Chapter 1: Remuneration in a time of austerity

‘WE KNOW who abolished boom’ Lord Mandelson apparently said recently and, when completing the last review of this topic, there was perhaps an unrealistic upbeat assessment of the longevity and indeed severity of the economic conditions impacting most areas of the western world. In addition, the economic upheaval in the last few years has been characterised as being less politically stable. These two elements coming together make the business landscape challenging, and this may be true for a very long time. Law firms are businesses and are subject to the vagaries of the markets in exactly the same way as any other organisation. Even the most successful law firms who have, in some instances, directly benefited from the downturn in the wider market, will have to look very carefully at their people management and in particular at reward and motivation.

There are some quarters of the legal profession whose pomposity when describing their market or government policies and their impact is almost charming. (Have a look at the letters page of The Times and the recent legal aid budget reductions and indeed some of the commentary around the commoditisation of legal services and/or third party investment). Clearly in some instances managing partners are in denial about the extent of the prevailing economic circumstances and their possible longer term impact.

There have been a number of developments generally throughout commerce, and more recently the public sector, in the area of remuneration and very few of them about raising levels of motivation. A much more common feature has been organisations trying to squeeze out more for less as they try to manage cash flow and flatlining demand for their services. See Figures 1 and 2 (on page 2) for the trends in average base salary by global region and in the per cent of companies freezing salaries.

It is a well-documented aspect of the last few years that private sector reward levels have fallen behind both the public sector and indeed inflation. This is less pronounced in law firms and professional services generally, but even the high margin global payers will have felt and indeed witnessed far less growth in their earnings. At the opposite end of the legal market there will have been very real reductions in some instances and business failures and reduced working to preserve business finances. No sector can be immune over the medium term to an economic downturn and many assumptions held in the past shattered as redundancies, and in some instances, business collapses, were seen.

Reward, a new paradigm
In many areas of the legal market there will have been increased emphasis on total reward and an implicit and sometimes explicit assumption that having a well-paid job was sufficient to maintain levels of engagement and productivity. This assumes a number of things about human behaviour and expectations which are plainly wrong.
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Figure 1: Trends in average base salary increases by global region (Source: 2012–13 Culpepper Salary Budget & Compensation Planning Survey)

Figure 2: Trends in per cent of companies freezing salaries (Source: 2012–13 Culpepper Salary Budget & Compensation Planning Survey)
It should not be assumed that reactions to the economic circumstances will be the same or consistent throughout individuals or groups of employees. The labour market, it has often been commented, has reacted in a fairly strange manner during this period with unemployment, while remaining high, not growing to the levels anticipated. Indeed, the number of private sector jobs created during this time is surprisingly high. There are a whole series of explanations for this (i.e. the creation of part-time roles and in some instances, employees actively pricing themselves to make the creation of new jobs easier).

At this time, the economy is still experiencing skills shortages, however, and significant pressure points in the supply of appropriately skilled individuals. As the economy slowly improves so will employee expectations and it would be unwise of employers and, in this instance, for law firms to assume a benign labour market forever. Recent announcements of pay rises at associate level in certain larger firms shows that some are already perhaps considering employee expectations as the economy improves.

Some of the organisations at the centre of the ‘crisis of capitalism’ have already sent out clear signals that levels of remuneration, particularly at the very senior end, may not rise for many years. Depending upon one’s view of the world this may be a longer term structural change whereby a gap between those at the top of the income scale and those at the bottom narrows. This has implications for law firms where partner earnings are under pressure. On the basis that much of the management of partners is geared to managing partner profits, this has a very real implication for the approach, not just quantum when looking at remuneration.

In summary, therefore, rational expectations, the ‘war for talent’, and skills shortages, as well as flat economic growth, will result in a set of employment situations which are very specific to where a firm is in the market and the need to employ particular individuals.

In this time of austerity we have also witnessed an incredible backlash in public opinion on what is perceived to be the greed of ‘city types’ or highly paid people, by average standards, everywhere. This will inevitably have resulted in organisations thinking very hard about remuneration levels even when their specific business circumstance permit higher levels of reward. Bonuses are to be confined to the same category of language as ‘privatisation’.

In the public listed regime, disclosure is now required at an extraordinary level of detail and shareholders are encouraged to critically assess both remuneration policy and its operation. This aspect of corporate governance is both value laden and full of potential traps for those in the listed sector. Many institutional investors will be keen to ensure value for money when purchasing legal services. This is likely to be a real concern when they themselves are subject to the level of scrutiny on their own levels of reward.

In summary, remuneration is a very hot topic. Given the private nature of law firm earnings, and to date the lack of remuneration regulation and disclosure, this means that there is less transparency and therefore less comment about those at the upper end of the law firm scale. This will be discussed later but pressure will surely grow, even for private organisations, to increase transparency and explain their reward approach (if not quantum) to their clients at the very least.

Some of the consequences of these troubled times go to structure and/or
ownership models, in others it will have resulted in slowing down the pace of career progression. There will also have been even more emphasis yet again on variable pay or bonuses. Whenever there are difficult economic circumstances professional services, including law firms, usually come up with some new tool to ‘drive up performance and reward excellence’ (the implication being that in better times one need not worry about either of these concepts). It is unlikely, or at best unwise from a management perspective, to assume that any new approach which seeks to drive behaviour will happen overnight.

Bonus basics and variable pay

It is worth bearing in mind that during a prolonged period of challenging business circumstances there will have been even more pressure to look at bonus schemes. As a result, it is useful to recap on bonus structures and rewarding performance.

Bonuses awarded in partnerships will almost always be cash awards. Clearly in the corporate world bonus schemes are usually a blend of cash and shares subject (increasingly) to regulation, and quite often deferred or subject to performance periods, measured in relative and absolute terms.

The huge controversy around the complexity of bonuses in the corporate world, which are expected to be deferred and subject to claw back, might lead one to suggest that there is an even lesser clarity around which structures are best suited to achieving good results for business.

On a rather esoteric point, comparisons with partnership structures may be easier if bonuses are thought of in terms of both cash and career progression. What is meant here is that, rather than benefiting from a large award vesting within a long term investment plan (LTIP), individuals within professional services are rewarded with partnership or access to the full equity.

A simplistic way of looking at bonuses – whether cash or equity – is that they are employed to:

- Improve business performance (for example, productivity, sales, or profits);
- Focus employees’ efforts on key objectives such as client service, quality, and on-time delivery. In time-capture environments, this sometimes leads to the measurement of financial hygiene factors such as billing, write-offs, actual profits, or matter and cash collections;
- Increase employee motivation by establishing a clear link between pay and performance at an individual or team level; and
- Support stakeholders (within professional services this group is largely members of the firm and clients) and allow employees to share in the success of the business.

Professional services bonus schemes

Firms have wrestled with these issues in both good times and bad, and approaches that have been taken have been affected recently in terms of quantum and, in some instances, have been specifically altered to reflect the current economic climate. The bonus schemes which are most difficult to alter, when the profits dictate an alternative approach, are those which can best be described as deferred salary. These bonus arrangements are usually characterised by the following features:

- They are established for many years;
- They are loosely-framed performance objectives;
- They are originally employed to flatten demands for salary increases;
■ They are operated in environments where profits are subject to considerable volatility; and
■ They are a modest percentage of salary.

These schemes are difficult to alter for they may be described as discretionary and non-contractual. However, rational expectations dictate that the absence of line of sight between results (however they may be defined) and bonus outcomes will inevitably mean that people will come to expect bonus payments come what may. Such bonus schemes are an entire waste of a firm’s assets and merely serve to accentuate the problems inherent in having a muddled and ineffective view of performance – either on an individual or team level.

Nevertheless, there are a surprising number of organisations where this approach – usually by default – is the one being adopted. Within professional services this particular type of bonus arrangement will often be associated with support or back office (however non-fee earners are described). The firms that fail to properly manage this cost base and have created rigidity around it are the firms least able to deal with the economic downturn. A failure to adopt a rigorous approach to reward across the whole firm will result ultimately in failure to sustain or grow profitability – or perhaps even survive.

Much of the surveying and analysis of broad, firm-based bonus schemes have found these to be the least effective in increasing productivity. There will be a huge temptation to quickly install crude productivity-based bonus schemes. Deloitte’s findings, in their surveys, state that fee earner plans driven by individual results have a positive effect on behaviour (which, in turn, result in an increase in chargeable hours worked). There was room for improvement in recognising that chargeable hours should not be the only strategic focus for delivering a firm’s success. Bill Cohen, a remuneration specialist at Deloitte commented on the survey findings: ‘An increasing number of law firms are introducing bonus arrangements which deliver significant levels of reward for outstanding levels of productivity. It is expected that the prevalence of these plans will increase over the next few years. While these arrangements can support the strategic goals of law firms, both in motivating staff to deliver financial objectives and in attracting and retaining key talent from the market, it is important to ensure that these are designed to mitigate the risk of encouraging negative behaviours.’

While this survey pre-dates the economic downturn of recent times, on the basis of much commentary in the legal press and conference presentations the speed with which law firms have moved to productivity-based schemes for fee earners has, it would seem, accelerated. The significant advantage of such schemes at this time is to load the variable pay element of total reward and reduce expectations of salary levels. They also have the added advantage of a clear line of sight with easily understood and measured targets.

There are both attractions and dangers to such an approach. While accepting the harsh economic realities of the situation, where trading conditions dictate a serious focus on costs – while still trying to reward effort – there are dangers in focusing only on short-term objectives, unless firms are explicit about said objectives, communicate and share the issues with employees, and reaffirm the overall business objectives.

The dangers of focusing on individual awards are well described by Professor Jeffrey Pfeffer at Stanford University in
a course he ran on ‘Human Resource Management’. This research is not new but will still have resonance in many firms today. He sets out how the focus on individual rewards may result in:

- Employees learning that political efforts may be rewarded more than individual performance;
- Teamwork erosion as individuals compete for their rewards;
- Reward systems not contributing overall to organisational performance;
- Short-term rather than longer-term focus; and
- An overall sense of fear rather than teamwork in the workplace.

While recognising that the low growth in profitability will have made necessary the employment of some short-term tactics, these tactics can put in train the sorts of behaviour which will be difficult to unravel as firms gain confidence about the future.

While there have been examples of lessons learned from the last recession – where there was less ‘slash and burn’ – there is evidence of firms de-constructing their approach to people management and again failing to recognise the linkage between remuneration and overall business culture and people management. By making hard financial targets the overwhelming driver in assessment of performance, this somewhat detracts from a more complete and longer-term view of performance – and it is at odds with the desire to be a perpetual business. The measurement of performance, and being clear about what firms value in performance, will set the tone for some time to come.

In some instances, in order to secure their position in the market, organisations are examining their approach to performance management in some detail. This will require nimble and clever management in an intellectually-rich professional environment, where a firm’s competitive advantage is driven by the talent of its people. There is a real tension between the required longer-term focus on career development, firm culture, and creating a pipeline of talent for the future, within the current economic circumstances. To be able to ride out the storm will, and indeed has already, stretched the management capability of many firms. To be able to differentiate around performance, and to do so effectively as a short-term or new measure, is a high risk.

**Performance management systems**

The whole area of performance management is one laden with fads and jargon. Many of the ‘of-the-moment’ systems simply miss the point. At the same time, some HR professionals become fixated with process, the implementation of online appraisals, 360 degree feedback, and whatever else is currently in vogue.

A sound activity for a firm, when considering the effectiveness of its performance management system, is to consider its original purpose, for example:

- Defining objectives and standards;
- Allocating resources and taking action to achieve objectives;
- Analysing and reporting on results; and
- Taking the necessary corrective actions to mitigate risk and ensure success.

Where there is a disconnect between what rewards and behaviours a firm has deemed important through their performance management system, the inevitable result will be less of those identified behaviours being evident within the business.
As stated previously, in difficult economic times, firms have reduced their focus on longer-term objectives and focused, in some instances, purely on the short term. The reduced profitability will mean:

- Resources are allocated towards short-term objectives. The evidence can be seen in firms training fewer people;
- Most partners’ time is focused on the urgency of achieving the next set of results; and
- Short-term success can mask the failure to achieve longer-term goals.

**Linkage with performance**

Evidence suggests that people will do what is measured. There is a crisis of confidence generally about performance-related reward systems. This is perhaps evidence of a failure to see reward, motivation, and business success as a continuum rather than a discrete set of activities:

- People do manage their expectations when faced with difficult economic circumstances;
- Money alone was never the sole reason that people chose to do what they do; and
- Setting out both a plan and a compelling vision for a firm is key to employee motivation.

**Surviving the downturn**

With structural changes to the market affecting many areas of the law, there has been considerable activity around structure, ownership models, and indeed convergence in the market. Chapter 3 will examine some of the implications for reward as a function of a merger. Generally, while growth in salary levels have slowed for most parts of the economy, the proportion of profit consumed by staff cost is still high in the legal sector and therefore when there are pressures on growing the top line, there will be an increased focus on ensuring a maximum return. There are examples throughout the UK, and one can only assume elsewhere, of a number of measures to avoid reducing headcount when demand for services is flat or even declining; sabbaticals, delaying training contracts and, of course, redundancies. The almost silent change which will also have been evident is the removal of partners from firms. This latter point is usually not just for cost but a static partnership is obviously one which will fail to retain pipeline talent and future partners. Labour costs and partner profits are the most pressing issues that firms are dealing with after the pressures on revenues.

There are accelerating pressures to address elements of the support function through off-shoring, outsourcing, and in some cases at least entirely outsourcing back office support. Whether in the city of London or elsewhere in the country, law firms will tend to be concentrated in commercial or financial districts. Geography plays its part in skewing the demand and supply of appropriately qualified individuals and this will have further added to the cost pressures facing managing partners. Such issues, as well as having operational implications for law firms, have a serious impact on firm culture and should not be entered into lightly. Save for partners, it is support staff who often have the most enduring relationships with law firms. This type of change can impact significantly on those partners with the most conservative or paternalistic approach to management. Such a change can chip away at the ‘glue’ in a business and change the culture significantly. The impact of the moves to outsourcing, near and offshore, is rarely considered
in terms of its effect on the culture of a business and particularly one which has stated regularly that everyone contributes to client service.

In the last edition of this report, Skaldany was quoted as capturing the sentiment of employees in difficult times, essentially making the comment that if no more pay is available then firms should ensure that whatever is there is distributed fairly. The features of fairness (that is, transparency, equity, and rational decision making) are not always and should not always necessarily be features of the management style adopted when dealing with reward issues. Therefore the economic situation in terms of internal management will have become a great deal less comfortable for those charged with reaching agreement about salaries and bonuses.

Low growth will have resulted in some scenarios of a greater level of differentiation, and this too poses real problems as firms are then forced to agree what is to be measured and how performance is to be differentiated. Sadly for line managers, as soon as variable pay becomes a larger component of total reward, they are required to exercise judgement and in doing so be seen to be fair and rational – sometimes a tall order.

Some firms have risen to the occasion and increased the pace at which their firm moves to a more corporate style of openness and structure around employee communications, and a more standard and considered approach to remuneration. Others have re-discovered – or perhaps just discovered – that rather than driving up performance, increased use of variable pay can help hold down fixed costs. The wider treatment of employee benefits will also have come under scrutiny for once where various employer insurances were an ‘add on’ but not a very significant cost. This is no longer true and therefore we have also seen the increased use of flexible benefits to both increase employer choice but also in some instances to save cost around insurances. (Flexible benefits are not always a literal translation of the benefit cost to cash and therefore one can, in certain circumstances, hold down costs). Where individuals have a choice they are being more careful about the tax liabilities and sometimes opting for cash rather than expensive insurances for which they place little value.

When businesses are in difficulty or operating in a tough market, they sometimes become much more creative, open, and consultative organisations. Once this has become a feature of the management style it is difficult to revert back to a greater command and control culture. In the future when things do become more positive it would be sad if, where it has been proved to have been a positive development, firms revert to a more traditional style of management.

Albeit private organisations, and therefore the level of disclosure even for those with LLP status is far less onerous than for listed companies, there can be little doubt that in partnerships it will have been noticed that there is a distaste for what are perceived to be very high levels of pay in whatever form. It is perhaps more surprising that those law firms who materially benefited as a direct result of the banking crisis, and those for example involved in the banking sector re-structuring, escaped the wrath of the press and public. As stated earlier, one is forced to ask just how long that will go on, and even in the absence of a legal requirement, whether high level purchasers of the large law firm services will tolerate, during tendering, being denied exposure on PPP levels and the wider cost base in terms of remuneration.
A leap in the dark
In many instances there is a genuine desire to re-shape and define law firms as modern, progressive, and forward thinking while trying to shake off the image of a somewhat outdated and old fashioned profession. The approach to reward will also impact on the perception of law firms in the minds of those considering the law as a career and perhaps more importantly longer term as a legal partner.

Only with the passing of time will there be sufficient evidence to suggest that some of the changes which are being applied in the way law firms are responding to the current economic circumstances are permanent. The broader market and structural changes, however, will demand, in certain circumstances, those firms who have resisted change to respond. The reluctance to address new and different aspects of the employment relationship and the market led demands will be remembered by employees and, perhaps as important, by clients.

The rules of engagement
In the last edition of this report much was made about levels of engagement (engagement refers to the level of discretionary effort, i.e. going above and beyond) and how key this aspect of management is when determining the firm’s ability to deliver excellent service and encourage creativity and innovation. The point was also made that maximising return on investment in all people-related matters was vital in establishing what works and what does not. There is a natural temptation to deem the whole issue of measuring engagement, or its impact on client service, such that it is not considered at all or is measured in fairly crude way and linkage with client satisfaction is often not explored.

One of the key measures employed in measuring engagement is length of service and this is fraught with difficulty as, at the moment, it may be more about lack of alternative opportunities rather than engagement which is driving length of service at a particular firm. Looking solely at or giving too much weight to length of service is simplistic and can lead one to the entirely wrong conclusions about the inherent stickiness of the business and on levels of genuine engagement. This way of examining engagement is hard when up until fairly recent times seniority driven off length of service was the most consistent feature of the approach to reward.

The key to engagement is a convergence of expectations around career progression and reward. There can be little doubt that the pace of career progression has slowed down considerably in the last few years and one might even see the skipping of entire generations in terms of partnership promotions. This, coupled perhaps with slower income growth, could make for a toxic mix in terms of the attitude of employees to the firm, client service, and perhaps even the legal profession as a career choice. It would be extremely naïve of firms to assume that this does not ultimately impact on precisely what is needed to retain and grow the practice – excellent customer service. In short, this period of prolonged flat economic activity will have left many displaced through redundancy, possibly feeling under rewarded as they see the pace of income growth slow down, and perhaps from a partnership perspective a very real negative impact on attitudes towards the likelihood of securing a partnership deal.

The robustness of partnerships is inextricably linked with earnings level, peer group comparison, and perceived ranking with colleagues both outside and within the
firm. This set of circumstances will go right to the heart of how the firm is run and the day to day experience of employees and partners alike. One would not need to be so very cynical to opine the view that, when activities do return to more normal levels, those firms who have not worked hard to maintain relationships and acknowledge that people have had to reshape their expectations (which can be painful) will have failed to maintain a culture conducive to business success. Worse still, when management actions are perceived to be largely driven by expediency rather than strategy, and actions which appear to be solely about creating PPP, firms may experience difficulty. Gratitude in employment is not exactly a thing of the past but it is unwise to assume that maintaining employment levels, possibly even awarding modest salary increases or bonuses, will buy undying love and affection.

Reference