McLagan Alert

Allowances and Benefits in the Financial Industry – Current Strategies and Changing Landscape in the Middle East

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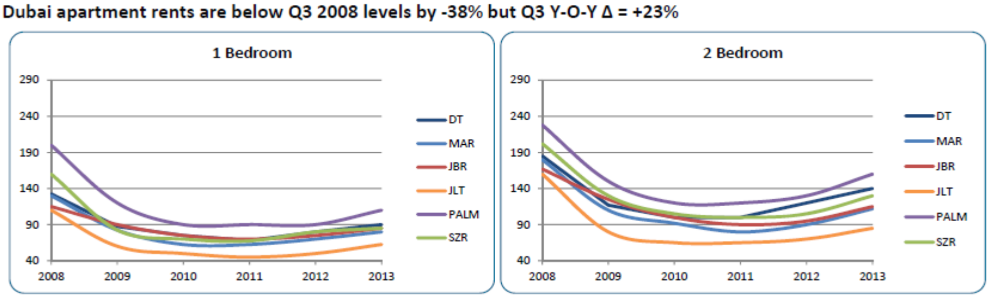
The structures for allowances and benefits in the regional financial industry are often complex and in many cases, independent of the business and HR strategies. Given the regional employee demographics, with a mainly expatriate workforce, and the tax-free environment, international banks often struggle to maintain parity with their foreign operations in regard to reward structures. Local financial firms also face issues such as, legacy compensation structures with excessive numbers of allowances, and complex employee demographics.

While the regional financial sector has seen robust business growth, factors such as rising inflation and competition for key talent have inhibited the ability of the firms to motivate their staff without adopting major structural reforms in compensation and broader HR strategies.

Recently, many banks in the region have experienced an increase in employee complaints about rising costs especially around Housing and Child Education. Employees are demanding a reevaluation of the Housing and Educational Allowances, as well as increases in the basic salary. Given that most banks, especially consumer banks, are under severe pressure to maintain acceptable levels of cost-to-income ratios, the response to employee demands has been fairly muted. Although the rents in cities like Dubai are still lower than they were during the peak, not many firms have decreased their housing allowances.

Dubai apartment rents are below Q3 2008 levels by -38% but Q3 Y-O-Y Δ = +23%



Source: *McLagan 2013 UAE Allowances and Benefits Report*

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Firms are justifiably cautious not to strictly follow the property market. Given the unpredictable and often volatile nature of this market, firms should consider the approach of leasing or owning residential properties of different sizes across various locations in the city and letting them out to their employees, as per their entitlements.

Given that talent retention is instrumental in sustaining business growth, firms cannot afford to ignore the growing employee demand to match increases on various cost components, including Housing and Child Education. So, what should the banks do to ensure that they strike a balance between the expectations of the shareholders and those of the employees?

Financial firms in the region have diverse allowance structures that often vary significantly from one group to the other – Retail, International, Local Investment and Sovereign Wealth Funds (SWFs). In many cases, the allowance structure offered to the employees is different than the one used for the calculation of statutory benefits such as pension schemes for nationals. Such an approach works well because it ensures a balance between ease of communication, and compliance with legislation around gratuity and pensions.

The number of allowances managed also varies significantly across firms. Local firms often manage larger number of allowances than their international counterparts. In most cases, organizations that maintain a lean allowance structure have invested time and effort in consolidation of allowances. In general, we see the following ranges of consolidation of the allowance structures:

1. **Full Consolidation** – employees receive one consolidated allowance in addition to the basic salary. The consolidated allowance is paid each month in equal installments. Benefits such as Child Education are kept out of the remit of the consolidated amount. Also, the national allowance, which is provided to all employees who are citizens of the home country, and job related allowances, such as Teller Allowance, are not consolidated and are managed separately. Such an approach is still relatively uncommon in the region. There are, however, some examples of firms (both investment banks and consumer banks) in the region that have adopted full consolidation.

2. **Partial Consolidation** – few allowances are consolidated into a lump sum, while others are retained as individual components. In this structure typically, allowances like Housing are retained and not consolidated. Such structures are adopted either by firms that want to achieve full consolidation over the long run but wish to reach there in

stages or those that find it easier to communicate the pay structure comprising of key allowances like Housing. Most investment banks in the region have moved towards partial consolidation, though the proportion is higher among the international investment banks than the locals.

Many banks also offer low/zero interest loans to fund the annual housing expenses. Keeping the Housing Allowance separate helps these banks better communicate the proposition to the employees.

3. **No Consolidation** – some firms continue to retain various allowances as a part of the fixed pay structure. Such a structure is still fairly common across SWFs and other government organizations in the region.

Alongside various degrees of consolidation, firms also manage the yearly increases on fixed pay in different ways. Some effectively link the salary increases to increases in the market fixed pay for the job or the grade. On the other hand, a few banks (especially, investment banks) give increases only on the basic salary, while keeping the allowances static. Here are a few of the key approaches adopted within the sector:

1. **Target Market Position on Fixed Compensation:** This approach works best for banks which have consolidated their allowance structure, at least partly. Banks adopting this approach benchmark their fixed compensation against the market. They then cover the gap to the target levels by allocating a certain portion of the increase to basic salary and spreading the rest across various allowances. As a result, these banks work towards achieving a targeted ratio between basic salary and aggregate allowances.

2. **Allowances as a Proportion of Basic:** In this approach, the basic salary is benchmarked against the market each year. The allowances are determined based on a fixed, often pre-determined, percentage of the basic salary.

3. **Target Market Position on Basic and Key Elements of Fixed Pay:** This approach is almost entirely market driven whereby a bank would benchmark both the basic salary and pay elements, such as Housing, against the market.

The table on the following page provides a summary of the pros and cons of the above approaches:

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Approach	Pros	Cons
Target Market Position on Fixed Pay	Accurately translates overall bank-wide pay philosophy into salary administration	Variable pay may not be in line with the market
	Captures the market data on fixed pay	May not reflect the housing rental market
	Mimics employee expectations of salary components	More difficulty in budgeting
	Easier to implement and administer	Often perceived negatively by employees
Allowances as a Proportion of Basic	Captures the market benchmark data at the basic salary level	Employee negotiations around basic salary increases
	Easier to administer	May not reflect the actual market housing rentals or the market housing allowances
	Cascades corporate pay-mix philosophy	More difficulty in budgeting
	Consistent pay-mix across various grades	Fixed pay may not be in line with the market
Target Market Position on Basic and Key Elements of Fixed Pay	Captures the market benchmark data at a more granular level	May not be suitable for a broad-banded structure
	Gives the flexibility to vary allowances by location (Dubai vs. Abu Dhabi)	Data may reflect market inconsistencies
	Gives the flexibility to vary allowances by grade	Will not result in a consistent pay-mix across various grades
	Easier to administer and implement	

It is clear that there is a strong divergence in the practice adopted by various firms. It is important to understand that there is no 'right' method in managing allowances – country contextualization is important and so are the unique requirements of each firm.

Given that there are multiple strategies which firms can and do adopt while shaping their allowance structures, what would work best in the current scenario of rising employee expectations and an equally strong mandate from the shareholders? Can firms do better than adopt a 'wait and watch' policy on these matters?

We believe they can. We have summarized a few approaches firms should actively consider which balance the expectations from various stakeholders: employees who demand increases in various elements of pay to help mitigate rising costs; shareholders who continue to press for better cost-to-income ratios; and regulators who want to ensure that compensation is effectively governed and better aligned with risk.

Employee Communication: Most banks in the region are severely deficient in communication to their employees. Ironically, this area can help banks deliver the highest value to the employees at the lowest cost to their shareholders.

A good communication strategy helps employees understand the various elements of their compensation, and see how they are linked and how they relate to performance. Most financial firms do not have a formal compensation philosophy document that summarizes the intent of compensation and how it links to the HR and organizational strategies. Such a document would bridge the gap between organizational intent and employee perception around various elements of compensation. For example, it is common for employees in a firm to erroneously perceive that allowances such as Housing and Transportation are meant to cover the full cost of the actual expense. Such an expectation often raises a critical philosophical issue – should firms pay allowances for the job/role or for the employee's individual circumstances such as family size or marital status?

While employee communication is often perceived as a one-way street, a good communication strategy is reciprocal – it periodically gauges employee perception and requirements around compensation while delivering messages from the employer to the employees. Targeted employee compensation surveys are often an excellent medium to achieve the intended results.

Most communication plans fail because they are singularly orchestrated by the HR division and are too narrowly focused on the outcomes of the year-end pay review exercise. The success of employee communication around reward hinges on the involvement and capabilities of line managers. They are the best medium of reward communication given their physical and structural proximity with the intended audience.

Consolidation of Allowances: Most banks in the region have done away with excessively large number of allowances – some of which were introduced in the last decade to create differentiation in the market and help recruit talent. While a full consolidation is difficult for most banks to achieve in the short run, some degree of consolidation would help most, especially if done the right away. Consolidation helps organizations better communicate the reward

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proposition to the employees. Having a small set of allowances better communicates the value of each element of total reward and how it is linked to both job content and employee performance.

We believe that the approach of 'Partial Consolidation' discussed earlier, would work best for most banks in the region. They should target no more than three allowance elements (including national allowance, but excluding job-related ones) within the compensation structure. There are examples of a few international investment banks and local consumer banks, which have successfully adopted a partial consolidated allowance structure and subsequently seen value.

Total Rewards: Many financial firms in the region still take a piecemeal approach toward compensation – offering annual increases on the basic salary based on individual performance and sporadic increases on housing, Transportation, and national allowances based on market movements and employee demands. Such an approach often compels the firms to take knee-jerk reactions to volatile market movements.

A good compensation program brings together all elements of pay and performance management and links them effectively. While firms should take note of the market movements around various elements of pay, the deployment of the annual increments should be based around a target competitive positioning on total compensation. An optimized Total Reward offering would leverage all elements of pay effectively and maximize the value of the compensation spend.

A good way to leverage the 'non-core' reward elements more effectively would be to deploy a strong suite of non-monetary reward plans and communicate them clearly.

Benefits: We notice that financial firms in the region continue to undermine the potential of benefits because they remain fixated on basic salary, allowances and variable pay. Benefits can be used to help banks meet employee needs at low costs.

Many banks often do not differentiate 'allowances' from 'benefits'. Consequently, several elements of pay that should ideally be considered benefits are treated as allowances. Child Education is an obvious example in this regard. The differentiation between allowances and benefits has relevance beyond semantics. The purpose of each component is different from the other. While allowances are revised almost every year, benefits are fairly static. A differentiated strategy towards both benefits and allowances would ensure

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sufficient focus on both. As a rule of thumb, allowances are generally uncoupled from employee circumstances such as marital status, or number of children.

The very nature of the business allows banks to offer several benefits to employees at often very low costs. Employee loans are an obvious way to deliver substantial value to the employees. While most banks in the region offer some form of loans to the employees, the range and proportion of these offerings can be improved.

Employee and Job-Related Compensation: Most compensation programs in the banking sector meet the needs of the organization, while failing to meet specific needs of the employees. The resource pool in a bank is often diverse, comprising employees who have various backgrounds and qualifications. Such diversity is also linked to a varied set of roles within banks, often across various domains – revenue generating, support and control.

Differentiation and segmentation of the compensation structures are often seen to be very effective at ensuring a balance between the needs of the employees and their organizations. Pay segmentation doesn't merely rely on differentiating the quantum of various elements of pay, based on job family or job role. It goes a step further and links all elements of performance management and Total Reward to specific employee demographics.

Conclusion:

Allowances and benefits are key reward tools for attracting and retaining talent. In this region, they serve as useful levers for firms to attract talent from international markets – they play a particularly important role around bridging reward gaps on pensions and social security.

While the compensation programs in the financial sector are fairly sophisticated compared to other sectors around incentives and variable pay plans, they surprisingly lack the flexibility that sectors such as fast moving consumer goods (FMCG) often have. While somewhat aggressive for the region and the sector, concepts such as 'flexible benefits' and 'cafeteria style' compensation may lead the way in the future.

The volatile housing market and overall inflation have exposed the structural weaknesses in compensation across many firms. They have big challenges on their hands to ensure a proper balance between the needs of various stakeholders. The increase in the cost of living led by house rents and

children's education has led to a stronger employee demand around increases in allowances.

While the financial firms in the region are not taking any short-term measures on these matters, they can ill afford to neglect the employee expectations in the long run.

For the last six years, McLagan have been running a dedicated Allowances and Benefits Practices Study for Banks in the Middle East region. This study looks into the market and industry practice around allowances and benefits. McLagan also helps clients derive the maximum out of their investment into compensation. Our focus and methodology help banks meet challenging and often conflicting goals around compensation and productivity. For further information and details around how we can help, please do reach out to your dedicated Relationship Manager or alternatively, to the author of this alert.

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