



Stern Stewart Research // Volume 40

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 stirred up so many emotions like managers' compensation. Not entirely without reason, as causal research of the current economic crisis has exposed.

However, the partly understandable anger does not lead to meaningful solutions. Capping salaries takes away management's incentive to participate in company's success. It cannot be the goal of compensation to take away management's belief in opportunities of entrepreneurial decisions, especially in times of crises.

There is no doubt, that the "standard compensation model" that was predominant – not only in banking, but in many other management boards as well as in entire companies – does not meet the requirements of today's reality.

Truly entrepreneurial compensation schemes thus need to fulfil three central criteria:

- Creating clarity about definition and measurement of success
- Rewarding sustainable and long-term value creation
- Ensuring participation in entrepreneurial opportunities as well as risks

The sheer enormity of today's crisis provides the possibility to bid farewell to traditional and outdated compensation schemes and implement a real and sustainable participation of management in opportunities and risks of the company.

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, that the manager in question is creating for the company. Today's crisis shows that in many companies reality is different. As soon as record profits were reported and bonuses in the millions were paid out to single managers, not few companies are back in the red and some are even facing bankruptcy. How can this be? Were bonuses paid out too quickly and without ensuring that company's performance had reached a sustainable level? And more importantly: How can such mistakes be avoided in the future without eliminating variable pay altogether?

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

- The applied performance figures are wrong and do not capture value creation
- Achieved success is rewarded immediately, even though it could be a bonfire
- Managers are participating in opportunities but not in risks

Each of these systemic mistakes sets wrong incentives. Aggregated they could even lead to the contrary of what was originally intended – the compensation system is rewarding value destruction and punishing sustainable value creation. In order to motivate employees to think and act into the right direction, entrepreneurial compensation schemes have to be simple and need to fulfill a few elementary preconditions.

Clarity about defining and measuring success

A uniform definition about what is success and how it can be measured does not exist in practice. Some common performance measures are used over and over again, in order to measure performance. However, they are inadequate for steering and sometimes even counterproductive.

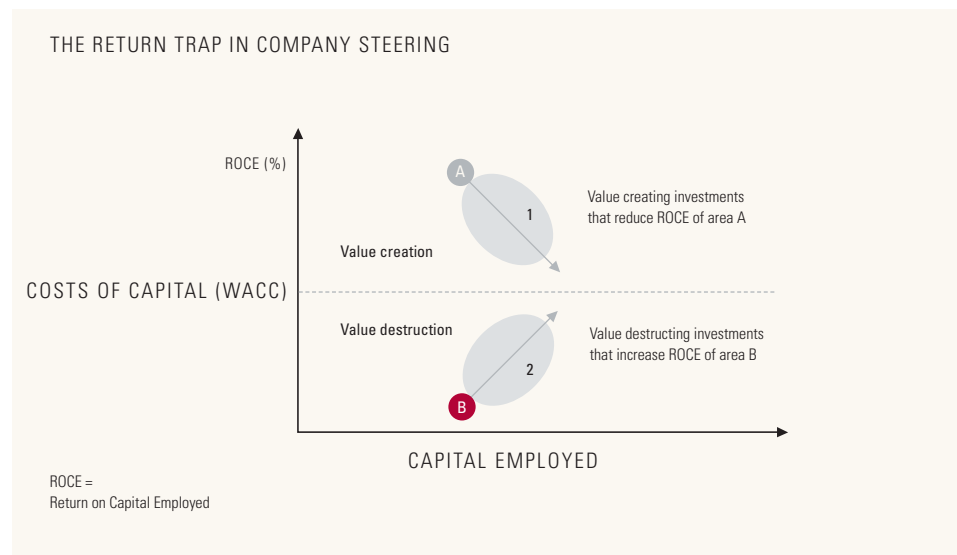
The trouble with commonly used, absolute performance measures

The majority of companies are using quantitative 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 cost of equity is ignored. Until today opportunity costs of equity providers are not accounted for in international accounting standards.

But entrepreneurial actions 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 in the case an investment is not earning the cost of invested capital. None of the mentioned earnings measures thus allow the conclusion whether an entrepreneurial action really creates value or not. The logical consequence of this is that these performance measures are suitable neither as an indicator for value creation nor as basis for calculating compensation.

The trouble with commonly used relative performance measures

In order to take into account the return on invested capital, many companies additionally use performance measures such as ROI, ROCE and ROE. Such a performance measurement is also recommended by several corporate governance codes. Business success measured by an absolute measure like EBIT, EBITDA or Net Income should be connected to return on invested capital. However, as much as it sounds plausible that with a combined EBIT and ROI measurement it is possible to correctly evaluate performance, this is not the case. The reason for this is that relative performance figures have the disadvantage that actual performance is used as the hurdle rate for evaluating future investments: The return trap in company steering.



Returns will improve if a new investment is resulting in a higher return than the already existing business. The more profitable the current business, the more difficult it is to further increase returns, and the higher the hurdle rate is for future investments (area 1 of graphic above). The more unprofitable the current business, the easier it is to improve this performance (area 2 of graphic above). In this case, 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 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 at 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 capital returns was responsible for dramatic developments in 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. If buying back shares, equity is reduced and the same business is attached to less capital. This way a bank can improve its return on equity, but automatically the risk of a bankruptcy increases. In other industries this trend is still being strongly followed, and is even supported by active “balance sheet management”. This means for example that accounts payable are kept as far away from the balance sheet as possible. Many forms of “off-balance sheet financing”, like leasing, factoring and others are being used to stretch current accounting rules to the limit. As a “honest merchant” one should try instead to depict economic realities as good as possible and include entrepreneurial risks in the balance sheet – and thus also the economic capital base for the performance measure.

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. As a performance figure for measuring success thus only absolute excess profit figures are suitable (like for example Value Added) where cost of both equity and debt are taken into account.

Ensure sustainability of success

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

Two things are responsible for this problematic situation: On the one hand performance is usually assessed against the yearly budget, and on the other hand bonuses are paid out immediately without ensuring the sustainability of achieved success.

The trouble with performance assessment against the budget

In order to judge a given performance, it is typically compared with a target like the yearly plan or budget. In this case, target bonus is achieved if plan or budget is met. If the result is better than the plan the bonus will be higher, if not, it will be lower. By connecting to the annual plan a “political” process is initiated. 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 as easy to reach targets as possible, in order to secure their own compensation. This dilemma can only be solved through separating targets for the compensation scheme strictly from the planning process.

Targets for compensation schemes need to be derived from the long-term strategy and should not be renegotiated yearly. The overall goal for each compensation scheme must be participation in true value creation, for example measured by excess economic profit (Value Added). Targets should be derived in a top-down manner for each division and for each single year from the company's long term target.

The yearly planning should therefore be processed independently from the target setting. However, it should be based on ambitious albeit realistic goals for the next year. These yearly (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 yearly planning process, since their bonus is oriented on the long-term target of the compensation scheme which is not being adjusted on an annual basis.

The trouble with immediately paying out the full bonus

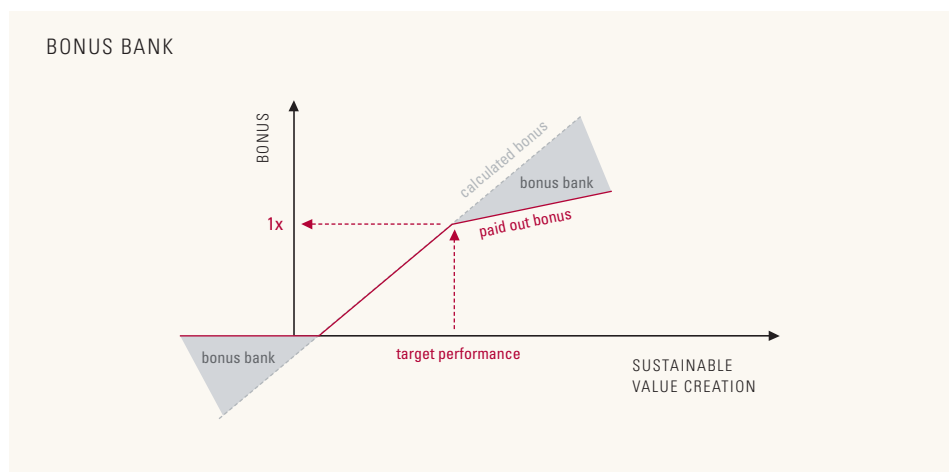
Independently from the used performance measure, one cannot eliminate the possibility that a given performance increase proves not to be sustainable and that the result will be reduced in future. In this case the compensation system should avoid that managers are being paid high bonuses and cannot be made accountable for a decrease of performance in subsequent years.

However, if performance is measured on a yearly basis (or even on a half-yearly or quarterly basis), unsustainability of performance is only surfacing when the bonuses have already been paid out. For the decrease of earnings in the following years, reasons outside the sphere of influence of management are searched for and targets are downwardly adjusted.

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

The solution lies less in performance measurement itself, but more in the mode of bonus pay-out profiles. High bonuses can be ascertained but they should not be fully paid out immediately. If a part of the bonus is kept back and subjected to business risk, this part of the bonus can also be lost in the following years in the case of bad performance. We have developed a comprehensive concept to deal with this, the so-called “bonus bank”.

The bonus bank is not a bank in the proper sense, but something closer to a “performance-memory mechanism”. Using the bonus bank the ascertained bonus of a specific year is not fully paid out immediately, and a part is credited into the personal bonus bank. A fixed percentage of the bonus bank balance is paid out each year while the rest is transferred to the next year. That way the compensation scheme is expanded by a mid-term component, which even makes the allocation of negative bonuses in single years possible. Through the integration of a bonus bank, a significant part of the bonus is subjected to business risk which is a form of active capital participation of 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 there are still bonuses paid out. However, participation in losses is never an issue, even if company owners (shareholders) have to endure significant losses to their capital.

True sharing of risks

The bonus bank concept opens up the possibility to let employees share not only in opportunities, but also in risks of the company. One part of the bonus is thus not distributed immediately and remains in the bonus bank being 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 optimisations motivated by the compensation system.

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 calculation above 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 towards 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 are credited into the bonus bank and are exposed in the following years to entrepreneurial risk. In the third year the company achieves such a bad result that the calculated bonus is negative.

Through the bonus bank, this effect is smoothened. The -40 from the calculated bonus are added to the 120 credit in the bonus bank balance. From the remaining 80, the employee is paid out again 25%, which in this case are 20. Irrespectively of losses in year 3, the employee receives a small bonus but at the same time he effectively loses money, as his bonus bank balance is reduced from 120 to 60.

Continuity in success participation creates trust

One of the main problems of current compensation scheme lies therein that before designing the scheme, it is not explicitly defined whether management should only be rewarded for its performance or rather 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 of "everyone made great effort" or "market environment was exceptionally tough", even though the performance was bad. If under these circumstances a minor bonus (or even a zero bonus) seems to be unreasonably low, targets are adjusted downwards so that a bonus can be justified, even according to the current compensation scheme. 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 would need 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 the results could be worsening?

Frequent changes of 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 effective. 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 create that part too large while refrain from constantly adjusting it.

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 all cost of invested capital – is used as the basis for the calculation of the bonus. In addition to this, great success should lead to high bonuses only if these effects are sustainable. Improving the balance sheet, through skilfully avoiding the full disclosure of liabilities and risks is contributing to value creation as little as reducing Capital Employed does, in order to increase ROE.

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

- use absolute excess profit measures for performance measurement that take into account the full costs of invested capital
- set targets for compensation over many years and separate them from the yearly planning process
- use the bonus bank, in order to let managers share opportunities and risks of the business

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