewards runs the risk of lacking real weight. To be workable, regulation would need to be global – something that experience in other areas suggests is extremely difficult to develop and enforce, although the regulators of the major territories are seeking to collaborate on the matter.

'It may be that the most likely outcome in the short term is 'regulation by speech', where influential regulators announce their intention to take pay into account, but only gradually implement the mechanisms by which this actually happens,' says Dominic Nixon, Financial Services Asia leader at PricewaterhouseCoopers (Singapore). An initial step might involve regulators asking probing questions and seeking further information from companies on their remuneration policies, in the hope that the mere fact of greater scrutiny will encourage action. Concrete regulatory actions, such as capital reliefs and penalties, would then follow, once regulators' understanding of the issues had increased. Another implication of this approach is that, where regulators lead, rating agencies are likely to follow, and this will potentially add another layer of influence.

But even as executive management and shareholders cry out for substantive remuneration reform, the priorities of most financial services companies seem to lie elsewhere.

Differing priorities

For example, asked about their remuneration priorities of the past year, more than two-thirds of respondents say that their primary objective was to strengthen talent management processes.

Their second most important priority has been to ensure that profitable performers are being adequately compensated. In other words, as the credit crisis continues, financial institutions are focusing on retaining the employees that are most critical to revenue generation.

According to Justin Ong, a partner at PricewaterhouseCoopers (Singapore), the need to focus on talent management processes really resonates. 'In Asia,' he explains, 'financial services are in expansion mode. There are sectors that are

growing at incredible rates – for example, private banking in China is growing at 35%. Consequently, the focus here is on finding and retaining talent. Other compensation issues are taking a back seat.'

Other important initiatives of the past year, according to respondents, include improving performance measurement and management techniques and strengthening communications with employees – a reasonable measure during a time of uncertainty.

Bringing up the rear at 24% is the issue that seems top of mind to shareholders: shifting a greater element of compensation towards long-term reward.

However, as a senior financial executive at a prominent US-based regional bank explains: 'Shareholders are often fighting the wrong battle at the wrong time. Right now, we're not on as firm a footing as we're accustomed and it's time to stay afloat.'

He adds that steps to improve compensation policy will follow, but should only take place when banks are in a better position to implement them. 'Then, we can take more strategic steps, such as improving controls, tightening the linkage between risk management and operations – really elevating the role of risk management – and take a look at what we can do with longer-term, equity-like compensation.'

Looking to the
future, there is good
and bad news.

The willingness to change

The good news is that executives appear very open to making changes to compensation structures and that some degree of reform is already under way. The bad news is that executives also realise that many of the necessary changes will be difficult to implement unless adopted more broadly by the industry as a whole. As Sir Win Bischoff of Citi explains: ‘There is no first-mover advantage with compensation reform.’

Despite the problems associated with reform of compensation systems, the survey shows that the industry is taking steps to address key issues. Some of the most visible developments include:

A shift towards longer term incentives

Asked about the changes they have already made to their compensation plans, 43% of survey respondents report an increase in the use of long-term incentives and 32% report an increase in the proportion of remuneration paid for periods of three years or longer. Taken together, these findings in Figure 7 illustrate a gradual trend towards a longer term focus among respondents.

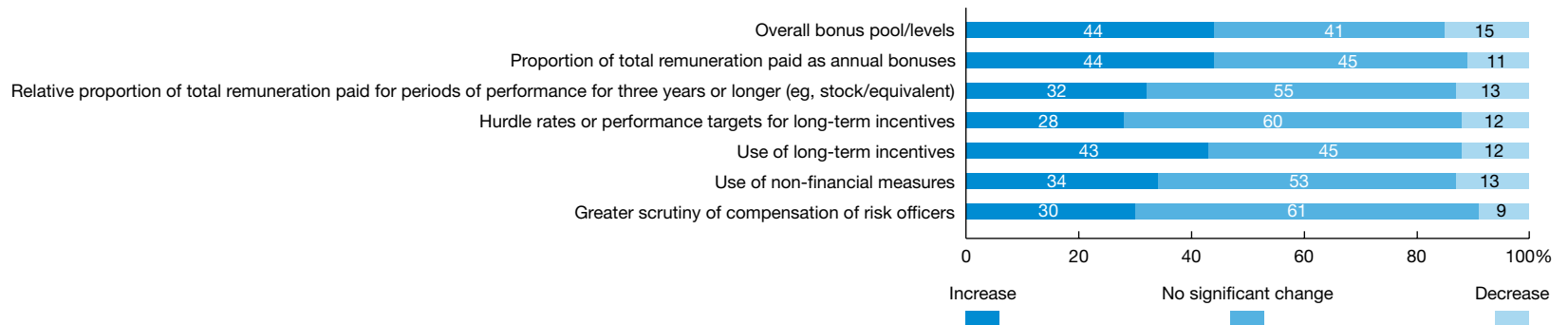
‘It’s possible that we will see a trend towards more deferral, and more remuneration paid in stock, which clearly you can argue is more

aligned with the interests of shareholders’, says Mr Moss of Aviva. ‘I would expect remuneration committees would be thinking about this issue and it may lead to some voluntary changes.’

Among the survey respondents, more than half say that they would support a move within their organisations to act independently – regardless of whether the industry follows in lockstep – to increase long-term reward as a percentage of total compensation. By comparison, about one-third of executives say they would do so only if such a shift becomes an industry-wide initiative.

Figure 7

Question 6. Over the past year, what changes have you made to the following aspects of your compensation plans?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

Just over one-third of survey participants say that they would support the use of more deferred bonuses, while a similar number would support such a move only as an industry-wide initiative. The idea of making the eventual receipt of deferred bonuses subject to longer term performance conditions is also of interest, with 39% saying that they would support this independently, and the same proportion only if it were an industry-wide move. 'People talk about whether reward should be measured over the longer term through the increased use of deferrals', says Mr Lee of Hermes. 'But our view is that this does not go far enough. The period over which performance is judged needs to be extended to encourage more of a longer term view. It's a crucial area we are arguing for and one where there seems to be a very significant misalignment of interest.'

Bonuses should be driven, not by an annual measure of performance, but on performance measured over a period closer to the life of the product – at least three years – so that there is not an incentive to make a quick flip but genuinely to create value over the longer term.'

Eamonn Maguire, a Managing Director at PricewaterhouseCoopers (US), believes that steps can be taken to generate alignment. 'Market forces limit the extent to which compensation is deferred, so you will never get a perfect match between the timescales of risk and reward, but you can improve the alignment', he explains. 'And another key issue is looking at what any deferral is linked to – as an alternative to deferring into stock, organisations should be exploring how to link the value of the deferred bonus to the long-term profitability of the business area. This also helps to stop intergenerational issues where people are punished because of loss-making business instigated several years ago by someone who may now have left the firm.'

Of course, executives can be somewhat, if not staunchly, resistant to the conversion of significant portions of their bonuses to equity structures. 'The nature of what I do is very focused, very transparent and it creates an easily measurable value over a very specific timeframe', explains a vice-president from a major US investment bank. 'So essentially, [the institution]

makes its money in the current quarter or the current year – and I believe it is fair for me and my team to do the same.'

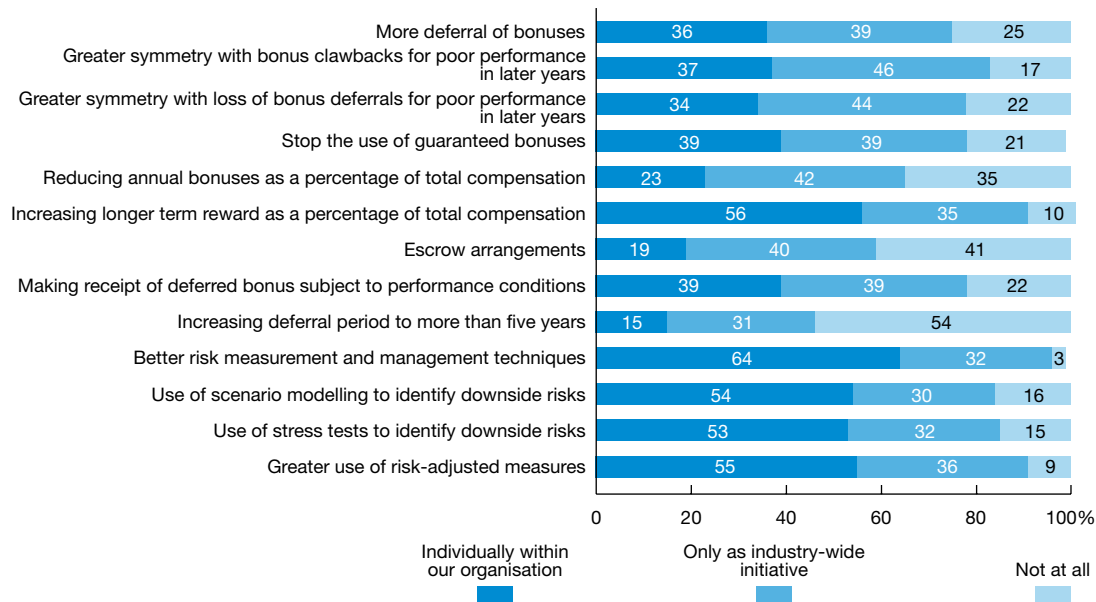
Well over one-third of executives say that they would also like to see a greater linkage between long-term performance and some sort of bonus clawback (see Figure 8). In this case, however, 46% of executives say that they would support such a move only if broadly adopted by their peers. 'Getting the industry to accept something like that would be very challenging', believes Mr Tilmant of ING.

A more intensive focus on risk

If nothing else, the credit crisis has resulted in a healthy debate on both real and potential shortcomings in the alignment between risk management and compensation. One-quarter of executives, for example, say that shareholders have expressed concern regarding incentives and risk-taking (see Figure 6 on page 20). In particular, there is concern that risk and compensation are not always closely aligned. For example, an executive might be able to take a bonus, based on a mark-to-market profit in one year, which becomes a loss in subsequent years.

Figure 8

Question 20. Which of the following initiatives would you support in your organisation, and which would you support only if it were an industry-wide initiative?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

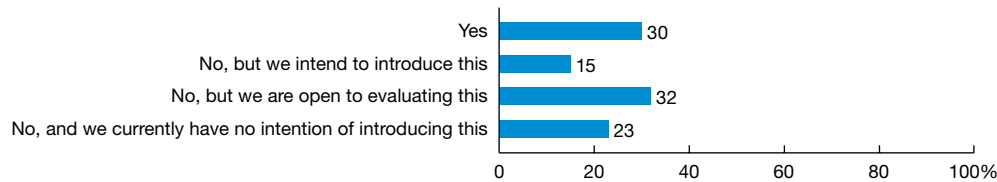
While companies are definitely looking to address this situation, answers are not always easy. ‘There can be great difficulty in finding appropriate common denominators between risk and reward’, says Edward Bonham-Carter, Chief Executive of Jupiter Asset Management. ‘Let’s take a nuclear engineer as an example. The risk of what he does might not materialise for 35 years, so will you claw back his pension when he’s 85?’ So while it is important for financial services companies to try to more closely align risks with compensation, drawing a clear line and establishing an appropriate timeframe is not always straightforward.

Once an organisation begins to charge for the relative risk of the capital employed, debates may become heated. ‘If I say the risk is “this”, then some other manager will be able to provide 100 arguments why I got it wrong and why the risk is actually so much less’, explains Sir Win Bischoff of Citi. Although he agrees that it is important to begin paying more attention to the role of risk in remuneration, ultimately it won’t be easy. ‘Risk,’ he says, ‘is very much in the eye of the beholder.’

The willingness to change continued

Figure 9

Question 7. Does your company use a risk-adjusted profitability measure, such as risk-adjusted return on capital (RAROC), risk-adjusted cost of capital or capital-adjusted value at risk (VaR), to determine performance-based compensation?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

Sir Andrew Likierman from the London Business School agrees that companies in general have not been able to come to grips with the relationship between risk and performance. 'There's a lot of room for improvement', he explains. 'Companies need to consider the relationship of risk to the individual in terms of meeting their performance target and what that risk means to the organisation. Individuals may take risks that are too great, or they may take insufficient risks. Either has implications for the organisation and they need to sort out the relationship.'

In recognition that certain business activities are significantly more risky than others, executives are expressing greater interest in creating risk-based performance metrics. Just under one-third of executives say that their companies utilise risk-based measures, such as RAROC or VaR, but an additional 47% say that they either intend to introduce the use of these measures, or are open to evaluating them. Again, this finding seen in Figure 9 reflects a trend towards greater attention being paid to risk adjustment.

The implementation of risk metrics is far from straightforward, however. 'When it comes to allocating capital, we absolutely look at risk', says an executive from a major US hedge fund. 'Once that capital is allocated, all people care to look at is the total number of dollars that capital generates. My bonuses? They're based on the dollars I bring in, the value I create, not the relative risk of the capital I use.'

There are also problems with defining and measuring risk. 'If you start basing compensation on the relative risk of capital, who's going to be the arbiter of whose capital is risky and whose isn't?' says an executive from a US hedge fund.

'Will you spend time to create a model? Will you update the model? I think you'll get into lots of trouble going down this path plus you'll stop taking on the sorts of investments that can really pay off in the long run.'

Other market observers, however, say that risk-adjusted performance measures are an idea whose time is long overdue.

Companies looking for a means of evaluating and establishing the relative risk of capital employed, need look no further than the Basel II capital framework. As part of this framework, banks are establishing risk-adjusted performance measures, which enable them to measure returns against risks taken.

Mr Gosling of PricewaterhouseCoopers (UK) says that although risk-adjusted performance measures are not a panacea, they have to be part of the solution.

'One of the reasons why relatively few organisations have linked bonuses robustly to risk-adjusted metrics is that smart people who are resistant to the change can always come up with 100 reasons why it won't work. Senior management needs to be prepared just to say "OK, we know it isn't perfect but it's better than what we've got and we're going to push it through".'

A shift from individual to organisational

The survey also reveals that some companies are attempting to shift their cultures towards a more group-wide performance orientation. For example,

as seen in Figure 10 overleaf, nearly half say that they are increasing the percentage allocated, based on group performance, although it is worth noting that 46% forecast no change and 6% say that this will actually decrease.

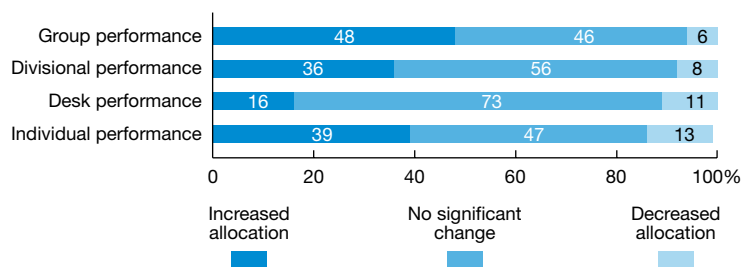
Introducing a group performance bonus may seem a small step but, in practice, it is challenging to implement. 'There's always a difficult balance to strike when rewarding individuals for their own performance and for the performance of the company as a whole,' says Mr Lee of Hermes, 'but it's very clear that banks are terrified of being the first mover on this.' Despite the difficulties, Mr Lee believes that financial institutions need to pursue such initiatives and that reform must begin at the top.

'Senior managers should be driving the organisation as a whole,' he says, 'so their compensation should set an example, too.'

Ron Collard, a partner at PricewaterhouseCoopers (Singapore), highlights the difficulty of rewarding individual performance when the overall organisation has performed poorly. 'I was speaking with an executive who was saying that,

Figure 10

Question 9. In the next year, what change do you expect to make to the proportion of the bonus paid for performance in the following areas?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

while his securitisation desk had lost a great deal of money, there were others in the organisation who had an incredible year.' So can an organisation pay bonuses to one area while another is losing money? Is it prudent or even necessary to pay bonuses to well-performing executives, even if the company overall is losing money? A majority of survey respondents think so, with 61% agreeing with the statement that it is

acceptable for a high-performance individual to receive significant rewards, even when the overall business has performed badly.

An executive from an investment bank highlights some of the retention difficulties associated with a shift to a group-wide view. 'There will be quarters or years where we make a ton of money on our book and everyone else is going nowhere', he says. 'It may feel right to

share the pain, but that's going to increase the odds that a lot of very talented and valuable people are (going to) pull up tent stakes.'

He adds that it is not fair to deal-makers to force them to accept 'the vagaries' of overall company stock performance. 'It's appropriate to provide some degree of compensation in the form of long-term equity – I can appreciate how that creates commitment to a "brand" and promotes integrity and internal co-operation', he says. 'However, what happens when things outside my control depress the stock price? That's robbing a person of the value of their labour and intellectual capital – and that's going to create a very bad feeling.'

As ever, it is a question of striking the right balance. While a degree of group performance in remuneration seems sensible, institutions should be careful to prevent too great a shift. The profits of many institutions are derived not just from teams, but also primarily from the vision and efforts of talented and motivated individuals. To go too far in the direction of group performance over individual rewards could potentially do more harm than good by removing the incentives that drive the top performers in the industry.

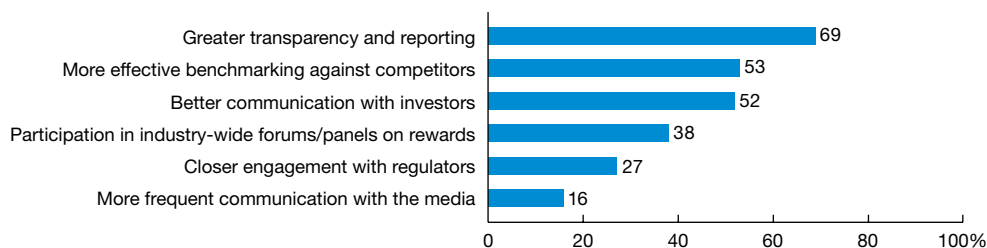
Striking the balance between variable and fixed

A number of the interviewees questioned for this report point to problems, particularly in investment banking, with the variability of salaries and the skewing towards bonus rather than fixed salary. 'If you pay a too low fixed salary,' explains Mr Tilmant, 'what happens is that people need their bonus for their standard of living. So the large degree of bonus compensation becomes a device to take risk. They simply cannot pay their bills without a good part of their bonus. The total compensation needs to be sufficiently stable.'

A related issue is that investment banks treat bonuses as though they are a variable cost, when in reality, they are fixed, at least to an extent. More than one major investment bank has allowed its compensation costs as a percentage of net revenues to rise above the normal range in order to retain key staff. If part of the bonus pool really is fixed, perhaps this should be acknowledged explicitly in how pay is structured.

Figure 11

Question 23. What steps does your organisation plan to take to improve stakeholder relations around rewards?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

Introducing greater communication in remuneration issues

Financial institutions recognise that there are fences that need mending in terms of communication with stakeholders. An important goal will be to provide assurances that compensation systems are fair, as well as being aligned with stakeholder needs and longer term outcomes. To this end, 69% of organisations say that they will offer greater transparency and reporting to stakeholders, while just over half

say that they will begin using more effective benchmarking with competition (see Figure 11). A similar proportion say that they will engage in closer communication with shareholders regarding remuneration. Other measures include greater participation in industry-wide forums on compensation and rewards, which just over one-third say that they will undertake, and closer alignment with regulators – an initiative for just over one-quarter.

Achieving change

Implementing the kind of changes detailed above will not be easy. 'This is not a case of moving the deck chairs', says Jon Terry, a partner at PricewaterhouseCoopers (UK). One challenge, he believes, is a lack of coherence within organisations in terms of how functions are brought together in the design of compensation arrangements.

'Too often, design and management of reward programmes is viewed as a human resources (HR) issue', he says. 'But HR departments can't be expected to have the skills to understand and model all the complexities of a modern financial services business. We need a new way of ensuring that senior executives responsible for risk, finance and treasury work closely with HR, and are jointly accountable for the design of pay programmes.'

Moreover, the idea that reform of compensation by itself can achieve change is an illusion. John Garvey, Financial Services US Advisory leader at PricewaterhouseCoopers (US) explains: 'Governance structures, decision rights and controls, risk and financial reporting and performance metrics all need to be aligned if you're going to change the culture – by itself, pay is not enough.'

The risks and rewards

Figure 12

Question 15. In your view, what are the biggest risks associated with reforming the current compensation system?



Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, May 2008.

There are risks associated with implementing compensation reform that need to be considered. For example, the survey revealed a number of concerns among respondents, such as greater difficulty in retaining talent, reduced motivation or the potential that a reformed system will not provide adequate incentives. But the biggest risk of all, according to respondents, is talent retention. By reforming compensation systems, executives are

concerned that top performers would fall into the hands of rival firms that may offer more generous incentive packages. That point is further bolstered by 41% of respondents who say that they could create a competitive disadvantage for themselves by implementing reform ahead of their competitors (see Figure 12).

The risks and rewards continued

Consider the following scenario. Imagine if one investment bank were immediately to halve or even suspend its annual bonuses, converting instead to long-term equity incentive structures. 'The immediate effect would be your top performers jumping ship – going right next door

where the bonus scheme is still skewed towards near-term payout', explains an executive from a large US bank.

The same is true for myriad strategies and practices. Attempt to implement any sort of longer term oriented remuneration practice to a

significant degree, and the talent vacates. 'You can only swim against the stream for a short time', explains the Non-Executive Director introduced earlier in the report. 'Unless others in your sector adopt the same policies, you'll be at a commercial disadvantage.'

A history lesson

In 1994, the US investment bank, Salomon Brothers, was rocked by scandals and facing a loss for the year of almost US\$1 billion. In October of that year, Chief Executive Deryck Maughan announced a plan supported by the bank's largest shareholder, Warren Buffett of Berkshire Hathaway, to rein in what was seen as extravagant bonuses, and to prevent individual traders from earning huge sums at a time when the bank overall was losing money.

The new compensation scheme stipulated that traders would only receive bonuses if the bank itself earned a profit. The plans were watched

carefully by the industry as a whole, which would have been likely to emulate the proposals if they had been successful.

Salomon traders were infuriated by the new compensation structure. With many likely to see their pay cut by almost two-thirds compared with the previous year, an exodus of key employees followed. Within months, 30 of the bank's 210 managing directors had resigned, including three members of the executive committee.

The scale of the departures took the board and shareholders of Salomon by surprise and ultimately prompted an about-turn. In April

1995, it was announced that outstanding performers would, after all, be rewarded, if the bank failed to reach its targets. A large part of the experiment had failed and Salomon Brothers ultimately returned to its traditional compensation system.

There are interesting parallels between the situation that faced Salomon Brothers and the position in which investment banks find themselves today. While many banks would like to reform their compensation systems and prevent huge payouts despite overall losses, they are extremely nervous about experiencing a similar reaction to that at Salomon Brothers.

This fear underlines an important point about reform in compensation systems – without industrywide support for change, it will be very difficult for individual institutions to implement significant reforms. The fear that they will lose key staff is simply too great.

One way such risks might be mitigated is through coordinated, industrywide effort. ‘If an industry body were to come up with a recommendation and policies – such as a code of conduct – then 90% of the largest institutions would likely subscribe’, explains a senior US banking executive. ‘In the short run, a number of

institutions might instead attempt to exploit the situation by poaching talent and failing to adopt the new guidelines. But over the long term, such an industry-wide move would eventually cause others to come along.’

Other risks also bear mentioning. Poorly implemented reforms to a remuneration system could reduce motivation or simply fail to provide adequate incentives. The danger here is that banks restructure their compensation systems to please shareholders or regulators, only to find that employees are no longer sufficiently incentivised to perform to the level that is required.

This risk is leading many organisations to adopt a ‘wait and see’ approach. ‘At the moment, you’re hearing a lot about reforming remuneration’, says Mr Bonham-Carter of Jupiter Asset Management. ‘But this pressure for reform may dwindle. If the credit crisis unwinds fairly rapidly and if we avoid a severe downturn, then you might see a lot of this fade into the background.’ Should that happen, it will be the loss of a great opportunity. As Mr Bonham-Carter concludes: ‘Remuneration needs genuine reform.’

A prospectus for reform

So how can financial services companies navigate this uncertain environment, and what actions should they be considering? Each company clearly needs to consider its own circumstances, and target reform where the risks and misalignments are greatest. In some cases, little change will be required, while in others, major reconstruction of compensation arrangements will be the order of the day. At the very least, companies should be prepared to respond to challenges about their pay policies from compensation committees, shareholders and regulators. A one-size-fits-all approach to compensation design is clearly not appropriate. However, firms should consider how they would 'comply or explain' against the following principles.

1. Incentive payments should be based on performance measures that adequately account for the risk taken in producing profits.

Too many incentive plans ignore risk when assessing bonus payments. Apparently strong results can look more anaemic when the risk taken to produce them is properly factored in. There seems little doubt that better practices in this area would have lessened incentives for excessive risk-taking and would have provided an early warning system about the risks being taken. Change in this area need not lead to the

much feared first-mover disadvantage. Using risk-adjusted measures does not necessarily mean that bonuses need to fall, just that they need to be justified by real performance.

2. Bonus pools should not be struck below the level at which cost and risk can be allocated.

Competitive pressures for talent have led to an 'eat what you kill' culture in many investment banks. In order to retain key staff, many firms have been driven to align bonus payments with increasingly localised results. Often, the bonus assessment is based on such a granular level of business unit that the firm's systems can no longer accurately allocate risk, or even cost. This has led, for example, to payments based purely on revenues in some cases.

Firms need to address this from three directions:

- i. Significant investment in improved cost and risk allocation systems to enable a more granular understanding of risk-adjusted performance (this is a fundamental business management issue as well as a compensation issue).
- ii. Recasting bonus pools at a higher organisational level, where risks and costs are already well understood. However, this needs to be balanced against the risk of losing key people, as this will be less attractive for some key revenue generators.

iii. Retention concerns and the time taken to improve risk reporting and measurement systems means that firms may need to live for a period of time with measures that do not adequately account for risk. Where this is the case, firms need to recognise that this gives rise to additional business risk, and counteract this by: consideration of other risk management mechanisms such as deferrals; and instigation of additional controls and review procedures in the affected business areas.

3. Rewards should be aligned with the risk profile borne by the firm.

More use should be made of long-term incentives and deferrals in business areas that take longer term risks. Exactly matching the term of different product lines is unlikely to be practical. And deferrals beyond three to five years are likely to be so heavily discounted by executives as to have no impact on behaviour. But even with these restrictions, better alignment can be achieved. Structuring separate, explicit, LTI vehicles may be more effective than deferral of bonus, given the tendency (increasingly supported by case law) for bonuses to be paid out when an individual leaves the business.

4. Deferrals should be linked to the realised profitability of the business on which the bonus was based.

Those wishing to argue against deferral as a solution, point out the fact that Bear Stearns had higher levels of stock-ownership than many banks. But deferral into stock, while it might encourage individuals not to leave, does not do much to militate against short-term behaviour. For all but the most senior individuals, the stock price of the entire enterprise is a very remote concept. Even with deferral, the prime incentive is still to do what you need to do to get the stock in the first place – that is, deliver on the annual bonus targets. Instead, companies should look at linking the value of deferrals more closely to the area of business in which the profits were generated. Achieving an exact match is likely to face severe practical constraints, but linking deferrals to future local business area profits, even if not to the exact book of business that generated the profits, would help. This would also support a culture of peer review, because managers in the same business area would be encouraged to look at each others' activities to make sure that the value of their own deferral was not being put in peril.

5. Managers should have a significant proportion of remuneration based on divisional or group-based bonuses.

Bonuses based on very localised measures of performance are often praised as providing improved 'line of sight'. In other words, because executives can see and control what they need to do to generate a bonus, it provides a stronger incentive. However, this also increases risk unless the metrics are robust (and risk-adjusted) and the control environment strong. Line of sight also creates the moral hazard that bonus targets may be manipulated or achieved in ways that have unanticipated consequences. Greater use of divisional or group-based bonus pools reduces these risks and also encourages individuals to think more widely about the health of the entire enterprise. Firms also need to look at the longer term patterns of remuneration for individuals over time – is remuneration excessively volatile, encouraging a short-term mentality? Or do individuals feel themselves to be long-term partners in an enterprise in which they are building long-term value?

6. Compensation design should be considered a key business competence and resourced as such.

The bonus culture is a reality in financial services, and as a result pay does affect behaviour. Yet too often, compensation design is entirely left

to HR departments that can never be expected to have the entire range of skills required to design and monitor compensation in a financial services environment. Yet in our experience, HR faces significant difficulties in engaging other parts of the firm in compensation design. Organisations need to ensure that appropriate input from risk, finance and treasury is brought to bear, together with HR, in compensation design. These functions must have it impressed upon them that compensation design is a priority business activity.

7. Compensation design should be viewed in conjunction with wider people management practices in order to support a consistent approach to achieving the desired culture.

Although pay is important, it is far from the only issue, as highlighted in this survey. Looking at compensation in isolation, is unlikely to achieve the desired result by itself. Organisations need to review: how they develop and manage talent; how they manage performance (what is it that is really recognised and rewarded?); how individuals' careers are developed; and how the desired culture and expected standards of behaviour are communicated and reinforced.

As the credit crisis continues to unfold, governments, regulators and the industry itself continue to seek a better understanding of its causes and implications.

Conclusion

Regulators are taking a close interest, and seem likely, at the very least, to ask probing questions about remuneration. There is also a political vacuum to be filled. The combination of economic downturn and electoral politics in the US and Europe means that ‘something must be done’.

Views differ as to whether remuneration was a symptom or cause of the credit crisis. It is almost certainly too simplistic to say that it was a prime cause. But the conclusion from this survey is clear. There is a widespread consensus that genuine reform is needed, and should not be viewed as a fig leaf in response to mounting external pressures.

Of course, there is a possibility that a quicker than expected economic recovery will lead to the current problems being forgotten. But that would be a mistake. There is currently a window of opportunity for meaningful reform to take place, which would benefit the operation and stability of the financial system as a whole.

Companies should respond positively to this opportunity to ensure that any reform that takes place is effective, and supportive of a vigorous, yet robust, financial services sector. Strong and visionary leadership will be required to overcome the fear of change. The case also needs to be made to employees that initiatives that seem unattractive in the short term will have a payoff in the future.

In this way, the sector can regain its rightful place as one in which innovation flourishes and that supports economic growth. For this reason, well-considered voluntary initiatives from industry bodies, such as the IIF and the Counter-Party Risk Management Policy Group, are welcome. There is a fair degree of consistency between the recommendations emerging from these bodies, and our own, which suggests a consensus may be starting to emerge.

Individual firms should review their remuneration policies against the principles outlined in this survey and ensure that any deviations can be justified. How would the firm respond to probing questions in these areas from the regulators?

By indicating that they are considering these issues voluntarily, financial institutions should encourage regulators to take on approaches that go with, rather than against, the grain of the market. An appropriate, light-touch, regulatory response to the issue may be the catalyst required for reform to take place.

While no one denies the right of individuals in a talent-driven industry to earn rewards, it is clear that the financial services sector as a whole recognises that its current remuneration practices are in need of reform. As Michael Rendell, a partner at PricewaterhouseCoopers, (UK) puts it: ‘All of us involved in financial services need to ensure that rewards reflect truly sustainable performance and are not a short term mirage. First, because it’s the right thing to do. Second, because it is always better to embrace change than to have it forced upon you.’ □

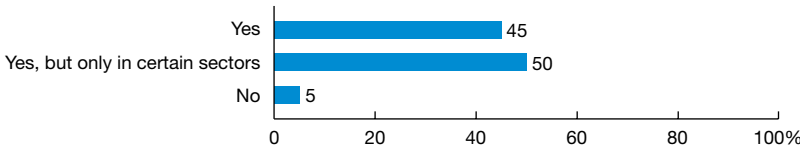
PricewaterhouseCoopers and the Economist Intelligence Unit conducted a global online survey of financial services industry executives and commentators. The survey attracted 264 participants from the Americas, Asia and Europe and was conducted in May 2008.

Appendix: Survey results

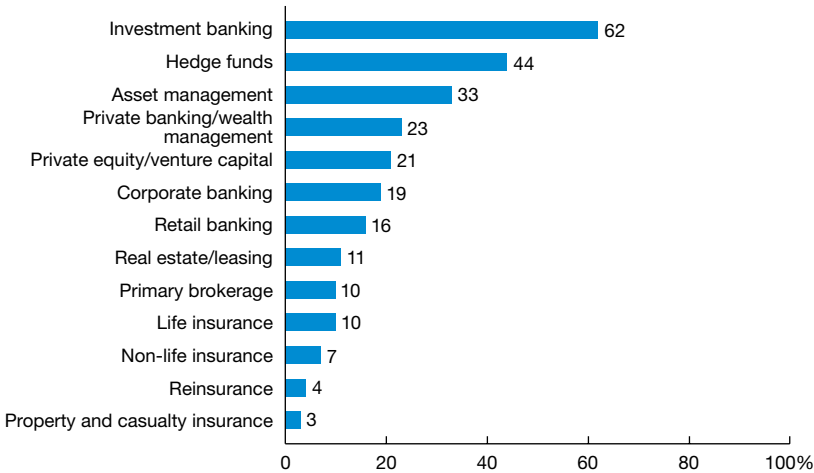
Our thanks are due to all those who participated for sharing their insights with us.

Please note that totals do not always add up to 100 because of rounding, or because respondents could choose more than one answer.

1. Do you think that the compensation systems in the financial services industry need reform?

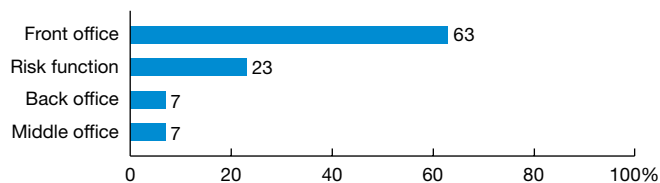


2. In which of the following sub-sectors of financial services do you think reform is most needed? Select up to three.

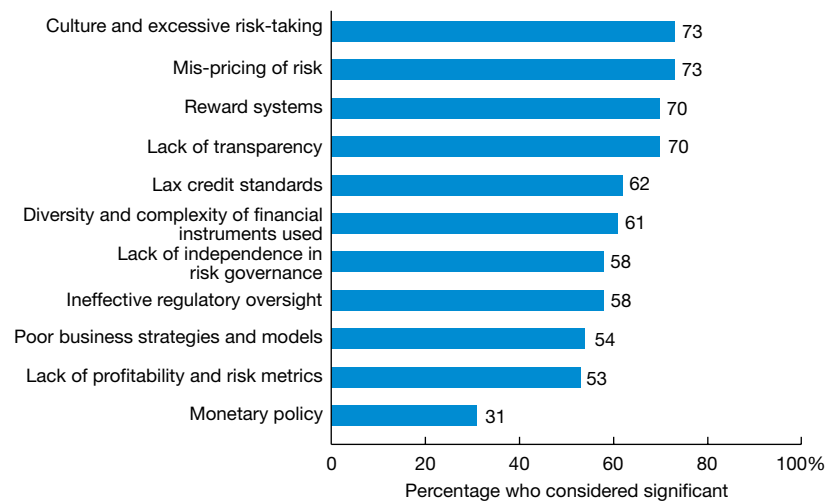


Appendix: Survey results continued

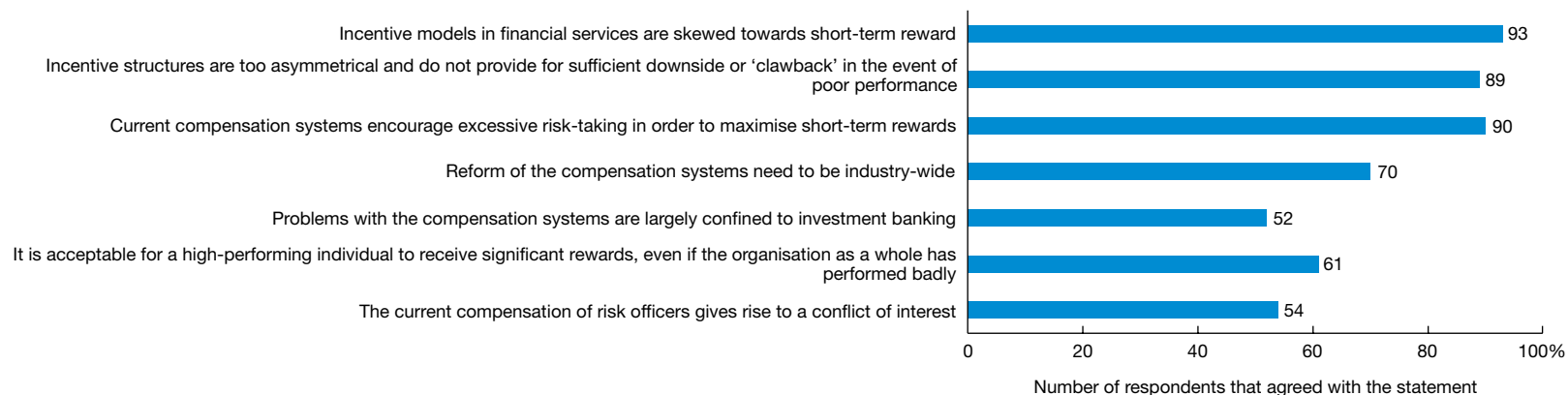
3. In which of the following functions are the compensation systems most in need of reform?



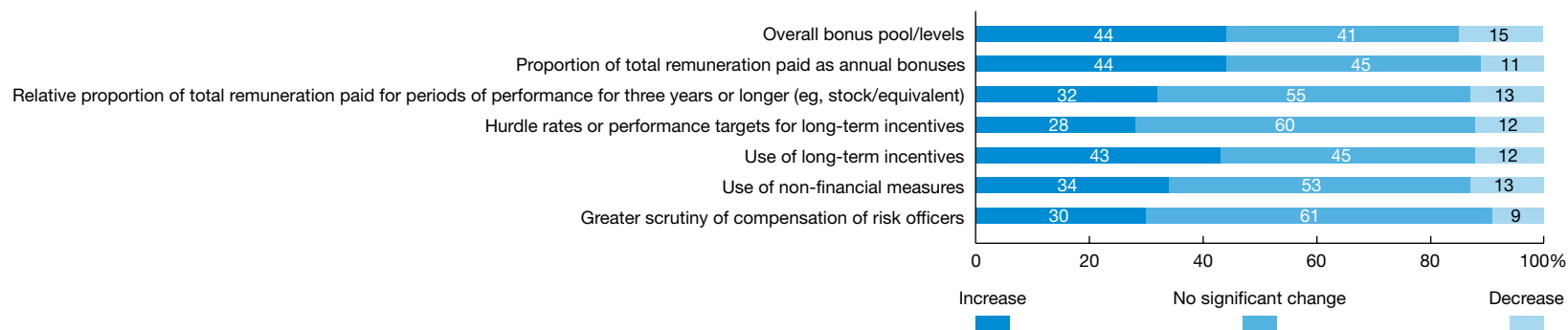
4. What factors have created the conditions for the current credit/banking crisis?



5. Please indicate whether you agree with the following statements.

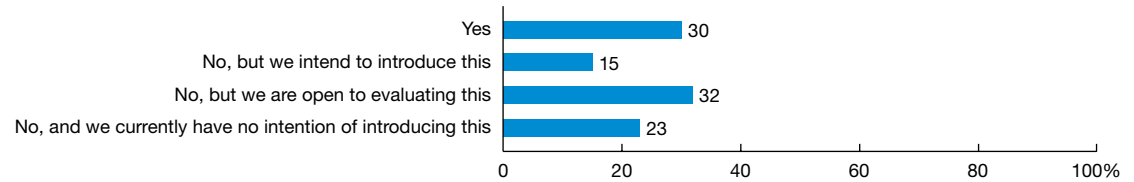


6. Over the past year, what changes have you made to the following aspects of your compensation plans?

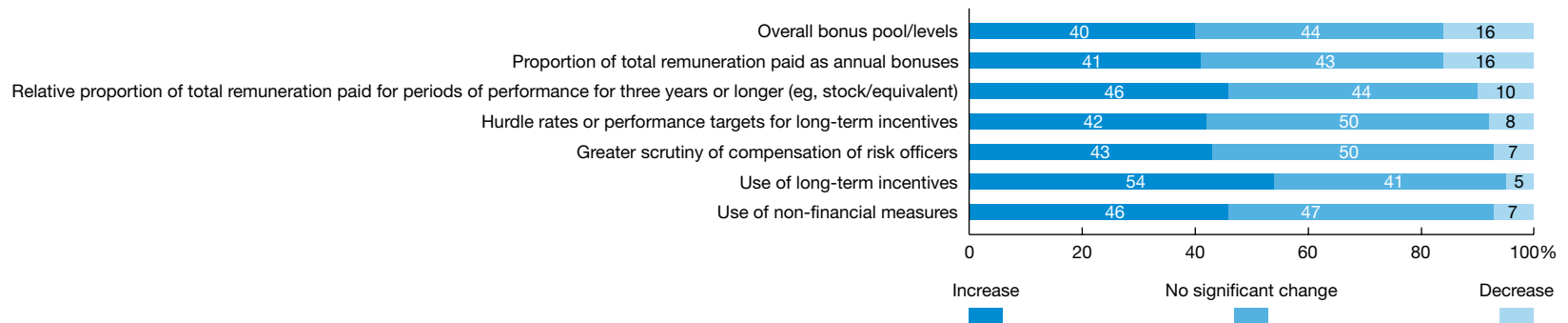


Appendix: Survey results continued

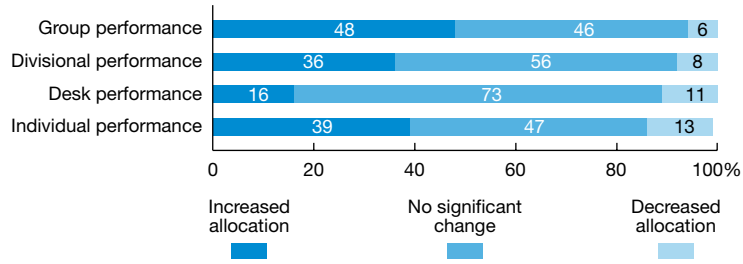
7. Does your company use a risk-adjusted profitability measure, such as risk-adjusted return on capital (RAROC), risk-adjusted cost of capital or capital-adjusted value at risk (VaR), to determine performance-based compensation?



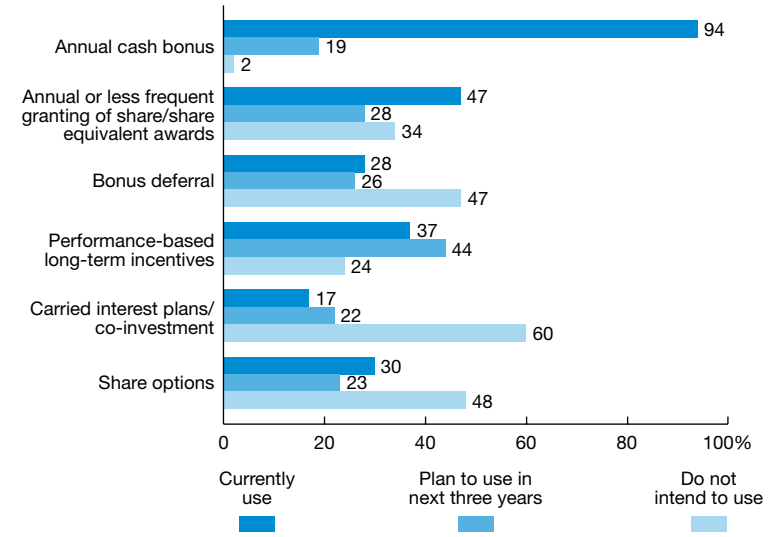
8. Over the next year, what changes do you expect to make to your compensation plans?



9. In the next year, what change to you expect to make to the proportion of the bonus paid for performance in the following areas?

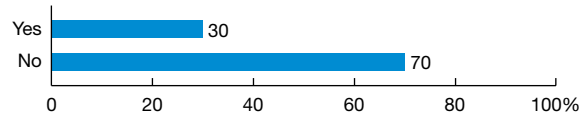


10. Which of the following components do you currently use in your compensation programmes and which do you plan to use over the next three years? Please select all that apply.

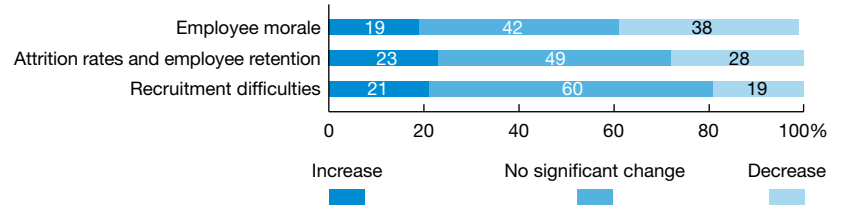


Appendix: Survey results continued

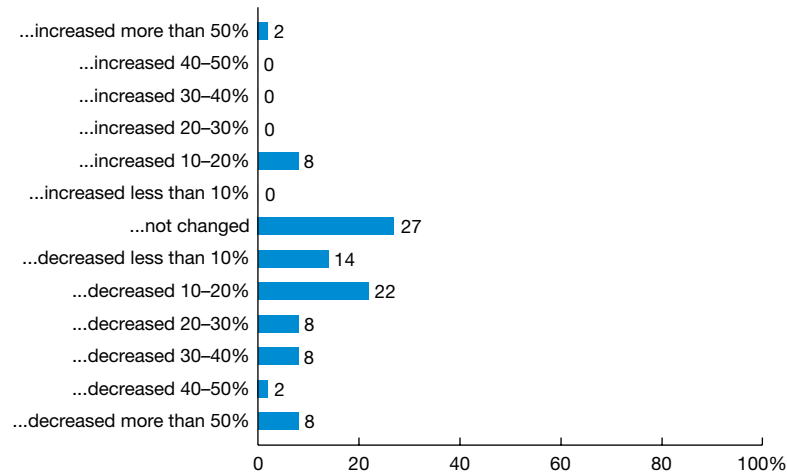
11. Has there been any reduction in headcount at your organisation as a result of the current credit/banking crisis?



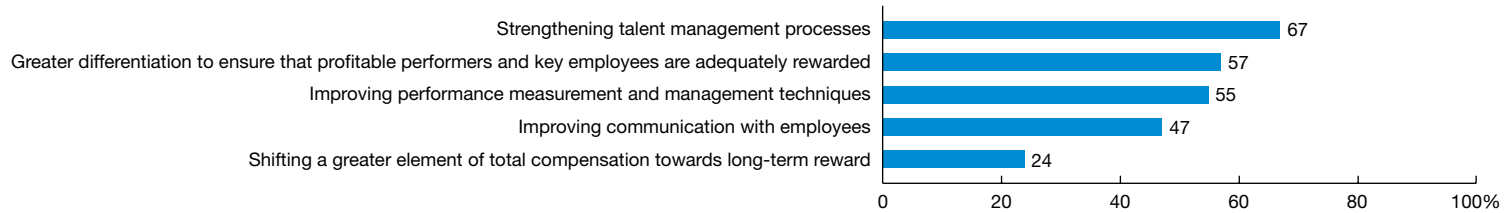
13. If you have reduced bonus levels paid out this year, what has been the impact on the following?



12. To what extent have bonuses at your organisation changed as a result of the current credit/banking crisis? Bonuses have...



14. In the past year, what have been your priorities in terms of improving the management of your organisation's compensation?

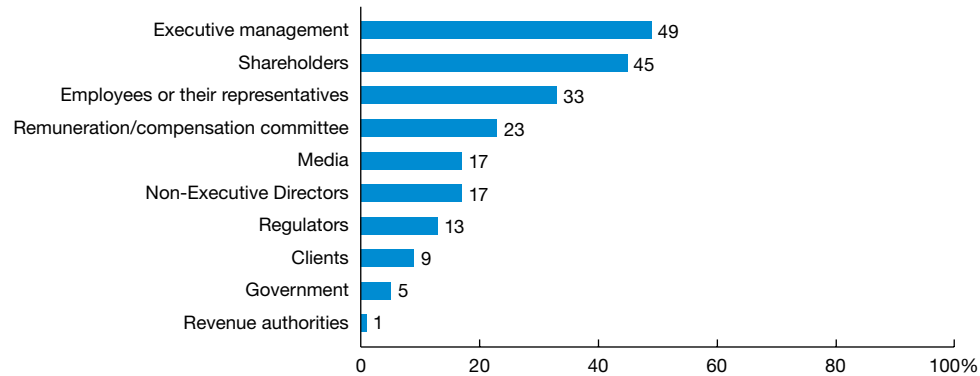


15. In your view, what are the biggest risks associated with reforming the current compensation system?



Appendix: Survey results continued

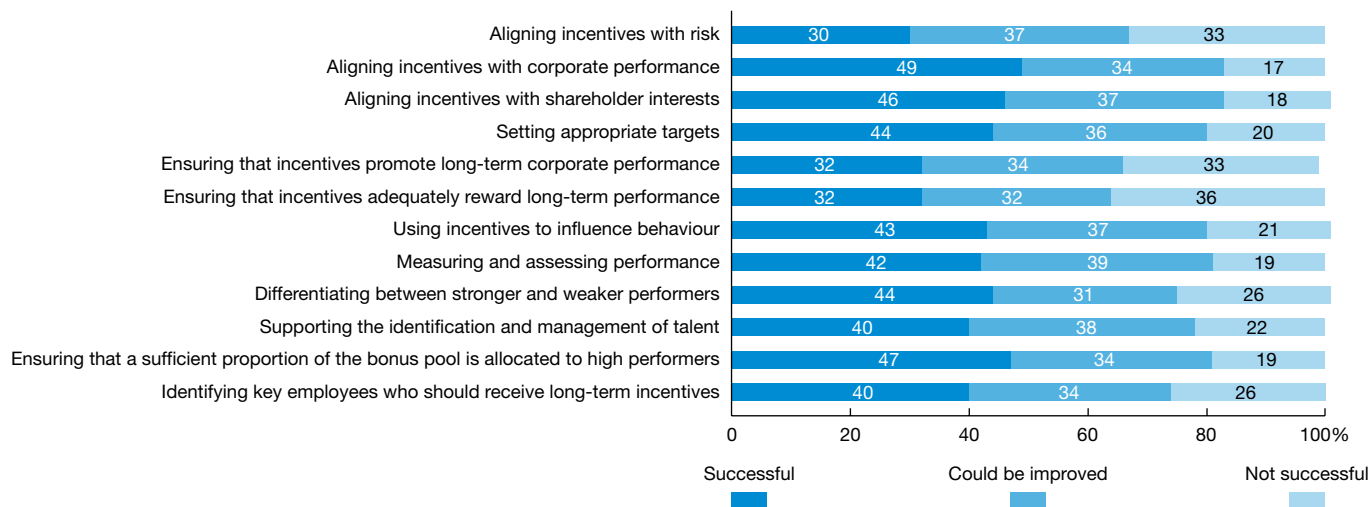
16. Which of the following stakeholders currently exert the greatest pressure on your organisation to change its compensation programmes?



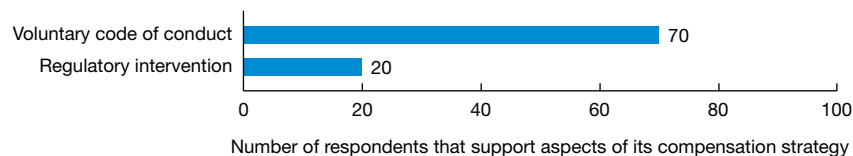
17. In the past year, have shareholders expressed concern about any of the following aspects of your company's compensation programmes?



18. How successful do you think your organisation is at managing the following aspects of its compensation strategy?

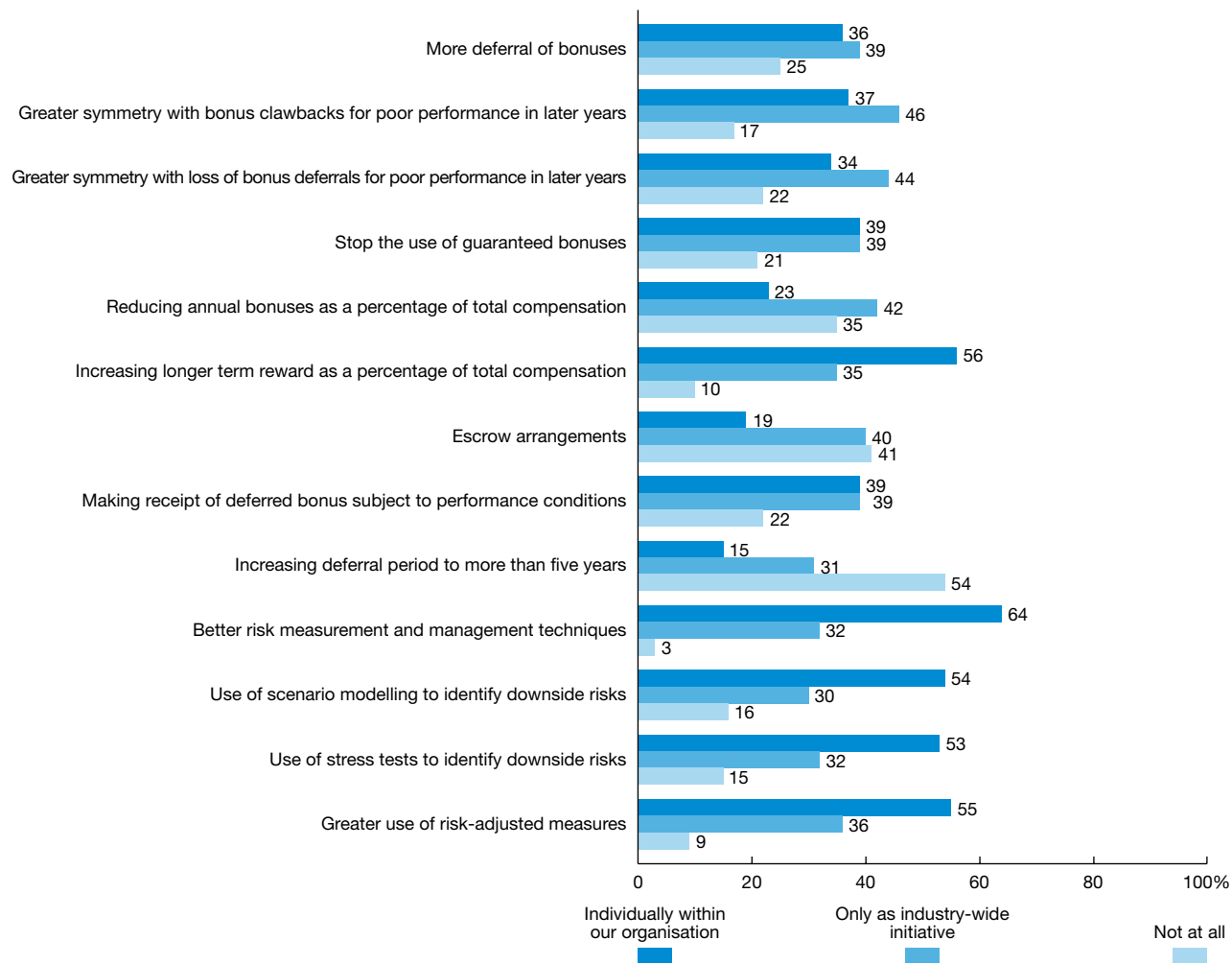


19. Would you support either of the following, related to compensation in financial services?

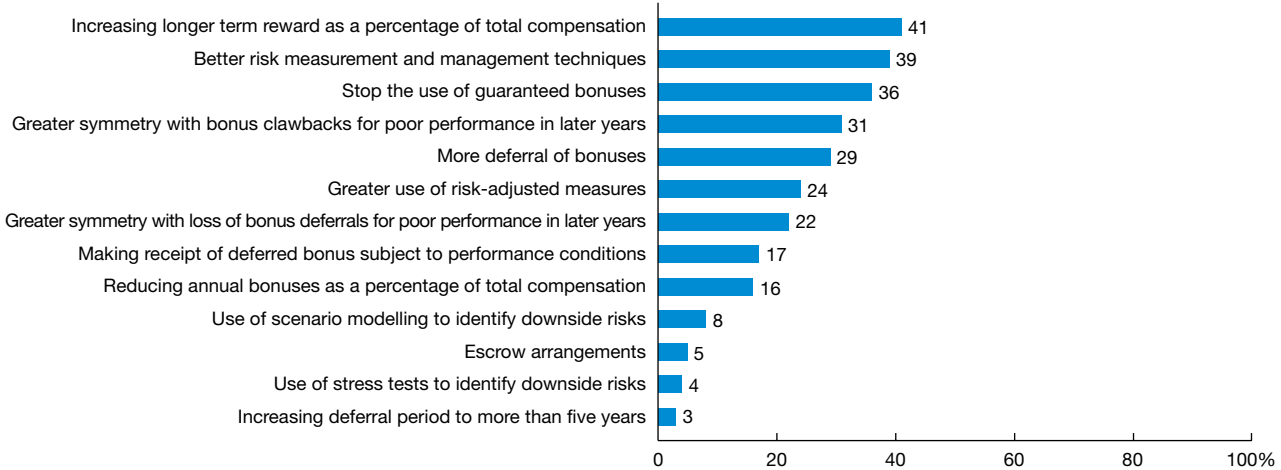


Appendix: Survey results continued

20. Which of the following initiatives would you support in your organisation, and which would you support only if it were an industry-wide initiative?

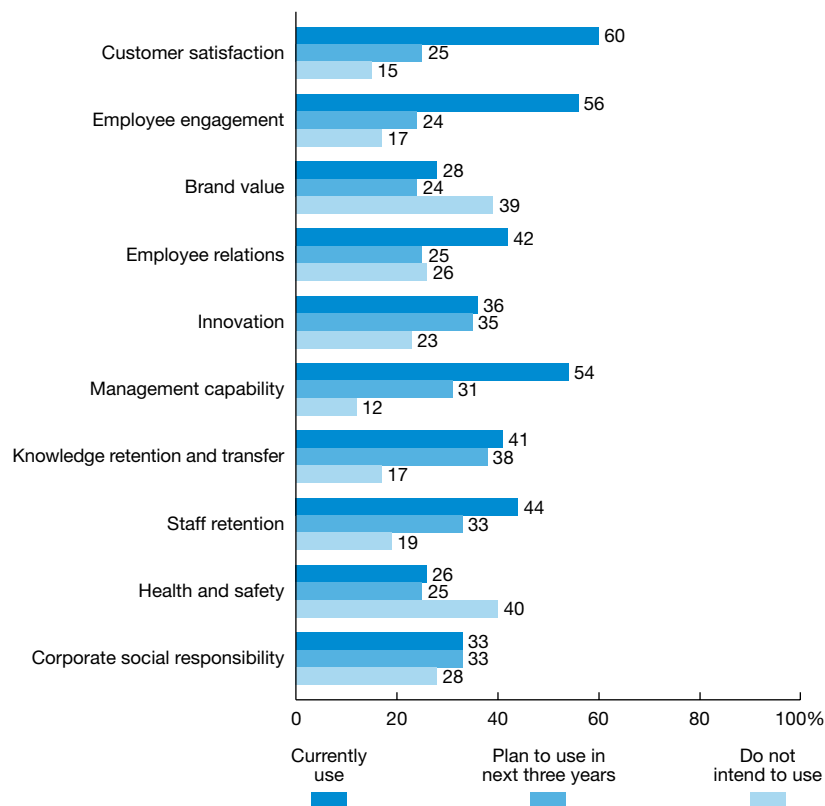


21. In your view, which of the following initiatives would be most effective at leading to better alignment between incentives and risk?

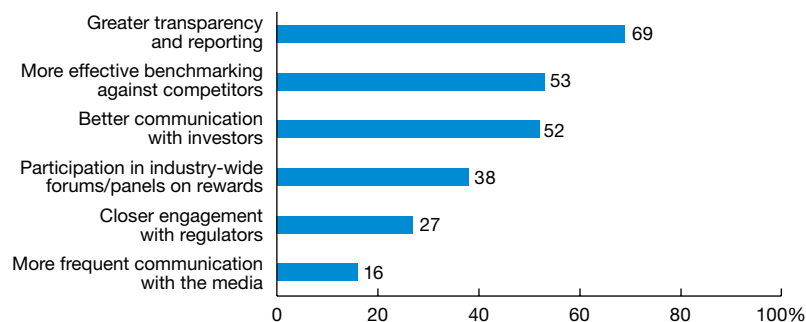


Appendix: Survey results continued

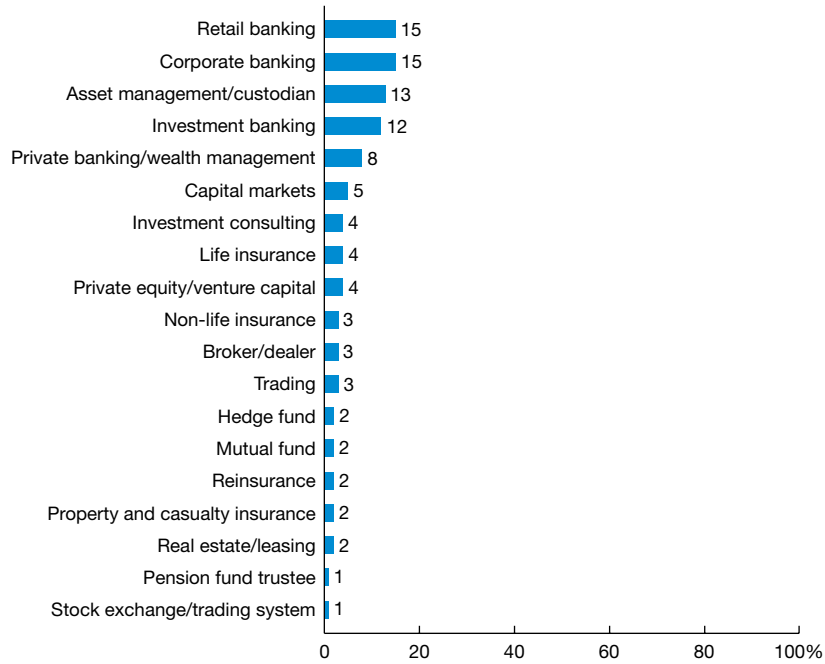
22. Which of the following non-financial measures does your organisation use or intend to use as part of its incentive scheme? Please select all that apply.



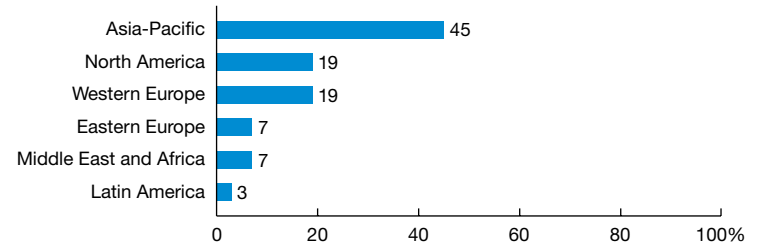
23. What steps does your organisation plan to take to improve stakeholder relations around rewards?



In which area of financial services do you work?

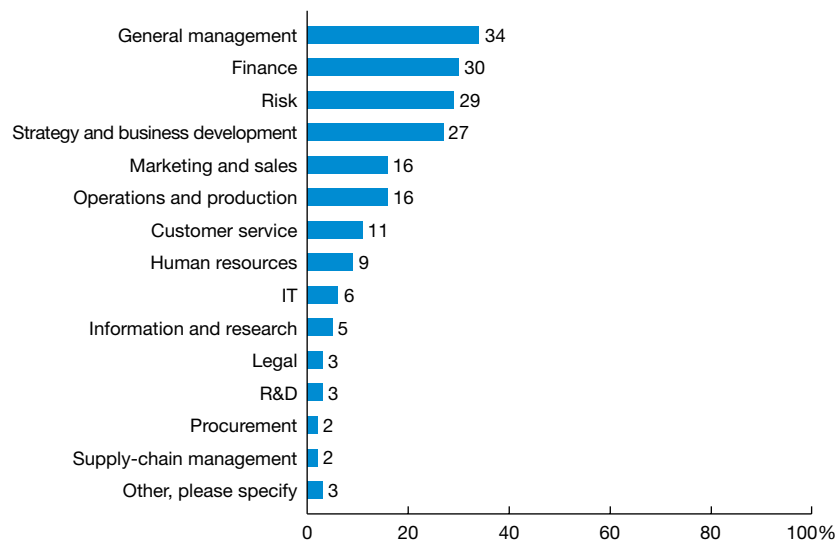


In which region are you personally based?

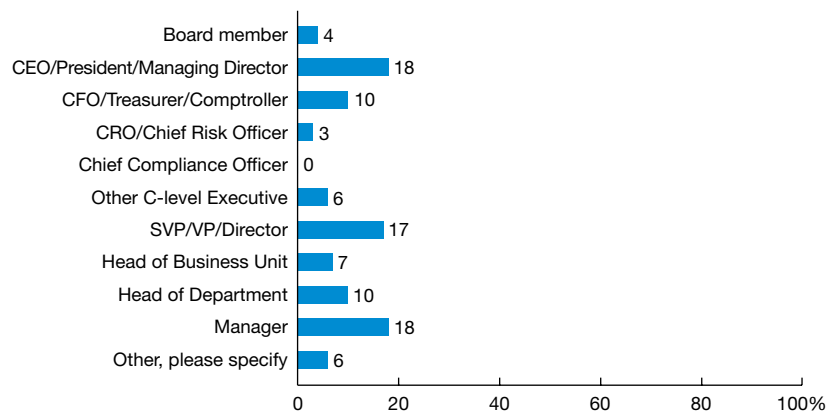


Appendix: Survey results continued

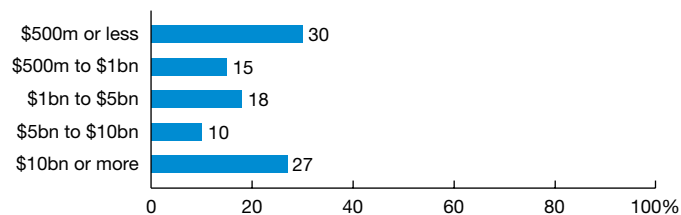
What are your main functional roles? Please choose no more than three functions.



What is your title?



What are your company's annual global revenues in US dollars?



Contacts

If you would like to discuss any of the issues raised in this briefing in more detail, please speak to your usual contact at PricewaterhouseCoopers or call one of the following:

PricewaterhouseCoopers Editorial Board

Laurence J Best

PricewaterhouseCoopers (US)
1 646 872 8802
laurence.j.best@us.pwc.com

Christopher Box

PricewaterhouseCoopers (UK)
44 20 7804 4957
christopher.box@uk.pwc.com

Jamie A Burstell

PricewaterhouseCoopers (US)
1 646 471 4293
jamie.a.burstell@us.pwc.com

James Clemence

PricewaterhouseCoopers (Singapore)
65 6236 3948
james.clemence@sg.pwc.com

Ron Collard¹

PricewaterhouseCoopers (Singapore)
65 6236 3388
ron.p.collard@sg.pwc.com

Della Conroy

PricewaterhouseCoopers (Australia)
61 3 8603 2999
della.conroy@au.pwc.com

Keith Donohue

PricewaterhouseCoopers (US)
1 646 471 1667
keith.donohue@us.pwc.com

Ed Donovan

PricewaterhouseCoopers (US)
1 646 471 8855
ed.donovan@us.pwc.com

Bernard Dubois

PricewaterhouseCoopers (Luxembourg)
352 49 48 48 4301
bernard.dubois@lu.pwc.com

Debra Eckersley

PricewaterhouseCoopers (Australia)
61 2 8266 9034
debra.eckersley@au.pwc.com

Bonnie Flatt

PricewaterhouseCoopers (Canada)
1 416 869 2590
bonnie.flatt@ca.pwc.com

John Garvey

PricewaterhouseCoopers (US)
1 646 471 2484
john.garvey@us.pwc.com

Tom Gosling

PricewaterhouseCoopers (UK)
44 20 7212 3973
tom.gosling@uk.pwc.com

Matt King

PricewaterhouseCoopers (UK)
44 20 7212 2801
matthew.king@uk.pwc.com

Robert W Kuipers

PricewaterhouseCoopers (Switzerland)
41 58 792 45 30
robert.kuipers@ch.pwc.com

Eamonn D Maguire

PricewaterhouseCoopers (US)
1 646 471 7107
eamonn.d.maguire@us.pwc.com

Hank Mlynarski

PricewaterhouseCoopers (US)
1 312 298 3436
hank.mlynarski@us.pwc.com

Scott Olsen

PricewaterhouseCoopers (US)
1 646 471 0651
scott.n.olsen@us.pwc.com

¹ Member of the Global Financial Services Leadership Team.

Contacts continued

Justin Ong

PricewaterhouseCoopers (Singapore)
65 6236 3708
justin.ong@sg.pwc.com

Gavin Phillips

PricewaterhouseCoopers (UK)
44 20 7804 9988
gavin.phillips@uk.pwc.com

Jeff Picton

PricewaterhouseCoopers (UK)
44 20 7804 3215
jeff.m.picton@uk.pwc.com

Pars Purewal

PricewaterhouseCoopers (UK)
44 20 7212 4738
pars.s.purewal@uk.pwc.com

Phil Rivett¹

PricewaterhouseCoopers (UK)
44 20 7212 4686
phil.g.rivett@uk.pwc.com

Robert M Ross

PricewaterhouseCoopers (US)
1 312 298 2042
robert.m.ross@us.pwc.com

Chris Rowland

PricewaterhouseCoopers (UK)
44 20 7212 4684
chris.rowland@uk.pwc.com

Jeremy Scott¹

PricewaterhouseCoopers (UK)
44 20 7804 2304
jeremy.scott@uk.pwc.com

Jon Terry

PricewaterhouseCoopers (UK)
44 20 7212 4370
jon.p.terry@uk.pwc.com

Nigel J Vooght¹

PricewaterhouseCoopers (UK)
44 20 7213 3960
nigel.j.vooght@uk.pwc.com

¹ Member of the Global Financial Services Leadership Team.

Global Financial Services Leadership Team

Jeremy Scott

PricewaterhouseCoopers (UK)
44 20 7804 2304
jeremy.scott@uk.pwc.com

Markus Burghardt

PricewaterhouseCoopers (Germany)
49 69 9585 2240
markus.burghardt@de.pwc.com

Javier Casas Rua

PricewaterhouseCoopers (Argentina)
54 11 4850 4504
javier.casas.rrua@ar.pwc.com

Rahoul Chowdry

PricewaterhouseCoopers (Australia)
61 2 8266 2741
rahoul.chowdry@au.pwc.com

Ron Collard

PricewaterhouseCoopers (Singapore)
65 6236 3388
ron.p.collard@sg.pwc.com

Ian Dilks

PricewaterhouseCoopers (UK)
44 20 7212 4658
ian.e.dilks@uk.pwc.com

James Flanagan

PricewaterhouseCoopers (US)
1 646 471 5220
james.f.flanagan@us.pwc.com

Chris Jones

PricewaterhouseCoopers (UK)
44 207 804 2393
chris.p.jones@uk.pwc.com

Colin McKay

PricewaterhouseCoopers (US)
1 646 471 5200
colin.mckay@us.pwc.com

David Newton

PricewaterhouseCoopers (UK)
44 20 7804 2039
david.newton@uk.pwc.com

Dominic Nixon

PricewaterhouseCoopers (Singapore)
65 6236 3188
dominic.nixon@sg.pwc.com

Thomas Pirolo

PricewaterhouseCoopers (US)
1 646 471 3790
thomas.pirolo@us.pwc.com

Phil Rivett

PricewaterhouseCoopers (UK)
44 20 7212 4686
phil.g.rivett@uk.pwc.com

Marc Saluzzi

PricewaterhouseCoopers (Luxembourg)
352 49 48 48 2009
marc.saluzzi@lu.pwc.com

George Sheen

PricewaterhouseCoopers (Canada)
1 416 815 5060
george.sheen@ca.pwc.com

Nigel Vooght

PricewaterhouseCoopers (UK)
44 20 7213 3960
nigel.j.vooght@uk.pwc.com

Akira Yamate

PricewaterhouseCoopers (Japan)
81 90 1816 7737
akira.yamate@jp.pwc.com

PricewaterhouseCoopers Global Financial Services Briefing Programme

- **Transparency versus returns: The institutional investor view of alternative assets**
– February 2008
- **Creating value: Effective risk management in financial services**
– March 2007
- **Winning the battle for growth: Building the customer-centric financial institution**
– May 2006
- **Effective capital management: Economic capital as an industry standard?**
– December 2005
- **Offshoring in the financial services industry: Risks and rewards**
– September 2005
- **Focus on growth: Striking the right value balance within financial services**
– May 2005
- **From aspiration to achievement: Improving performance in the financial services industry**
– December 2004
- **Uncertainty tamed? The evolution of risk management in the financial services industry**
– August 2004
- **Governance: From compliance to strategic advantage**
– April 2004
- **Focus on restructuring: The drivers shaping the financial services sector**
– December 2003
- **Compliance: A gap at the heart of risk management**
– July 2003
- **Illuminating value: The business impact of IFRS**
– April 2003
- **The trust challenge: How the management of financial institutions can lead the rebuilding of public confidence**
– December 2002
- **Risk Management Survey – A follow-up to Taming uncertainty: Risk management for the entire enterprise**
– November 2002
- **Taming uncertainty: Risk management for the entire enterprise**
– July 2002
- **Economic Capital: At the heart of managing risk and value**
– March 2002
- **Wealth management at a crossroads: Serving today's consumer**
– November 2001

PricewaterhouseCoopers (www.pwc.com) provides industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 146,000 people in 150 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

The Financial Services Briefing Programme is produced by experts in their particular field at PricewaterhouseCoopers, to address important issues affecting the financial services industry. It is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. If specific advice is required, or if you wish to receive further information on any matters referred to in this briefing, please speak to your usual contact at PricewaterhouseCoopers or those listed in this publication.

For information on the PricewaterhouseCoopers Global Financial Services Briefing Programme please contact Áine Bryn, Marketing Director, Global Financial Services, PricewaterhouseCoopers (UK) on 44 20 7212 8839 or at aine.bryn@uk.pwc.com

For additional copies please contact Maya Bhatti at PricewaterhouseCoopers (UK) on 44 20 7213 2302 or at maya.bhatti@uk.pwc.com

pwc.com

© 2008 PricewaterhouseCoopers. All rights reserved. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Designed by studioec4 19481 (09/08).