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Royal Bank of Scotland's suggested new bonus regime must properly incentivise staff to avoid a return to the 'bad old days' of excessive risk taking in the finance sector

Catherine Gannon

Royal Bank of Scotland (RBS) revealed its new bonus plan for senior executives earlier this month, to be approved at the AGM on 28 April. It could allow up to 400% of salary to be awarded in shares by way of performance-related bonus. For chief Executive Stephen Hester, on £1.2 million basic, this could be £4.8 million.

This has attracted much media attention and comment in the current climate, especially as the bank is 84% taxpayer owned and this is therefore our money. Is this just a return to the bad old days?

The bank has explained 50% of the payout will be based on the economic profit of the bank and the other 50% on shareholder returns. Profit and increased shareholder value should be rewarded, surely. But of course the devil is in the detail. In the upturn, we would expect that any bank is going to increase its profits and RBS, having suffered such large losses, even more so. And as that happens, shareholder value increases. How much of these increases would have happened anyway, and how much will be attributable to the special skills of the senior executives? In other words, what will be the actual added value that these particular individuals are bringing? This, on RBS's explanation, is what the bonus should relate to.

A lot will depend on the level at which the remuneration committee sets the bonus thresholds. All too often thresholds are set so low that a large part of the bonus at least is almost inevitable and not really independent on excellent individual performance and added value. A close eye will be kept on the remuneration committee's judgments in this area and the extent to which it seems truly independent of board influence as it should be. But is this really the whole story?

There are three basic reasons for a bonus which any employer's human resources policy must juggle: to reward past performance and loyalty, to incentivise future performance and to engender future loyalty. The first of these is avowedly not the intention and is often not the main driver for bonus calculation (an exception often being in sales-related posts). The key issues are therefore likely to be to incentivise future performance and to retain staff. It is essential for an incentive to work effectively that it is the desired effect that is in fact incentivised. We have seen the results of incentivising short-term

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performance without regard to long-term stability. The other part of the equation is retaining staff (or attracting new staff on the basis of their likely compensation). The argument is that if a bank does not pay suitable competitive bonuses, its talented staff will go somewhere that does, and it will not be able to replace them with suitably talented individuals. The quality of its staff will then be lower, as will its profits and business generally. It has to pay at a certain level to compete.

In RBS's case, both these elements are at work. The remuneration committee will be able to clawback up to 100% of bonuses retrospectively if the rewards are not borne out by long-term performance. Additionally, Alistair Darling announced in the Budget that the chief executive's bonus would be dependent on the bank meeting lending targets - the objective is to increase lending as this is clearly a very specific incentive. However, various press comments seem to suggest that a significant part of the thinking is in reality about retaining and recruiting staff. If other banks are paying their staff at this level, how can RBS not? Is it really just keeping up with the Joneses?

Ultimately, if the remuneration committee does its job and sets ambitious targets, with effective clawbacks to incentivise long-term growth and stability, it probably does not much matter.

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