ALLEN & OVERY

Reshaping bank compensation strategy: aligning corporate values with remuneration

As banks rebuild their compensation structures to shape conduct as well as drive profit, embedding values and purpose in the way that employees are paid will require a focus on fundamentals, communication throughout the organisation and leadership from the top.

Banks face the challenge of building compensation strategies that reflect social responsibility, as well as delivering on corporate transparency, organisational purpose and evolving stakeholder and regulatory expectations. Raw profit is no longer the sole yardstick for compensation. Human resources leaders and boards of directors are striving to design, harmonise and deliver remuneration structures that align with ambitious environmental and social standards, as well as measures of diversity and good conduct.

But what standards and measures are appropriate for banks to track and reward? How can they keep their focus on the bottom line, while building better systems?

In business, compensation is one of the primary drivers of performance and conduct. Today, stakeholders want HR leaders and boards of directors to look at the issue of executive compensation through the prism of equity, equality and social responsibility. A significant challenge for banks is to ensure that compensation is reflective of the individual, the team and the organisation's ability to deliver ethically-sound profits and deliver against values, and in turn be a driver of change.

Employees, shareholders and regulators all want to see that compensation is rewarding the behaviours they prioritise. Employees expect more from the organisations they work for – this is particularly strong among younger employees and millennials. They want their employer to reflect their own values, and for compensation to be set on an equitable platform.

Many shareholders have a growing appetite to see investments that recognise the logic of environmental, social and governance (ESG) concerns. They want assurances that such improvements are not just a line item in the annual report, but are embedded in company culture, and reflected in the compensation package.

In addition, many regulators are developing mandatory frameworks to ensure that banks include sustainability and Diversity, Equity and Inclusion (DE&I) measures in their remuneration structures. These frameworks focus mainly on the disclosure of measures, enabling stakeholders to gauge banks' commitment to these issues and hold them to account.

The demands of each of these three groups are changing the way banks compensate their employees.

However, banks still need to respond to these demands in a way that delivers on the promise of a compensation system that is ethical, fair and purposeful. At the same time, they need to maintain their competitiveness and profitability. This means meeting the external challenges of regulation and competition, as well as the internal challenges of managing compensation. Such governance needs to makes sense, not only in large, multi-jurisdictional banks, but also in smaller, national banks across the world. It also requires creating a compensation structure based on recognised metrics. Understanding and balancing these challenges is the key to meeting them.

A new environment for reward strategy

Regulators in many jurisdictions are moving quickly to redraw and bolster the rules on compensation and the values it should reflect. In 2018, the UK's Financial Reporting Council updated its Corporate Governance Code for listed companies to stress the importance of remuneration policies and practices that support strategy and promote long-term sustainable success. Another of its core principles expects executive remuneration to be aligned to a company's purpose and values, and clearly linked to the successful delivery of the company's long-term strategy.

The discretion that banks can exercise in relation to compensation is already subject to local law and regulatory constraints, but this continues to narrow. To a large extent, policy and regulation is being driven by societal expectations. The EU prudential framework under the revised EU Capital Requirements Regulation and Directive (CRD) makes demands for better alignment of banking strategies and business models to ever more appropriate risk management, broader sustainability and governance trends and targets. Revised guidelines from the European Banking Authority, which guide firms on how to implement the remuneration aspects, expect ESG objectives to form part of remuneration policy, and proposed rules from the US Department of Labor may result in ESG factors influencing investment decisions to a greater extent.

Additionally, under the new CRD regime, some smaller banks previously exempt from the strictest remuneration rules are now in scope due to a narrowing of proportionality exemptions. For many, this is a substantial change.

Against this backdrop of increasing regulation, competition from established financial services companies and new entrants to the industry, such as fintechs and challenger banks, is pushing compensation levels higher.

Competition for banking talent is also a growing external pressure. After a post-Covid surge in deal-making – M&A deals reached an all-time high last year – fixed pay is up across the board, and bonus pools are bigger than expected. This reflects the increasing difficulty of attracting talented staff in a market where more financial services companies are competing for the same talent pool.

Competition for talent is sharpened by the fact that listed banks are frequently in competition with asset managers and private equity firms. They are subject to less stringent regulatory compensation restrictions and disclosure requirements under the relevant EU Directives, and no bonus cap applies to them.

Nevertheless, banks can respond to these challenges in a way that creates opportunities. Appropriate risk alignment, ESG and DE&I can act as drivers and as change agents for banks and their activities. They can also demonstrate that they respond to societal and stakeholder demands, make tangible community impacts, and reflect those factors in compensation. If they can articulate a corporate culture that resonates with employees, those measures may become a powerful tool to attract and retain key talent. Therefore, it is critical that banks start with a clear sense of their organisational purpose and values, because developing the right non-financial metrics and how they should be weighted builds directly from that starting point.

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Meeting the challenge of banking compensation strategy design

Before banks can set a compensation strategy, they need to decide what behaviour they want to reward. But designing a values-led compensation structure that makes sense is complicated. It is even more complicated in a diversified global organisation. Banks headquartered in Switzerland or Singapore, for example, are at liberty to determine compensation which those in the EU cannot match. In the EU, bonuses of material risk-takers within banks are capped at 100% of fixed pay (or up to 200% of fixed pay with shareholder approval). Some EU jurisdictions extend this to all staff within the bank and some impose an even lower cap, such as 20% of fixed pay in the Netherlands.

However, most banks have evolved mechanisms to deal with competitive inconsistencies across operating geographies. In such circumstances, a values-led compensation structure should not create universal practice, but rather reinforce universal principles. This is where banks need to decide which values are most important to them, and which values resonate throughout a diverse organisation.

Trying to cover every topic of social concern everywhere in the world does not make for a good compensation structure. It may even end up alienating stakeholders in some jurisdictions. Deciding what is critical to the vision of the business and its future, and driving that through global compensation principles with explicit leadership backing, is what works best.

The best sources for measures and scores that can be used to build compensation strategies are often found within banks themselves. With the growth in data analytics tools and technologies, such information is readily at hand. Rather than relying solely on externally mandated measures, banks may internally analyse data and set their own metrics. With gender pay gap reporting rules in the UK and proposed gender pay gap reporting in the EU, published pay gaps will yield valuable data that to prompt reflection on DE&I performance in workforce pay. In the UK, this data set will be broadened as the regulators are expected to issue stricter rules, and greater disclosure, on DE&I in the financial sector. Banks can evaluate their own organisation's sustainability performance and the ability of individual employees to influence those metrics. U.S. public companies need to comply with the CEO pay ratio, which discloses the ratio between the compensation of the CEO and the median employee.

Organisations cannot fix what they do not measure. Banks can do a better job than external agencies when it comes to assessing their DE&I performance, the attrition or burnout rate of employees, the number of customer complaints or other risk events. They can then use that data to effect change, including making remedial action part of the compensation criteria.

One important channel for gathering such data is an employee feedback board or staff survey. UK directors have legal duties in any event to take account of stakeholder interests, including employee interests, in their decision-making, and engagement with the workforce is a core part of the UK Corporate Governance Code. Banks should use the information they gather to evolve and refine their compensation structures on a continuous basis, having regard to constraints, but also employee perspectives. What was appropriate only a short time ago may not be appropriate now, and setting compensation metrics is an iterative process.

Setting meaningful ESG and DE&I metrics for compensation

Once understood, this data will help banks to set meaningful metrics covering areas such as climate change, DE&I or organisational carbon-footprint targets. Close scrutiny is required here, so that only metrics that are genuinely measurable and achievable are chosen. Targets do not incentivise anyone if they are never going to be reached. In addition, some metrics – such as those on DE&I – are more obviously applicable to individual actions and behaviour.

In such cases, a clear mechanism is needed for weighting those metrics against others on the scorecard for an individual bonus calculation. In the same way, compensation policies should make sure that executives are not only rewarded for being successful in their work, but for how they operate within the business and interact with their colleagues.

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Where local laws require DE&I targets, metrics should be, at least, compliant. For example, a proposed new EU directive aims to improve gender diversity in boardrooms, with the legislation aiming to ensure gender parity on boards of publicly listed companies in the EU. The directive aims to ensure at least 40% of non-executive director posts or 33% of all director posts are occupied by women by 30 June 2026. In the U.S., some states are considering legislation that would impose board diversity quotas for the same reason. However, in California, there have been successful legal challenges to laws that require companies to have boards that include members of underrepresented communities or women.

Gathering this data and acting on it is not just about managing risk. It is about actively building a better organisation and helping to improve individual, team and corporate performance in a way that aligns with firm values and makes better corporate citizens.

The UK regulators are further convinced that improved DE&I within banks will not only reduce groupthink, but also encourage debate and innovation, thereby improving outcomes for consumers and across markets.

Long-term thinking?

What is the right timeframe for incentive-based compensation linked to ESG goals? Regulators are becoming convinced that a long-term sustainability strategy is required. The European Banking Authority's 2021 report on ESG risks in investment proposed at least a 10-year strategic horizon. This long-term bias is reflected in the CRD regime, although the legislation and EBA Guidelines do not prescribe a period, instead leaving it to banks to restrict and measure variable remuneration over a multi-year framework aligned to their business cycle.

Compensation strategies will have to seek a new balance between short and long-term performance rewards. The emphasis is to move to the long term, with appropriate malus and clawback provisions in place. However, short-term steps toward any long term goal remain critical. Banks could, for example, set a 12-month target around DE&I measures, sustainability factors such as emissions scores or health and safety metrics, which could be factored into bonus decisions.

There will never be a one-size-fits-all compensation structure that works across the banking industry. A degree of subjectivity is inevitable and necessary within each workplace. However, there is one thing that does not change: the need to consult and communicate with staff about what is in any compensation package and why it is there. In any event, employers must have regard to duties under local laws and negotiated arrangements to inform and consult, and sometimes agree, changes to pay terms with employee representatives such as trade unions and works councils, or with employees. Training should also be given, so that employees impacted by changes to their remuneration policy understand it and what they need to do to optimise their bonus potential.

This offering should include training on DE&I in the workplace. Such training is an essential risk management tool to reduce the risk of discrimination and harassment claims, but its importance impacts on remuneration. For example, Allen & Overy has trained more than 1,000 staff in a Luxembourg-headquartered multi-national company on DE&I thinking, why it is part of the company culture and what is expected of individual employees. Being clear about corporate values and why and how non financial performance measures relate to them, as well as their weighting within the overall remuneration package, is vital not only to encourage the right behaviours but also to incentivise them.

Creating efficient banking compensation structures

Organising a compensation design and management process is also a big challenge. Banks are often federated organisations and sometimes lack cooperative thinking or common processes. That can hinder the development of shared and transparent compensation structures.

For example, traditionally, compensation for front-office staff has been linked to high frequency financial performance measures, whereas compensation for staff in the middle and back offices, where managers, analysts and support staff operate, has depended on more qualitative performance measures.

However, there is little evidence that compensation linked to pure financial performance is effective from a risk or reputational perspective. On the contrary, many commentators considered this to be a key contributor to the financial crisis. The EBA guidelines now emphasise the need for an appropriate balance between quantitative and qualitative, as well as absolute and relative, criteria.

In our view, it is certain that regulators will be asking banks for a much higher level of sophistication in how they score all employees for compensation purposes. They may put special emphasis on qualitative reviews of conduct in front-office roles. Making granular distinctions between different functions and roles, and reflecting on what non financial metrics are appropriate for scrutiny within each will lead to better results.

The importance of compensation strategy as a means of shaping behaviour and reducing operating risk is also becoming clear. Banks will also need to be able to show, when asked by regulators, how any disciplinary actions,

breaches of codes of conduct or adverse behaviour had an impact on remuneration. This is built into the UK remuneration regime, which is aligned with its accountability regime (SMCR) applicable across the financial sector. For example, certain senior managers within UK banks are subject to seven-year deferral of variable remuneration, and to a seven-year clawback period (extendable to 10 years in some cases).

Another related issue that banks are contending with is whether there should be additional incentives for exceptional positive behaviour, or whether these are already part of the compensation packages offered. Any such incentives would need to be justifiable within regulatory parameters and assessed in a non-discriminatory and otherwise equitable manner.

Moreover, banks may need to streamline their often complex arrangements for setting compensation targets and assessing performance. Cooperative thinking on how to devise a more values-led compensation structure and roll it out across a complex organisation can be hindered by the existence of many overlapping committees and steering groups with compensation-related responsibilities. Yet, this challenge must be managed in order to meet regulatory expectations. Under the EBA guidelines, for example, a remuneration committee has to involve all independent control and other relevant functions and collaborate with other committees (such as risk, audit and nomination committees) of the supervisory function whose activities may impact on the design and proper functioning of compensation policies and practices.

In a typical real-world example, one global bank structures its European compensation design and management around no fewer than five separate oversight committees. These include a locally headquartered management committee, an HR compensation committee, an oversight committee charged with risk management, a board-level review committee and a specialised committee to monitor compliance with regional compensation regulations.

Communication is crucial to success here. What is needed is a clear and documented procedure for how everyone involved talks to each other, and how these discussions feed into the process of making compensation decisions and designing remuneration policies.

It is also important that committees of the board, or others charged with responsibility for remuneration policy, have their values and purpose completely nailed on. Being clear on what is important to your organisation makes it much easier to prioritise which non-financial performance metrics align with those values and the overall organisational purpose.

Beyond any involvement at committee level, which is legally required and indeed often adds depth to the debate, one of the most important success factors in values-led compensation is clarity and leadership from the top. This requires a mandate from the CEO, the head of HR and relevant executives and business leads responsible for DE&I initiatives.

In addition, it requires full engagement, company-wide. Unambiguous leadership and the expectation of change from those two offices sets the right impulse for any stakeholders lower down. It helps to ensure that cultural transformation imperatives do not get lost in wider processes.

A new concept of value and profit

In our experience, some banks still struggle with a perceived dichotomy between values and profit. This can inhibit the development of functioning values-led compensation. Yet it is a false dichotomy. Long-term profitability and prosperity actually depend on values as much as anything else. Embedding an organisation's core values into its compensation structures is a good way to ensure its success and growth.

They are also a compelling attractor and motivator of talent. The reality is that compensation is no longer the key retention factor across a range of white-collar industries, including financial services, and that getting fulfilment in a job for an employer that has the right values, or work/life balance, can be more important than pay for many employees. Expressing those values through compensation is one way that banks can leverage unique advantages and attractors such as job security and career progression opportunities.

Compensation has always been a critical issue for banks, and it remains a source of criticism. It consumes much management time, but it also determines relative advantage in a competitive market that is increasingly concerned about stability, conduct and purpose.

In that setting, values-led compensation is a path to success. There is a golden opportunity for banks to play to their strengths and to position themselves as corporate culture leaders. That way, they can create places where the best people want to work, build long-term careers, and make measurable, positive contributions to society.

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