

Expensive Pinstripes

Business and Compensation Models in Private Banking

by Stephan Hostettler*

Private Banking is a people intensive business. Employees cost a lot of money – and generate a lot of money for the bank – if they are good. Particularly in the present rough banking environment we find plenty of illustrative examples. Hardly a week goes by without the media reporting on private bankers or whole teams leaving.

Many roads lead to the goal. This also holds true for private banking. Various business models can be used successfully. They offer private bankers varying degrees of freedom in defining the investment strategy and selecting suitable products. At one extreme, private banks act similar to family offices and merely provide client advisors mid office and back office services. The bankers act independently regarding investment strategy and choice of products. Bank Vontobel's recently established VT Wealth Management, a cooperation with external asset managers, roughly follows this approach. At the other extreme are private banks that keep the client advisors on a short leash regarding customer care and determining the portfolio.

Multifarious Incentives

The financial incentives in the individual private banks vary greatly. This is an expression of a corporate culture that has diverging opinions about the performance of whole teams and individual bankers or rather their commitment to the company. Thus the remuneration system defines to a greater extent what type of banker fits within the scope of the business strategy. This leads to the crucial question: How can a variable remuneration system balance out the expectations of the bank with those of the bank or its owners?

Three factors need to be taken into consideration: Firstly, financing the bonus – where does the money come from? Secondly, allocation of the bonus – who

2 / 4

receives how much? Thirdly, its payment – when and in what form is the bonus paid? Regarding financing, the first question that comes up is that of the approach: top down or bottom up? For the top down approach the whole bank has to be successful, because the bonus pool is fed from the consolidated profits and split up among the individual units, usually on the basis of contribution margins. In the bottom up approach, the bonus pools are augmented according to contribution margins: per market segment, team or even per individual banker. The advantages of the bottom up approach are obvious to a successful banker. There is a direct relation between performance and payment. In view of the competitive environment, more and more banks are switching over to this concept. Closely intertwined with this form of financing is the question of allocation. In the case of top down models, allocation is made mostly on the basis of contribution margins per business unit or on the basis of individual performance. Criteria for distribution, i.e. allocation of the bonus pool, more often than not correlate with the business strategy. Often in addition to financial goals such as net new money or managed assets, qualitative goals such as leadership quality or customer orientation often come into play. What is often forgotten in these goal checklists: the quality of the program declines the higher the number of goals is, because they are often contradictory and result in focusing on the short term. These dangers are known to the bank managers, which is why they seldom make any commitment as to when and whether a bonus will be paid. Thus bankers like to complain a lot: “I really don’t know how much I’ll be earning this year. I can’t directly influence this anyway.” This in turn leads to bankers looking around market and comparing wages. As is generally known, the “others“ always pay more. What remains hidden is the performance behind this. Thus bonus payments spiral – also because of intransparent allocation – upwards.

«Golden Handcuffs»

When paying out bonus, three variations are encountered: immediate payment, deferred compensation or compensation at risk. Immediate payment is by far the most prevalent instrument. It is certainly doubtful that this form of bonus payment is ideal for a business or owner’s strategy which envisions long term successful development. Often deferred payment is used to counter the surge of quitting that takes place shortly after bonus is paid out. This is rarely successful.

3 / 4

«Golden handcuffs» offer only limited influence in today's environment. The best people are snapped up by the competitors. Furthermore, bankers who remain at a bank solely on the basis of remuneration are not necessarily a good influence on the company culture. Instead the so-called compensation at risk model is better, because also negative company performance and contingent risks such as reputation can be taken into account. A penalty (malus) is also possible. This concept attracts entrepreneurial people, who not only pay attention to annually stable bonus payments. This requires a clear and transparent deal for both parties concerning the future, without any ifs and buts.

Two trends are discernable regarding private banks. On the one hand long term agreements based on formulas are gaining ground amongst individual bankers. These are conducive to the idea of "entrepreneur in the enterprise" and are utilized mostly in growth markets and with top performers. On the other hand, traditional incentive systems, which if anything, are construed for the short term and are based on attaining individual goals, still have numerous enthusiasts particularly on the executive floor. Neither of these two basic approaches is a priori superior to the other. Both can make sense, depending on the owner's strategy.

Conditions necessary

In times where private banks are strongly expanding as is presently the case, it is absolutely legitimate that owners invest in developing the business by paying out bonus. However, in the long run the balance between shareholders' interests and bankers can only be established if long term conditions that are binding on both sides are met. These must not only reward investment volumes and market shares realized in the short term, but also build up on effectively realized profit contributions and thus take into consideration appreciation value. It goes without saying, that this calls for the right leadership and corporate culture, a clear understanding of all employees as to the vision and direction of the bank as well as the courage of both management and the board of directors to abide by the conditions in good times and bad times and to communicate this internally and externally.

* Dr. Stephan Hostettler is the founder and Managing Partner of the independent consulting firm Hostettler & Partner AG and lecturer for Corporate Governance at the University of St. Gallen (HSG).