Incentive Pay for Support Staff

Should Banks Consider Moving to Salary *Only*

By Warren Rosenstein and Jeremy Smith
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OVERVIEW

As firms look to reduce costs, the topic of how infrastructure or support staff should be paid is frequently raised. A number of firms have broached the topic of removing incentive pay for some or all of these employees and compensating them on a pure salary basis. Other firms, who have moved compensation from variable to fixed over the past 5 years are now unhappy with their rising fixed cost base – not just for revenue generators, but for support staff as well.

While there are some sensible reasons for considering changing the pay structure for support staff, there are concerns that these efforts may create more harm than good. As with most questions, one answer does not fit for everyone. Firms should consider the points outlined below and how / whether they apply to their unique situations.

AVOIDING EXCESSIVE RISK

Since the financial crisis, there have been a number of voices calling for the end of incentive pay for support staff, mainly focused on those in control functions such as risk management, product control, audit, and compliance. As incentive pay is generally profit-linked, the concern is that if these employees see a connection between their personal pay and corporate profit, then it will encourage them to allow excessive risk. Some of this thinking has come from those in regulatory roles or people in the political arena.

However, the goal of control functions within a bank is to facilitate effective and appropriate risk-taking, and to partner in creating a profitable business. Who would want to own shares in a bank where the control functions are incentivized to prevent all risk? If you break the link between profitability and pay in control functions, in essence, you are encouraging staff to prevent any transactions from taking place, since they have no upside if the firm is profitable, and may be culpable if the firm takes a loss. Ideally, the control functions should work closely with the front office to ensure that a firm is effectively taking and managing risk and optimizing profitability. When this succeeds, control functions staff should be paid bonuses to reinforce this alignment, and when it fails, they should feel the sting of this failure with no bonuses.

COST CONTROL

Before the financial crisis, roughly 70% of aggregate pay for infrastructure staff came in the form of salary with the balance being in incentive pay, mainly in cash. This is now about 80% salary and in some organizations, as high as 90% salary. This seriously impacts a bank's ability to reduce compensation costs in a poor year because even

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eliminating bonuses would have a minimal impact. To reduce infrastructure compensation costs, banks have had little alternative other than to cut headcount or transfer roles to lower cost locations.

In order to best navigate the choppy waters and cyclical nature of the business, firms need <u>more flexibility in pay levels, not less</u>. While there is, and ought to be, more volatility for revenue producers, firms do need to be able to reduce compensation costs in difficult years without cutting their back office (and incurring sizeable recruitment costs in rehiring later). The best way to do this is with a significant portion of infrastructure compensation being variable.

PERFORMANCE MANAGEMENT

There are many factors that drive employee behavior. Pay level is just one of many. That said, the variability of the size of incentive pay is a powerful tool for recognizing performance, both good and bad. In an environment where all infrastructure staff are paid on a salary-only basis, a firm's ability to differentiate pay between high performers and low performers is based only on the size of the salary increase you can give. This is a real problem.

- For the low performer, since you cannot decrease pay, the punishment for poor performance is simply static pay—not a very powerful message.
- For the high performer, it is even more of a challenge. Will there be salary budgets large enough to give a salary increase that is truly compelling? And if you could significantly bump up base salary, what happens if the following year the firm profitability is down?

COMPETITION OUTSIDE THE INDUSTRY

One of the most compelling cases for eliminating incentive compensation for infrastructure staff is the idea that as the premium paid by financial services over other industries is shrinking, it is increasingly important to offer "all salary" compensation in order to compete for talent. This point has some merit, as employees typically prefer all salary / all cash compensation, when possible. The question remains, however, at what level these salaries would have to be set by financial services to continue to offer a differentiated employee value proposition versus the broader industry.

When you consider the typical hours worked in banking and the stress levels, along with factors such as the environment and high expectations, simply matching salary rates with the broad industry will not be enough to recruit, engage and retain talent. In order to create a strong attraction for working in finance, even if you cannot deliver a substantial pay premium in all years, it is important to be able to deliver it in <u>some</u> years, and that can best be done with incentive pay.

COST REDUCTION - SUPPORT COSTS

With the exception of the regulatory initiated demands referenced above, the drive to reduce incentive pay for support staff has been part of firms' demands to reduce their overall cost base. However, it is seen as unacceptable to cut bonuses without some increase in base salary (even if this is lower than 100% of the former bonus level), and

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in most cases, the changes proposed would only impact junior staff, who generally receive small bonuses anyway. Therefore the actual quantum of the saving would be relatively low when compared to overall support costs. Would this saving be worth the impact that such a change would have on morale and competitiveness in recruiting staff?

COST REDUCTION - EFFICIENCY IN THE COMPENSATION ROUND

The turn of the year is an extremely busy period, not just for HR / Reward staff but also for management and supervisors who are trying to allocate bonus pools over a huge number of staff. Since many of these employees are likely to receive only small or token bonuses, then is it really worth all the effort? For example, eliminating bonuses for the bottom half of the support population would significantly reduce effort. This is the strongest case for eliminating incentive pay for a specific set of employees executing transactional work. In some cases, firms have already made shifts for groups of employees where there are historically limited incentive pay opportunities, and there is limited differentiation in individual performance, and these changes have been helpful in reducing administrative burden.

CONCLUSION

While much about how banks deliver pay has been ill-conceived in the past, the idea that an individual is paid on a combination of firm, business and personal performance still has merit. All employees ought to be focused on driving the profitability of the firm. That effort should not fall exclusively to the revenue producers. Likewise, all contributing employees ought to get outstanding rewards when the firm performs well, and suffer as a group when the firm fails. Firms need agility in managing costs, so that in down years they can take down the compensation spend significantly, without cutting staff. Taking away incentive pay may remove the motivation to take risk, but banks are not barber shops, and heaven help the financial services firm with a pay construct that doesn't encourage and reward effective risk-taking.

In addition, from a cost reduction point of view, the realized savings are not likely to be large and changing employees' terms and conditions is always a messy and time-consuming process. In our view, firms should primarily consider the following solid business logic: you do not increase fixed costs in a time of challenging and volatile revenues.

ABOUT THE AUTHORS

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