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Peak Performance
*A Reality Check
for Performance
Management
in Financial Services*



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EXECUTIVE SUMMARY

Performance management is central to the debate about banks' problems and their future. It is wrongly blamed for their current struggles, but rightly seen as central to their recovery.

The role of performance management is to translate top management intent and strategies into organisational action. It should not be blamed for the evident failures in the direction itself. Banks have now made radical changes in their strategies, and they will depend on performance management to translate their changed objectives into action. The performance management cycle does this by broadly influencing organisational behaviour and performance, not just compensation. At its foundation is a process of defining and then evaluating performance in specific and often quantitative terms. The newly increased emphasis on risk and long-term planning makes that more difficult.

A good performance management process also includes and promotes constructive dialogue, focusing on business as well as individual performance. The banks will benefit from the improvement to behaviour and culture that a well-designed performance management process will deliver.

EXPECTATIONS AND REALITY

Performance management is becoming central to the turnaround of banks. Under intense public, investor, and political scrutiny, bank leaders, owners, and regulators all want to reshape how financial institutions work. To that end, much interest has focused on managing performance and compensation. In the U.K., the Financial Services Authority (FSA) has drafted rules and guidance covering remuneration, to be in force beginning in November 2009. Many people are interested in how bankers should be rewarded, and few want compensation to be handled as it was in the past.

Some of the blame attributed to performance management is misplaced, as is some of the hope that it can substitute for strategy. Performance management is an instrument to shape organisational action into alignment with leadership intent. Blame the compensation system if it fails to translate intent into action or stimulates the wrong sort of action. That happens with rogue traders. But in this crisis, the problems started at the top with the actual intent of leadership. Misunderstanding their institutions' interests, markets, and risks, leaders sought and encouraged rapid growth in assets, short-term trading, and market-based liquidity. That intent proved to be the main problem, since

it came at the expense of long-term stability, as well as risk management and mitigation. Indeed, organisational systems, including performance management, served only too well to translate strategy into effective action. Blame the driving on the driver, not the steering wheel.

For the bankers at the top who shaped the strategy, "rewards for failure" are rightly criticized. Some executives have certainly been over-protected from the consequences of failure. Still, there is another side to the story. Most senior managers had substantial, committed personal investments in their institutions. When their strategies collapsed, executives' personal wealth and their reputations were shredded. If incentives were everything, top management had good reason to avoid the crisis. The rewards for failure seem more unintended consequences than cunning plots. Rather than focus on conspiracy theories and greed, a more charitable view allows that banks simply joined the long list of human institutions overwhelmed and damaged by failure to anticipate new dangers, group think, and overconfidence. If organisations and governments were immune to those mistakes, history would be very different.

BANKS’ PRIORITIES

Reform of banks’ performance management must start with changes in what the banks are trying to do. Bank leaders face common challenges in restoring stability and trust, whether or not their institutions are owned or supported by the government. As part of this renewal, banks will probably need to rely more on core banking functions such as taking deposits, making loans, and transmitting money. It is the importance of these functions that warrants and invites extensive public support for banks. The reciprocal obligation of banks is to commit heavily to these core functions and shun the complexity, obscurity, and risk associated with some other businesses they have developed.

Risk management has naturally become a renewed priority, and one that banks will have to understand and manage more broadly and effectively, paying particular attention to systemic risk. Yet at the same time, an urgent priority is to shape lending policy toward the business and mortgage lending that is essential to economic recovery. That goes hand-in-hand with shifting the focus to home

country customers—who wield power with their votes—and away from international expansion.

We may also see a broader refocusing toward consumer orientation. In the U.K., banks made choices that were detrimental to public trust and confidence, including semi-concealed current account and credit card charges, bad decisions about short-term profitability goals, and carelessness about the customer’s best interests. Through these actions, banks acted in ways that lost consumer and public esteem well before the crisis. Despite much effort, neither competition nor regulation has convincingly addressed these issues. What is really needed is change in the culture and orientation of the banks to become more customer-centric. Now, in the U.K. and elsewhere, temporary government ownership may be an exceptional opportunity to influence the focus, role, and organisational culture of the banks, in response to both business arguments and public pressure. As a result, we may see radical changes in banks’ strategy, indeed, in their very *raison d’être*.

ROLE OF PERFORMANCE MANAGEMENT

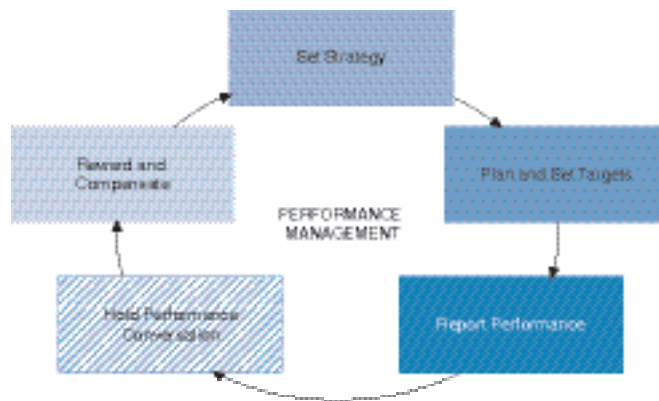
Banks depend on their performance management systems to transform purpose and strategy into action and actual performance (see Exhibit 1). This process begins when strategy is translated into specific plans and targets. Those targets become the yardstick for reporting progress and performance in functions across the enterprise, from marketing to human resources to finance. In a well-functioning system, layers of management engage in conversations about results, their cause, and how to improve or sustain them. The final phase of the performance management cycle is to determine rewards and compensation that reflect both understanding of the results and plans for the future. Systems are effective only when these various elements work together.

In the banking industry, both business and individual operational targets have been seriously flawed. Across the U.K. commercial banking industry, growth metrics dominated for years. Trading activities focused on short-term profitability. In neither case was the level of risk adequately reflected in performance metrics. In invest-

ment banking, deals, deal revenues, and the feed to proprietary activities dominated. Many believe that clients' interests were compromised, eroding long-term franchise value. Critics point to short timelines, too brief to capture the real risk, and insensitivity to the relevance and impact of extreme outcomes—occasional, large risks big enough to affect overall returns disastrously, yet rare enough to be ignored by annualized performance measurement processes.

Now begins the work of extending and rebasing bank metrics in every business area so they are in line with new priorities, new understanding of risk, and new strategies. A good performance measurement system requires clarity about what is to be achieved and reliable measures of progress. In practice, this is going to be challenging. Both systemic and liquidity risk are huge issues, yet what we know about them is limited. Existing “risk models” have proven inadequate. Banks need, but do not yet have, replacement models that provide good, practical measures of risks that guard against large, rare, but possible events.

*Exhibit 1
The Performance Management Cycle*



Source: Booz & Company

The historically quantitative nature of many performance management systems demands a measurement standard that may be impossible to sustain moving forward. The same goes for liquidity risk—we don't yet know how to measure the risk of panic, or where it may arise. The FSA paper dodges questions about how banks can put the recommended principles into practice. Absent the ability to reliably quantify risk, the best answer may lie in broadening these quantitatively mechanical performance management systems to put more value on educated and balanced judgment. Just because we cannot yet quantify risk, we cannot ignore it or exclude it from the measures of performance.

There are also problems with the emphasis on letting risks play out

over time and compensating after the results are in. The FSA paper favours this approach. However, delayed and uncertain compensation doesn't help an executive pay the bills today. Under this system, executives may focus more on the immediate component of their rewards; delayed components may be devalued and have little impact on action.

That dynamic may be even truer if the executive believes that the results depend on chance—on the actual outcome as opposed to the risk-adjusted expected outcome. Furthermore, for systemic or binary risk, time and the resolution of uncertainty do not reveal the actual risk. For example, if a bettor places a wager on red rather than black and the result is red, that does not mean the bettor ran no risk. In

fact, a single outcome reveals almost nothing about the true risk level in that wager. It's fair enough to assess the actual risk of a large portfolio of consumer loans by averaging loss experience over five years, since the law of large numbers comes into play. However, that approach works poorly for rare, big, or binary outcomes.

Banks will also need more customer metrics in their performance assessments, if customer-centric strategies become more prevalent. They will need clear views of strategy and intent by customer segment, and a carefully chosen set of metrics to monitor progress and the balance between costs and rewards. They will also have to find a way to reflect the fact that enduring customer franchises are built over years.

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BEHAVIOURAL AND CULTURAL CHANGE

The way performance management systems operate and the discussions they force are just as important as what they measure. They extensively influence behaviour and organisational culture. People, even bankers, are not just economic animals, motivated by incentives. They also want to learn and are motivated by social norms. Good performance management systems have components that strongly promote learning and encourage desired behaviour.

Discussions of business performance are essential to reinforcing those types of behaviours. A well-designed performance management process systematically encourages discussion of the reasons for performance and what can be done to maintain or improve it. When the performance management process goes beyond superficial discussions of rewards, both business and individual come under scrutiny. In a favourable context, different perspectives can be tested and blended to produce better results, allowing the company to benefit from the skills and

experience of the full management team. The process also helps offset agency problems, by sharing more data far more widely. Better data produces a better balanced perspective on an individual's challenges, strengths, and weaknesses. That, in turn, results in more appropriate compensation decisions.

Better access to information and greater transparency can improve a practice that has been too common in the banking sector: the rise of the financial bonus culture and the mercenary banker. Different from the stereotypical conservative financial steward, the rise of this new breed of banker led to conversations that focused exclusively on performance against targets and compensation, rather than the reasons for the performance. In recent years, those targets were short-term and risk-insensitive, and the performance conversations were really compensation negotiations. Once the solvent of money dissolved the partnership culture of traditional investment banks and the institutional

ethos of clearing banks, performance management conversations were reduced to self-interested negotiations. Extreme organisational decline may still have been the exception, but the directional influence of a bonus-based culture was pervasive. Reversing that tendency in banks will be a major contribution to the turnaround of the sector.

Performance management will change this dynamic in tandem with strong leadership example and good human resources (HR) practices. The HR function should connect closely with the performance management system and, in many cases, will play a key role in shaping the new cultures of the institutions. By marrying behaviour,

people, and culture to organisational purpose and strategy, performance management systems and HR policies will become the wheels on which new intent will ride.

That applies to regulatory institutions as well. With the perspective we have gained through this most recent sector decline, we can see the power of collective assumptions and how difficult it can be to announce that the emperor has no clothes. We can also see that our best protection against future problems will be curious and persistent regulators. Rules can address the specific issues that led to this crisis, but we have to help regulators become more capable and inclined to identify and address the new forms in which

collective delusion will reappear. They must have judgment, courage, and correctly balanced incentives to stand up and act when they need to—even when few others see the need.

Performance management within regulatory organisations can help, by creating incentives for people to do this difficult job in the right way, rather than falling back on the resort of the bureaucrat everywhere—box ticking and procedural compliance. This will be hard; performance management within public institutions has particular problems, especially around identifying and sanctioning poor performance. But it is going to be vital.

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THE CORE ELEMENTS OF GOOD PRACTICE

Once financial institutions and regulators develop strategies for reform, they must align organisation, team, and individual activities. Their approaches may vary, but the core elements of good practice are clear.

- Performance management will begin by defining specific goals and measures in line with the new objectives of the organisation. The challenge in banks is to broaden the dimensions of reporting, most notably in reporting risk, and to lengthen the period over which performance is assessed.
- The performance discussions that follow assessment are critical to shaping behaviour and culture. Regular conversations improve the chances of identifying poor performance early and making corrections aimed at improvement. To be effective, managers must have the skills to tackle tough conversations and the willingness to act decisively when required, rather than avoiding confrontation.
- Banks must reward and compensate in line with the new set of objectives. They will need to develop or revert to forms of reward such as promotions rather than bonuses. Such

measures tend to reward performance over longer periods of time and can be withdrawn or reversed if past performance proves illusory. That promotes institutional loyalty by rewarding successful performance with career progression. Regulators and the government will have active oversight of these processes, and performance management systems that are well thought through will shine in this transparency.

If performance management is working in an organisation or sector, the impact will be seen in behaviours as well as actions and results. Starting at the top, effective performance management systems facilitate positive change throughout the organisation. The managerial dialogue will be broad-based and constructive. Those who successfully adapt to new ways of working—by increasing their focus on either risk management or customer-centricity—will be rewarded and will advance. Those who do not will leave. Through that filter, the cultures of the institutions will change. By marrying behaviour, people, and culture to purpose and strategy, performance management systems will become the instrument whereby a new, shared intent for banks translates into reality.

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Richard Rawlinson is a Booz & Company partner working in London, where he leads the organization, change, and leadership practice.

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