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Consciously Uncoupling Complexity in Retail Banking Incentives

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By Rob Northway and Ryan Caravella
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"The business schools reward difficult complex behavior more than simple behavior, but simple behavior is more effective." - Warren Buffett

Historically, branch employees were the main interface with the customer. Today customers have more frequent interactions with their banks through technology, thus altering the role of branch employees. Within retail banking, incentive plans have grown overly complex in response to the historic branch business model. However, technology-driven changes in the branch are enabling model firms to simplify their incentive plans and drive desired staff behaviors within a new banking model. Firms that are able to make this change will have a competitive advantage in recruiting staff and serving customers.

Retail banks have four major pressure points that are impacting incentive plans. In this article we will examine their effects on the retail banking industry:

- Changes in the digital transformation of customer behavior
- Regulatory impact
- High turnover
- Cost reduction strategies

We will provide observations and insight into how firms are altering their compensation strategies in response to each of these challenges. Additionally, we will provide guiding principles and suggestions to help adapt compensation models to this new era in retail banking.

Changes in the digital transformation of customer behavior

The change in the customer interface with branch staff is the single most dynamic transformation to retail banking. Technology now allows for the majority of basic banking transactions to be accomplished remotely. This modern way of banking has changed the way customers expect to interact with their banks. All aspects of the branch (e.g., economics, performance goals, role profiles and headcount) need to adapt to this change. Staff will be required to be more technologically well-rounded (service and sales oriented) and specialized (higher communication skills and product knowledge). For example, when branch staff operates like a "Genius" within an Apple retail store, their goals will be to help customers use existing products as smoothly as

possible **while expanding their relationships with the brand through *cross-selling and new customer sales*.**

This will require one of two possible actions: (1) hire more skilled labor which requires higher pay levels, or (2) train and develop existing staff to do more, and subsequently pay them more for the additional responsibility.

Current retail banking incentive schemes are not positioned well to adjust to this new reality. Indeed, most schemes have spun out of control trying to encompass customer needs and cover each and every product. **With so many of the traditional consumer banking activities taken out of the branch, it is time to revisit this theory.**

McLagan has recently completed incentive plan projects with several universal and regional banking clients and has seen plans with up to 60 distinct transactional, service, and referral key performance indicators (KPIs). On an annualized basis, this means the average incentive dollars per product ranged from $25 - $200, which is not very motivating to the individual recipient. Additionally, the complexity of the plans imposes a massive administrative burden on HR. As firms look to focus upon the customer experience, the next generation of compensation programs needs to follow suit.

There is a misalignment of pay opportunities and performance drivers needed to gauge success. As a first step in correcting this, ask the following questions:

- What are the predictive behaviors required for staff to drive performance (e.g., experiences of customers in the branch, quality, pricing and execution of products and services, or new sales growth)?
- What are the best measures of success against these behaviors (e.g., increase in net promoter score (NPS), deposit growth, loan volume, referrals)?
- How much incentive will really influence behavior? Is it affordable for the firm?
- What are the ramifications of maintaining existing pay schemes?
- How transparent and efficient is the communication and administration of the plan?
- What attributes of branch employees' roles are beyond their control (e.g., product pricing, operational execution)?

Retail banks will come out with different answers to the questions raised above. But as the implications of these changes in retail banking become clearer, leadership will require retail banking HR professionals to have conviction in their answers.

Regulatory Impact

Once the firm has settled on a business strategy and pay philosophy, it is time to examine the impacts of the various regulatory overtures and determine how they may impact the firm's plan design. The various global regulatory authorities are not united in their direction; however, through our work with clients responding to the US Federal Reserve Board (FRB), US Office of the Comptroller of the Currency (OCC), US

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Consumer Financial Protection Bureau (CFPB) and UK Financial Conduct Authority (FCA) several themes have been uncovered:

- Performance should be evaluated at all levels within the organization including business unit, branch and individual
- Performance metrics need to be tied not only to productivity, but to the quality of the products delivered
- Incentive schemes need to be balanced between transparent formulas and discretionary adjustments for quality
- Performance monitoring periods should be extended as far as responsibly possible (e.g., monthly to quarterly, quarterly to annual) and based on the type of transaction
- Pay levels should be prudently weighted between fixed and variable pay
- There should be significant governance, such as ongoing assessment and reporting on the plan performance, regarding the conceptualization, administration and review of incentive schemes

How do banks manage this tangled web of regulatory guidance? Start by answering the following questions:

- *Who* is the regulatory authority that my firm needs to be most acutely aware of? Since there are several significant philosophical and operational differences, knowing your regulators' mandate/perspective is key.
- *Who* "owns" and who "operates" the incentive plan? What are the defined roles of the line of business, HR, Finance, Risk, and Compliance in the process? If the departments listed above are not currently part of the process you now know you have a gap.
- *What* are the potential options for structuring a compliant incentive plan?
- *When* do these plan design changes get implemented? Some of the specific regulatory rules are already effective, such as CFPB mortgage rules, FCA mis-selling, CRD IV, while others are yet to be enacted (e.g., provisions from the Dodd–Frank Wall Street Reform and Consumer Protection Act).
- *How* are the current incentive plans structured and how different are they from the regulatory themes? Are they aligned with the business strategy? Are they able to attract and retain talent?

Many firms have already adjusted their current incentive plans based on regulation. If your firm has not yet done so, it is important to develop a response to how your current plans operate and begin to strategize potential alterations.

High Turnover

Many financial services firms have public relations issues that are negatively impacting employee retention. Unlike during the global recession, employees have employment options outside of finance. This is acutely apparent in retail banking, which continues to experience significant turnover rates for the branch staff. The average turnover is

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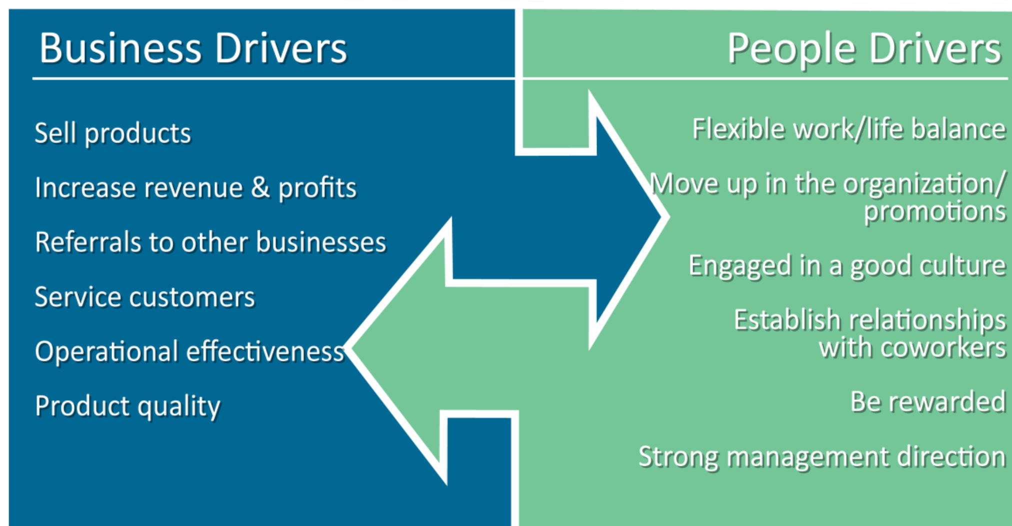
15-30% in the branch overall but can be as high as 40% for certain roles. Given the pressure to revamp the business model, control cost, and diversify employees within the branch, high turnover is a significant barrier to success.

With the average cost of turnover at 1.5 – 2X fixed pay, unwanted turnover has a significant impact on the bottom line. Even when modeling with a low turnover rate (20%), the costs are significant, as outlined below.

TURNOVER COSTS FOR 1,000 INTERMEDIATE TELLERS					
	US	UK	Dubai	HK	Japan
Median Fixed Pay	$24,000	£18,000	AED 140,000	HKD 380,400	JPY 4,580,000
Turnover Rate	20%	20%	20%	20%	20%
Aggregate Cost – 1.5X Fixed	$7,200,000	£5,400,000	AED 42,000,000	HKD 114,120,000	JPY 1,374,000,000
Aggregate Cost – 2X Fixed	$9,600,000	£7,200,000	AED 56,000,000	HKD 152,160,000	JPY 1,832,000,000

Within the branch, absolute pay levels are not a fundamental driver of turnover. Employees are much more likely to leave because they feel disconnected with the business results and incentive plan payouts. Additionally, as the role of a branch employee shifts, there is an inherent conflict between some of the historic “business drivers” and the behavior necessary for staff to best serve the customer (e.g. sales quotas vs. customer satisfaction). What are the possible solutions to counter this attrition? One clear answer is establishing a better line of sight for performance and reward.



Business leaders will need to determine the behaviors they want branch staff focused upon.

Banks can start by doing the following:

- Service-focused firms should remove complex, transaction-based incentive structures and allow employees to focus on the customer experience. Service metrics also take longer to obtain and review, so extending the performance period would be appropriate.

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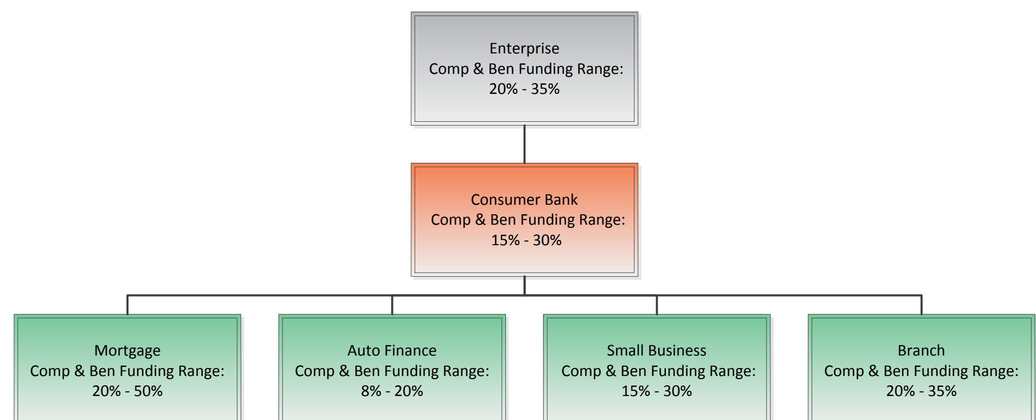
- Build team-based incentives that reinforce collaboration and culture. If people are engaged with their fellow branch members they may be less likely to leave for a competitor's branch.
- Consider publishing scorecards. Showcasing the achievement, or lack thereof, of a branch can be very motivating. It is important to note that the metrics of the scorecard need to be clear and achievable or the effect on staff may be demotivating.
- Remove incentives that represent less than 5% of total compensation. Compensation plan administration has become very costly and a distraction to staff. Removing low impact incentive plans are necessary especially when you add in additional costs such as benefits and overtime.

Cost Reduction Strategies

Many firms have announced strategic initiatives to reduce costs within the retail bank. A significant portion of cost can be reduced via non-compensation related areas such as real estate, marketing, and operations; however, staff costs are still the dominant expense driver. Two levers available to other business units, funding rates (% of revenue allocated towards awards) and incentive pools (size and distribution of the total pool), are not as impactful to retail banks given the historically low fixed to variable pay and incentive funding ratios.

The charts below examine the following:

- 2013 compensation and benefits spend as a percent of net revenue by consumer lines of business
- Percent of total compensation delivered in variable pay
- Revenue per head by consumer lines of business



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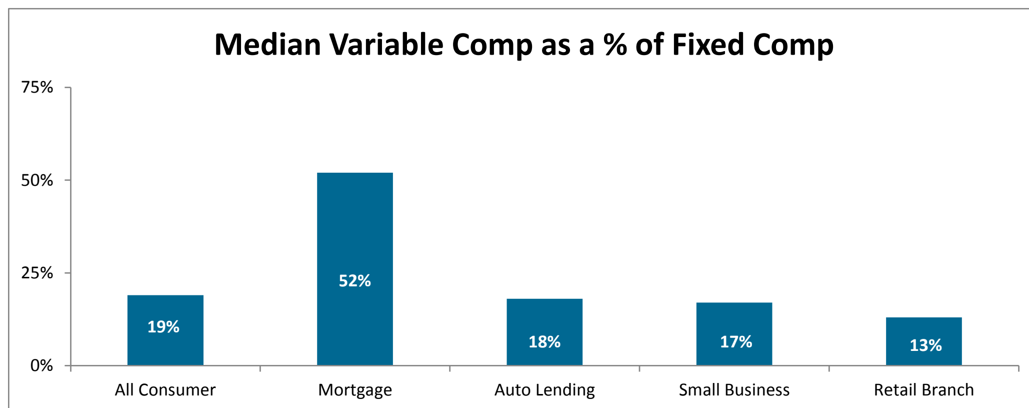

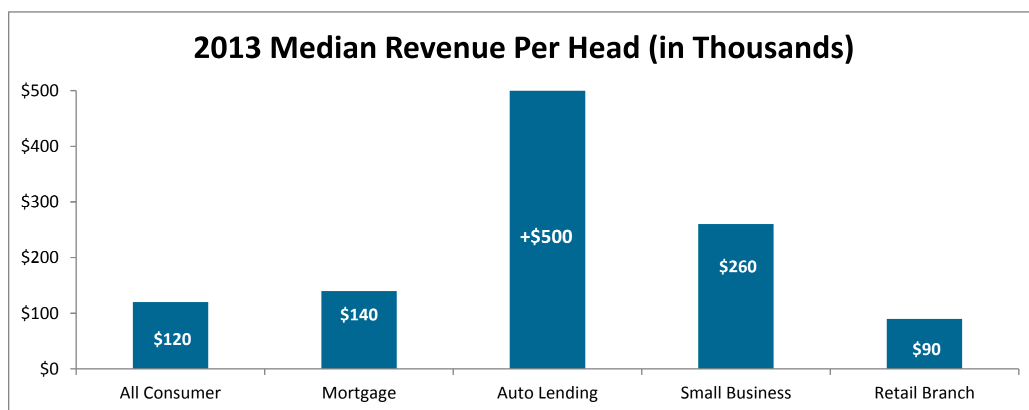

Source: McLagan 2013 Enterprise Expense Benchmarking of US Regional Banks

Given the limited impact and flexibility of retail banking incentive pools, headcount is the main driver of cost reductions for the branches. Our clients' business models are changing and as a result they may pay fewer people more dollars in incentives. Here is how that may look:

LEGACY	EMPLOYEE 1	EMPLOYEE 2	EMPLOYEE 3	EMPLOYEE 4	AGGREGATE
Total Compensation	$33,000	$37,300	$42,500	$52,900	$165,700
New Deposit Generation	$1,100,000	$3,350,000	$25,000,000	$77,000,000	$106,450,000
New Loan Volume	$323,000	$1,000,000	$2,400,000	$5,000,000	$8,723,000
New Loan Units	15	44	79	110	248

NEW MODEL	EMPLOYEE 1	EMPLOYEE 2	EMPLOYEE 3	EMPLOYEE 4	AGGREGATE
Total Compensation	$60,000	$43,000	$49,000		$152,000
New Deposit Generation	$77,091,900	$3,337,540	$25,193,800	Reduction of	$105,623,240
New Loan Volume	$5,100,000	$1,500,000	$2,400,000	one FTE	$9,000,000
New Loan Units	120	55	79		254

Source: Per Capita Productivity Data from McLagan 2013 US Consumer, Retail & Small Business Banking Survey

In the example above, 8% of aggregate compensation costs are removed, while productivity increases slightly. Additionally, improved training and technology would more than likely improve per capita productivity.

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Conclusions

Balancing the varying demands of the changing face of retail banking is no easy task. Banks need to focus on the common themes across these challenges. These themes are pointing toward compensation plans that do the following:

- Reward employees for doing what is best for the customer
- Make it easy for employees to understand how to be successful
- Focus incentive dollars on top performers and emphasize employee quality over quantity

Given the pressure on banks to adapt their franchise models within the retail branch, network alterations to pay philosophy and structure are needed. For many this will test the historic value system that the retail bank has maintained for years. Those who do not adapt will be viewed as antiquated by customers and employees alike.

ABOUT THE AUTHORS

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