Building Societies Association

Perspectives: Governance in building societies

Remuneration at Building Societies – the remuneration committee perspective

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Introduction

PwC was asked by the Building Societies Association to conduct a review of remuneration in the building society sector. Specifically, PwC was asked to comment on the regulatory framework in which remuneration at building societies must be considered, and interview the remuneration committee ("Remco") chairs of 12 of the 44 building societies to understand the issues that societies were facing and how they had addressed these. The Remco chairs we interviewed represented 94% of the sector by asset size, varying from several of the largest societies with national presence to smaller ones that operate only in their local region. We are grateful to all the Remco chairs who participated in the review. Their openness, candour and the passion with which they described the business and cultures at their societies made the interviews a rewarding and engaging experience.

Regulatory background

Remuneration was one of the high profile fields of regulatory intervention in the FS sector following the financial crisis, despite minimal prior regulatory activity in this area. Regulators examined the role played by banks' remuneration arrangements, considering how they may have contributed to the crisis by either directly incentivising excessive risk-taking or not providing sufficient incentive for risk management. The remuneration regulations that were developed apply across the full range of banking, including building societies.

The current regulatory position responds to some of the conclusions drawn by regulators on the structural flaws in pay arrangements in banks, as well as additional perceptions from politicians, the press and the public that compensation in the FS sector was too high and undeserved. In particular there was a perception that when performance was poor, individuals were still rewarded handsomely, including generous severance packages which amounted to “rewards for failure”.

The response of regulators was intended to address this perception of highly paid bankers enjoying high levels of variable pay with little personal accountability. As the activities of building societies overlap with some of those of banks they have found themselves within the scope of these regulations, which are intended to address issues which, for the most part, have never been a problem in the building society sector.

The resulting PRA/FCA regulation is a mixture of regulation ultimately derived from the EU (via CRDIV) and areas where UK regulators have chosen to go further than the EU requires. Inevitably the focus has been on the activities of banks, with the consequence that some regulations do not translate well into the building society sector. The key features relevant to our review in the building society sector are:

- firms are required to identify staff whose activities have a material impact on the risk of the business (called material risk takers (“MRTs”));
- performance measurement for variable pay must be based on a mixture of group, business unit and individual performance, including both financial and non-financial measures, and must be appropriately adjusted for all current and future risks;
- a cap on variable pay of 100% of fixed pay (which can be increased to 200% with the approval of members); and
- up to 60% of the variable remuneration of MRTs is subject to deferral for a period of up to 7 years for the most senior staff, and at least 50% of payments must be delivered in the form of instruments which must be held for a further period.

The other key feature of the UK implementation of the EU requirements has been the UK regulators’ approach to “proportionality” under which the PRA and FCA allow smaller firms or individuals with both low total remuneration and low variable pay to be exempted from some of the structural provisions of the rules, including the requirements to defer variable pay and deliver it partly in instruments.

The exemptions under proportionality cover all but the largest building societies (those with assets over £15bn) and even within the larger building societies in general only the most senior staff earn enough to exceed the threshold. Therefore, for the most part, building societies have been able to disapply the full rules on deferral and instruments, although in practice many do operate some form of deferral. For the small number of societies and individuals who are caught, these requirements add significant extra complexity to the delivery of remuneration.

Finally, the focus on accountability has led to the introduction of the Senior Manager Regime (“SMR”) which lays out a number of roles which are classed as “senior manager functions” and requires firms to allocate certain prescribed responsibilities to those roles. The individuals concerned are personally accountable for the delivery of these responsibilities.

Remco chair interviews

From each conversation that we had with the Remco chairs it was clear that the mutual nature of the building societies that they represented was at the core of their decision making on pay. However, there were some significant challenges around reflecting mutuality in pay structures, especially for more senior executives. At a senior level the resulting pay structures are significantly different from those operated by UK-listed retail banks, including the niche and challenger banks, which have much higher levels of variable remuneration. For more junior employees the remuneration arrangements tended to reflect a combination of the local market (more so for the smaller societies) and wider financial services (more so for larger societies).

In general the remuneration arrangements for senior employees could be summarised as follows:

- Base pay was often set to be broadly comparable with banking peers.
- Variable pay opportunities were typically lower than might be paid by a bank.
- Variable pay was typically provided by way of an annual bonus. There was a distinct lack of long term incentives.
- Performance metrics typically took account of profit, but also member and employee experience in order to take a holistic view of performance. The resulting "balanced scorecards" are not dissimilar to those now used in most banks.
- No society had found a measure that they felt adequately reflected "mutuality". However, as a proxy for that, many focussed on customer service and downplayed profit relative to their banking peers.

Many societies took a cautious approach to setting financial bonus targets, with target ranges focussed on rewarding hitting strategic plan and little incentive to pursue higher outcomes in the short term. The focus was therefore on consistent long term progression rather than short term spikes in performance.

Remuneration philosophy

Something that came across strongly from all of our conversations was that the Remco chairs were all very mindful of their societies' status as mutuals when it came to their thinking on remuneration. Therefore although they want to be able to recruit and retain the right people for running their societies, they recognise that this must be done in the best interests of members which in this context involves paying no more than is necessary and ensuring that executive reward is aligned with the experience of members.

They are mindful that they are usually competing for key talent with organisations outside of the building society sector which are not mutuals and which have very different core principles, being much more directly profit driven organisations. The societies generally do not look to compete directly with banks on pay – the quantum would be unaffordable for a building society and would be difficult to justify to members. More fundamentally the societies are generally looking to attract executives who are a close cultural fit.

From our conversations with most Remco chairs the principle of mutuality shaped their remuneration arrangements in terms of setting the constraints on how they approach remuneration, for instance modest levels of variable pay and not over-rewarding achievement of financial metrics, particularly profit (see further below). However, something which did not come across strongly from the interviews was how the status and purpose of a mutual should shape the structure of remuneration. We recognise that stakeholder alignment in particular is a challenge as it is a lot harder to articulate and measure the value delivered to members than it is for an organisation with share capital or even other entities such as partnerships. We are aware that some building societies are examining methods in which the value delivered to members can be measured and articulated. If these methods can be sufficiently developed and stand up to robust testing we would encourage societies to be bold in building these into remuneration structures, including assessing whether the currently predominant pay model of fixed pay plus a modest annual bonus supports this.

Several Remco chairs also emphasised that mutuality does not just extend to relationships with members, but also with staff. Therefore decisions on executive pay were made with the pay structures and conditions across the whole society in mind. Therefore while some Remco chairs were comfortable with having a different structure for their senior management as compared to the rest of their society's staff, others have them with some reluctance but out of a desire to be market competitive, while some take the approach that one of the features of a mutual should be that pay principles and structure for executives should be no different to those for all staff and so operating only a single variable pay arrangement for the whole society. We would note that those in the latter category were more towards the mid-range of the sector in terms of size, where perhaps they have found they do not need to operate additional executive bonus arrangements to attract and retain the right talent.

Quantum of remuneration and balance between fixed and variable pay

Fixed pay

The approach of most societies is to position base salaries around market median, with some who face challenges in recruiting due to their location or recent business performance accepting that they need to pay closer to upper quartile than perhaps they would like in order to attract executives of the required calibre.

The largest building societies look to benchmark salary against those of a comparable size (where applicable), other mutual organisations, challenger banks and where deemed appropriate the divisions or UK arms of big banks. However this is on salary alone: they do not seek to compete on variable pay with organisations outside of the sector.

The remainder of the societies we spoke to tended to benchmark themselves against societies of a similar size, overlaying factors relevant to their location and local market in setting pay.

Several Remco chairs at the societies which are above the £15bn threshold (the level 1 and 2 societies) and which therefore have to apply the full requirements of the remuneration regulations to their most senior staff commented that they have been driven to having higher fixed pay than they would have liked. This has resulted from a re-balancing of variable pay into fixed pay – i.e. a reduction in bonus opportunity partially compensated for by an increase in base salary. The driver for this rebalancing has been the reduced "perceived value" of variable pay in the eyes of executives due to extended deferral periods and delivery in instruments. One chair commented that the effect of remuneration regulation was therefore to drive his society to having a higher fixed cost base and less flexibility on remuneration in times of financial challenge – surely not the intention of UK regulators., whose ability for manoeuvre in some areas is restricted by the rigidity of the EU rules.

Variable pay structure and approach

Variable pay opportunities at building societies are lower than the amounts elsewhere in the FS sector and, as might be expected, tend to be larger at the bigger building societies, with some of the smaller societies interviewed not offering a specific executive variable pay arrangement at all.

The vast majority of building societies operate an annual bonus only, with varying degrees of deferral often applied on a voluntarily basis even where regulations would permit deferral to be disapplied on the basis of proportionality. This is despite several Remco chairs commenting that they would prefer the incentive arrangements to have a focus on longer term performance, to reflect the long term nature of a building society and the period of time over which performance results from certain decisions will emerge. They achieve this to a limited extent via a risk adjustment or review process within the deferral mechanism, but most do not have a dedicated long-term incentive plan (”LTIP”). While the deferral of annual bonus payments provides a longer term payment profile, the widespread use of simple deferred cash with no further performance conditions generally does not reflect a society’s performance over the payment period..

A particular challenge for a building society in designing an LTIP is the difficulty in selecting measures which can be measured over the long term and then calibrating performance targets around these which achieve suitable alignment between individual reward and society performance. Listed banks are able to rely on shares to achieve at least part of this alignment, and their unavailability to building societies makes achieving the longer-term alignment much more challenging. For the most part, the building societies who must use instruments have opted for the simplest instruments possible under the regulation – achieving compliance but limited alignment.

In a building society LTIP the long term alignment therefore has to be driven by the performance targets and risk adjustment processes alone, placing significantly more pressure on both of these elements than at an organisation which uses shares in its LTIP structure, and perhaps helping to explain the relative scarcity of LTIPs in the sector

When articulating the purpose of variable pay, some Remco chairs commented that it was for more than just doing the day job and accordingly stretching targets were set. However, the majority felt that it was viewed by executives as a reward for delivering financial results in line with the corporate plan rather than a targeted incentive rewarding outperformance against certain financial metrics. It was noteworthy that customer experience targets were often set with significant stretch, as societies recognise this is a key differentiator in the FS market, as well as being one way of capturing member value.

Running variable pay in a manner which is “not too hot, not too cold” on financial metrics is consistent with the long term nature and approach of a building society. It often is not in member interests to over-reward outperformance against financial targets in the short term. While a reasonable level of profit is healthy in helping build capital, societies do not want to maximise this in the same way as pure profit organisations.

A further consequence of this approach to variable pay is that annual bonus outcomes tend not to vary too wildly from year to year. This is in line with the "reward rather than incentive" philosophy. An additional point which may underlie this approach at some societies is that executives who have come from outside the building society sector may have historically been used to far higher variable pay opportunities and therefore expect a relatively stable pay out given the reduced opportunity.

Performance metrics

Common targets for annual bonuses include profit, customer service, customer satisfaction and cost and efficiency measures.

Profit features in the majority of bonus schemes, either as a standalone measure or a gateway that unlocks a bonus. Targets around this are based on the principle that a degree of profit is necessary as it is the main way a building society can build capital, but an excessive amount is not the interests of members. Remco chairs felt that building societies had more leeway than listed companies to set profit targets lower than the prior year where their society was investing in the future, with many of them citing investment in major technology projects as reasons for this. However, it is still a challenge to explain variable pay outcomes against reduced targets to members, whose perception that more profit is a good thing is coloured by the more well understood nature of "pure profit" organisations.

The fact that profit is only one of a number of ways that societies provide benefits to their members is reflected in the widespread use of balanced scorecards of measures. These help meet regulatory requirements, but also try to reflect other factors that capture the member value being delivered. Unsurprisingly, customer experience as a measure is almost universal. Other common measures in balanced scorecards include colleague engagement, growth in mortgage lending and delivery of strategic objectives (e.g. digital offering).

Recruitment

A common message from Remco chairs was that they found they were fishing in a smaller talent pool for candidates to join a building society than the banks would be. This is partly due to their geographical locations – all societies being headquartered outside London, but mainly it is because societies neither want to, nor are capable of, attracting executives whose main motivation is to maximise their earnings.

However, despite this, the majority had found that when they had needed to recruit for executive roles in recent years they had found individuals of the required calibre, albeit they often had to work hard to seek out the required talent. So the pool may be smaller, but there is no shortage of quality candidates looking to join a building society. As several summed it up, mutuality does not mean mediocrity.

The attraction of working for a mutual, being an organisation with a culture and values that work in members' interests and in the interests of the community, is seen to be the key differentiator when recruiting. Despite this and subject to a couple of notable exceptions, most Remco chairs felt that their society could be better at promoting this, particularly to people starting their careers. They felt that the principles of a mutual should sit well with the personal values of millennials.

Several Remco chairs found that they could categorise the types of executive candidates they would encounter and the personal motivations of those individuals as falling within one of three main classes:

1. New talent – early in their careers, are not motivated purely by money and are actively seeking new career opportunities
2. Mid-career – individuals who have been successful in their careers to date at big banks, and have significant LTIP opportunities together with outstanding deferred remuneration which they would lose if they changed roles, together with significant personal financial commitments based on current earning power; and
3. Highly experienced – executives who are at a stage in life where they're personally financially secure and are now looking for more than just money from working, perhaps wanting to feel that they're putting something back into society.

Building societies find it easier to attract executives that fall within a) and c), but not those in b), as they cannot match their current earnings and those individuals cannot afford to leave their roles. A few noted that this may be restricting diversity in the sector.

Several Remco chairs mentioned that one of the features of working for a building society that they use in attracting candidates is the fact that they will get to run an element of the business, rather than be part of middle management in a much larger organisation. This particularly appeals to individuals from larger organisations who want to take a step up to an executive board from a second-in-command role.

An additional challenge is recruiting people from outside of the FS sector for roles that do not require specific FS experience, e.g. HR and digital, due to the regulatory constraints on pay across the sector. This was seen to be a particular problem in digital, where FS organisations, be they building societies or banks, are not competing on a level playing field with non-FS employers for the best talent in this growth area.

Internal recruitment was also not without its challenges, as some Remco chairs felt their societies were not doing enough on developing their own talent. Smaller societies are faced with the same challenges as any small organisation, where for many people promotions only occur due to the person in the role above moving on. In these circumstances it is hard to develop and retain new talent. In addition, the number of societies offering dedicated graduate programmes is very limited. One Remco chair suggested that building societies should collaborate on graduate development, for the benefit of the sector as a whole. In response to such concerns, the BSA and the School of Business and Economics at Loughborough University launched in 2015 the first UK Masters programme geared specifically for those who work in a customer-owned/mutual financial services firm. We understand this has proved popular, with the first cohort of 26 MSc students due to graduate in 2018

For the majority, location was not seen as a barrier to attracting the right talent, as they found that there were sufficient numbers of candidates who may be looking to move out of London or to return to the area in which they grew up. While retention wasn't generally perceived to be a problem, what was clear was that at more junior roles in a building society, the principles of a mutual were not in themselves enough of a differentiating factor for them in the local employment market, and that they had to ensure they were competitive on pay too. In addition, those societies within commuting distance of London found that staff at all levels were head hunted by financial services organisations based there. Several Remco chairs were mindful of non-financial benefits such as secure parking and good quality on the job training as additional benefits to be used in recruiting and retaining staff.

Regulation

The feeling of those we interviewed was that the overall regulatory burden on building societies, including in respect of remuneration, is disproportionate given the scale and complexity of most of them and given the risk profile of a mutual. They accept that the regulatory framework was not designed with them in mind, but feel they were caught up in issues not of their making which impact on the wider FS sector.

The larger societies have adapted their pay structures to ensure that they comply in a practicable fashion. One area of concern is building societies' lack of shares (or any other robust way of meaningfully tracking their long term value). Where listed companies can rely on shareholdings to help align executives and owners (for example via minimum shareholding requirements or the delivery of long-term variable pay via shares) building societies do not have this option. This has resulted in real challenges developing reward structures based on sustained longer-term performance, despite the general view that a greater link to longer-term performance would be desirable.

For larger societies, remuneration regulation also creates cliff edges where an individual's shift in responsibilities or promotion may take him into being an MRT or may take him above the proportionality threshold, so being subject to the more onerous requirements on deferral of variable pay and payment in instruments. Where these exist they are presenting barriers to either recruiting people or staff taking a promotion, with inevitably greater levels of remuneration required to facilitate the move.

The result of this combination of pressures – constraints of a mutual, market competitiveness, regulation - is that most building societies have remuneration structures which meet their needs in a practical and regulation compliant fashion, but which are compromises on the principles of their ideal structures. In our view, this has resulted in pay structures that do not contain features which are particularly unique or distinctive for building societies' status as mutual organisations although, as noted above, the total packages tend to be distinct from those offered by banks. We recognise that a challenge for Remco chairs is that, particularly in the absence of a straightforward method of tracking value delivered to members, it is hard to articulate what this mutual status should mean for the purposes of remuneration.

Finally, the impact of regulation was on the mind of the majority of Remco chairs, particularly those at the larger societies in proportionality levels 1 and 2, as they seek to implement remuneration structures which are compliant with regulation while maintaining a strong motivating and retentive effect. Several noted that seeking to achieve this balance has resulted in structures that they wouldn't necessarily have chosen had they had a free hand in drawing them up.

Interactions with members

At the AGM, executive pay is inevitably a lightning rod for disgruntled members. The Remco chairs were used to the level of questioning they get at AGMs and were comfortable in their explanations for their pay arrangements, in that their societies need to pay market rates to attract and retain high calibre executives. They also noted that despite the noise from a vocal few, members were usually very supportive on pay, with remuneration reports (where put to a voluntary vote, as this is not mandatory for building societies), receiving significant votes in favour.

Outside the AGM, the common experience was that engaging with members is difficult, particularly as it is hard to get them to see beyond the headline numbers on pay. For all the agonising that Remcos go through in relation to bonuses, deferral, performance metrics and the like, the focus of members tends to be firmly on the overall quantum of pay – which for those willing to voice an opinion is generally regarded as too high.

While some have tried to run member workshops etc., the AGM remains the main forum where they get any engagement with members on pay. This means that members only tend to comment on pay in retrospect, whereas the Remco chair of a plc has the advantage of being able to maintain an ongoing dialogue on pay with his key investors and consult them before implementing arrangements. The flip side of this is that there is less short-term focus on results, enabling the societies to reward a more holistic assessment of overall performance, including progress towards long-term goals.

Conclusion

The building societies have, for the most part, adapted their remuneration structures and policies to cope with changing markets and regulations. Although the resulting structures often involve areas of compromise, for senior employees the society's approach is generally close enough to the wider market to enable them to attract and retain staff. However, that does not mean that they are without their challenges. One long-standing challenge for the sector has been measuring and rewarding all the aspects of value delivered to members, particularly over the longer term. With ever increasing focus on the long-term aspects of remuneration structures this is a challenge that is not going to go away.

A further challenge is attracting the next generation of talent into the sector. To date, societies haven't found recruitment too difficult, but it seems that challenges are looming, particularly in attracting staff into non-FS specific roles and NEDs with the right experience. Building societies will therefore need to invest more in developing their own talent, as well as ensuring that they continue to make an attractive proposition to new joiners, differentiating themselves on features other than remuneration. Key to this will be promoting the attractions and benefits of working for a mutual organisation. Additionally, strengthening this articulation of the principles of a mutual may assist Remcos in creating new reward structures that derive directly from these principles, rather than being driven by being practical and pragmatic approaches to dealing with the various challenges and constraints in which pay at a building society must operate.

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