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# Will There Be a Lasting Reset in Pay Levels?

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Duxbury, MA 02332
Tel: +1 781 934 8400

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Chicago, IL 60601-6421
Tel: +1 312 381 9700

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Dubai International Financial Centre
Currency House | Tower 2, Level 5
P.O. Box 506706
Dubai, United Arab Emirates
Tel: +971 (4) 389 6444

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381 Huai Hai Road Middle
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**STAMFORD** (Headquarters)
1600 Summer Street, Suite 601
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Tel: +1 203 359 2878

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Akasaka Twin Tower, 16th Floor
17-22, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
Japan
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**By Warren Rosenstein, Blake Kerrick and Doris Van Beck**

## Overview

As banks begin to make their year-end pay decisions, it is clear that incentive pay for employees across investment banking, equities and fixed income will decrease at most firms, particularly the largest ones. Veterans of compensation management know that pay tends to be cyclical and closely aligned to business performance, and that it takes a discerning eye to differentiate between a typical cyclical variance and an actual reset, which is far less common.

In looking at the current year-end process, we see a variety of factors depressing pay: a stagnant economy, political pressure / the need to deliver greater shareholder returns, the European debt crisis, the elimination of prop trading, and deleveraging due to increased capital requirements. All of these factors will lead to decreased pay levels for banking and capital markets employees; however, the question of whether we are experiencing a down cycle versus a reset remains.

The first three factors mentioned above are ones that will likely work their way through the system over time, and then recede. The economy will inevitably bounce back and the various other pressures and crises will resolve themselves without creating a fundamentally different revenue (and thus compensation) opportunity for most banks. However, the last two factors, the elimination of prop trading and the deleveraging of firms, are likely to have lasting effects on both business structure and pay for certain groups of employees.

As firms are compelled to use capital more sparingly, they will also strengthen links between pay rates, capital usage and the risk profile of businesses. For businesses like asset management or wealth management, the impact will be limited – these businesses do not commit significant capital, and will not experience a reset in pay levels as the result of deleveraging or loss of trading profits. Interestingly, corporate banking, which is highly focused on lending firms' capital, will likely not have a reset either, as cost of funds, loan loss provisions and other metrics that acknowledge the use and inherent risk of committing capital have always been integral to the pay equation. In this regard, the lending businesses have already come of age in setting compensation levels based on capital usage.

In somewhat stark contrast is the banking and capital markets business. While firms were realizing enormous profits from mark-to-market snapshot views of transactions, compensation was linked primarily to revenue with limited focus on metrics like

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return on risk-weighted assets (RORWA), which is now a fundamental metric for measuring performance. Because of the shift away from pure revenue metrics for determining performance, there will be some degree of reset for pay levels in this area. If firms are committing significantly less capital, generating less profit, and forging a stronger link between pay and RORWA, pay will simply come down. The questions are less about whether there will be a reset, but rather, how big, how broad, and what will be the consequences of the coming action?

## Will this affect all roles in banking / capital markets?

This is a question that is difficult to answer simply. The closest thing to a straightforward answer would be to say that the downward pressure on pay will likely be proportionate to the amount and risk profile of capital required to conduct the business. To be clear, employees doing M&A advisory work will see less of a reset assuming that they can generate fees without providing capital (a big assumption). The other variable in this equation is the portability of the skill set: M&A bankers can easily find other opportunities, or open their own shops much more readily than those who underwrite debt or equity offerings that require funding. It is also worth noting that there are a substantial number of firms focused purely, or primarily on M&A activity that would be happy to pick off top talent from the largest firms, should these firms cut pay too deeply. While this set of boutique and middle market firms do not have the capacity to hire away all of these bankers, they do have the capacity to hire away the most talented, which would be consequential.

Further review of the profitability and RORWA within lines of business will not only drive the reset of pay levels for employees in sales and trading; it will also drive firms' long-term business strategies. And in this brave new world of RORWA, it will be even more critical to benchmark these metrics so that firms can better understand what it really means for a business to perform well.

So, what does this mean for pay rates in sales and trading? Again, the sensitivity will be linked to the capital committed. Employees trading on behalf of clients and not taking long positions may see payouts equal to those of the past. Employees engaged in complex derivative transactions that tie-up large swaths of capital with uncertain valuation and long settlement horizons will inevitably see a decrease in pay as these businesses are rationalized and leverage is cut. Headcount reductions in these areas may offset the lower risk-adjusted profits to allow per capita pay to rebound eventually, but pay rates for large teams within firms maintaining scale are unlikely to bounce back any time soon.

Employees engaged in equity and debt capital markets may see some downward pressure on pay, but not a long-term significant downward reset – the money committed by firms in these transactions is limited, and the downside risks are easy to quantify and understand.

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### If banking / capital markets revenue shrinks how material is this?

Deleveraging could reduce overall revenue expectations for the largest global banks by about 5%. Banking and capital markets accounts for roughly 35-40% of firm revenue on average, with fixed income comprising half of BCM revenue for a typical firm (or 15-20% of overall revenue). Given the limited ability for firms to reduce non-compensation costs, a 5% revenue decline will have a significant impact on profitability and resulting compensation spend (approximately 10% lower compensation spend required to maintain the new, lower profit margins). Non-global banks will be less impacted because investment banking and sales and trading comprise a smaller portion of their overall revenues and their business models tend to be less leveraged.

### Will this change the banking / capital markets competitive landscape?

Given the current and proposed regulatory guidelines, banks will continue to focus on low capital businesses and generate less revenue on their principal activities. This could result in more firms focused on “flight-to-safety” products, thereby increasing competition and eroding margins. Some firms will become smaller as they choose to de-emphasize or exit certain products, while other firms will maintain their size or become larger as they maximize scale, particularly in flow products. Getting the balance right between product focus and optimizing client revenues will be key. In either case, the market will be impacted by having fewer and / or more concentrated specialist staff across business areas. Additionally, new entrants will continue to emerge and along with 2nd tier organizations will look to capitalize on opportunities. These factors will maintain competitive pay pressure for high performing staff with a diverse set of employment choices; however, the inability for many firms to return to historic profit margins, particularly the largest global banks, will keep pay levels from returning to record levels.

### What are some strategies for firms to help cope with the new environment?

Firms will focus on their future business models when making difficult year-end decisions, to ensure these are aligned. In looking for ways to better link performance and reward, and maximize margins, firms should challenge some of the historical conventions:

- **Measures of performance –** The highest profit margins do not necessarily coincide with the products that yield the best returns; is reward aligned with performance metrics based on return on risk-weighted assets (rather than revenue or profit)?
- **Franchise value versus individual value –** Are the funding rates for products that are largely driven by the franchise (e.g., flow FX / Rates) set appropriately to reflect this, and are they aligned to firm-wide performance in addition to product performance alone?

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- **Mix of front office roles –** Does the headcount and cost in each role (sales, trading, research, relationship management, etc.) make sense versus firm and client value? Should the mix of staff be adjusted to have a greater focus on client-facing roles in the new business model? How should client penetration/market share versus product P&L be considered in measuring performance?
- **Entry level talent plan –** Does the model of paying very high wages to analysts and then encouraging them to leave the firm after three years make fiscal sense?
- **Pay premium for each title –** Should there only be incremental rewards for progression through the organization, where high pay levels are not achieved until there are significant contributions from an employee? Does the percent of spend per title align to the incremental contribution by title?

### What is the likely outcome of all of this?

There is likely to be a smaller group of organizations that successfully navigate this difficult environment and emerge as the leading global banks. They are the ones that will have successfully balanced risk and returns. Higher capital requirements, elimination of proprietary trading and limited ability to achieve outsized returns, coupled with the need to build capital and boost shareholder return and ROE, will impact aggregate compensation funding for employees.

Firm-wide compensation spend and the focus on sharing rates between employees and shareholders will temper pay even as firms focus on bottom up performance and reward at the product and division level. Over time, firms will adjust their business models and smaller teams in capital intensive businesses may reach pay levels well above this year. Likewise, favorable market environments in flow businesses may result in years of higher pay for key performers in these products. However, the per capita pay opportunity in aggregate and over time will be far below the high water mark of 2005-2007.

This broad pay reset will require organizations to focus more than ever before on aligning performance and reward, determining the 'right' performance metrics, and identifying how they differ by business area. The greater alignment of performance and reward will by nature create greater pay differentiation across firms and within a firm (across products and individuals).

This reset does not necessarily translate into reduced pay levels for all individuals, but does mean lower pay for the average performer. Greater differentiation by business based on risk-adjusted returns and significant divergence in pay between the highest performers and average performers will be required to attract and retain key staff while balancing pay with shareholder returns.

## ABOUT THE AUTHORS

**Warren Rosenstein** is a Principal at McLagan. Mr. Rosenstein has authored numerous articles and whitepapers, most recently in *the Conference Board Review* and *The Secured Lender*. He can be reached at (203) 602-1205 or warren.rosenstein@mclagan.com.

**Blake Kerrick** is the Head of Banking and Capital Markets at McLagan. In this role, Mr. Kerrick provides performance and reward consulting services to the leading global banks and securities firms, regional banks and broker-dealers, and commodity trading firms. He can be reached at (203) 602-1239 or bkerrick@mclagan.com.

**Doris Van Beck** is the Chief Operating Officer at McLagan. Ms. Van Beck focuses on global compensation surveys, market practice studies and incentive plan design for leading banks and securities firms. She can be reached at (203) 602-1208 or dvanbeck@mclagan.com.

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33 Railroad Avenue
Duxbury, MA 02332
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200 East Randolph Street, 10th Floor
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