INDEPENDENT REVIEW INTO RETAIL BANKING REMUNERATION FOR THE ABA

REMUNERATION PRACTICES IN THE UK - DETAILED REVIEW

APRIL 2017

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Introduction

Background and Scope

Mercer has been engaged to review variable pay arrangements for customer-facing staff in UK retail banks, to support the Independent review into remuneration at Australian retail banks being conducted under the auspice of the Australian Bankers' Association (ABA). The ABA is seeking to understand in more detail the structure of variable pay plans for customer-facing employees, focussing on the design of the variable pay plans currently in place and the consequences of using such plans.

This Review covers the structure of variable pay, how it has evolved over time, and the participants' views on the impact of changes on employee behaviours, customer outcomes and business performance.

The Review is focused on retail banking services (including mass affluent, but excluding wealth management, private banking, and ancillary services) within UK banks.

The roles in scope are the three predominant customer-facing roles in the branch network and their equivalents in telephone banking:

- **Frontline staff or Customer Service employees** (customer-facing staff involved in providing customer services and enabling certain products e.g. bank customer services representative and telephony banking equivalent);
- **Advisers** (customer-facing salespeople of both regulated and non-regulated products[1]); and,
- **Managers** (supervisors or line managers of the above roles).

This Review focuses on the structure of variable pay and design consequences for this population. In particular, the following pages:

- Provide an overview of the typical variable pay plans observed and how they have changed over time;
- Review variable pay plan design, including structure, funding, performance assessment, deferral and malus and clawback provisions; and,
- Consider the consequences of using such plans.

It should be noted that this Review considers variable pay arrangements for the three categories of staff referred to above only, and does not consider remuneration requirements or variable pay arrangements for retail bank employees more generally.

[1] For clarity, Advisers includes home lenders.

Conduct of the Review

Banks invited to participate comprise the largest 28 retail banks in the UK. Sixteen banks agreed to participate in this Review, including the largest UK retail banks. The participants have total assets of between c.£1,800bn and c.£4bn, and these participants comprise approximately 85% of the UK retail banking market based on headcount[2]. Participants that agreed to be named are as follows:

Table 1: Participating banks (by total assets in £ millions)[3]

Bank	Total Assets (£m)	Headcount
HSBC	1,802,808	255,203
The Royal Bank of Scotland	815,408	93,659
Lloyds Bank	806,688	75,306
Standard Chartered Bank	640,483	84,076
Santander UK	281,406	17,506
Svenska Handelsbanken	229,143	11,819
Nationwide Building Society	208,939	18,000
Clydesdale Bank	39,929	7,244
The Co-operative Bank	28,916	4,470
Leeds Building Society	13,507	8,890
Tesco Personal Finance	11,001	3,631
Aldermore Bank	7,009	845
Metro Bank	6,148	1,821
Shawbrook Bank Limited	4,000	514

Data was collected using a structured interview and/or a written questionnaire. The majority of the data was collected using a structured interview; see Appendix A for the discussion guide.

Participation was targeted at senior Reward / HR professionals with visibility to incentive practice(s) across the retail bank.

Data collection included both qualitative and quantitative questions for the categories of staff referred to above, and covered:

- Variable pay design (and whether variable pay is in place);
- How design has changed over recent years and any planned or expected changes;
- The perceived effectiveness of variable pay and the impact of any changes.

Data was collected and analysed between December 2016 and March 2017.

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[2] Source: Total banking population - BBA, https://www.bba.org.uk/about-us/members/, 14 February 2017; Banking population at participants - latest published data sourced from relevant Annual Reports as at 14 February 2017

[3] Source: Thomson Reuters (February 2017) or otherwise latest Annual Report. Where relevant, data converted to GBP using 12-month exchange rate to 15 February 2017 of 0.087 for SEKGBP, 0.827 for EURGBP, and 0.748 for USDGBP (source: Thomson Reuters)

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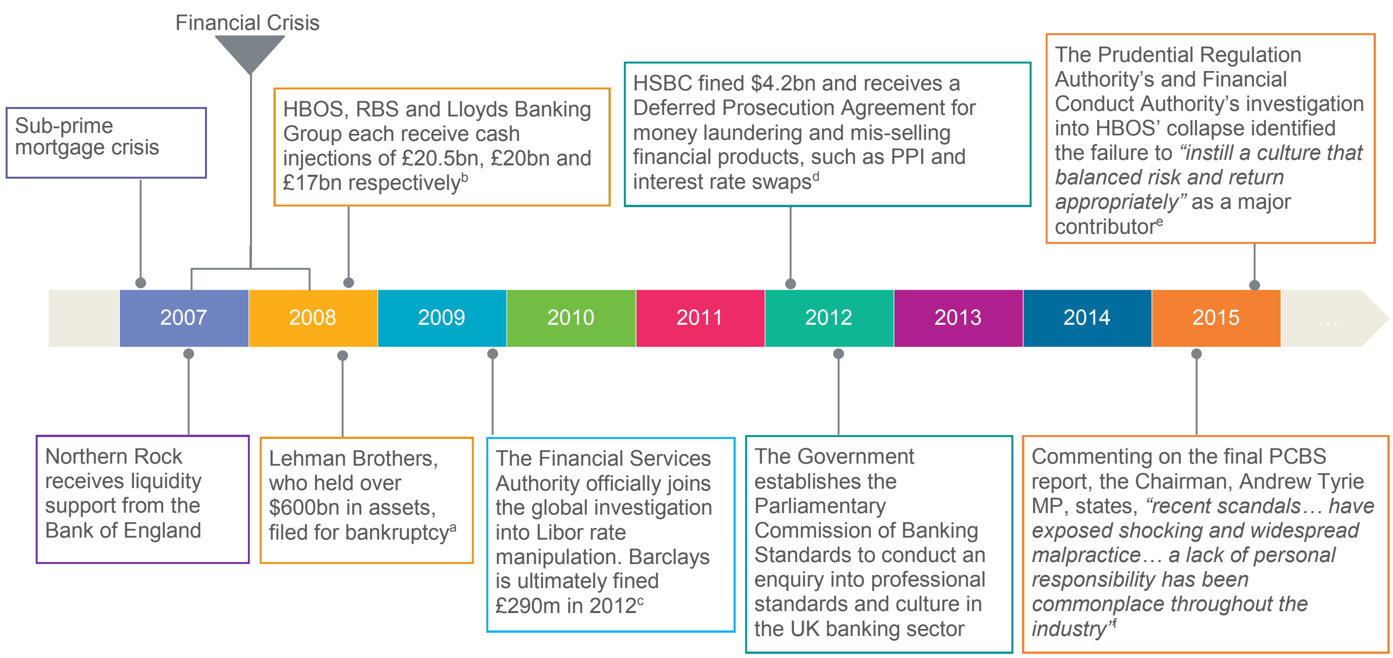
Context

In the UK, variable pay for customer-facing staff in retail banking continues to attract societal and political and, therefore, regulator scrutiny, and as a result continues to evolve in terms of market and best practice.

In 2006, David Cameron (the then Leader of the Opposition) stated, *"The lessons from the City are clear. Low tax. Low regulation. Meritocracy. Openness. Innovation. These are the keys to success"*[4].

However, the years that followed saw the financial crisis followed by a number of governmental interventions into the financial services market, including cash injections, investigations into banking culture, and ultimately regulatory change. The chart below summarises some key events:

Figure 1: Key events in the banking industry in recent years[5]



[4] David Cameron, Leader of the Conservative Party, *The new global economy*, 22 June 2006
[5] [a] CNBC, *Lehman Brothers Files For Bankruptcy, Scrambles to Sell Key Business*, http://www.cnbc.com/id/26708143, 16 September 2008
[b] Morse, A., National Audit Office, *Maintaining financial stability across the United Kingdom's banking system,* 2009, p.42
[c] Aldrick, P., The Telegraph, *Barclays: how the Libor scandal unfolded*, 2012
[d] BBC, *HSBC pays $4.2bn for fines and mis-selling in 2012*, 4 March 2013
[e] Prudential Regulation Authority, *The Failure of HBOS plc*, 2015, p.1
[f] Tyrie, A., Parliamentary Commission UK, *Banking Commission publishes report on changing banking for good,* 2013

In 2013, Clive Adamson, Director of Supervision at the FCA, said, *"It is fair to say that… the cultural approach of doing the right thing has been lost for financial services. It is clear to us, therefore, particularly as a conduct regulator, that the cultural characteristics of a firm are a key driver of potentially poor behaviour"*.[6]

On assuming the role of CEO of the Financial Conduct Authority in May 2016, Andrew Bailey stated, "*The common theme there is that the incentives facing a firm will determine its culture and will determine its success in terms of outcomes. One of the most important elements of the regulatory changes since the crisis is that we have adopted an approach of seeking to align those incentives with our public interest objectives as well as the private interest of the firm"*[7].

[6] Clive Adamson, Director of Supervision of the Financial Conduct Authority, *The importance of culture in driving behaviours of firms and how the FCA will assess this*, July 2013
[7] Andrew Bailey, CEO of the Financial Conduct Authority, *Culture in financial services – a regulator's perspective*, May 2016

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Regulatory considerations

In 2009, the Financial Stability Board ('FSB') published its Principles for Sound Compensation Practices, designed to *"ensure effective governance of compensation, alignment with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation"*[8]. Subsequently, this can be seen to have formed the philosophical foundation of the regulation of remuneration in financial services.

Principles relating to variable pay include:

- *Compensation must be adjusted for all types of risk, and not just be based on profit, and both quantitative measures and human judgement should play a role in determining risk adjustments*
- *Compensation outcomes must be symmetric with risk outcomes, such that individual variable pay should be linked to the overall business performance / size of the bonus pool as well as the individual's contribution*
- *Compensation payout schedules must be sensitive to the time horizon of risks; payments should not be finalised over short periods where risks are realised over long periods*[9]

Recent publications by the FSB have focused on risk management in remuneration and related progress reports. In its most recent progress report published in September 2016, the FSB highlighted that *"compensation tools play an important role in reducing misconduct risk by providing both ex-ante incentives and performance assessment mechanisms that can help to promote good behaviour and ex-post adjustment mechanisms that ensure appropriate accountability when misconduct occurs"*[10].

However, variable pay for UK retail banking staff was a focus of the then Financial Services Authority ('FSA'; now Financial Conduct Authority ('FCA')) even before this, principally through its Treating Customers Fairly ('TCF') programme. Launched in 2006, TCF is aimed at mitigating risks to customers by improving information flow and minimising the sale of unsuitable products.

In 2006, the Financial Services Authority outlined four characterisations of a successful TCF program, citing:

- *"the fair treatment of consumers is established throughout the firm… in business culture including strategy, training, remuneration and staff behaviours;*
- *TCF should be built into processes and strategy so that it is automatically taken into account in all relevant business decisions;*
- *adequate management information available for firms to monitor TCF; and*
- *improvement in the quality of the outcomes experienced by the firm's customer"*[11].

As the financial crisis unfolded, the focus on good practice in banking – including the publication of the FSB principles – provided increased incentives for banks to review retail banking practices, and regulators have retained scrutiny on these matters over the period from 2006 to the present day.

Over recent years, the FSA, and more recently the FCA, has published various guidelines on remuneration for sales / customer-facing staff for institutions in the UK – covering variable pay structures, governance, and approach to performance management.

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[8] Financial Stability Board, *FSB Principles for Sound Compensation Practices*, 2 April 2009, p.2
[9] Financial Stability Board, *FSB Principles for Sound Compensation Practices*, 2 April 2009, pp.2-3
[10] Financial Stability Board, *Measures to reduce conduct risk: Second Progress Report*, 1 September 2016, p.3
[11] Financial Services Authority, *Treating customers fairly – towards fair outcomes for consumers*, July 2006, p.20

Good practice guidelines on variable pay structures include[12]:

- Simple, well-communicated variable pay schemes;
- Performance assessments which are:
  - ultimately discretionary, rather than 100% formulaic;
  - based on a balanced scorecard of measures, with less than 50% linked to sales or financial performance, and a material element on 'how' the sales outcomes were achieved;
  - team- or branch-based, rather than linked [predominantly] to individual performance;
- An individual behaviour gateway for any variable remuneration to be paid;
- Payments calculated quarterly / half-yearly / annually, rather than monthly;
- Variable payments deferred until the end of the year (or later);
- Caps on incentive opportunities;
- No 'accelerators' i.e. no increase for incentive outcomes for the first employees to sell a product, for selling over a certain value or for selling one product over another, etc.; and,
- Appropriate and justifiable balance between commission / variable pay and fixed pay.

More recently, in September 2016, the European Banking Authority ('EBA') published its guidelines on remuneration for sales staff (effective January 2018). While the EBA introduces more specific guidance on the appropriate governance frameworks, for those institutions in the UK, the guidelines on variable pay structures largely align with existing FCA TCF guidance.[13]

[12] Financial Conduct Authority, *Risks to customers from performance management at firms*, March 2015
Financial Conduct Authority, *Risks to customers from financial incentives – an update*, March 2014
Financial Services Authority, *Risks to customers from financial incentives – final guidance*, January 2013
[13] European Banking Authority, *Final Report: Guidelines on remuneration policies and practices related to the sale and provision of retail banking products and services*, 28 September 2016

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Detailed review: variable pay design

Approach to variable pay

Participants overall report the approach to variable pay as being consistent across the bank.

The most prevalent approach amongst participants is for variable pay to be assessed based on a combination of organisation and individual / branch performance, with no direct link (or, at three participants, a marginal link) to revenue or sales performance. This approach is used at 12 of the 16 participants.

There are two main exceptions to this:

A. Three participants have removed variable pay entirely for customer-facing staff; and

B. Two participants award variable pay based on a flat share of a variable pay pool determined on organisation performance.

The relevant participants cited broadly similar rationale for these two sets of exceptions, with (A) predominantly linked to a desire to focus on customer outcomes and direct performance management rather than performance management through variable pay, and (B) owed to a desire for a consistent "cross-bank" one-team approach to reward.

Participants also noted the consistency of arrangements across the three categories of customer-facing staff (Frontline, Advisers, Managers), albeit for an increase in variable pay opportunity with responsibility at six participants.

The following analysis on variable pay design does not include those banks who have removed variable pay (unless otherwise stated).

Approach to funding and allocation

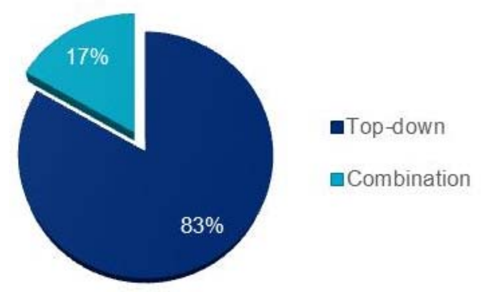
Variable pay funding can be 'top-down', 'bottom up' or a combination of the two approaches, defined as follows:

> *Approach 1: Under a top-down approach, the variable pay pool is funded based on organisation performance and allocated based on business / individual performance.*
>
> *Approach 2: Under a bottom-up approach, the cumulative value of individual variable pay awards determines the total variable pay pool / cost.*
>
> *Approach 3: Where a combination of top-down funding and bottom-up funding is used, performance is assessed at both the organisation and individual level, and an adjustment (up or down) is applied to determine the individual payout.*

These approaches, and use at participants, are considered in more detail overleaf.

Approach 1: Top-down funding

Figure 2: Approach to variable pay funding



This is the most prevalent approach reported amongst participants.

Where participants have a top-down variable pay pool, the corporate bonus pool is based on overall organisation performance, and typically then adjusted for divisional performance.

While divisional performance can theoretically adjust the pool up or down, in reality it tends to be down only.

The pool is normally then allocated based on individual, and potentially also team, performance.

The corporate variable pay pool is typically based on risk-adjusted profit and considering a scorecard of measures (capturing, for example, customer and risk management within the risk appetite).

A minority of participants report having a formulaic profit threshold that needs to first be achieved in order for variable pay funding to accrue. The majority of participants, however, report a discretionary threshold exists whereby the appropriateness of variable pay funding is considered each year based on the organisation's performance as a whole.

Team / individual performance is predominantly based on customer satisfaction, risk management within the appetite, and individual performance rating (encompassing an assessment of individual performance, and behaviour and values).

However, two banks report allocating each employee a fixed share of the organisation variable pay pool, to help foster a team-based culture.

Approach 2: Bottom-up funding

No participants report use of bottom-up funding; all variable pay funding is subject to at least some adjustment for corporate performance. This is in line with regulatory principles that seek to ensure variable pay is awarded only subject to satisfactory business performance.

Approach 3: Combined bottom-up and top-down funding

The typical observed approach to combined funding is first to define the variable pay pool at an organisation level, and then flex this pool up or down based on the cumulative performance of teams and individuals.

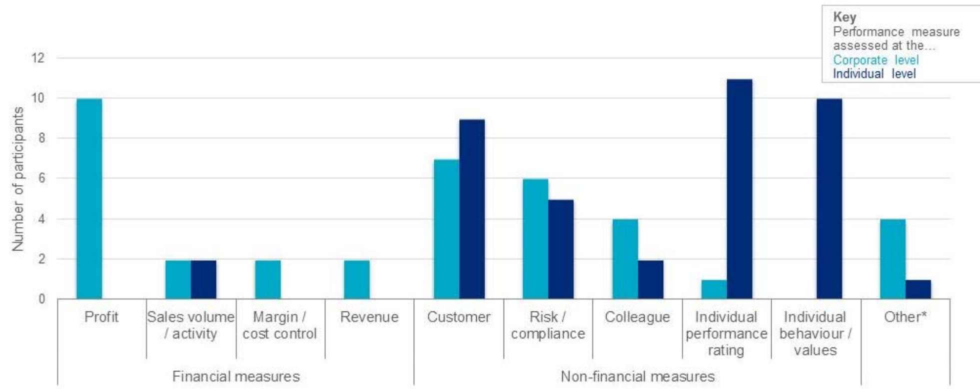
However, participants that report using combined funding do not follow this market-typical approach. One participant in particular reports reverse mechanics whereby the individual payout is first determined based on the individual's performance rating (comprising an assessment of individual values / behaviours) and is then adjusted based on organisation performance (using a scorecard of financial and non-financial measures). The participant explained this helps set the example of leading by behaviour.

Performance assessment

All participants report use of a combination of financial (i.e. linked to the bank's financial statements) and non-financial measures to assess performance.

The weighting on financial performance for variable pay funding is, on average, c.40%, with non-financial measures comprising the remaining c.60%.

Figure 3: Prevalence of performance measures



*Other includes general scorecard, fines and achievement of strategic objectives

Team / individual performance is typically assessed based on non-financial measures. Two participants only report including financial metrics (based on sales activity) in the individual performance assessment and one of these participants reports a specific intention to reduce focus on financial performance over the next 12 months.

Performance measures can be categorised as follows:

1. *Financial*

   Participants report use of profit, revenue, margin / profitability and/or sales volume when determining variable pay funding, with financial performance being measured for funding at the corporate level only (at all but one bank) and as part of a scorecard of financial and non-financial measures.

   Where used, financial measures typically focus on (risk-adjusted) profit and/or balance sheet health; revenue or sales volume measures are used at five participants only. At these participants, three measure revenue / sales performance at the corporate level with a subdued weighting (less than 15%), and the other two include sales / sales volume performance in the individual performance assessment as a discretionary consideration.

   Note, a minority of participants report measuring customer performance based, in part, on the number of customers; this is captured as a sales volume measure in this Review.

2. *Customer*

   'Customer' comprises customer outcomes, service or satisfaction and is the most commonly-reported measure. Where used, customer performance typically has a weighting of around 25-50% in the overall assessment.

   Customer is typically assessed through outcomes-focused metrics such as quality assessments based on customer surveys, customer loyalty, customer complaints, and/or Net Promoter Score (NPS). Depending on the sophistication of data reporting, this may be considered at a unit, region, and in some cases individual level (note, complaints are almost always investigated at an individual level).

   At the individual assessment level, performance measures might also include the quality of customer conversations (particularly in a telephony environment), the number of complaints, and any positive individual feedback provided by customers on named individuals.

   While Customer is more readily reported as being assessed at the team level (e.g. branch or region), our discussions with participants highlighted that Customer is also implicitly considered in assessments of individual performance and behaviours (and, at the very least, through consideration of individual negative feedback from customers).

3. *Risk and compliance*

   This is typically based on adherence to the Group's risk appetite, assessed as part of risk-adjusting the overall variable pay pool / funding and/or as part of an individual's performance assessment. Where not considered as a separate performance measure, participants report considering risk and compliance implicitly in performance assessments at both the corporate and individual levels.

   At the funding level, consideration is typically given to a Risk Assessment report produced by Risk and Compliance.

   At the individual level, metrics considered include Management Information relating to appropriate customer compliance checks, completion of the relevant administration, quality of telephone calls, etc. and tend to flow into the overall assessment of individual behaviour.

4. *Colleague*

   Typical measures include colleague engagement and culture. Colleague engagement is generally assessed at the corporate level, reflecting that such measures are typically influenced by more senior employees. Culture, however, overlaps with individual behaviour and therefore is more explicitly captured at the organisation level to set the 'tone from the top', but also implicitly in performance assessments capturing individual values and behaviours. This is particularly important for the managerial / people supervisory roles.

5. *Individual performance rating*

   All but two participants state the individual performance rating helps determine variable pay outcomes; at the remaining two banks, each employee receives a fixed share of the variable pay pool.

   The individual performance rating is based on an assessment of the individual's performance by the line manager, and typically considering customer satisfaction and risk and compliance within the risk appetite.

   The majority of participants report also considering individual behaviour / values in the individual performance rating. In other words, the individual's performance rating is based on 'what' outcomes were achieved as well as 'how' those outcomes were achieved.

   Individual performance assessments are considered in more detail below.

Gateway

A 'gateway' is a condition that must be met before a potential variable pay award can be accessed by the individual.

Participants generally report requiring above a minimum individual performance rating and/or behavioural assessment in order for an individual to receive a variable pay award (although the gateway one participant reports is subject to the individual not being subject to [potential] disciplinary action only). One participant includes an additional gateway on customer outcomes assessed at the team level; in most cases, customer outcomes are taken into account either directly or indirectly through the individual performance assessment.

Product Neutrality

Where individual performance is measured to some extent on sales, product neutrality is where employees are not encouraged to sell any particular product type.

Five participants only report linking some element of variable pay to revenue / sales metrics (three at the corporate level and the other two at the individual level), albeit with a marginal weighting. None of these participants report any product bias in assessing revenue / sales performance.

Some participants report that branch managers no longer receive individual sales performance data, concentrating instead on comparison with average / expected customer outcomes (i.e. an activity-based measure).

Modifiers

A 'modifier' increases or decreases the variable award once a performance condition has been met.

All participants report having a modifier inherent within the variable pay funding mechanism, but not in assessing individual awards.

In summary, participants report variable pay funding is based on either:

- top-down funding with the variable pay pool determined based on corporate performance and then allocated based on individual performance; or,
- a combination of bottom-up and top-down funding, whereby performance is assessed at both the organisation and individual level and an adjustment applied to determine the individual payout.

The majority of participants therefore first determine variable pay based on corporate performance and then allocate based on individual performance.

One participant approaches the modifier in reverse, such that corporate performance is used as the modifier to individual performance, with corporate performance based on an assessment of profit, customer, risk, colleague and culture. The participant explained this approach helps to lead by behaviour.

Accelerators

The term 'accelerator' (or 'stepped payment') refers to an arrangement whereby a higher rate of reward is earned with higher volumes of sales.

In line with FCA guidance, no participants report the use of an accelerator.

Frequency of reviewing performance targets

All but three participants now review performance targets annually; of the remaining two, one reviews targets on a monthly basis and the other two on a bi-annual basis, although one of these participants is moving to an annual basis. This is a marked step away from practice several years ago when the FCA was encouraging banks to move away from reviewing targets on a monthly basis.

In addition, a small number of participants do not disclose metrics to participants to help ensure focus is retained on appropriate behaviour.

Payment and deferrals

Payment frequency and vehicle

All but two participants pay variable pay on an annual basis; the remaining participants pay on a bi-annual basis, although one of these is moving to an annual basis.

Payment is typically in cash. One bank provides employees with the choice of whether to receive variable pay awards in cash or shares, although uptake of shares is limited.

Deferral

A deferral is a mechanism whereby a component of an individual's variable pay award is delayed or 'held back' for a set period, and released to the individual (in cash or equity) once certain conditions have been met.

Three participants report including some form of deferral in the variable reward arrangements for the customer-facing staff considered in this Review, albeit the approach to deferral varies:

- Bank one: performance is assessed on a quarterly basis but the variable reward is paid annually.
- Bank two: around one-third of variable pay is awarded as a share in a cash pool paying out after three years with the value tied to the company's share price growth.
- Bank three: variable awards are paid to the individual when the individual reaches age 60.

It should be noted that firms incorporate deferral arrangements for Material Risk Takers ('MRTs')[14], but the population considered in this Review is unlikely to be captured under the thresholds for defining MRTs.

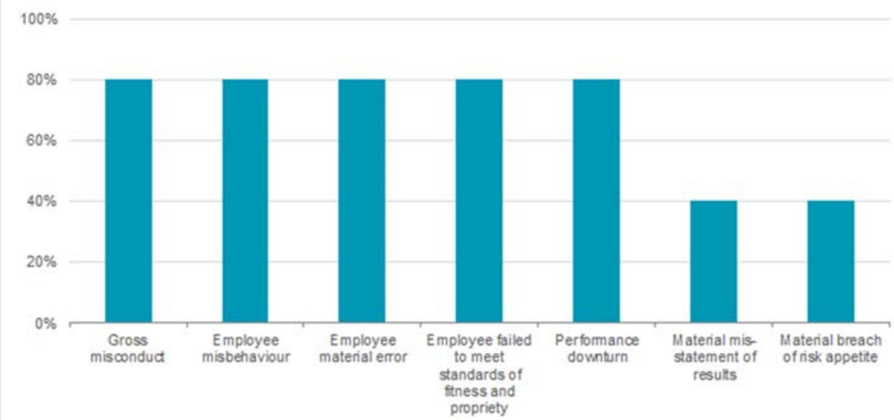
Malus and Clawback

Malus is the ability to reduce variable reward before it has been paid, and clawback is the ability to recover variable reward after it has been paid.

Variable pay for customer-facing employees is subject to malus and/or clawback provisions at around one-half of participants. Of these participants, the approach is split between including malus only and including both malus and clawback provisions.

It should be noted that the majority of banks include malus / clawback provisions for MRTs, and, where such provisions do not apply, state that this is due to the smaller materiality of the firm and/or of the staff considered in this Review.

Figure 4: Triggers for malus and clawback provisions
(% of participants that report having provisions in place)



Where malus / clawback provisions are present, the triggers under which these provisions can be used are fairly comprehensive.

[14] An employee whose professional activities have a material impact on the firm's risk profile, assessed based on various quantitative and qualitative criteria. Quantitative criteria include: total remuneration exceeds €500k (£500k in the UK) a year, or the role is in the 0.3% of staff with the highest remuneration in the company, or remuneration is equal to or greater than the lowest total remuneration of senior management and other risk takers.

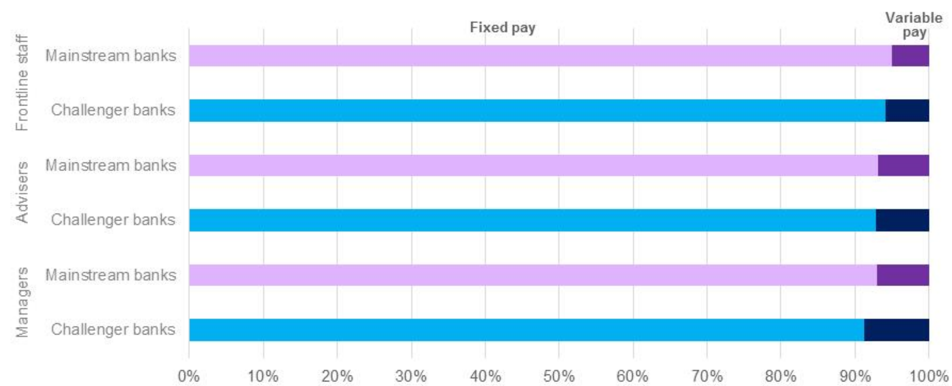
Size of awards and caps

Participants typically define variable pay opportunities as a percentage of salary (or short-term fixed pay), although a minority of participants consider variable pay opportunities as a £ amount or as part of an assessment of total compensation.

While capping opportunities is now prevalent practice, around half of participants communicate opportunities to participants and tend to focus on the target opportunity. Participants that communicate opportunities typically cite retention as a key driver for having variable pay. Conversely, those participants that do not communicate opportunity also do not tend to communicate performance metrics owing to a desire to move away from 'the distraction of incentives'.

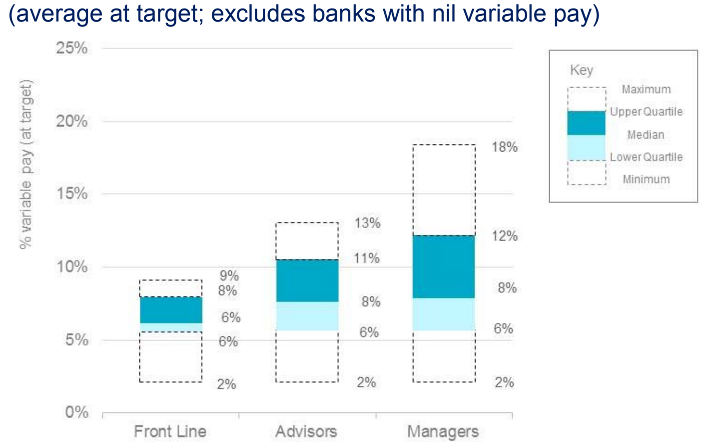
Overall variable pay opportunities comprise a modest portion of total pay, and this is more evident at mainstream banks.

Figure 5: Fixed:variable pay mix at mainstream and challenger banks
(average, at target)



Variable pay opportunities are overall broadly consistent across Frontline staff, Advisers and Managers. However, six participants report an increase in variable pay opportunity with responsibility, with target opportunity for Advisers being up to 2x that for Frontline staff, and for Managers up to 2.5x that for Frontline staff.

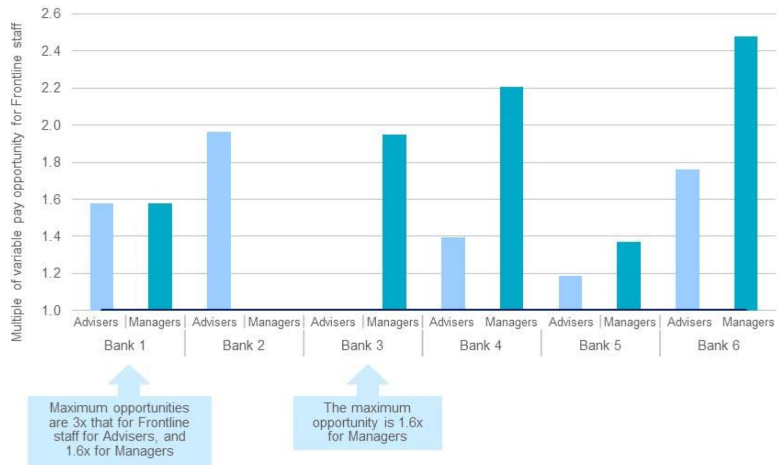
Figure 6: Fixed:variable pay mix by staff category
(average at target; excludes banks with nil variable pay)



However, the approach to increasing variable pay opportunity with responsibility varies:

- At one bank, both Advisers and Managers have the same higher target opportunities vs. Frontline staff
- One bank increases the opportunity for Advisers only
- One bank increases the opportunity for Managers only
- Three banks graduate the increase in opportunities from Frontline Staff, to Advisers, to Managers

Figure 7: Target variable pay opportunities for Advisers and Managers compared to those for Frontline staff (where different)



Note, one bank reports having a target variable pay opportunity for regulated Advisers of around double that for non-regulated Advisers.

Individual performance ratings and variable pay calibration

As discussed above, the majority of participants allocate variable pay based on individual performance. This is typically based on an individual performance rating, provided on some form of one-to-five scale, with the individual's performance assessed by the line manager considering customer satisfaction and risk and compliance within the risk appetite.

The majority of participants report also considering individual behaviour / values as an input into the individual performance rating, however two main approaches are observed:

- The rating is based on a holistic discretionary assessment of the individual's performance based on both what outcomes were achieved *and* how these were achieved.
  The line manager may be provided with guidance for assessing performance comprising high-level categories with examples of measures / outcomes and behaviours to be considered.
- The rating is based on the individual's performance against a scorecard containing specific metrics, with individual behaviour / values being a *consideration* in this assessment.

The first approach is more prevalent amongst mainstream banks; around half of challengers (predominantly those for whom banking is the sole or main activity) use the second approach.

Two main approaches to individual performance ratings are commensurately observed:

- The bank provides a rating based on a one-to-five rating for performance (i.e. 'what' outcomes were achieved) *and* a one-to-five rating for behaviour / values (i.e. 'how' these outcomes were achieved).
- The bank provides a one-to-five rating based on the individual's performance, *considering* the individual's behaviour / values. The company may provide separate ratings for behaviour but this behaviour rating has no direct link to variable pay outcomes.

Similarly, the approach to calibrating performance ratings and variable pay outcomes varies on a scale between:

- No formal calibration
- A guided distribution

The former approach is typically associated with more modest variable pay and a strengthened focus on rewarding for behaviour or merit or on recognition programmes (e.g. ad hoc awards for exceptional performance linked to the bank's 'values'[15]), along with a strong investment in leadership development and training.

[15] Note, recognition programmes are subject to governance processes such that the 'tone from the top' is appropriately reflected in rewards provided and rewards are not given for, say, revenue or sales performance.

5

Development of variable reward

Developments in variable pay for customer-facing staff over the last three years are broadly comparable across participants, and in particular reflect TCF guidance. Key trends include:

- Homogenisation of variable pay arrangements;
- Reduced focus on variable pay, with a higher focus on fixed pay (and caps on variable pay) and reduced frequency of payment;
- Elimination of revenue / sales measures, and reduced weighting on financial performance;
- Increased focus on customer outcomes;
- Increased focus on individual behaviour and conduct; and,
- Increased discretion in individual performance assessments.

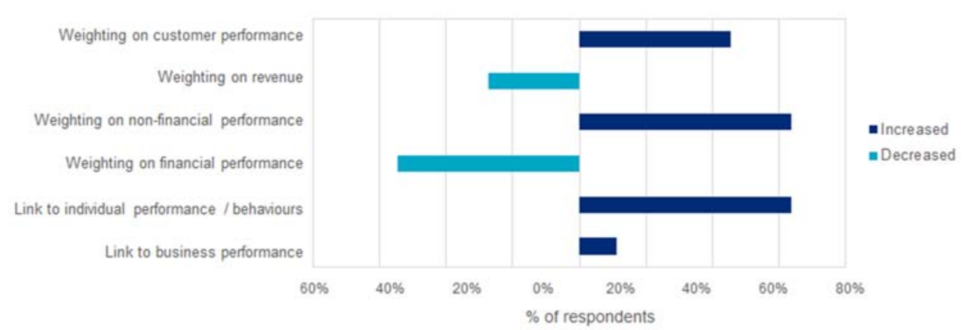
Mainstream banks have led the way with many of these changes, in part due to the increased scrutiny faced. The majority of mainstream banks report having reviewed variable pay in the last 12 months, compared to around two-thirds of challenger banks.

An emerging theme is a strengthened focus on how variable pay design and reward more generally now reinforces the appropriate culture. A number of participants said that *"sales happen if all other things are done well"*.

Developments of variable reward over recent years

Predominant developments over recent years are considered in more detail below.

Figure 8: Changes to variable pay design over the last three years



Homogenisation of variable pay arrangements

Participants generally report a consistent approach to variable pay across the bank. Further, two banks assess performance at the corporate level only with variable pay allocated on a flat share to all employees. While some participants report homogenisation presented initial challenges in ensuring appropriate performance differentiation, participants generally report this has strengthened a 'one-bank' team-based culture.

> **CASE STUDY**
> *Homogenisation of variable pay has meant our employees feel "they are part of one group"*

Reduced focus on variable pay

Variable pay opportunities now comprise a modest portion of total pay, with two banks removing variable pay altogether. Participants have generally reduced variable pay by averaging the individual's variable awards over, say, three years and consolidating a portion of this amount into the individual's fixed pay. However, some banks have consolidated into the total employee proposition including, for example, spend on leadership training. This latter approach is more prevalent amongst those participants which take a more discretionary approach to individual performance assessments.

CASE STUDY

On consolidating variable pay into fixed pay, one Reward Lead stated "employees like the certainty of having more fixed" and it is "good for changing the overall culture of the bank"

While banks report increasing focus on fixed pay has created greater stability in reward for employees, some have anecdotally commented some attrition of high performing sellers. A commonly-reported challenge is how to ensure appropriate progression for individuals – with performance management frameworks and recognition programs now playing a greater role.

Reduced weighting on financial performance

Financial measures are now predominantly considered at a corporate level only, for variable pay funding.

At the individual level, participants have moved to assessing performance based on non-financial measures; two participants report including financial performance as a discretionary consideration in the individual performance assessment, but one of these states a specific intention to reduce focus on financial performance as part of its journey to increase focus on customer outcomes as opposed to the "hard sell".

Increased focus on customer outcomes

'Customer' is now the most commonly-reported measure. While Customer is more readily reported as assessed at the team level, our conversations with Reward Leads highlight that Customer is also implicitly considered in assessments of individual performance and behaviours.

Increased focus on individual behaviour and conduct, and increased discretion in determining individual performance

Individual performance is now predominantly based on individual performance rating, with customer satisfaction and risk and compliance within the risk appetite also considered.

Participants report placing greater focus on 'how' outcomes are achieved in the individual performance rating, in addition to 'what' was achieved. The extent to which the 'how' is taken into account varies from *considering* the 'how' in the performance rating, to the performance rating being based on *both* the 'what' and the 'how'.

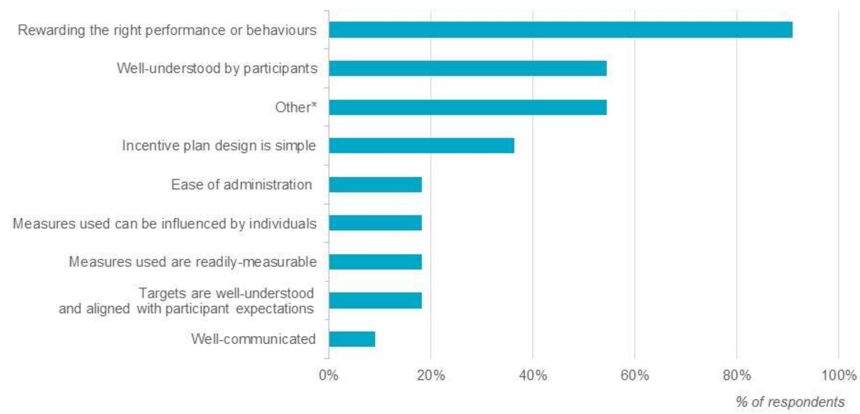
Performance assessments have also moved from being based on formulaic, quantitative metrics, to being based on the line manager's discretionary assessment of an individual's performance throughout the year.

Planned changes for variable reward

Participants most commonly cite *'rewarding the right performance or behaviours'* as the aspect that makes variable pay design most effective.

However, only a minority of participants exhibited high confidence in their variable pay arrangements driving the right behaviour, the right customer outcomes, and/or sales performance.

Figure 9: Key factors that make variable pay design most effective
(based on top 3 selected by participants)



** Other includes flexibility, an increased focus on risk and compliance, creating consistency across the group and a culture of collective responsibility*

A key challenge cited in variable pay design is ensuring the appropriate link to culture. Some participants provided examples of previous changes being isolated from the broader reward and culture agenda with adverse consequences for employee behaviour.

CASE STUDIES

Bank 1: An earlier iteration of variable pay design encouraged increased customer contact (and moved away from a sales-focused approach) but resulted in employees arranging unnecessary appointments for customers

Bank 2: Reduced significantly variable opportunity and reported a number of top-performing Advisors resigned seeking greater variable opportunity elsewhere

Other key challenges banks report include:

- How to drive the right customer outcomes
- How to drive the right employee behaviour
- How to ensure appropriate employee progression as variable pay opportunities reduce
- If and how best to calibrate variable pay outcomes, to ensure affordability and fairness in outcomes

One mainstream bank and a number of challengers specifically report intending to make changes to variable pay design over the next 12 months, with these changes all being evolutionary and in line with TCF guidance.

However, a number of banks report a shift away from ensuring variable pay is compliant with regulator guidance. Rather, banks are now considering changes to variable reward only following reforms to the performance management framework, to ensure reward as a whole reinforces the appropriate culture. This is especially prevalent at mainstream banks; responses at challengers are more mixed.

CASE STUDY

On reviewing variable pay design, "right now we need to focus on revamping the performance management system to ensure people do the right things"

Around two-thirds of participants indicated that they have made this journey or are on this pathway. Amongst these participants, certain key themes in variable pay design are observed:

(i) More discretionary approach to individual allocation

(ii) No variation in individual allocation

(iii) No variable pay

Participants also report material changes in the way individual performance is assessed, with these changes reflected in variable pay design and individual allocation in particular. Key themes include[16]:

- A move from performance assessments being based on outcomes, to both 'what' outcomes were achieved *and* 'how' they were achieved;
- Increased focus and investment in performance management and leadership development and training;

> **CASE STUDY**
> *"Performance ratings are all about the culture. We lead with behaviours. We have no forced or guided distribution, but the distribution follows the share you would expect"*

- Removal of a formal calibration process (owing in part to the strengthened leadership training); and,
- Increased focus on rewarding recognition through, for example, ad hoc awards for exceptional behaviour or performance.

Effectiveness of changes to variable pay design

Participants generally report assessing the correlation between 'performance and reward' to help ascertain the effectiveness of variable pay design, with 'performance' meaning the financial performance of the bank.

Banks also report considering wider aspects of 'performance', although aspects considered vary between banks and may include achievement of "business goals", customer feedback, and/or employee surveys.

The majority of participants consider it to be 'early days' to fully assess the impact of changes to variable pay design over recent years. Further, some participants note that recent changes to variable pay design are only one aspect of a broader cultural or reward agenda, and therefore it is difficult to isolate the impact of changes.

However, where impacts of changes to variable pay design were noted, these focus on increased employee engagement / retention, improved customer outcomes and strengthened individual behaviour. Particular themes include:

- Removing revenue / sales from performance assessments has not noticeably or adversely affected business outcomes since implementation;
- Variable pay that is now focused on customer outcomes and individual behaviour has resulted in employees focussing on delivering the best outcomes for customers; and,
- A more discretionary approach to individual performance has enabled a more collaborative working culture.

[16] The scope of this Review does not cover performance management frameworks; key themes are those reported from interviews with Reward Leads in light of the increased role of performance management and linkage to variable pay outcomes

6

Appendix

Appendix A: Discussion guide

MERCER

MAKE TOMORROW, TODAY

Discussion guide: Variable Pay for UK Retail Banking customer-facing employees

Background to review

Mercer has been engaged by the Australian Banker's Association (ABA) to research variable pay arrangements for customer-facing employees within UK retail banking.

The ABA is interested in the impact of the continuous regulatory scrutiny on how variable pay for retail banking staff continues to evolve in terms of market and best practice.

The review is focussed on variable pay for employees in retail banking, including those in mass affluent banking (but excluding wealth management, private banking, and ancillary services) and on three broad roles in the branch network and their equivalents in telephone banking:

- Front-line staff (i.e. customer-facing staff involved in providing customer services and enabling certain products e.g. bank customer services representative and telephony banking equivalent)
- Advisers (customer-facing salespeople of both regulated and non-regulated products)
- Managers (supervisors or line managers of the above roles)

For clarity, this review is focussed on the variable pay arrangements (for these specific roles) covered by the Financial Conduct Authority's Treating Customers Fairly program.

Discussion guide

- Summary of current variable pay arrangements, including:
  - Payment frequency
  - Funding determination
  - Assessment of variable pay outcomes (e.g. approach, performance measures, level of discretion)
  - Frequency of reviewing in-cycle performance targets
  - Summary of any performance modifiers, deferral arrangements, malus / clawback provisions
  - Indication of typical variable pay opportunities and typical target pay mix
- Discussion on approach to performance assessment
  - Individual performance
  - Organisational performance
  - Customer outcomes
- Summary of how arrangements have evolved over time
- Discussion on recently adopted / planned changes to key design features and rationale
- Thoughts on impact of changes (over time) on:
  - Individual performance and behaviours
  - Organisational performance
  - Customer outcomes
  - Anything else
- Consideration of the effectiveness of variable pay arrangements
- Anything else you want to cover?