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Infrastructure Pay Update: Rebalancing Value

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In a previous article, we discussed how banks largely “back into” funding incentive pay for their Infrastructure or support groups. Many firms use hard financial metrics to measure performance and create incentive funding in their revenue generating areas, and only after these obligations have been satisfied, divide up the balance for the Infrastructure groups.

While there will always be a differential between Front Office and Infrastructure (Back Office) pay, at some banks we may be seeing some early indications of change, both in terms of reducing the differential but also in giving greater attention to getting Infrastructure pay “right” for the current market.

Consider the following…

BALANCE OF VALUE

There has long been a gap in pay levels between Front Office staff and Infrastructure employees—this has been a fact of life. If we examine the reasons behind it, they seems fairly straightforward, and consistent with how we think about what is considered in compensation decisions:

- Ultimate contribution to the bottom line
- Scarcity / Need of skill set
- Ability for talent to go elsewhere

Said simply, in the past, it has long been clear that a high-producing trader makes a greater contribution to the firm’s bottom line than an accountant of similar seniority. There are fewer traders to be found, the demand for a successful trader is high, and if you don’t reward the traders, they can go to a hedge fund. Perhaps the only place in this equation where the accountant has more value is in the broader number of opportunities he or she may have outside financial services.

ULTIMATE CONTRIBUTION TO BOTTOM LINE

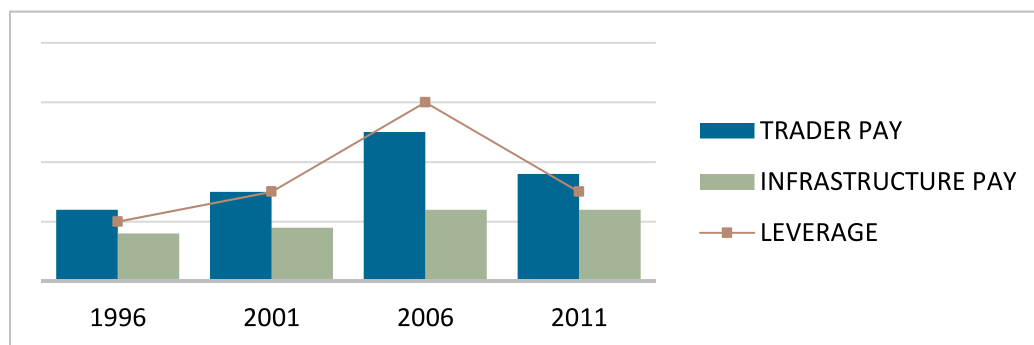
In the current environment of increased regulation and a deleveraged business model, pay trends for banks are changing as the balance of value has changed over time. With traders overall having less access to capital, making safer bets, and having less proprietary activity, it is likely that their contribution to the bottom line will be somewhat muted on a relative basis, at least compared to years like 2006 and 2007.

On the other hand, while more difficult to quantify, one can certainly make the case that the contribution to the bottom line by Infrastructure groups has grown significantly in the past three years. As firms are more heavily regulated,

Infrastructure staff have a greater role in helping firms navigate these new and challenging waters and indeed making sure they stay in business. Control areas like Compliance, Risk & Audit now have a more important seat at the table, and staff who do these jobs well (not just preventing transactions, but helping facilitate business and steering towards successful risk-taking) make a greater contribution to firms' bottom lines than they did in the past.

Consider this figurative representation of how deleveraging may tighten the gap between Front Office and Infrastructure pay:

Figurative Illustration of Link between Leverage and Front Office / Infra Pay Spread



SCARCITY / NEED OF SKILLSET

As we all know, the laws of supply and demand are as present in rewarding talent as in any other aspect of business. We have seen trends of scarcity where highly sought after talent has caused great spikes and declines in pay in a way that is not always linked explicitly to contribution (consider the steep rise, steep fall and modest rise of the perceived value of an Equity Research Analyst over the last 10 years).

As some firms shed or reduce proprietary focus and also look to make headcount reductions as a reaction to reduced revenue, the scarcity of the Front Office skill set may not be as pronounced as in the past. While there will always be a competitive appetite for high performing Front Office talent, the scarcity of high performing risk managers and also experienced compliance staff will upwardly impact their compensation.

In addition to risk management, there are several IT roles where deep knowledge of financial markets theory and quantitative techniques are required. Builders of models for algorithmic trading and valuation / pricing of derivatives are just as valuable as the traders themselves and, in some banks, are now paid accordingly.

ABILITY FOR TALENT TO GO ELSEWHERE

It has long been understood that Infrastructure staff have one small advantage over their Front Office colleagues: their skill set is more portable. Consider an example of two employees: the salesperson who sells interest rate swaps and the lawyer. It is

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easy to see how the lawyer could quickly find employment in other industries, but the interest rate swap salesperson may have a longer period of adjustment, and would likely not be paid the same premium in another industry.

As you look across the Infrastructure areas, many of the functions translate easily to other industries: Audit, Accounting, Human Resources, Legal, Communications & Marketing, Information Technology, etc. Should we experience shrinkage in financial services, these employees should have more immediate options outside the industry. However, this is not always the case and the greater need for technical and more focused product knowledge has meant recently that Infrastructure staff tend to stay in financial services or, if they do leave, work for a company that just supplies them back as “experienced consultants”.

EARLY INDICATIONS OF NARROWING DIFFERENTIALS

In our recent discussions with strategy, compensation and HR staff across the industry, it has been interesting to note that while there have been some bleak predictions around Front Office pay, at least for some business areas, we have been hearing more optimistic predictions around Infrastructure pay.

Let’s consider why:

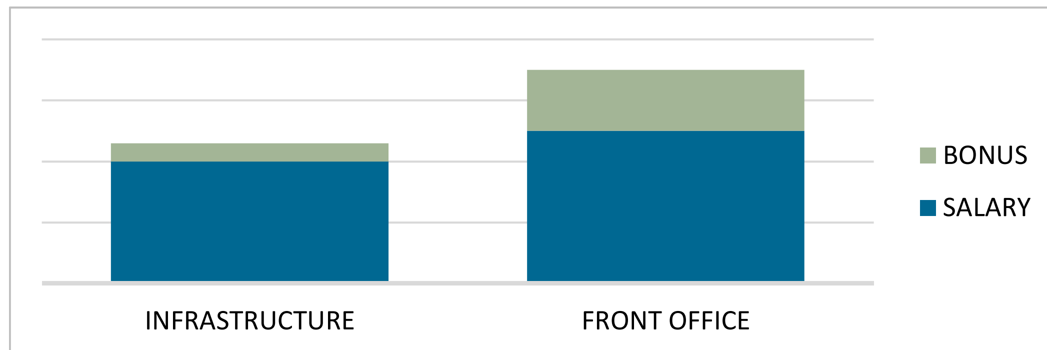
- Greater focus on fixed pay makes cuts difficult
- Reduced impact of bonus pool cuts on Infrastructure
- Impact of salary rises and freezes
- Less top-heavy staffing model

GREATER FOCUS ON FIXED PAY MAKES CUTS DIFFICULT

Infrastructure staff have typically received a large portion of their total compensation in salary. Recently, some firms have shifted more pay into salary and less into bonuses, resulting in a mix of pay that is even more heavily weighted towards salary (roughly 80:20), thus it is significantly harder to decrease Infrastructure total compensation in a bad year, particularly for employees that had a salary increase at the outset.

Consider the example of an operations manager who in 2010 had an $80K salary and a $20k bonus. Assume this manager received a 5% salary rise at the start of 2011. In order to keep this employee’s total compensation flat, it would require a bonus reduction of 20% (4K USD), while reducing their total compensation by more than 16% would be impossible!

Figurative Illustration of Limited Opportunity to Decrease Infrastructure Incentive Pay



REDUCED IMPACT OF BONUS POOL CUTS ON INFRASTRUCTURE

In good years, Front Office incentive pools grow in proportion to revenue, while Infrastructure pools tend to increase more conservatively. The same dampened volatility happens in a low performing year. As an example, a 10% decrease in Front Office pools may result in only a 3% to 5% cut to the Infrastructure pool.

EFFECTIVE IMPACT OF SALARY RISES AND FREEZES

For many years, most firms have managed salary rises on a "budget" basis, and while some firms have discrete budgets for merit / cost of living and promotions, many firms have a single budget over both Infrastructure and the Front Office.

In Infrastructure areas, where there are relatively more junior employees, most of the budget gets distributed on a "cost of living" or "merit" basis. This is particularly crucial when inflation is high, as in 2011. While there are also promotion costs for this group, they represent a small portion of the salary spend, as the salary steps below Vice President are smaller.

In Front Office areas, where the population tends to be more senior or top-heavy, the salary steps between officer titles are much larger, and so much of the salary budget is used to give promotion increases which do not impact the underlying pay scales. Additionally, in a down year, many banks will implement a salary freeze for senior staff which will impact the Front Office more than Infrastructure.

LESS TOP-HEAVY STAFFING MODEL

As mentioned above, the relative staffing of most Infrastructure areas is more junior than the Front Office, and thus, less costly. While senior staff in Infrastructure areas will be as vulnerable to cuts in bonuses this year as their Front Office counterparts, the small size of this group (e.g., less than 1% of Information Technology staff are MDs) will mean that the likely total compensation decrease for Infrastructure may remain relatively low.

That having been said, it is worth reviewing a hypothetical view of what "flat" total compensation might look like for Infrastructure pay—the relatively small group of

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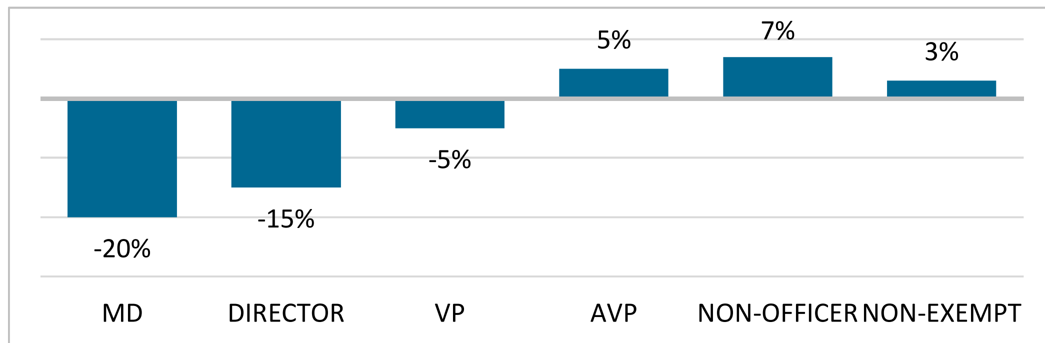
officers would have to come down significantly to fund increases for the large group of junior employees. It should also be noted that truly essential, scarce and high performing Infrastructure roles, e.g., Head of Risk, other key control function leaders, may have their pay protected.

Figurative Illustration of What Overall "Flat" Total Compensation May Look Like Across Titles



CONCLUSION

So, while firms have been talking about layoffs, we have been surprised to also hear of intact salary budgets (2% to 4%) and only modest decreases in Infrastructure pay. Given the reasons cited above, these pay forecasts begin to make some sense. Obviously, things tend to move quickly as we get closer to year end, and pay predictions can deteriorate, for Infrastructure AND Front Office staff alike.

It does seem reasonable to think that in the near future, we may see a continued trend of pay levels narrowing between Front Office and Infrastructure staff, though it would also be short-sighted to underestimate the ability of the Front Office to find new ways to make money and thus get rewarded for these contributions.

ABOUT THE AUTHORS

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