Considering Salary Increases

By Patrick Connell, Brian Dunn and Doris Van Beck
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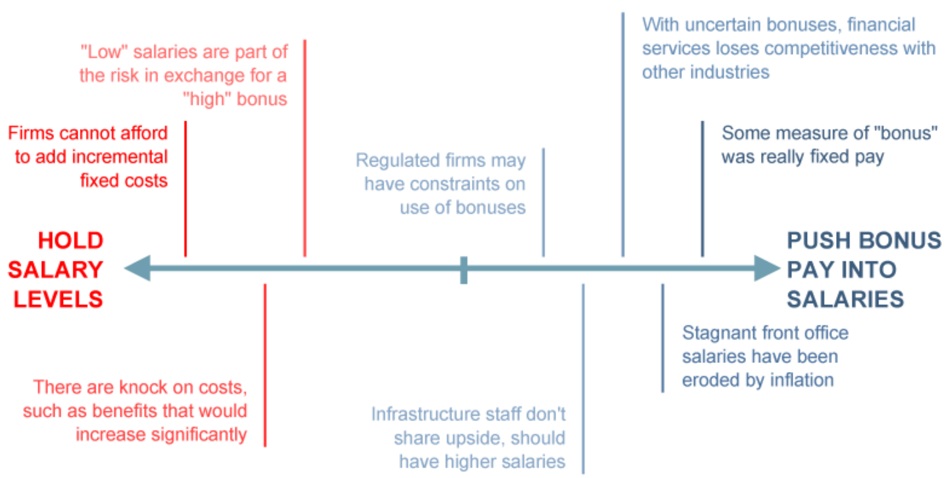
OVERVIEW

There has been lots of talk about increasing salaries in financial institutions. This is particularly surprising given that relative performance is, for the most part, declining.

Since the people raising the issue are neither naive nor stupid, there must be a method behind the madness. When you scratch the surface there are some very good reasons including:

- Proposed legislation that may limit (or eliminate) the ability to pay bonuses, leaving salaries as one of the few tools left to compensate employees.
- An implicit belief that people in financial services have always paid their employees on a total compensation basis and that the delineation between salaries and incentives is somewhat arbitrary. If that is true, it is less of an issue to move the line and reset the pay mix.
- The thought that a firm can actually save money by trading incentive opportunities for fixed compensation at a reasonable discount rate. In other words, we take away $2 of incentives for every $1 of increased salary. The trick in this environment is to answer: (1) How much of the incentive is real and how much of it is phantom? (2) What is the right exchange rate between incentives and salary?
- Finally, there are firms in crisis that simply need to offer some sort of assurance as to what people will get paid. Increased salaries and guarantees are the way firms are dealing with this challenge.



WHAT ARE THE PRIMARY DRIVERS BEHIND INCREASING SALARIES?

Let's take each of the four rationales listed above, apply them versus the market context and decide if changing salaries really makes any sense for a particular organization.

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1. **Regulation**

   The case for increasing base salaries has gained momentum as various regulatory policies and guidelines have been proposed that would put restrictions on the amount or structure of incentive pay for large classes of employees. These tend to be focused on the highly compensated.

   Firms must consider carefully if pushing money into salaries will be viewed as "gaming the system" and attract additional media, political and shareholder criticism. In fact, the amount of salary increase would have to be so large to offset the loss of incentive pay that it will be nearly impossible to justify. In other words, the increase might be appreciated, but would not be sufficient to keep an executive whole from a market perspective.

   The only situation where this seems feasible is to try and take advantage of a loophole and essentially pay a given year's bonus in 24 bi-monthly installments rather than in a lump sum as it is today. But, before we make any changes based on proposed legislation, we should wait and see what the regulations actually stipulate when they are released. Our view is that more rational thinking is taking hold, and the actual regulations will be more measured and balanced.

2. **Total Reward**

   At many firms, the current mix of pay includes salary, bonus and some sort of deferred pay. For years, many firms have been marketing a "total compensation" or "total reward" approach to their employees, urging employees to consider the value of their entire compensation package and not view the elements discretely.

   This approach to compensation does not necessarily distinguish the bonus as being truly 100% variable and there is often a perceived "floor" on these awards. In these firms, a salary increase is viewed more as a remix of pay than a salary increase. One could argue that a portion of bonus was really "salary in drag" anyway, and they might as well explicitly recognize it. The challenge is to determine what that amount actually is, how much the "knock on" costs are and whether they want to abandon the flexibility afforded by delivering compensation in a lump sum, in arrears. In other words, it is not as simple as taking all or a portion of the bonus and rolling it into salary and calling it a day.

   The total reward approach evolved over a long period of time and served the industry well over a number of cycles. It should not be thrown out as a quick fix. There is, however, an opportunity to carefully remix pay that may have gotten off track when bonuses were big and growing, and there was no need to make sure salaries kept pace. The bottom line is there are some opportunities to clean things up at the margin, but increasing salaries alone will not be a solution.

3. **Incentive Buyouts**

   There are clearly people and positions in many financial institutions that have become bonus eligible with the rationale that all people should have a significant component of their compensation being performance-based. By instituting bonuses, there was no longer any reason to

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differentiate performance through salary increases. The bonus add-on was also justified to reward harder, more demanding work environments and to create an elite esprit de corps that financial institutions wished to espouse.

The hard reality was that this bonus compensation was not really justifiable under real business needs; nevertheless, it became required to "be competitive". Salary levels did tend to be lower in financial services for those with fungible skill-sets that could be applied outside the industry (tech, finance, HR). For these people, largely in staff roles, particularly at junior levels, there may be a trade-off where a nominal salary increase could be used to buy employees out of bonus participation.

A ratio of 50 cents of salary increase for every $1 of bonus could be an excellent trade for companies and employees who value security over opportunity. Remember though that this will re-institute the pressure to reward future performance through real "merit" increases.

4. Companies in Crisis

Obviously when a company is fighting for its survival, it must do whatever is necessary to secure the best people possible to keep the ship afloat and to turn it back toward profitability. In those situations, there is no question that flexibility regarding salary is paramount.

In crisis situations, large salary increases – to the right people – are an entirely justified and wholly appropriate tool in the arsenal of the Board and management to get and keep the people that will drive the turnaround effort. High salaries alone will not be sufficient over time, but in concert with effectively designed long-term incentives, base pay can help get the job done. From an economic standpoint, salary is a very efficient form of compensation given the high discount rate applied to variable compensation in a challenged environment.

OTHER CONSIDERATIONS

1. "Health" of Firms

The financial stability of some firms is being questioned, contributing directly to the pressure they are feeling to make adjustments to salary (and pay mix). Firms that are poorly capitalized or potentially facing declining revenues / losses may not be able to afford to pay incentives, or at least not to the extent that they have historically. These firms are feeling tremendous pressure to ensure that their salaries are at least at market levels, if not above, in order to retain talent. The conundrum is that they are in a weak position to afford increased fixed costs.

On the other hand, well capitalized firms that are profitable are at an advantage and have more options on structure of pay. These firms can play up their capacity to pay incentives and use this to attract key talent. They also have more flexibility in adhering to a total compensation / reward model, as there are fewer questions about their ability to pay incentives. These firms should carefully consider the advisability of increasing fixed costs.

2. **Deleveraging of the Industry**
The deleveraging of the industry will put a downward bias on overall compensation levels. As employees perceive that upside potential has been reduced, firms are feeling pressure to provide employees with greater transparency around compensation opportunities. Firms must consider whether increasing salaries is the best way to provide this transparency.

3. **Inflation**
Salaries for officers have been largely static in the Banking / Capital Markets space for several years. There has been little pressure to give "cost of living" or "inflationary" increases, as there was a presumption that cash bonuses would compensate for salaries with less real purchasing power.

   In an environment with uncertain cash bonus levels, it may be sensible to consider if salaries represent the base level of compensation appropriate for the inherent requirements and location of the job while allowing for a fully-flexible incentive program.

4. **Flexibility**
Flexibility is important and there are real dangers to increasing fixed costs. Additionally, memories tend to be short, and with a hopeful return to prosperous times, expectations of historic bonus levels will creep back. Firms would need to be extremely diligent to maintain a new pay mix paradigm.

5. **Shotgun or Rifle Shot**
Before determining who should get a salary increase, it is important to conduct an overall assessment of compensation competitiveness across the organization to better understand salary and incentive positioning. A targeted approach is almost always preferable.

   For infrastructure staff, firms should consider how much upside opportunity staff really have in a profitable year, whether they really have the ability to drive overall firm performance and if the incentive plan truly drives positive behavior. Many infrastructure areas have a skill set that is portable to other competing industries. If salary levels are not competitive with these industries, there may be a drain on talent, as employees perceive a reduction in the historic overall pay premium for financial services. A true shift in mix of pay may work best for this group.

   For revenue areas, firms should consider the type of business (high vs. low risk, high margin vs. low margin, capital vs. non-capital intensive) and focus on the right mix of pay (short-term cash vs. long-term) more than on increasing salary levels. There are greater strategic opportunities to align pay and performance than simply increasing fixed pay.

   Finally, there are real international considerations and union issues that must be considered when adjusting salaries. These should be understood and considered before any action is taken.

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CONCLUSION

While not unexpected, the call for salary increases could not have come at a worse time, as de-levered financial firms are likely to continue experiencing reduced earnings potential. The reduced earnings and incentive opportunities will only reinforce employee pressure to increase salary. This feedback loop highlights the argument **against** salary increases—the issue isn't a pay problem; it's a performance problem.

Another argument against increasing salaries is that in the short-term, external employment opportunities and the need for salary increases for solid performers is low. Having said this, in any environment, the best talent essential to the business is always able to find new opportunities.

If incentives appear to be depressed on a more permanent basis and no salary increases are made, the concern is that some employees may reduce effort and loyalty, creating an adversarial employer-employee relationship. Employees also have real concerns about salary and "secure" pay, such as their ability to meet mortgage / rent, tuition and normal living expenses, particularly in high-cost financial centers.

This may not be viewed as the employer's problem initially, but it will be if pay fails to attract, retain and motivate the "right" employees. Firms need to carefully consider if salary increases are truly required to attract, retain and motivate employees or if there are other ways to do this that do not increase "fixed costs"—including more transparency on overall potential opportunity, other benefit enhancements, etc.

The decision to maintain or increase existing salaries must be made with the specific constraints and needs of each firm in mind and cannot be done without consideration of incentive philosophy / opportunity. The decision is too important to make in a knee jerk fashion. There are real justifications to make systematic salary adjustments—but they are limited. ■

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