THE MONEY GRAB – PROGRAMME TWO

HALL: Six months ago, it was claimed the banking crisis was going to change the bonus culture of the city for good.

But over the last few weeks it's been business as usual for banks such as Barclays and Goldman Sachs, as they announced their intention to reward a sizeable chunk of their multi billion pound profits to some of their top traders.

Is it right for finance firms to continue with their bumper cash incentives?

Or should city regulators begin to reel in potentially reckless remuneration practices?

What would be the consequences for companies and the economy if the brakes were put on bonuses? In seeking answers to some of these questions, I first turn to an old hand … a 50 year veteran of the banking world.

Sir Brian Pitman is the former Chairman of Lloyds TSB, having retired in 2001, long before the crisis took hold.

Does he think a quick return to the pay bonanza is necessary?

PITMAN: People find this extremely hard to accept, very, very hard to accept … you're paying this person ten million for one year's work. It sounds ridiculous to people, absolutely ridiculous, but we have to give them in my view, high rewards for high success and building the right team is the key to success. Comparisons are made with football teams, and there is a significant comparison … you're competing for this war for talent, you're competing absolutely all over the world. If you start losing a lot of your very able people and you ignore it, you're going to find your business will decline, sooner or later you'll fail as a company, be taken over by someone else, so you have to compete for the talent, there's no doubt about that.

HALL: This is the same case put forward by the Barclays chief executive, John Varley when justifying why Barclays was paying out bonuses, so soon after the industry bail out. But is this view shared by people outside the banking world? Let's look on the other side of the fence. What about the shareholders, for example?

Peter Montagnon is Director of Investment Affairs at the Association of British Insurers.

Its members have a combined investment of one and a half trillion pounds, and together own 1 in 6 shares listed on the London stock exchange … so it's fair to say they might be interested in what the banks are doing with their money.

MONTAGNON: Most people in jobs contribute to the work of a company or department and they believe they are useful, but they can't pinpoint the number. If you've been dealing, you can actually look at your record, and say 'I made this much money for the bank last year, that's what I'm worth and you've got to give me a share of it'. And it is necessary to go on paying these people, according to a structure which enables you to keep them.

HALL: This threat of moving to another country, or to another business, is it really realistic, or is it just people saying 'if you don't give me what I want, I'll leave'.

MONTAGNON: Well I think that it is in some cases actually more realistic than you would think. There is an issue there, and I think we've noticed that in one or two cases of the banks where the government has taken control, that there have been some signs that in some of these activities they have been tending to lose staff because there is a restrain on what they can pay them now. So we have to balance all this very carefully.

HALL: Gustavo Dolfino used to earn a 7 figure salary on Wall Street. Today, he is President of the global recruitment company, The White Rock Group.

I asked him, is this exodus of top talent really true?

DOLFINO: What's going on is a brain drain to other parts of the world, places like Hong Kong and Singapore, to work for firms that are actually taking advantage of the dislocation in the market.

This is one of the best markets ever to get a good job, because if you actually have the track record and you're able to move geographically, you will do well.

HALL: Have compensation packages gone down, stayed flat?

DOLFINO: Very, very senior people, they can negotiate whatever they want. Because they themselves are responsible for an incredible amounts of wealth generation. When people get this kind of money, they get the money because they know how to create money.

HALL: But what risks are being taken when creating this money?

After all, it was the highest-paid, best and brightest of the banking world, who brought down the global industry last year in their search for ever-increasing profits … spurred on, some say, by their lust for bigger and bigger cash bonuses. Sir Brian Pitman:

PITMAN: If you reward the people in the dealing room for how much money they make in the short time, they will take positions to make sure they make a lot of money in the short term but it may not be in the long term interest of the company. These are a few people who have this kind of behaviour, but they are a few people who can get you into a lot of trouble.

ARCHIVE – NEWS REPORT

“The Bank of England has warned that the large bonuses paid to some city traders could threaten the stability of the city of London. The prospect of huge bonuses could entice some traders into taking too many risks”

HALL: Question: when do you think that news report was broadcast? Last week? Last month? Maybe last year? Try NINETEEN NINETY SEVEN! Twelve years ago!

But if there’s been a concern over the risks of paying high bonuses for so long … how come the warning signs have been ignored?

SB: Well, people didn’t take any notice of much that the Governor of the Bank of England said. The Governor of the Bank of England had been warning for years that if we continue to behave in this way then we would have a big bust. But the truth is that when you have boom conditions, nobody wants it to stop. The individuals don’t want it to stop, companies don’t want it to stop, banks don’t want it to stop, governments don’t want it to stop, and therefore you wind up with a big bust.

HALL: In 1995, two years before the Bank of England raised the alarm, the then chairman of Marks and Spencer, Sir Richard Greenbury, was commissioned by the CBI to investigate corporate governance in British companies and the growing concern over what the press had dubbed 'fat cat pay'. The Greenbury Report also highlighted concerns over the way Bonuses were being paid.

GREENBURY: One of the things that we did say was that bonuses should not become a fixed part of the salary, and I would suggest to you that in many cases now they have become a fixed part of the salary.

HALL: Because often when you take on a new job, you're given a guaranteed bonus of one, two, maybe three years, regardless of performance.

GREENBURY: Exactly. That was one of the things we recommended, which I don't think has been practised.

HALL: What other parts of your report do you think are relevant 15 years after you wrote it?

GREENBURY: Well, the most relevant, without any doubt, was that there should be total transparency over what the top people in any company were earning. At the time some of us, including myself, felt maybe we were going too far. But in the end we took the view well, if it's all out there in black and white, in the report and accounts, the people who own the companies, which is the major investment institutions, and all of whom are employing large numbers of people, can crawl all over the detail, examine every aspect of pay, basic salary, bonuses, perks, everything, and if they're not happy they can go and talk to the board about what they perceive to be right or wrong. I'm inclined to think that the institutional investors haven't necessarily been as diligent and searching in respect of remuneration practice.

HALL: Institutional investors are the people who take our investments and pensions and put the money to work in the financial markets.

With sizeable stakes in some of the big financial firms, in turn they have influence over how the companies are run … but did they ignore this responsibility?

Peter Montagnon, of the ABI.

MONTAGNON: Some of this criticism, I think, is fair because the investor community didn't manage to stop what was happening. Some of it isn't really fair because we have power to vote over the pay of directors in UK listed companies. We don't have a power to vote over the pay of traders, bond traders, or whatever. Nobody apart from the banks themselves has had a say in that in the past.

We've always thought in our task of voting on the remuneration of the people at the very top, where there is transparency that it would be useful to know more about how the people underneath were being paid. In a lot of cases they are paid a lot more than the directors whose pay we're voting on.

ARCHIVE – GORDON BROWN

"We are leading the way, America, France, and other countries too, in sweeping aside the old short-term bonus culture of the past and replacing it with, first of all, a determination that there are no rewards for failure and, secondly, that there are rewards only for long term – not short-term – but long term success.

HALL: After the biggest banking crisis in history, the government can no longer ignore the warnings of the past. City compensation is now firmly on the political agenda. The Prime Minister, Gordon Brown, and the Treasury have stated their intent to instigate a cultural change in the way salaries and bonuses are paid in Britiain's financial services industry.

John McFall is the Chairman of the Treasury Select Committee.

MCFALL: What we've seen is that this compensation culture has led to this excessive risk taking and that was an intelligent bet on behalf of these individuals, because they knew at the end of the day that they were institutions that were too big to fail. So we need to get to a situation where compensation is in line with the risk taking. I feel the issue of compensation should be tied to the long-term interests and health of the company, so the bonuses they can be deferred payments.

HALL: How do you change that sense of entitlement to the bonuses?

MCFALL: I think it's very hard to change, and I think if you look at the bonuses that have been paid out recently, with the likes of Goldman Sachs and others, you will see that there's an attempt by the industry to go back to business as usual. So it's a bear and bull fight between government and industry on this issue.

HALL: But according to Sir Brian Pitman, there's a reason the banks pay their bonuses in cash.

PITMAN: There was of course a period when banks paid almost entirely in shares, but what happened was that competitors started to pay people in cash, so if you said to someone do you want a hundred thousand dollars in cash now, or do you want it in shares payable five years from now, which one are they going to choose? So the banks had to compete.

HALL: But if the banks continue to pay cash bonuses, when the regulators are urging them to switch to share-based incentives … why not just ban bonuses altogether?

Hugo Dixon is Editor in Chief of the financial commentary service, breaking views dot com.

DIXON: In recent months, the word bonus has been treated as a dirty word. Clearly, there are some abuses that we have seen of bonuses throughout the years but at least bonuses do have at least some relation to performance.

And one of the things that you've seen both in The City and also on Wall Street, is because of this backlash against bonuses, firms have started to increase base salaries and reduce bonuses, so they still may end up paying people the same amount of money, but they've repackaged it.

Now that, I think, is a very regressive step because you want these bankers to be on the hook. You want them to suffer if their results suffer. The key for the future, I think, should be not to get rid of the bonus, not to get rid of performance pay, but just to make sure that it is much more closely linked to genuine performance rather than flash in the pan performance.

HALL: The city regulator, the Financial Services Authority has been busy drawing up additions to the city's compulsory code of conduct.

These new rules will come into effect in January of next year, with the aim of ensuring company remuneration plans are in line with effective risk management.

Hugo Dixon of Breaking Views dot com.

DIXON: The regulators are talking about things like making sure that those banks that engage compensation practices that encourage excess risk taking, have to have more capital. And the point of that is that it’s not actually trying to say you can’t earn £10m but it’s saying if you have a scheme, that incentivises your traders to take excessive risk, then you’ve got to have a bigger cushion, so that if the risks don’t pan out the way that you want them to pan out, then your shareholders actually suffer, not the dear old tax payer.

HALL: Just how broad reaching the FSA’s new code will be, is yet to be determined – when approached for an interview for this programme, we were told nobody was available to speak to us. Aside from shaking up the bonus system, one of the other pledges from the Prime Minisiter, Gordon Brown is to end the practice of reward for failure.

NEWS ARCHIVE

He became known as Fred the Shred – a reputation built on cutting costs and cutting jobs. Under Sir Fred, RBS became one of the world’s top banks. It was a rapid rise to global domination and an even swifter fall.

HALL: One of the most baffling revelations of the banking crisis is how Sir Fred Goodwin could oversee the collapse of one of the biggest banks in the world, and still walk away with a pension worth £650 000 a year.

NEWS ARCHIVE

That's £12,500 a week.

HALL: Despite the very public apology, Sir Fred – who was never actually fired – got to keep most of the money in his pension pot.

So how can this kind of thing happen?

These jaw-dropping severance deals are essentially a hangover from the boom years during which companies were willing to sign super-lucrative contracts when hiring senior management, in part, because of the perceived shortage of leadership talent. This left the CEOs in a win-win situation. Sir Brian Pitman:

PITMAN: Well, what happened was in those crazy days, you wanted to hire somebody, you wanted to hire this man or woman but a lot of them would insist you gave them at least a two year contract, so even if the're dud after 6 months you're still going to have to pay them for another 18 months. The demands were so enormous - and it says it's got to be this amount of money and it's got to be a 2 year contract and he's got be allowed to fly back to the US four times a year, and I think what we've had is a big shock and I can see a lot of work being done on exactly how should we pay these people in the future.

HALL: But the companies don't always have their heads in the clouds. While it may not make sense to you and me when these sky-high severance packages are paid, it can be the case that the company has the bottom line in mind all along.

Compensation consultant, Simon Garrett of the Hay Group.

GARRETT: Many companies will feel that it's helpful from a commercial perspective just to pay the guy off, and not enter into a big long legal fight. It's not right from the point of view of the reward equation but it's right from the point of view of getting the commercials correct.

HALL: Have you ever thought that a company was paying a CEO or any senior executive, too much money?

GARRETT: Yes, it does sometimes happen. And many companies I think now are sitting on this burning platform, and saying 'look, we need to get out act together.

HALL: Do you think before a company offers a CEO a contract, they should look more at ‘what if?’ planning. What if we hire this guy, and everything seems rosy, but everything goes wrong?

GARRETT: Oh, I completely agree, and I think not only at the point of hiring do boards need to have these discussions, but periodically when they reshape their incentive structures. One of the things we always say to our clients is look for the unintended consequence, because you’ve got to envisage a wide variety of scenarios to understand that the outcomes that arise in those scenarios, are ones that you’re comfortable with. And that may well include what happens if you have to fire the guy. It may well include what happens if we suddenly make an absolute shed-load of money we weren’t expecting to make, and how much do the chief exec and his colleagues get paid? Those things need to be explored in a lot of detail, in order to get this process right, I think.

HALL: For any changes to take place in a company, the buck stops with the non executive board … and while they may not have tackled the issue of excessive pay deals in the past, the time has clearly come according to Brok Romanek of Compensation Standards, an organisation promoting responsible remuneration.

ROMANEK: The biggest thing that we all need for past practices to change, is for boards to challenge CEOs, just to have the hard conversation with CEOs, and say ‘listen, because of these broken processes over the last 15 years, your pay has gotten out of wack, we really need to reign it in. People need to get beyond being scared of having that conversation, but also the directors to basically admit that maybe they were following broken processes in the past.

HALL: I've worked on Wall street for 27 years, and there's one phrase that you rarely hear … "I was wrong" … how do you expect the board to say they were wrong … they won't do it!

ROMANEK: Well, that's … that's, I guess, the way of the world, and a lot of what we do is ego driven, and that clearly plays a role. I mean when it comes to pay there's no topic that's more sensitive. But to get us out the place that we're in, it has to be some hard conversations and boards have to take the ball into their own court.

HALL: The effectiveness of company boards to initiate change within their organisations was recently called into question by the former regulator, Sir David Walker, who published a government-commissioned report on how banks are governed.

ARCHIVE: Sir David Walker

In my view these boards need to become, frankly – and one hesitates before saying this – but, less friendly, cosy, easy environments. I've used the word in my report 'less collegial'

HALL: This concern over non executive boards is shared by John McFall, Chairman of the Treasury Select Committee.

MCFALL: This isn't just a part-time job that they get £60 - £100 000 a year for turning up a couple of times a year, having a coffee and a malt whiskey with the directors and then moving on. They have to ensure good stewardship of that company. Executives are on the board, to report to the non executives who do a more thorough job than they have been doing, at the moment.

HALL: But even if the non executive boards and the executive management of public companies, such as investment banks, WANT to initiate changes, and amend their pay structures … could they do so without losing out to the private sector? Another key factor that has kept up levels of compensation in public companies, is the pay practice in private firms, such as hedge funds.

Hugo Dixon of Breaking Views dot com.

DIXON: A specific feature of what has helped to drive City and Wall Street compensation even higher, this decade, is the explosion of hedge funds and private equity. And they have a particularly attractive compensation scheme. What they get is they get 2% of all of the money they manage every year, just for turning up to work, and then they get 20% of the profits. Now, at the extreme, these sums of money which weren't just millions of pounds but they were hundreds of millions -- that some people were pulling in, and classic investment bankers were looking at these hedge fund and private equity guys and they were feeling like poor relations and some of them, therefore, did actually go off into private equity or into hedge funds, then their employers thought 'oh my god, we've got to do something, otherwise we're going to lose our best people', and so that spurred Wall Street and City pay yet higher.

HALL: The dilemma for the banks is that the hedge funds are not answerable to share holders, and are, by and large, excluded from the current political conversation regarding restrictions on pay.

But even if a company ignores this competition, and makes a decision to reduce the money it pays to its employees … the market pressures can quickly restore the natural order.

Sir Brian Pitman, former Chairman of Lloyds.

PITMAN: I will remember when Warren Buffet bought a chunk of an investment bank in the States called Salomon Brothers, and he didn't like the way people were paid in Salomon Brothers. So he persuaded the chief executive to change the pay system.

And the chief executive said to me 'what do you think of that Brian' and I said that will never last, and within weeks, they were losing so many people out of Solomon Brothers, even though Warren Buffets thing was entirely logical, they had to change, change back to the Wall Street system of paying people.

HALL: But if shareholders and investors begin to voice concern over a company's remuneration practice, banks may well be forced to take action … and being the epicentre of the pay boom that spread around the world, other global financial centres are waiting on New York to take the lead, before following suit. Sir Brian Pitman.

PITMAN: Much depends, on this occasion, what happens with the Americans, because it's such a huge proportion of the total market. And I think they will introduce much longer term incentives. If they take that lead then that will change things. If they don't take the lead, if they let it disappear, as the banks recover, then it will not change much in the UK.

HALL: But for the time being, America is stuck in the same legislative limbo as the UK.

Whilst President Obama has pledged to exert control over corporate compensation practice, even hiring a compensation tsar to oversee the government's efforts, there's still nothing concrete.

But America will be wary, as previous regulatory changes, such as those that followed the Enron scandal, led to firms leaving Wall Street to set up shop overseas – especially London.

But there are possible changes afoot.

John Reed was Chairman and CEO of Citigroup. Retiring in 2000, he has been critical of the financial engineering which led to the credit crisis. However, he believes a cultural shift is gaining momentum on Wall Street.

REED: They clearly did not examine how real were some of these apparent earnings, nor did they say gee, if a company really does poorly and we have to fire this executive, have we entered into contracts that are going to look rather unattractive at the time that we're making that decision. But just as the mood can be very permissive, which I think it was over the past ten years, mood can turn in the other direction, and become more restrictive, and that new mood will transmit just as efficiently through that network, as the old one. Business needs social permission to exist. My sense is that the permissions for this kind of behaviour have been withdrawn.

ACT: PROTESTS

HALL: Mirroring events in the UK, the American public have expressed their anger by taking to the streets all around the US, to protest against what they see as the unwarranted avarice of big business.

With ordinary people now so switched on to the workings of Wall Street, can politicians ignore their calls to curtail out of control compensation practice?

REED: We've seen the financial sector and its regulators have a dramatically negative impact on the economy. We have extremely high unemployment, relatively low economic growth prospects, etc etc etc, and this is hurting the average person. And so all of a sudden they do know about Wall Street, and they do know about the compensation practices, and the public is unwilling to tolerate this. The public re-elect our Congress every two years, that means every Congressman is always looking at his electoral base, and this mood will get to the Congress, and this is a subject that is now centre stage.

HALL: A stage with a worldwide audience.

Just last month, the G20 leaders declared they were united on the issue of corporate extravagance, and pledged to work together to restore order to the global finance machine.

But I'm hesitant to say whether they can really make their mark.

Even if governments do come up with some kind of legislative shackles to prohibit exorbitant pay in banks, I'm a firm believer that where's there's money, there's creativity … and the finance elite will continue to find ways in which to reap the huge rewards they have become accustomed to in places and in firms where the regulations allow the money grab continue.