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Pay Pressures

As 2008 progresses, and the banking / capital markets business shows limited signs of bouncing back, firms are struggling to think of ways to deliver a reasonable level of compensation.

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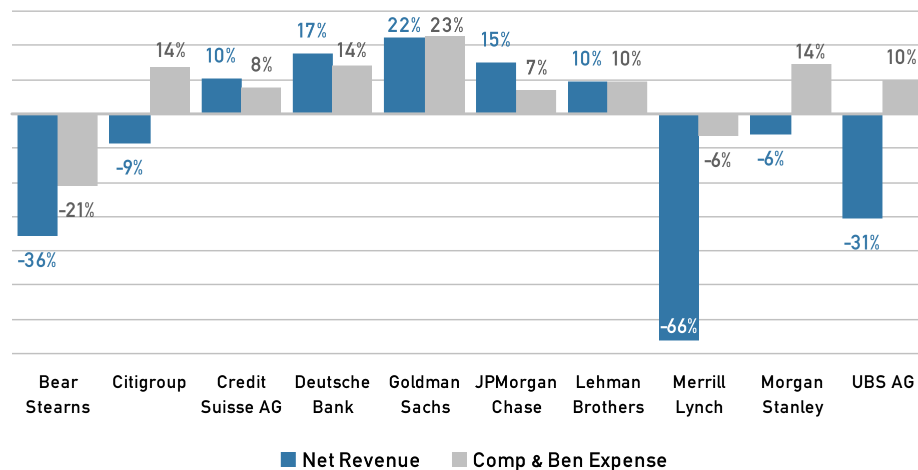
By Warren Rosenstein, Head of Client Business Analysis, McLagan
July 23, 2008

To some degree, this is a problem that is being carried forward from 2007, as many firms did not adjust pay levels downward in a way that corresponded to business results. Payout ratios, which have largely been a constant for mature businesses, increased in unprecedented and unsustainable ways:

2006 to 2007 Firm Wide Change



The general pay pressures that will likely exist based on poor performance in 2008 will be compounded by: timing of write downs, charges for extraordinary awards granted in 2007, and severance charges associated with 2007 staff reductions, being booked in 2008. While these factors all add up to a very difficult situation, on the positive side, firms generally have a limited number of guarantees to satisfy in 2008, some non-banking/ capital Markets businesses have performed well, and employee expectations are largely down. Also, a greater focus on firm wide performance at some firms may allow for greater flexibility.

HISTORIC MEASURES VS. ALTERNATIVE APPROACHES

This is not the first large scale down cycle we have observed, and there are measures that firms traditionally take in these business environments: downsizing staff, reducing pay levels, increasing funding rates, and increasing long-term deferrals. We will review some of these measures, but also try to shift the focus to different approaches, that may be less obvious.

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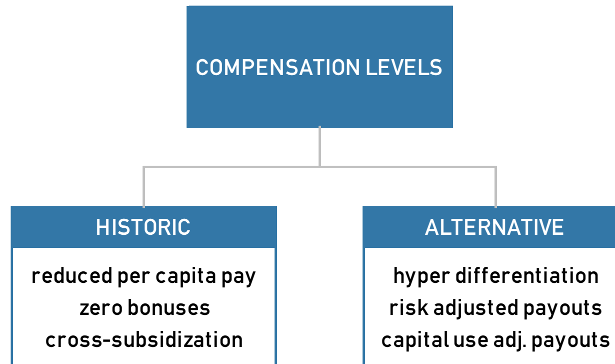
These approaches are being offered in the spirit of opening a dialogue on how to “weather the storm”—these may not be useful to all firms in all situations.



COMPENSATION LEVELS

While this wasn’t as evident as may have been expected in 2007, firms typically pay employees down in a year with poor business results. In 2001, the last large downturn, firms not only paid employees down, but actually made use of “zero bonuses” to a limited number of employees. This was a time when multi-year guarantees were more prevalent, leaving firms with very small discretionary spends in their bonus pools. Firms’ compensation resources are less encumbered in 2008 with respect to guarantees, but a different set of challenges exist.

While the cash equities business foundered in 2001, firms did not have the kind of losses that existed in 2007. There was certainly no event comparable to the collapse of Bear Stearns. While the outsized losses in 2007 were significant, of equal concern for 2008 is the heightened competition from other types of firms and industries, most notably hedge funds and private equity shops in financial services, and a host of other firms in infrastructure areas (pharmaceuticals, law firms, consulting firms, etc.). These firms are poised to lure away top talent, if compensation levels dip too low.

Firms have relied on cross-subsidization in previous down cycles, to help mitigate pay pressures for underperforming businesses. In the most recent down cycle, fixed income was able to foot the bill for investment banking and equities. The size and scope of the losses in fixed income in 2007 cannot be covered by a robust equities business. Likewise, investment banking, which trailed off in the 4th quarter of 2007, does not appear to be positioned to make a significant contribution in this regard.

ALTERNATIVE APPROACH: HYPER DIFFERENTIATION

While most firms think of themselves as “meritocracies”, and believe that they differentiate pay based on performance, statistically, this has not always been the case. Having observed extensive pay and business performance data, it is clear that many firms do not differentiate pay to the degree they believe they do. Further inspection of this data reveals that successful business results appear highly correlated with pay differentiation.

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Early in the compensation cycle, before the typical bonus process begins, firms can do a forced ranking (this likely has already been done in connection with layoffs) to determine who the real performers are at each level, in each line of business. Firms have little choice but to use hyper differentiation, which may amount to rewarding top performers roughly flat, to protect against poaching from other firms, but taking huge chunks of money away not just from poor performers, but from average ones. What follows is a hypothetical example of hyper differentiation. Note the difference in quartile spreads between 2007 and 2008:

	2007	2008
Employee 1	2,500,000	2,500,000
Employee 2	2,400,000	2,160,000
Employee 3	2,300,000	1,840,000
Employee 4	2,200,000	1,540,000
Employee 5	2,100,000	1,260,000
Employee 6	2,000,000	1,000,000
Employee 7	1,900,000	855,000
Employee 8	1,800,000	720,000
Employee 9	1,700,000	595,000
Employee 10	1,600,000	480,000
Employee 11	1,500,000	375,000
Employee 12	1,400,000	280,000
	23,400,000	13,605,000
High Quartile	2,225,000	1,615,000
Low Quartile	1,675,000	566,250
Spread	33%	185%

This approach needs to be conducted in tandem with determining what is the reasonable skeleton crew that must be kept intact, before you are “exiting the business”, as it is likely that some of the lesser paid staff will leave as a result. This method may also create some downward pay pressures across titles, as the low end of the spectrum for senior staff may cross the high end for intermediate staff. And this may be appropriate.

FUNDING RATES

Firms typically manage to a fairly specific global funding rate, often compensation and benefits as a percentage of net revenue. There are certain standard assumptions in this regard: a mature business will have a lower payout ratio than an emerging one, a firm more focused on banking / capital markets will have a higher ratio than a firm more broadly focused, etc. Firms that are concerned with cost control will look at metrics that factor in non-compensation expenses, to encourage good stewardship of resources. The ability to look at these rates at the business/product level, rather than on a firm wide basis allows for greater precision in making pay decisions. A subsequent McLagan Alert written by Michael Burke, an industry thought leader on this topic, will provide more color on this point.

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While the review of global payout ratios is commonplace, what is not typical is looking at risk-adjusted or capital use-adjusted payout ratios.

While global investment banks often have firm wide payout ratios between 42% – 48%, these ratios are really, in effect, an amalgamation of many individual business payout ratios. While some firms don't manage to specific payout ratios per line of business, when they do, these ratios are rarely risk adjusted, or adjusted to account for capital usage.

ALTERNATIVE APPROACH: ADJUSTED PAYOUT RATES

Firms would benefit from assessing payout ratios per line of business. While this happens in some instances, many firms manage to a "top down" funding rate across the firm, but use "bottoms up" in determining pools for individual lines of business. Managing to payout ratios in individual lines of business will also help make it clear which businesses may be ripe for exiting. But beyond this, firms should consider looking at risk-adjusted / capital use-adjusted ratios.

Two different lines of business may each need 45% of revenue to cover compensation and benefits expenses, but one line may have much greater capital requirements, or cause the firm to incur a much higher level of risk, in order to generate that revenue. An obvious example of this would be contrasting an M&A group with a prop trading desk. While both firms may be compensated based on a similar payout ratio, the M&A group's worst case scenario is fundamentally different from that of the prop trading desk. And based on a "current year" funding mindset, the prop trading desk takes no incremental charge for that risk. Until something goes wrong, at which point, zero bonuses alone may not repair the loss.

Firms would be well-advised to look across businesses, assessing how much capital is being used, how much risk is being taken, and then align payouts to the size of these factors, as well as the potential duration of the settlement of the underlying transactions. The "holdbacks" associated with these factors would not be withheld in perpetuity, and decrease the ultimate payouts, but rather, be "trued up" at a timing consistent with the settlement cycle of positions typically taken. What follows is a hypothetical example of how this can work, across two lines of business. The numbers are purely illustrative, and note that the holdback would be delivered in time, barring a loss:

Current Year Model			
	Revenue	Payout Ratio	Payout
M&A	1,000,000	42.50%	425,000
Prop Trading	1,000,000	42.50%	425,000

Risk-Adjusted Model				
	Revenue	Payout Ratio	Risk Holdback	Payout
M&A	1,000,000	40.00%	2.50%	400,000
Prop Trading	1,000,000	32.50%	10.00%	325,000

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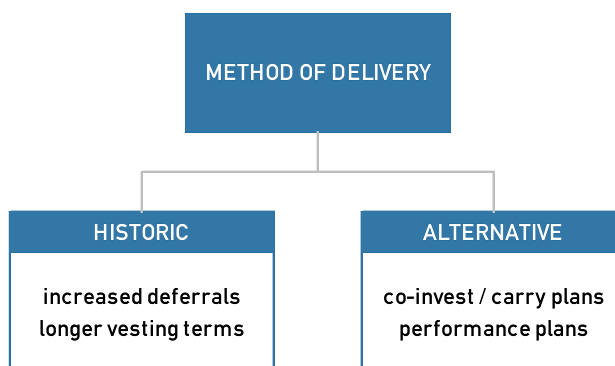

METHOD OF DELIVERY

Firms sometimes deliver higher levels of equity in more challenging pay environments. In 2007, a small number of firms made significant changes to their deferral plans, but for the most part, changes were limited, and usually affected senior staff. Firms may consider delivering significantly more long-term awards in 2008; however, not all firms have an unlimited amount of shares available, and the issue of retaining talent could become pertinent, as employees with portable skills could consider moving either outside financial services or to other types of firms within financial services (hedge funds) where there is more current-year cash.

While increasing deferrals solves some of the short-term problem in terms of firms' cash flow, most large firms may be delivering restricted stock units out of force of habit, rather than strategic thinking. Firms often cite their equity deferral plans as "aligning employee and shareholder interests", or "creating a retention vehicle", but does this really work? Does anyone but the senior-most employees really have the ability to drive the share price at a large investment bank? And haven't buyouts become so commonplace, that the risk of forfeiting equity awards has started to feel like no risk at all? Finally, in today's environment, equity may be perceived by some as a devalued currency.

ALTERNATIVE APPROACH: CO-INVEST/CARRY STYLE COMP PLANS

Firms have used co-invest and carry plans in the private equity space to link employee fortunes to those of the firm (fund), and even their clients. At hedge funds, fund managers' compensation is highly linked to the appreciation of the fund. This is real alignment of employee and shareholder interests. The kind of alignment that solves another very tangible problem, which is incenting an employee to really own the long-term risk associated with the positions taken.

There is a simplicity and elegance in structuring these plans when associated with a fund, or a transaction: it is easy to know when to payout (upon realization or exit of an investment), easy to measure (performance or returns), and employees generally buy in with little urging. It is more complicated, but perhaps worthwhile, to see how this can be adapted to fit other lines of business.

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The overall performance of a line of business could be thought of, and measured, like a fund. Employees who are accustomed to getting 80% of pay in cash and 20% of pay in company stock could be migrated to a very different model, one in which they still get company stock, but get a larger portion of their bonus in a fund, that tracks the performance of their business. The motivational factor of this would be enormous, as employees could see how the results of their efforts have a substantial impact on the value of their long-term awards. And, like carry plans or co-invest plans, the vesting of these funds could be tailored to coincide with the typical transaction cycle. An employee working primarily in cash products may have a portion of their bonus invested in a fund that vests relatively quickly; an employee working with more complex products, or securitized products may have a portion of their bonus invested in a fund that vests over a longer period of time.

An employee getting 50% of pay in cash, 20% in company stock, and 30% in a fund tracking their business would be appropriately balanced on a long-term / short-term, and personal performance / firm performance. Would this create retention issues, for employees not wanting to invest in their own work? Perhaps, but isn't it better to know which employees don't want to bet on themselves sooner, rather than later? And hasn't the migration to hedge funds, boutiques and other small firms been a sign that employees want more autonomy, and a clearer line of sight between pay and performance? This sort of arrangement would give them that, but also a much higher level of ownership of the risk associated with their transactions. Certainly the question of ownership / fund participation post termination of employment would have to be reviewed, as historic forfeiture provisions from equity deferral plans may not be palatable to employees in this context.

Obviously, this shift would be administratively complicated and may not be easy to implement in 2008. But this may be a starting point to looking at a more efficient way to deliver compensation, particularly long-term awards.

CLOSING

There are no simple answers, and certainly no "one size fits all" solution to the challenges firms will face in 2008. We hope some of the thoughts presented here may be useful, at least as conversation starters. We will be in dialogue with our clients throughout the year, brainstorming, strategizing, and trying to figure out the best way to weather the storm.

We look forward to your feedback and ideas and the chance to work together on this. ■

Warren Rosenstein is Head of Client Business Analysis at McLagan. Mr. Rosenstein works with clients to develop customized analysis strategy across compensation, staffing and productivity. He has provided solutions for a variety of client needs, including compensation plan design, organization structure and salary strategies.

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