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**A Recipe for Creating Resentment and Dissatisfaction': A
Study of Payment Systems in Investment Banking**

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ABSTRACT

This paper examines the use of variable pay schemes in the UK financial services sector. The principal-agent model is outlined as a theoretical framework for explaining the choice of payment system and the provision of incentives to employees. Analysis of the 1998 Workplace Employment Relations Survey shows that the financial services sector is unusual in its use of incentive pay. Interview data is then used to gain an insight into the processes that inform the determination of bonuses. Survey data is then used to highlight the increased importance of bonuses during the 1990s. The paper concludes that the extensive use of bonuses in financial services has little to do with providing incentives workers and is more concerned with satisfying firms' recruitment and retention needs.

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A RECIPE FOR CREATING RESENTMENT AND DISSATISFACTION¹: A STUDY OF PAYMENT SYSTEMS IN INVESTMENT BANKING

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INTRODUCTION

This paper will analyse the use of payment systems in the UK financial services sector. The interest in variable pay has been heightened by the increased use of such schemes across most sectors of the economy. Various economic theories have long predicted the potential of a payment system to increase the productivity of workers. In situations where employers cannot accurately assess whether an employee is working sufficiently hard, theory suggests that performance related pay schemes are a way that sufficient worker effort may be elicited.

The theoretical framework of the paper will be based on the principal-agent model. The theory will be briefly outlined and some predictions as to the use and suitability of incentive pay explored. In the second part of the paper an analysis of the 1998 Workplace Employee Relations Survey (WERS 98) will explore the incidence of variable pay in the financial services sector and compare it to the economy as a whole. Having established that financial services are characterised by extensive use of variable pay schemes the remainder of the paper will use case study interviews and industry specific survey data to examine the link between pay and performance and the mechanisms through which variable pay is delivered. Finally, a tentative conclusion will be reached as to the question of whether these variable pay schemes achieve their aim of increasing organisational and employee performance.

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THE THEORY OF INCENTIVE PROVISION

It has long been recognised that the market for labour does not behave in the same way as those for other commodities. A variety of features combine to make the analysis of the exchange of labour services more complex than simply the interaction of supply and demand; 'the variable to be determined is not a price but a complicated functional relationship' (Arrow, 1985, p44). Principal-agent theory is an attempt to better explain this relationship. It, therefore, provides a valuable starting point for analysing the choice of payment system.

The employment relationship may be characterised as a principal-agent problem in that the principal (employer) pays the agent (employee) to undertake work on his behalf. The principal-agent problem becomes analytically interesting when: a) the agent's action is not directly observable; or b) output is not completely determined by the agent's effort. These can be termed the 'hidden action' and 'hidden information' problems respectively (Arrow, 1985). In the former, worker effort is the hidden action and is also a source of disutility to the worker. In the latter case, the agent has information that is not revealed to the principal, who cannot thereby check to see that the information is being used in an appropriate manner.

There emerges a problem of incentives. The principal must design a contract that maximises his expected utility given that the agent will act to maximise his own utility arising from the compensation scheme. The principal must, therefore, offer sufficient rewards to induce the agent to accept the contract, the so called 'participation constraint'.

The classic case of share cropping between landowners and tenant farmers illustrates the basic features of the principal-agent model (Stiglitz, 1974). The landowner is assumed to be able to costlessly measure the quantity and quality of output, whilst the direct monitoring of the farmer's work effort is taken to be prohibitively expensive. The landowner is therefore faced with designing an output based reward structure to motivate the farmer to work the land efficiently. A simple incentive contract would be for the owner to charge the farmer a fixed fee in return for the farmer being able to sell the produce from the land. However, since the output of

the farm is not wholly attributable to the farmer's effort the incentive scheme outlined will expose the farmer to variations in income resulting from random variations in factors outside his control, most obviously the weather.

The landowner is assumed to be risk-neutral. As a result he is in a position to offer the tenant farmer an insurance contract, whereby the farmer is paid a fixed wage and the farm output accrues to the landowner. When the agent is insured against bad outcomes his interests are no longer perfectly aligned with those of the principal; there is no incentive to exert effort in order to avoid bad outcomes (Sappington, 1991). The optimal contract will, therefore, be one in which the farmer is paid a fee that is less than his alternative wages but he will also receive a share of the farm's output. The size of the fixed-fee component will rise with the farmer's risk aversion and will decrease when greater effort incentives are needed (Stiglitz, 1974; Nalebuff and Stiglitz, 1983). Thus contract choice falls on a spectrum with the provision of risk sharing at one extreme and the provision of incentives at the other (Stiglitz, 1987).

The principal-agent problem can be applied to understanding the choice facing firms regarding the optimal payment system. Many of the principal-agent models, including the sharecropping example outlined above, assume that principals have information regarding the agent's output. The problem arises from this output being partly determined by environmental factors. The principal is left with the task of obtaining some measure of the agent's effort in an attempt to insure them against fluctuations in income (Brown, 1990). An adaptation of this model has been proposed, whereby a firm does not know the level of worker output unless some form of output monitoring is undertaken (Lazear, 1986).

Lazear examines: 'the choice between a fixed salary for some period of time, that is, paying on the basis of input and paying a piece compensation that is specifically geared to output' (Lazear 1986, pp.405-6). Fruit picking is illustrative of the extreme case of a pure piece-rate system where an amount of payment per unit of fruit harvested is specified in advance. Lazear argues, however, that many other occupations exhibit characteristics that can be effectively treated in the same way. The distinction drawn is that between a system where there is a 'synchronisation

between output and compensation' on the one hand, and salaries on the other, which implies that a worker's pay is independent of output (Lazear 1986, p407).

Much of the existing literature on principal-agent theory seeks to evaluate the effectiveness of incentive pay as a motivating device. The purpose of this paper is not to add to that body of work, but rather to explain the choice of payment system facing firms in the financial services sector. One study that seeks to do something similar is Brown (1990). He proposes a choice of three pay schemes; piece-rates, merit pay and standard time rates all associated with different monitoring costs. A list of factors that are significant in determining a firm's choice of payment system emerges, which include establishment size, occupational concentration within a firm, the diversification of duties within a particular occupation, and the degree of teamwork required in the production process (Brown, 1990).

The fundamental prediction underlying the above analysis is that the use of variable pay schemes is inversely related to the costs of monitoring worker effort. This leads to the prediction that bonus pay will be more prevalent in occupations where performance is readily measurable. This paper will assess the extent to which this is true in the context of the UK financial services sector, and the mechanisms through which such bonuses are determined.

METHODOLOGY AND DATA

Gaining research access to financial institutions is difficult. The dearth of empirical data on this sector of the economy is testament to this fact. The sensitivity of remuneration data in a highly competitive sector was the reason usually cited by institutions in declining to participate in the research. Despite the considerable problems in gaining access, a cross sectional sample of six case studies was established. Factors such as firm size, nationality of ownership and occupational dispersion within a firm influenced the choice of case study institutions. The final sample contained British, continental European and Japanese institutions. The size of the firms ranged from the very small to the large and there was a mix of specialised organisations and those that provided a full range of banking services.

The interviews were designed to gain information about both the process of pay setting and the factors that were important in determining the structure of remuneration. Five of the six interviews were conducted with either personnel managers or senior managers in the institution. All of the interviewees had a detailed knowledge of remuneration management across the whole of their institutions. The interviews were semi-structured in nature. This was to allow comparability across the sample but also to encourage as wide a discussion of pay policy as possible. Therefore, the case studies were not primarily used as a source of quantitative data, but rather as a means of understanding the institutional context of pay setting in the financial services sector.

Quantitative data on pay in the financial services sector is difficult to obtain due to the institutions' concerns over confidentiality. However, an invaluable, yet untapped, source of quantitative data comes in the form of third party consultant's pay surveys. One of the best established of such surveys is the International Banks and Investment Houses, Remuneration Guide published by the Monks Partnership (Monks Partnership, 1997). This survey series has been conducted since 1990 and is published quarterly. The data contained in the survey provide a good picture of pay practice in the city due to the fact that it gathers data from over 150 institutions. The validity of the data is enhanced further by the fact that they form the basis of pay setting in the sector itself. The fieldwork interviews revealed that consultant's surveys, including the one published by the Monks Partnership, were an important tool in determining the market level for both salaries and bonuses. The data can, therefore, be viewed as an authoritative source of information on pay practices in financial services.

THE INCIDENCE OF VARIABLE PAY IN THE FINANCIAL SERVICES SECTOR

There is a popular perception that workers in the financial services sector, especially the City of London get paid well, and that a large proportion of this wealth comes in the form of bonuses (Taylor, 2000). By analysing WERS 98 it is possible to compare pay patterns in financial services with those in the rest of the economy. In the

analysis that follows, the differences between the results for the financial services sector and for the economy as a whole are all statistically significant at the 95% level.

(Insert Table 1 about here)

Table 1 explores the factors that underline the variation in actual pay levels for full time employees. The data refers to the largest occupational group in the establishment and not all employees. The comparison between financial services and the whole economy is illuminating. The most important determinant of pay differences in both sectors is job grade or classification. However, there are important differences between the economy as a whole and the financial services sector. Particularly notable is the reported use of incentive or performance related pay and performance appraisal or assessment. Table 1 shows that for the economy as a whole these factors were only cited as important by about a quarter of establishments. The table above indicates that in the financial services sector 79 percent of establishments claim incentive or PRP is important and 71 percent claim that performance appraisal or assessment is. This corresponds to approximately 80 percent of employees being employed in firms where such schemes are used.

The reported use of time-based measures to explain differences in pay is similar to the economy wide pattern. Hours worked and overtime are determining factors in 50 percent and 55 percent of establishments respectively. The age of employees is less important in the financial services (13 percent as opposed to 18) whereas length of service is more important (43 percent versus 34 percent for the whole economy). There is another significant difference between the financial services sector and the wider economy; the use of skills or core competences to explain pay differentials. In the economy a whole 46 percent of establishments claimed it was a contributory factor. The figure for the financial services sector is 65 percent. In terms of numbers of employees the gap is even larger (48 percent compared with 78 percent for financial services). This suggests that it is the larger firms (in terms of employees) that are using skills or core competences as factors in determining pay.

Thus even the crudest measures of pay determination summarise striking differences between the economy wide picture and the financial services sector. The much

higher incidence of forms of PRP and performance appraisal in the sector warrants further investigation.

(Insert Table 2 about here)

Table 2 illustrates the extent of different variable pay schemes in both financial services and the wider economy. The data are suggestive regarding the size distribution of firms and how it relates to different payment systems. For the economy as a whole there was a positive size effect for all five of the variable pay schemes listed. That is to say that the proportion of employees in firms where the schemes were used exceeded the proportion of firms themselves. This leads to the conclusion that the firms that use variable pay schemes are, on average, larger than those that do not. The financial services sector, however, reveals a different picture. There is the same positive size effect for all of the schemes except for profit-related pay where there is a negative effect. The interpretation being that smaller firms tend to favour such schemes. This may be evidence of larger firms being better able to absorb the sunk costs of more complex pay schemes. This finding is consistent with Brown's (1990) analysis payment systems where the costs of monitoring increase with the accuracy of the measurement.

(Insert Table 3 about here)

Using the data contained in WERS 98 it is also possible to examine the mechanisms by which performance is measured. Table 3 illustrates the various means by which the amount of PRP is determined. For the economy as a whole, the trend is for the more individualised measures to be more popular amongst firms. This pattern is repeated in the financial services sector, with the exception of organisation-based measures which will be examined later. The proportion of firms claiming to use individual measures of performance or output to determine the level of PRP is 88 percent. This compares to 74 percent for the wider economy. Group or team based measures are the next most widely used with three quarters of firms reportedly utilising this variable. Again, this is higher than the 51 percent of firms in the whole economy.

An important distinction between the financial services sector and the rest of the economy is the differing use of establishment versus organisational measures of performance. Table 3 shows that in the economy as a whole, workplace-based measures are used by 39 percent of firms and organisation-based by 32 percent. In contrast, for the financial services sector, workplace-based measures are used in 43 percent of firms whilst organisational measures are used in 64 percent of cases. This difference suggests that for financial firms, it is preferred to offer employees an incentive structure that rewards individual effort, but also takes account of the performance of the organisation as a whole. The issue of the focus of performance measurement will be returned to in the case studies.

(Insert Table 4 about here)

Table 4 summarises the particular methods of assessing individual performance. PRP is most heavily influenced by individual measures of performance or output in both financial services and the wider economy. It is unsurprising to see piece rates are not reported as being used, since they are not applicable to financial services. Output-based measures are reported as being used in almost half of establishments. This compares with 52 percent in the whole economy, or 63 percent if piece-rates are included as an output-based measure.

Assessment by supervisor is far more common in the financial services than in the wider economy. Only 46 percent of firms reported using it as a means of assessing individual performance in the economy as a whole. This compares to a figure of 79 percent for the financial services sector. What is more, the size effect is operating in the opposite direction, with a strongly negative effect in financial services versus a positive effect in the economy as a whole. Finally, the acquisition of core competences was only cited as being relevant in 14 percent of financial firms.

Performance related pay and performance appraisal are important instruments of pay determination in the financial services sector. In the economy as a whole they are eclipsed by other variables. There are also substantial differences in the determination of PRP, as well as its use. In the economy as a whole, output-based measures are used to determine the level of PRP in 63 percent of firms, whilst

assessment by a supervisor is only used in 46 percent. This compares to the situation in the financial services sector where output-based measures are used in 50 percent of firms, whereas the percentage of firms using supervisors' assessments is nearly 80 percent.

When evaluated in the light of principal agent theory these findings are significant. The principal claim of the theory is that the incidence of incentive pay schemes is inversely related to their associated monitoring cost. The size of the establishment is predicted to vary positively with the use of output based pay. The data presented by analysing WERS 98 seem to support this hypothesis; it is the larger establishments that implement such pay systems. Thus an important prediction of the theory of payment systems is supported. However, in order to gain a full understanding of the determinants of payment systems in the financial services sector, it is necessary to examine the institutional environment in which they occur.

THE INSTITUTIONAL BACKGROUND TO PAY DETERMINATION

The 1990s saw a period of high growth in the UK financial services sector. This growth was due to a number of factors. The City was still enjoying the growth brought about by the 'Big Bang' reforms of 1986, which had modernised and deregulated the operation of the London Stock Exchange and heralded a new era of price competition into the City. This increased competition became increasingly international over the decade. The City had historically enjoyed a position as an international financial centre, helped by its location (the working day of London overlaps with both the US and Asia) and language. This internationalisation increased during the 1990s due to a number of factors including: the expansion of the Eurobond market, the increased foreign ownership of shares and the international merger boom, all of which required the services of financial institutions. The consequence of this trend was that by the end of the decade it was estimated that between 50 and 70 percent of City jobs were dependent on foreign business (Golding, 2001).

The fact that the City became increasingly engaged in foreign trade during the 1990s had implications for the institutions that operated within it. The Corporation of London estimated that around 40 percent of City jobs were in firms whose ultimate ownership was non-British, with only 13 percent working for non-UK EU firms (Golding, 2001). The 'Americanisation' of the City was a feature of the 1990s. The big US banks emerged from the recession of 1990-91 in good shape and were keen to use London as a base for their European operations (approximately 80 percent of US-owned bank staff working in Europe are based in London). The decade saw the number of bank takeovers and mergers accelerate; so much so that by the end of the decade the number of traditional City banks remaining in independent hands could be listed as Schroders, Lazard and Rothschilds.

The changes outlined above also had repercussions in the labour market. The mid 1990s saw employment surge in the City. Lombard Street Research estimated that whereas in 1995 there were approximately 250,000 'City-type' jobs in London, by 1998 this number had risen to 300,000 (Golding, 2001). The internationalisation of the City was also reflected in the labour market, especially at the more senior management grades with increasing numbers of foreign executives working in the UK for varying periods of time. The decade also saw the geographical area of the City expand, outside the Square Mile to areas such as the West End and Canary Wharf. Despite this increased geographic dispersion, labour market information arguably became more available due to the exponential growth of recruitment services dedicated to service the burgeoning finance sector. The 1990s can be characterised as a period of intense growth and competition in the City, both in product markets and labour markets. It is within this context that the analysis of pay determination needs to be placed.

Institutions operating within the City are faced with a number of constraints. At the most basic level the neoclassical assumption of profit maximisation is particularly applicable to the financial services sector. Firms are then faced with competing claims on these profits. Shareholder interests have to be satisfied through the payment of dividends. Investment in upgrading to the latest techniques and technology is a further drain on the profit stream, and finally there are remuneration costs, which constitute a particularly high proportion of a financial institution's costs.

Allied to this is the fundamental problem of labour market scarcity. This was a recurring theme in the interviews; there is a limited pool of specialised people and therefore they are a scarce resource. The importance of this fact should not be underestimated when it comes to analysing the design and implementation of payment systems in the financial services sector.

Despite the large sums involved and the sometimes complex formulae employed to distribute them, the basic forces of supply and demand lie at the heart of the wage determination system.

The Culture of Remuneration

The 'bonus culture' has been evident in the City for as long as most practitioners can remember. One retired broker remembered: "I usually got 25% of salary and some years 50%, and that was in the 1970s". As the city grew in the 1980s following deregulation and 'Big Bang' the use of variable pay and bonuses became more widespread. Aside from the purely economic influences in pay there are a number of less well-defined determinants that may be labelled 'cultural factors'. These relate to the prevailing norms within an institutional, sectoral or even national framework. The case study interviews highlighted the importance of cultural factors in determining a firm's payment system.

There are striking international differences in remuneration practice. "The American banking culture is very bonus driven, very transaction driven; 'do the deal', don't worry about the relationship...Similarly the European system has been relationship driven, but this is also changing". There was an assertion amongst the interviewees that American managers are less risk averse when it comes to designing pay structures and are eager to maximise the potential financial gain to the employee. The American banks now dominate the city and, as a result, the tradition of paying bonuses is well entrenched. The notion of a transatlantic cultural difference is certainly diminishing to the point of being imperceptible. One of the interviewees commented on the difference in working for a British bank versus an American one;

"The trade off [used to be] lower total reward in exchange for a more benign employer. Nowadays everyone works hard."

In London based subsidiaries of foreign banks the cultural aspects of pay are particularly highlighted. In the Japanese bank interviewed the 'delegate' staff - Japanese ex patriots - are paid in a completely different manner to the 'local' staff. Almost without exception the Japanese workers are employed on a lifetime contract, reflecting the social norms in Japan. As the personnel director explained, the differences in approach are startling and stem from the fact that Japanese workers are not incentivised to maximise profit but to minimise risk.

Where these cultural differences exist in local subsidiaries they have ramifications for the process of pay setting. In the Japanese firm interviewed, approval from Tokyo was required for any total remuneration package that exceeded £100,000, although this was in the process of being raised to £250,000 as the previous threshold was being breached regularly. There was a similar system of sign-off with the European firm whereby the parent company followed closely remuneration levels, especially bonuses.

The primacy of money in the City cannot be overstated. In the city, non-fixed remuneration tends to mean cash bonus; as one interviewee put it "money is what matters." This is in contrast to most other sectors in the economy where non-pay terms and conditions of employment are regarded as important and perquisites viewed as a useful tool of remuneration management. This was highlighted in the interviews: "working conditions are poor in comparison with industry; most people work in open-plan offices and you would often be hard pressed to tell the difference between the desk of a director and the secretary." The term 'variable pay' covers a multitude of different arrangements. This is particularly true within the city to an extent and the interviews revealed a taxonomy of pay systems that are used to varying extents. Table 5 summarises the principal variable pay schemes operating in the city and draws attention to their characteristics.

(Insert Table 5 about here)

The cash bonus is the most basic form of variable pay and is paid annually, usually at the end of the financial year. The objectivity of measurement will be discussed in detail later, but usually combines some combination of objective output measurement together with a managerial assessment of performance.

Deferred bonuses and long term incentive plans are similar in character and aim. They extend the period of measurement and payment in an attempt to engender loyalty and reduce staff turnover costs. Bonus deferral or bonus banking refers to the practice of paying the majority of the bonus immediately but deferring the remainder over a medium term time span. Long-term incentive plans are add-ons to the bonus and are usually linked to a broader measure of corporate performance. When a particular target is met, this triggers the payment, which may accrue all at once or gradually over time. In this way long-term incentive plans are more objective in nature.

Large organisations that have a healthy share price can choose to pay their employees in stock or stock options. This has the advantage of costing the bank less (except for the costs associated with a dilution in shareholding) and gives larger banks a comparative advantage over small competitors with a less successful share profile. The basis of reward in the case of payment in stock is company performance. This compares to bonus payments, which are linked much more closely to an individual's performance. Equity based pay is usually reserved for the more senior employees within an institution. Participation is an arrangement that gives certain groups of employees the opportunity to co-invest in a particular transaction with the institution and appropriate a share of the resultant revenue. These particular schemes are more common in the US and remain institutionally isolated.

THE DETERMINATION OF INDIVIDUAL BONUSES

The design of a variable pay scheme in the city involves strategic decisions on different levels. One interviewee summarised the choices thus: "you decide the percentage of profits or value you give them, you decide the time period over which the rewards are paid and you decide the form in which the rewards are paid." It has

already been established that city institutions overwhelmingly use short-term cash bonuses as the means of delivering their variable pay. This leaves the question of how the bonus levels are arrived at. As the interviews revealed, there is almost universal bonus-pool deliverance of pay. There are, therefore, two distinct processes that need to be understood in order to assess the delivery of performance related pay in the city: the determination of the aggregate bonus pool and the subsequent allocation to individuals.

The Determination of the Bonus Pool

Despite the wide variety of methods employed to determine the size of the bonus pool it was universally recognised that it was directly related to profit. This simple fact means that whatever institutionally specific arrangements exist for distributing bonuses, there is an element of profit-related-pay inherent in all variable pay schemes in the city.

The precise method of determining the aggregate bonus pool was found to vary according to the institution. The most straightforward method of deciding the bonus pool is to take a fixed proportion of profits each year. Indeed, this is the practice that prevailed in the small European institution that was interviewed; 20% of profits were set aside for the bonus pool.

In the Japanese bank interviewed the starting point for determining the bonus pool was to look at the level for the previous year and assess (in light of the current year's profits) whether it needs to be adjusted up or down.

Different institutions viewed this formulaic approach to determining the bonus pool as having advantages or disadvantages depending on their particular circumstances. One foreign owned subsidiary, which had only been operating in London for ten years, claimed that having a transparent formula for determining the bonus pool was important for reassuring staff about remuneration. The major disadvantage of having a fixed proportion of profits determine the size of the bonus pool was the consequent inflexibility it afforded the institution to respond to external forces. The most important of these external forces was the labour market.

According to one recruitment consultant "even if profits are low, firms risk losing people if they don't pay bonuses in line with expectations." In the case of the small European institution that was interviewed, the fixed 20% of profits rule had been breached the previous year in order to ensure that bonuses were high enough to effectively 'lock in' staff during a period of internal restructuring when retention of staff was viewed as critical. Thus, when determining the size of the bonus pool banks appear to remain pragmatic to ensure that the goal of retention is met.

The level at which the bonus pool is determined varies. Common to all the institutions that were interviewed was an attempt to align the bonus pool as closely as possible to the origination of the associated profit. In all but one institution the starting point was the profitability of the local office. In the case of the Japanese and European institutions, for example, the bonus pool was derived from the profitability of the London office. The process of allocating the aggregate bonus pool to individual departments or divisions broadly takes two forms. Wherever possible management will seek to allocate departmental bonus pools according to that department's contribution to profits. In some cases this can be relatively straightforward, as in the case of revenue generating activities such as dealing rooms. As a general rule management will want to identify as many profit centres as possible.

This process of bonus pool allocation is frustrated in the case of more complicated activities, where the contribution to final profit cannot be easily disaggregated along departmental lines. Examples of this problem that were highlighted during the interviews included that of a large international mergers and acquisitions transaction which may have been worked on by corporate finance executives from different departments across the company. Management would then be faced with a decision of how to apportion the resultant contribution to the bonus pool. The Japanese bank interviewed claimed to have formal revenue sharing agreements in place between departments in the case of some large-scale activities. In other cases, senior management had the responsibility for deciding the relevant bonus pool allocations.

There are significant areas of activity that are not suited to this type of bonus pool allocation. Non-revenue earning functions of the bank such as the middle and back

office do not directly contribute to profits, and therefore their bonus pool cannot be allocated in the same way. The interviewees agreed that there is little or no attempt to quantify the contribution these areas make to profits because of the inherent complexity involved. Likewise there are no attempts to assess how to quantify the level of cost saving that these functions provide. Consequently these cost-centres are written off as overheads and senior management allocate the bonus pool out of aggregate company profits. In this way the link with profits is retained but is more dilute than for the front-office functions where the measurability of revenue generation is higher. At this aggregate level therefore, the prediction that cost of measurement is important in determining the type of payment system is supported (Brown, 1990). Where monitoring 'profits' is difficult a more subjective managerial assessment will take place.

The link between departmental profitability and the bonus pool can also be relaxed due to strategic reasons. Two institutions that were interviewed highlighted the case of non-competitive departments within the bank. The bank will have a core business in which it is competitive and from which it earns the bulk of its earnings. However, in order to offer existing and potential clients better service it may also offer services in which it is not as competitive. Obviously these divisions will be run as profitably as possible but their primary aim is as an add-on to the core business. The bonus pool for these departments will not be determined by their competitiveness but by an assessment of their contribution to the profitability of the wider organisation.

The interviews highlighted the different institutional arrangements for distributing the aggregate bonus pool to individual departments. To a greater or lesser extent it can be seen that profit-related-pay is inherent in the pay of the vast majority of staff in the city. Since the subject of this research is to examine the determinants of individuals' pay it is necessary to examine the next step in the process; namely the arrangements under which bonuses are determined for individual employees.

The Determination of Individual Bonuses

The factors that go in to determining the amount of variable pay an individual receives are many and complex. There is the desire to reward performance but the

interviews revealed that this can be frustrated by the need to remain competitive in the labour market. The case studies also showed that there was a high degree of consensus as to the factors important in bonus determination. Although there was variety in the administration of variable pay schemes, the underlying determinants appeared constant.

Four fundamental variables emerged from the case studies as being particularly important in the determining individual bonuses: the degree of individual power, the economic value that is being created, the complexity of that value and finally, the degree of teamwork required. These insights correspond strongly with the predictions of economic theory and will be examined in further detail.

The degree of individual power refers essentially to the bargaining power of the individual with respect to the firm. This power derives from the fundamental problem of economic scarcity. One bank that was interviewed explained that their strategy for allocating the bonus pool was to protect the 'crown jewels' and prevent them from leaving the organisation. According to more than one interviewee, banks often pay above the market clearing level in order to retain the services of the individual and the associated revenue stream. This was not an isolated comment and many institutions spoke of the difficulty in reconciling the wage demands of high achievers with the desire to retain some kind of internal consistency in remuneration levels.

That remuneration is linked to the economic value being created is consistent with economic theory. The marginal revenue product theory of wages predicts that since the value created by some individuals in the city is exceptionally high wages should follow suit. During the course of the interviews it became apparent that managers have a conception of a worker's marginal product, which is expressed in terms such as 'economic value' and 'revenue generation'. There is an accepted classification system of 'front', 'middle' and 'back' office functions that implicitly refers to the marginal revenue product of the employees within them. The level of value created will not just be a function of individual effort however, and is likely to be related to occupation, job grade and prevailing market conditions.

The complexity of the value refers to issues such as whether it is discrete in the sense of being fully under the influence of the agent or alternatively contingent on factors outside the individual's control and the time frame over which the value is created. Principal-agent theory predicts that incentive contracts will be more successful where the costs of monitoring output are lower (Lazear, 1986). The determinants of complexity will again vary according to the business environment in which the individual is working.

The degree of teamwork called for is important in determining the basis for reward. The interviews revealed a universal recognition that if you offer incentives based purely on individual financial targets then you will encourage individualistic behaviour, or as one interviewee put it people with 'sharp elbows'. Therefore, in occupations where there is a requirement for people to work in teams, the design of bonus schemes will reflect this. Again, this supports the predictions of theory (Brown, 1990).

There are strong interactions between these four factors. The power of the individual with respect to the institution will be positively related to the economic value they create and negatively related to the complexity of that value and the degree of teamwork required creating it. Despite the difficulty in disentangling the individual factors at work from each other, this framework provides a useful basis for analysing the process of individual bonus determination. Furthermore, it can be used to yield predictions about the patterns of pay that are observed in the financial services sector.

A factor which has not been mentioned thus far but which is central to the process of bonus determination is that of observability. The principal-agent problem occurs because there is asymmetric information about the amount of effort the agent is expending. A solution to this problem is for the principal to take output as a proxy for worker effort and to link reward to a measure of output. The problems that are highlighted by theory are also evident in practice, namely the question of how output is measured and also the robustness of the link between worker effort and observed output. The observability of output will have a direct and negative effect upon the complexity of value created. Thus, it might be expected that as output gets more observable the use of variable pay will increase relative to non-variable pay.

The interviews did indeed highlight the importance of observability, with one interviewee conceding that "to some extent [the salary-bonus relationship] depends on the ability to measure someone's contribution; with trading it's a lot easier since you can see the trade someone's done and whether they've made a profit or loss." This link between observability and occupation emerged strongly in the course of the interviews and there was a consensus about this link.

Dealing positions were universally identified as having highly observable outcomes. The complexity of the value created is very low since a dealer can be assessed on the money they make on a daily basis. The nature of the business is such that financial performance can be readily identified. The case of corporate finance is one where performance is still measurable but less so than in dealing. The complexity increases due to the fact that the time frame is likely to be longer and there are more likely to be more than one employee working on any particular area. Another area of activity in the city, namely fund management was identified as having more complexity still, primarily due to the much longer time period it takes for a fund manager to build a successful reputation. Given this spectrum of measurability of output, and taking into account the theoretical insights regarding the costs of performance measurement (Brown, 1990), it might be expected that bonuses would be related to occupation in a systematic fashion. The lower the costs of monitoring, the higher the proportion of bonus pay.

THE MEASUREMENT OF WORKER EFFORT

Aside from the measurement issues that have been mentioned above, there are other choices that face personnel managers in setting pay. The actual process by which bonus levels are determined can be broadly split into two types. On the one hand there are schemes that were variously referred to in the interviews as 'mechanistic', 'formulaic' or 'algorithmic'. As the names suggest these plans are characterised by a fixed and pre-specified relationship between some measure of output and the level of the bonus. In some way, these plans may be regarded as

analytically similar to piece rates, despite operating in a rather different environment to the one where those type of payment systems are usually found.

The other type of plan is more subjective and seeks to take more factors into account when determining the bonus than do the purely formulaic plans. There appears to be a dichotomy in how the bonus is determined according to occupation. Support services, back office and management posts all rely more heavily on a judgemental process of bonus determination. Dealing posts are again an exception to the general rule in that nearly a mechanistic process determined 60% of bonuses. As has already been discussed, this is likely to be due to the higher degree of measurability of output in that occupational group.

Subjective Performance Evaluation

The interviews revealed that some form of subjective performance evaluation is used even in those occupations where output is regarded as visible and measurable. One of the major reasons behind this was identified as being the unreliability of relying solely on financial measures of performance. As one bank employee pointed out, the fact that an equity salesman's revenue is observable may not have very much to do with the skill of the individual concerned. There are a number of factors that will need to be taken into account before the individual's contribution can be accurately assessed.

First of these are the conditions that prevail in the product market. As the personnel director of one bank commented, if a particular market is depressed then simply breaking even could be regarded as stunning performance. Another important caveat to using an individual's financial performance figures is that it disregards the contribution made by the various support functions within the institution such as the market analysts and the research department. The final difficulty with using crude performance figures is the fact that in areas where it is important to attract new customers there will be a 'firm effect'. This will be greater, the stronger the reputation of the firm in the market. Essentially what the firm wants to be able to do is to measure the value added by the individual, over and above that which would accrue simply by virtue of them being an employee of that particular institution. This issue

relates back to that of the power of the individual versus the institution. Just as individuals may have significant reputations with which to bargain over pay, the same may be true of the banks themselves.

The desirability of implementing some form of subjective performance evaluation is not confined to redressing the inadequacies of attempting to measure individual financial performance. Nearly all of the firms interviewed cited the desire to include non-financial goals in the pay determination process. There was a recognition that having output as the sole basis for determining bonuses would encourage undesirable behaviours, or the people with 'sharper elbows' that have already been mentioned. This is analogous to the multitasking problem where employees respond to incentives in an undesirable way from the employer's perspective (Holmstrom and Milgrom, 1991). As a manager in the European bank that was interviewed said "we don't want to encourage people to be individual to the point of selfishness."

There was also a degree of consensus as to the issue of what other variables should be included in the determination of an individual's bonus. The Japanese bank that was interviewed was in the process of introducing a management framework to identify and measure non-profit contributions by staff. Amongst the factors that they identified as being important were contribution to cross selling (selling additional banking services to existing customers), being aware of the greater good of the organisation, management skills (where appropriate) and participation in recruitment. In this particular institution every member of staff had a set of objectives set out for the year. For the front office staff it was usual to set some objective and easily measurable goal. This corresponds to the practices advocated in goal setting theory (Latham and Locke, 1987). The 'softer' measures would then be used to weight somebody's formula driven bonus depending upon how they have performed against the new criteria. The personnel manager explained that the system was designed so that "Ideally what you should see, if someone is working in exactly the same markets and the same products and made exactly the same money for the organisation, but one has helped other areas, has contributed to other parts of the organisation, has established good relationships with the back office and other areas - and the other person hasn't then we should see a differential in terms of the first person getting paid more than the second."

The European institution that was interviewed told a similar story of having recently formalised the process of pay determination. Under their new scheme objectives are set and staff are then judged against them to determine their bonus. There has been an explicit attempt to widen the objectives to include non-financial measures of performance. In the case of fund management there will still be a core assessment of how well an individual's fund has performed but also of their contribution to the overall performance of the group, and finally less quantifiable measures such as the extent to which they are a team player. Like the previous example it was envisaged that the less qualitative performance indicators would be used to weight the individual's financial results to determine the final bonus.

It is interesting that in two of the organisations that were interviewed, the incorporation of the more subjective performance measures into the process of bonus determination had happened very recently. This seems surprising given the apparent inadequacies of relying solely on financial measures of performance. In some cases the organisations confessed openly as to not being able to accurately measure financial performance. A senior fund manager in the European institution that was interviewed conceded that the difficulty in using individual performance "is that we don't have adequate performance measurement tools ourselves, so it's very difficult for us personally - we're a very small organisation." This directly supports the hypothesis that the prevalence of output-based pay will be related to firm size (Lazear, 1986; Brown, 1990). A remuneration consultant who was interviewed confirmed that many banks do not have the tools in place to accurately disaggregate individual performance from the 'firm effect' that was discussed earlier. It is perhaps not surprising then that banks have been turning their attention to more holistic measures of performance.

Principal-agent theory suggests that relative performance ranking may be a way of overcoming the information asymmetry facing managers. If the agents are working in the same environment then the uncertainty that surrounds the link between worker effort and observed output is common to all agents and can be effectively disregarded. There was some evidence of relative evaluation being used by some of the interviewed institutions. One personnel manager explained: "if you have a

manager who has ten people working for him and it's a front office environment, one of the first things they will tend to look at is how much each individual has pulled in, in terms of revenue or profit. That's a good indicator of the relative bonuses they will receive." Such performance ranking is only used informally however, and is increasingly subject to non-financial measures of performance.

As one interviewee put it, the use of subjective performance evaluation is "more art than science." In the spectrum between mechanistic bonus schemes on the one hand and judgement based on the other, most institutions appeared to be trying to find a combination of the two. There is a stated desire to have objectively measurable goals as the basis for bonus determination, but to weight this with other less quantifiable but nonetheless important measures of performance. Both extremes are viewed as undesirable. The possibility of individualistic behaviour resulting from formula driven bonuses has already been highlighted. A complete reliance on managerial appraisal also has its drawbacks with the potential for managerial arbitrariness creating problems (Prendergast, 1999). The prospect of employees engaging in influence activities was also raised by one interviewee as a reason not to rely too heavily on managerial assessment of performance.

THE INCREASE IN BONUSES IN THE FINANCIAL SERVICES SECTOR 1990-2000

Despite these problems in accurately measuring worker effort, the use of bonuses in the City is ubiquitous. By analysing survey data for the period 1990-2000 it is possible to examine longitudinal patterns in the use of bonuses in financial institutions. The aim of this analysis is to examine the importance of bonus pay relative to basic salary and to examine how pay patterns have changed over time.

The data used are taken from the August quarter of the Monks Partnership survey for each of the years in question (except for 1995 where the November data was used, as the August survey was not available). The data are discontinuous in that both the participating institutions and the composition of the occupational groups have changed over time. Whilst the desirability of fully continuous panel data is unquestionable, such data simply do not exist. Furthermore, there is good reason to

believe that the Monks Partnership data provide a valid basis for longitudinal analysis. There is no reason to believe there is any systematic bias that would affect the validity of analysing the 'average' firm. The occupational composition of the survey has risen to reflect the increasing diversification of the sector. The longevity of the survey combined with the fact that its primary purpose is to inform the remuneration policy of participating institutions adds strength to its claim of representativeness. The data can, therefore, be viewed as a valid basis for research.

AGGREGATE PAY PATTERNS 1990-2000

Figure 1 illustrates average salary levels and bonuses for the financial services sector as a whole over the period 1990 to 2000. Over the period the sector has undergone significant changes and these are reflected in the composition of the survey. The number of different occupations classified in the August 1990 survey was 193. This number had risen to 450 by August 2000. This underscores the extent of the change that the industry has undergone in the last decade.

(Insert Figure 1 about here)

The data in figure 1 are illuminating. The pattern of base salary levels (which have been deflated to constant 1995 levels to control for inflation) has two principal features. The most striking aspect of the data series is the large fall in average salaries from £44,428 in 1992 to £40,840 the following year. This represents a year on year fall of 8.1%. The cause of this crash in salaries may be related to the prevailing economic recession and consequences of 'Black Wednesday' when Britain withdrew from the Exchange Rate Mechanism in October 1992. What is also striking about salary levels over the period is that following a three-year recovery to 1991 levels, there is very little trend growth in average real salaries for the latter half of the decade. This is despite strong economic and financial performance over the period. In fact, average real salary levels never reached their 1990 level of £45,043; the figure for 2000 being £44,429. Thus, apart from the dramatic events of 1992 it can be shown that average salary levels in the financial services sector have remained remarkably constant over the period.

The same cannot be said of bonus levels. Figure 1 shows how bonus levels expressed as a percentage of base salary have changed over the period. There are a number of interesting characteristics to these data. Average bonus levels are seen to be more volatile than salary levels. There is a pattern of bonus levels rising one year and falling the next. This pattern is repeated for the whole of the period from 1993 to 1996 inclusive. It is also interesting that during the period when average salary levels fell dramatically, there was no accompanying falling away of bonuses. Bonus levels did fall during 1992 but only from 9.8% to 9.6% of base salary. The other significant contrast to the pattern of salary levels is that there is a clear trend increase in bonus levels over the period. In 1990, the average bonus level was 11.7%. By the end of the period in 2000, this had more than doubled to 24.6%.

(Insert Figure 2 about here)

The increasing importance in the bonus in overall remuneration is illustrated in figure 2, which shows how the composition of total remuneration has changed over the period. As was suggested by the previous analysis, the importance of bonus pay has increased dramatically over the period. In 1990 the percentage of total remuneration accounted for by cash bonus was 10.5%. Eleven years later in 2000, that proportion had nearly doubled to 19.7%. The proportion of total remuneration accounted for by non-fixed pay was highest in 1998 when bonuses accounted for 21.5% of total pay.

The survey data is broken down into occupational groups. By looking at one such group, that of secretarial occupations, it should be possible to assess whether the pattern shown in figure 2 is unusual or industry specific. Secretarial functions are common to all areas of the economy and require little, if any, industry-specific skills. As a result, pay levels are likely to be more representative of labour market conditions and less influenced by a need to recruit and retain specialist staff. Longitudinal data for secretarial remuneration is presented in figure 3.

(Insert Figure 3 about here)

Figure 3 indicates that remuneration patterns for secretarial occupations are indeed different from the general pattern for the financial services sector. The principal difference lies in what happened to base salaries over the period. Unlike the general pattern where salary growth was stagnant or even negative over the period, figure 3 shows that average salary levels enjoyed steady real growth over the decade. There are interruptions to this upward trend in 1991 and 1996, but over the period as a whole average salaries rose from £14,886 in 1990 to £18,002 in 2000. This is an increase of 20.9% in real terms. Non-fixed pay is a relatively unimportant component of overall remuneration in secretarial occupations, as would be expected. However, there is a similar upward trend in bonus levels over the period, from 4.2% of base salary in 1990 to 8.0% in 2000. Thus, despite the relative unimportance of bonus levels, they exhibit the same upward trend as has been found in the rest of the sector. This may be evidence of remuneration practice for front office functions feeding its way down to the back office, or it may be a reflection of the greater use of incentive pay schemes in the economy as a whole.

The case of secretarial occupations, which better reflect prevailing wage norms in the wider economy, suggest that the phenomenon of stagnant salary growth being compensated for by an increase in bonus levels may be industry specific. This doubling in the proportion of total remuneration accounted for by bonuses is a tangible expression of the perceived rise of bonus culture that was identified in many of the case studies.

CONCLUSIONS

The importance of cultural factors in determining the shape of the payment system is hard to overstate. There is a spectrum of attitudes towards PRP ranging from the bonus driven US banks on one hand and the Japanese model of lifetime employment on the other. The increased competition in the City that accelerated after the deregulation of the sector in the mid 1980s has resulted in the US model becoming dominant (Coggan, 1995) and the increased use of bonuses during the 1990s is likely to be a reflection of this change in the market environment that has evolved over the period.

This cultural shift has implications for the effectiveness of incentive pay in the City. The increased dominance of the US model has pushed the type of contract towards one of incentive provision, and away from risk sharing (Stiglitz, 1987). Thus, the contrast with the Japanese model of pay, which emphasises risk sharing at the expense of incentive provision, grows ever more pronounced.

Economic theory states that the aim of variable pay schemes should be to provide incentives and encourage desired behaviours amongst employees. The preceding analysis has brought to light the many problems of trying to achieve this end. The interviews highlighted the fact that within the sector itself there is a recognition that the system of bonus payments that is in place may not fully satisfy its stated aims and indeed might create as many problems as it attempts to solve.

A major cost of the observed system of bonus payments is that of dysfunctional incentives. The problems inherent in choosing an appropriate tool for measuring individual performance have been discussed. The desirability of linking an individual's remuneration with their marginal revenue product is tempered with problems of measurement. More than one interviewee stressed the vital role that management information systems play in a successful payment system. The case of rogue traders such as Nick Leeson highlight the consequences of incentivising people to maximise profits without having adequate measurement tools to assess whether or not those targets have been met.

Perhaps more damning is the perception that the concept of a perfect pay scheme is unobtainable. One interviewee claimed that; "the whole bonus system is a recipe for creating resentment and dissatisfaction." More than once, the task facing managers was claimed primarily to be one of managing the expectations of staff in the face of limited resources. The most often cited drawback of the system was the high degree of staff turnover. If management fail to meet the expectations of staff in terms of the level of their bonus they can expect those workers to collect their bonus and then leave the company for a competitor. A senior remuneration consultant described the process "as a merry-go-round and the merrygo-round actually gets faster every year." The economic costs associated with this high turnover include recruitment and

re-training costs. Though the banks are only too aware of this problem they are effectively constrained in their attempts to introduce alternative, longerterm incentive plans by the degree of labour market competition.

This recognition of the fact that variable pay schemes are used more as crude tools of recruitment and retention, than as a means of motivating workers is highly significant. That is not to ignore the relevance of economic theory altogether; some of the predictions of the principal-agent model regarding the link between observability of output and the incidence of PRP are supported by this research. What emerges from an analysis of pay setting arrangements in financial services is that the reason the sector is different from the economy as a whole is less to do with more advanced management techniques of motivation, and more to do with an increased obsession with bonuses in the face of acute labour scarcity. Thus the most relevant economic theory for explaining the patterns of pay in the City may be the simplest, namely that of supply and demand.

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TABLE 1
Factors explaining the differences in actual pay levels of full time employees^a

<i>Factors affecting Pay</i>	<i>UK Economy</i>		<i>Financial Services</i>	
	<i>Establishments</i>	<i>Employees</i>	<i>Establishments</i>	<i>Employees</i>
Hours worked	51.8	56.4	50.0	52.2
Overtime	48.5	61.6	55.5	61.5
Shift premiums	15.2	38.6	2.2	21.7
Age of employees	17.9	18.3	13.4	10.9
Years of service	34.1	38.7	42.9	36.2
Skills / core competences	46.0	48.4	65.1	77.7
Formal qualifications	26.1	26.4	28.0	30.1
Job grade / classification	60.1	72.9	87.4	82.2
Incentive or performance-related pay	24.8	32.5	78.6	80.4
Performance appraisal or assessment	25.0	30.6	70.9	79.0

Base: workplaces with 10 or more employees

^a Applies to employees in the largest occupational group at the establishment.

TABLE 2
The extent of various variable pay schemes in the Financial Services Sector

<i>Pay Scheme</i>	<i>UK Economy</i>		<i>Financial Services</i>	
	<i>Est'ments</i>	<i>Employees</i>	<i>Est'ments</i>	<i>Employees</i>
Profit-related payments or bonuses	31.8	37.4	91.0	77.7
Deferred profit sharing scheme	5.8	6.3	22.2	29.1
Employee share ownership scheme	14.7	22.1	57.7	60.5
Individual or group performance-related scheme	18.2	28.1	53.2	58.6
Other cash bonus	21.8	25.4	39.3	46.7

Base: workplaces with 10 or more employees

TABLE 3
The measures of performance used to determine the amount of PRP

<i>Method of performance measurement</i>	<i>UK Economy</i>		<i>Financial Services</i>	
	<i>Est'ments</i>	<i>Employees</i>	<i>Est'ments</i>	<i>Employees</i>
Individual performance / output	73.7	72.4	87.5	88.5
Group or team performance / output	51.2	49.9	75.5	50.4
Workplace-based measures	38.8	30.2	42.8	29.4
Organisation-based measures	32.2	40.6	63.8	57.5

Base: workplaces with 10 or more employees with non-managerial occupations eligible for PRP

TABLE 4
The methods of measuring individual performance or output

<i>Method of performance measurement</i>	<i>UK Economy</i>		<i>Financial Services</i>	
	<i>Est'ments</i>	<i>Employees</i>	<i>Est'ments</i>	<i>Employees</i>
Piece rates	11.5	8.2	0	0
Other measures of output	52.3	39.5	49.7	52.8
Assessment by supervisor	46.3	58.7	79.4	59.5
Acquisition of skills / core competences	16.2	16.3	14.0	20.5

Base: workplaces with 10 or more employees in the financial services sector where individual performance is used to determine the amount of PRP

TABLE 5
A Taxonomy of Variable Pay Schemes in Financial Services

Pay Scheme	<i>Basis of Reward</i>	<i>Timescale</i>	<i>Objectivity of Measurement</i>
Cash Bonus	Individual Performance	One year	Variable
Deferred Bonus	Individual Performance	Multiple years	Variable
Long Term Incentive Plan	Company Performance	Multiple years	Objective
Equity Participation	Company Performance	Open-ended	Variable
Participation	Profitability of specific deal	Duration of specific deal	Subjective

Figure 1 Average Salary and Bonus Levels 1990-2000

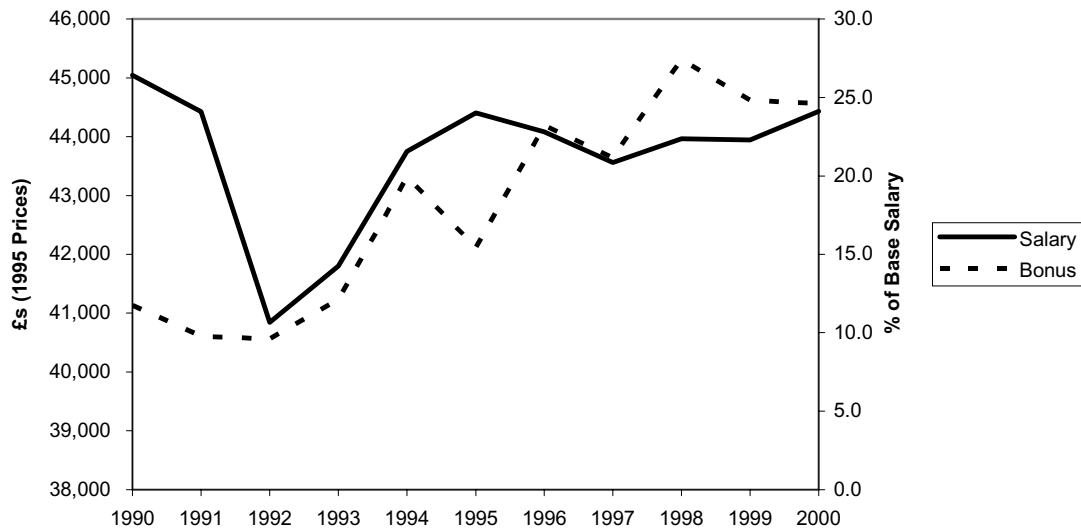


Figure 2 The Composition of Total Remuneration 1990-2000

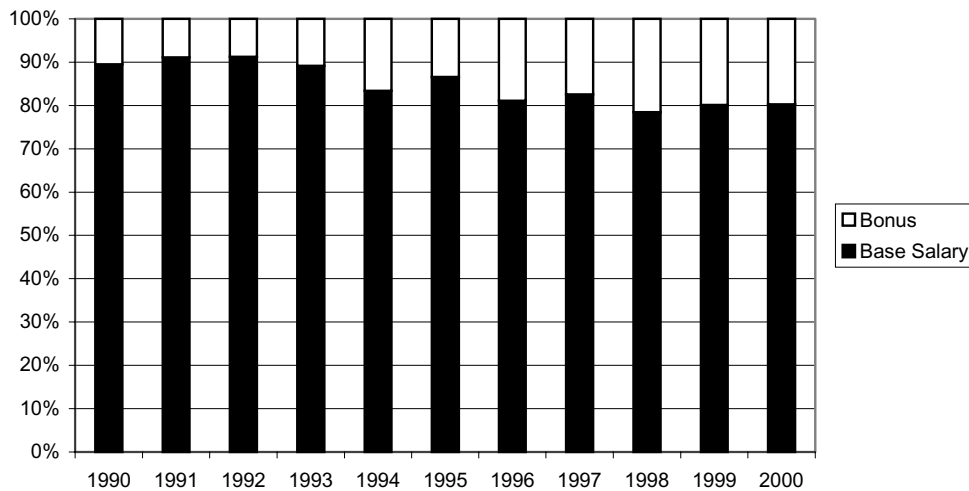
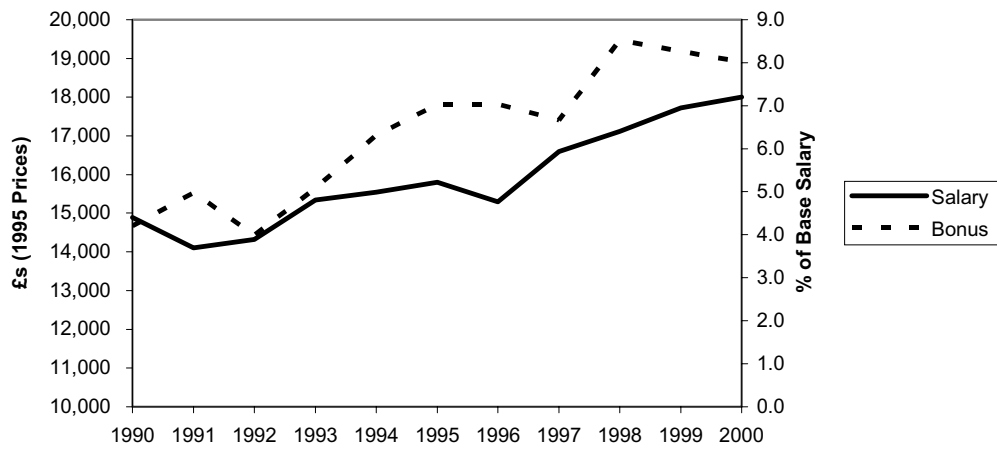


Figure 3 Average Salary and Bonus Levels for Secretarial Occupations 1990-2000



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