

A Study of Payment Systems in Investment Banking during the 1990s

David Nash
Cardiff Business School

ABSTRACT

This paper examines the use of variable pay schemes in the UK financial services sector during the 1990s. Institutional isomorphism is outlined as a theoretical framework for explaining the choice of payment system within the City of London. Analysis of the 1998 Workplace Employment Relations Survey shows that the financial services sector is unusual in its use of incentive pay. Survey data is then used to highlight the increased importance of bonuses during the 1990s. Interview data gives further insight into the processes that inform the determination of bonuses, and highlights the importance of cultural factors. The paper concludes that the extensive use of bonuses in financial services has little to do with providing incentives to workers but is better explained by analysing the institutional factors that face organisations in the investment banking sector.

INTRODUCTION

Since the autumn of 2008 and the ensuing financial crisis, there has been unprecedented interest in the financial sector, and the bankers who work within it. It has been a preoccupation of the media to claim that the seeds of the current catastrophe were sown in the pay policies of the banks; policies that encouraged excessive risk and yet rewarded failure. This paper will analyse the use of payment systems in the UK financial services sector in the 1990s and attempt to unravel the reasons why banks chose remuneration policies that with the benefit of hindsight seem highly flawed.

The paper will briefly outline the economic rationale for providing incentive contracts before analysing the institutional factors that may constrain firms' choice of pay system. Analysis of the 1998 Workplace Employee Relations Survey (WERS 98) will establish that financial services were characterised by extensive use of variable pay schemes. Longitudinal data will be presented that show how variable pay increased in importance over the decade. Interview data is used to further analyse this emergent bonus culture. The paper will conclude that institutional isomorphism provides a better framework for understanding remuneration policies within the financial services sector than simply relying on the economic theories of incentive provision.

THEORETICAL FRAMEWORK

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: 44). Principal-agent theory is one attempt to better explain this relationship and predict the factors that will determine an organisation's choice of payment system (eg Brown 1990, Prendergast 1999).

The fundamental prediction underlying principal-agent theory 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.

An alternative framework for understanding how organisations develop policies, including those around remuneration is that of institutional isomorphism. This theory, first proposed by DiMaggio and Powell explains how organisational homogeneity can result where those organisations face the same set of environmental conditions (DiMaggio and Powell 1983: 149). Three mechanisms are identified which may lead institutions to resemble one another. Coercive mechanisms are those that stem from political influence and the regulatory framework. Mimetic mechanisms arise from organisations having standard or similar responses when faced with common uncertainty and finally normative mechanisms can occur where there are strong professional identities amongst workers (DiMaggio and Powell 1983: 150-2).

In their 2003 paper, Paaue and Boselie explicitly apply the concept of institutional isomorphism to the study of HRM and produce a number of propositions based on the three mechanisms outlined above (Paaue and Boselie 2003). According to these propositions, factors that are associated with an increased degree of HRM homogeneity are extensions to the national or international regulatory regime, the use of external consultants or management blueprints and the existence of formalised professional education and subsequent membership of professional associations (Paaue and Boselie 2003: 62-3).

This paper, in seeking to explain the remuneration patterns in the financial services sector will be cognisant of the economic imperative of designing an appropriate incentive structure as stressed by principal-agent theory but also the potential importance of the institutional context facing organisations when choosing their payment systems.

METHODS AND DATA

The data that informs this study comes from three sources and is both quantitative and qualitative. The 1998 Workplace Employment Relations Survey (WERS) is analysed to outline the use of variable pay schemes in the economy as a whole and compare this to the financial services sector. The 1998 survey is the fourth in the series of studies that date back to 1980 and provide a valuable insight into British industrial relations. The sample of financial services firms in WERS 98 consists of 101 firms out of a total sample of 2191.

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 remuneration consultant's 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 data can, therefore, be viewed as an authoritative source of information on pay practices in financial services.

In addition to these quantitative data, this research also draws upon interview data from a number of interviews that were conducted in six financial institutions in the City of London. The 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. The 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 and a further means of understanding the institutional context of pay setting in the financial services sector.

RESULTS

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, Lazards 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.

The Incidence of Variable Pay in the Financial Services Sector

The 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 is not new (eg 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.

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 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.

The Increase in Bonuses in the Financial Services Sector 1990-2000

The cross sectional analysis of WERS 98 shows the financial sector to be distinctive in its use of variable pay but is static in nature. 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.

Figure 1 illustrates average salary levels and bonuses for the financial services sector as a whole over the period 1990 to 2000. 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 was very little trend growth in average real salaries for the latter half of the decade. This was 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 remained remarkably constant over the period.

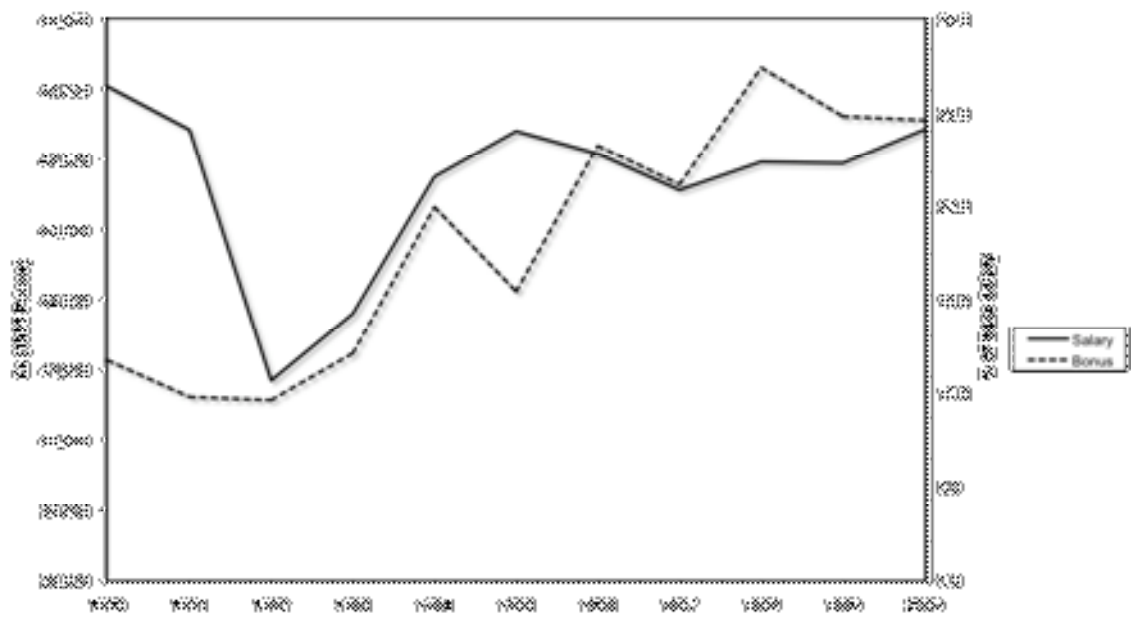


Figure 1: Average Salary Levels and Bonuses for the Financial Services Sector (1990-2000)

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%.

The increasing importance in the bonus in overall remuneration is illustrated even more strongly 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.

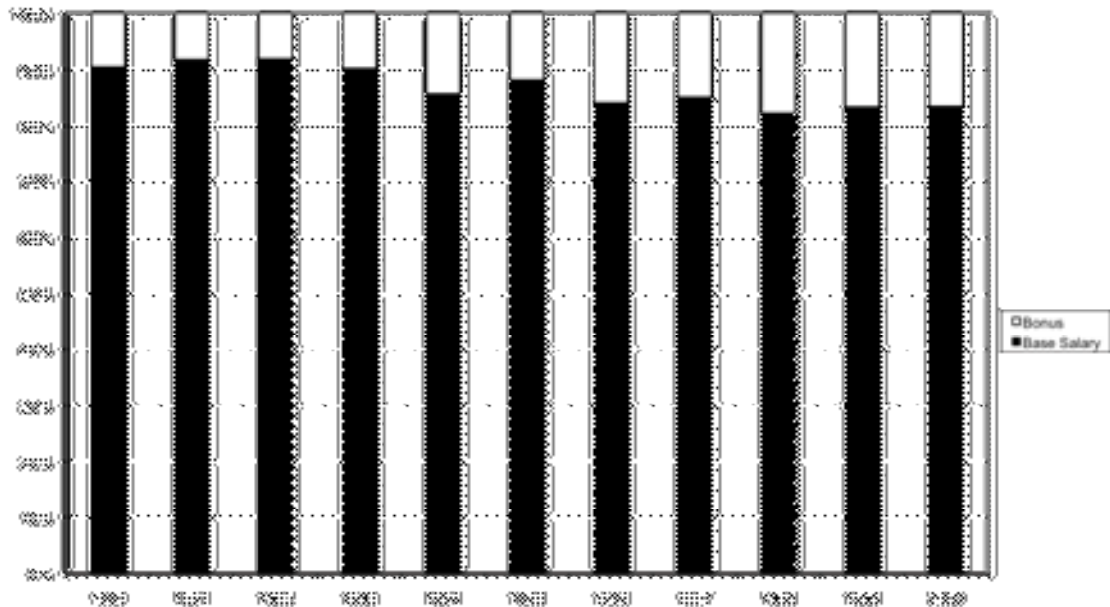


Figure 2: Composition of total remuneration 1990-2000

The 'bonus culture' is not a new phenomenon and 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, however. The interviews highlighted that despite the ubiquitous nature of bonuses payments there was a degree of heterogeneity in the gearing of variable pay. Specifically, the interviews highlighted the importance of national cultural factors in determining a firm's payment system. One interviewee reported that *"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"*.

In London based subsidiaries of foreign banks the cultural aspects of pay were particularly highlighted. In the Japanese bank interviewed the 'delegate' staff – Japanese ex patriots – were 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 significant and stem from the fact that Japanese workers are not incentivised to maximise profit but to minimise risk. Contrastingly, 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.

As has already been asserted, by the end of the 1990s American banks dominated the city and, as a result, the tradition of paying bonuses had become well entrenched. Thus this notion of a transatlantic cultural difference had diminished 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."*

CONCLUSION

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 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. What the preceding analysis shows is that there are non-economic, institutional factors that appear to be highly relevant in explaining the observed pattern of remuneration in the City of London. DiMaggio and Powell's concept of institutional isomorphism appears to have some salience (DiMaggio and Powell 1983). The deregulation of the markets in the 1980s is an example of a coercive mechanism that prompted a strategic response from the institutions operating within those markets. Similarly, as the degree of competition rose and the city became dominated by US owned banks, the heterogeneity of pay systems decreased. This mimetic mechanism was reinforced by the concurrent emergence of consultancy services. Finally, although the City is not characterised by professional associations in the same way that the medical and legal professions are, there is a coherent sense of professional identity amongst bankers. The tight social networks and small geographical spread of the labour market reinforce this normative mechanism.

Thus, in attempting to explain the pattern of remuneration in the financial services sector, this paper concludes that the institutional factors outlined above are at least, if not more, relevant than the traditional economic explanations. This might be of some comfort to contemporary policy makers as it suggests that attempts to eradicate the culture of greed within the sector might be successful. If the regulatory changes that emerge from the current crisis are strong enough then the theory of institutional isomorphism implies that this will constitute a coercive mechanism that will cause change within the sector.

REFERENCES

- Arrow, K. (1985). The economics of agency. In J. W. Pratt & R. Zeckhauser (Eds.), *Principals and agents: the structure of business*. Boston Mass: Harvard Business School Press.
- Brown, C. (1990). Firm s' Choice of Method of Pay. *Industrial & Labor Relations Review*, 43(3), S165-183.
- Coggan, P. (1995). *The money machine : how the city works*. Harmondsworth: Penguin 1995.
- DiMaggio, P., & Powell, W. (1983) 'The iron cage revisited: institutional isomorphism and collective rationality in organisational fields' *A merican Sociological Review*, 48(2), 147-160
- Golding, T. (2001). *The city : inside the great expectation machine : myth and reality in institutional invest ment and the stock market*. Harlow: Financial Times Prentice Hall 2001.
- Monks Partnership. (1997). *International banks and investment houses: a remuneration guide*. Safron Walden: The Monks Partnership.
- Paauwe, J., & Boselie, P. (2003). Challenging 'strategic HRM' and the relevance of the institutional setting. *Hu man Resource Management Journal*, 13(3), 56-70.
- Prendergast, C. (1999). The provision of incentives in firms. *Journal of Economic Literature*, 37(1), 7-63.
- Stiglitz, J. E. (1987). The design of labor contracts: The economics of incentives and risk sharing. In H. R. Nalbantian (Ed.), *Incentives, cooperation and risk sharing*. Totowa, N.J.: Rowman & Littlefield.
- Taylor, R. (2000, 9 November). How the rich get richer. *The Financial Times*.