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The Post-Crisis Evolution of Pay

Ten years ago this month, the financial crisis came to a head with the failure of Lehman Brothers. While there have been too many stories written on the crisis to cite, one thing we can agree on is the shared culpability ranging from individuals over-extending themselves in the housing market, the distribution of bad loans, poor underwriting and mortgage lending standards, packaging of securities by banks, uneducated ratings of these securities by agencies, and greedy and naive investors searching for yield.

As events unfolded and regulators and politicians alike looked to place blame, mortgage brokers and ultimately banks were deemed to have incentivized this negative behavior in part due to the compensation programs that existed.

What changed?

McLagan was at the forefront of reward changes across the banking industry, as U.S. regulators dug into a business that they were initially ill-equipped to understand or implement change.

Fast forward to today. The safety and soundness of the banking industry is far better than it was in 2007. Banks are less leveraged, funding with more equity and less debt, and less revenue is derived from trading activities. Regulators hold the largest banks both in the U.S. and UK/Europe to regular stress tests and living wills to ensure that any potential failure would occur in an orderly fashion.

There were significant lessons learned and changes made as regulators, HR leaders, and consultants reviewed the existing business and compensation structures. The investment bank and trading functions were the initial focus. Since pre-crisis, pay levels for senior fixed income traders have declined 40%, as the leverage and subsequent profits declined, and risk-weighted capital became a key measure of performance and funding incentive pools. Credit standards for mortgage and consumer underwriting were also significantly enhanced, while incentive plans were reviewed and consolidated to allow for better governance of these pay programs. Today, employees who are deemed the top risk-takers are now subject to year-end pay reviews that address risk, and culture and conduct is at the forefront of bank's talent focus. Deferral plans across firms have been enhanced to include stronger forfeiture and claw-back language, permitting businesses to penalize employees in the event of financial losses and individuals' sub-standard behaviors.

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Where do we go from here?

As we talk to our clients across the globe, one telling observation is the differences in regional regulatory policies. As a result, HR and Reward teams must navigate a sea of complex and inconsistent regulations. Ironically, the Financial Stability Board was created by the G20 to prevent this! Now we have Europe with prescriptive rules-based regulations, North America with a principles-based approach to pay, and APAC and the Middle East introducing very minor changes that vary by country. In a recent roundtable with the APAC regional heads of reward for the largest global banks, local/country-specific regulations were by far the single most prevalent topic discussed. Not only does grappling with regulations consume an exorbitant amount of time, but firm headquarters often don't fully understand the requirements to manage the many local regulators. Consider a country where local boards are required to sign off on incentive pools for local staff. This is clearly at odds to a globally funded and managed Investment Banking pool at a large firm.

While the Financial Stability Board *did* establish initial global guidelines for sound compensation practices in 2009, application of these by local regulators resulted in varying pay structures globally. Caps on incentive pay as a function of base salary have driven up salaries and fixed-pay for global staff of European headquartered firms, in addition to European-based staff of U.S. and other non-EU banks. For a U.S. firm, regulated staff in Europe are subject to a higher deferral rate than that of the firm's U.S. population. More recently, the Australian regulator has mandated similar deferral levels for regulated staff.

Human capital is the most important asset

While these differences could lead to "regional or regulation arbitrage" for talent, this has not broadly impacted the management and location of banking staff (the caveat being the evolving Brexit-related staffing moves that may end up otherwise). The largest post-crisis change regarding talent is that banks who were once the employer of choice, driven largely by lofty pay levels, are now challenged by other industries—namely, technology.

The evolution of digital transformation and technology-driven change in all areas of banking is resulting in a convergence of talent. Technology firms have the edge here, with more flexibility in pay packages, a culture of innovation, and more favorable perks/benefits. In short, tech firms generally offer a better Employee Value Proposition, and it is here that banks and financial services firms are now more broadly focused.

Despite these emerging challenges resulting from tech disruption, banks will not only survive, but firms that lead in adopting and delivering technology-driven change will thrive. Banks and HR teams will continue to educate themselves on talent practices across technology, as well as other sectors as their human capital becomes more diverse. The employee lifecycle at a bank will continue to change at all stages, from hiring practices and assessments to performance management and pay.

We believe most of the regulatory changes that have taken place are positive, but global consistency should be a continued goal of the FSB. In addition, after a decade of regulation, firms must switch their mindsets from compensation changes based on regulatory requirements, to those that will allow them to differentiate themselves and better reward and retain their best performers. Creative solutions are in a bank's DNA. This time it will not be a solution that packages bonds or mortgages, but rather a multi-faceted human capital strategy that attracts, retains, and promotes the best talent of the future.

To learn more about post-crisis changes in pay, please contact our team.

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