Reforming Wall Street Pay

By Brian Dunn
April 10, 2012

OVERVIEW

The noise around "Wall Street" pay is deafening. The industry, its employees and the regulators are under daily attack. The criticisms, while loud, are not particularly constructive. The purpose of this paper is to separate fact from fiction, to distinguish the naive from the realistic and to level set the kinds of reforms that are both necessary and practical.

THE LANDSCAPE

Increased scrutiny and regulation of the financial services industry is a fact of life. Firms can choose to institute reform or they can be regulated to do so. If firms find themselves in a position where they are playing catch up to regulations, they will find the result cumbersome at best or, more likely, destructive to the long term value of the enterprise. It is, therefore, in the bank's best interest to proactively make reforms that are likely to be compliant while preserving the culture and motivation that are critical to the industry. These self-instituted reforms will go a long way in the eyes of both regulators and shareholders. This is no easy task as the regulations confronting global financial institutions are incomplete, contradictory across jurisdictions and often impractical and contrary to sound compensation management. Having said that, it is best to understand the intention of the new regulations and construct programs that pass regulatory muster, while maintaining the goal of attracting the best to the industry and directing their actions to the ultimate benefit of shareholders.

While there are still a number of challenges ahead, we need to give credit where credit is due. Many financial institutions have already made a number of reforms and are having conversations at the top management and board level about how to better align compensation with shareholders' interests. Many firms have increased their deferral percentages in addition to decreasing total compensation costs over the past three years. Sharing rates have decreased and firms are increasingly factoring metrics like the return on risk weighted assets or the economic value-added into business line incentive plans. These are all steps in the right direction, and firms need to continue down this path.

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THE STATE OF PLAY

The perceptions surrounding "Wall Street" pay are numerous and often inflammatory. While one can argue that these perceptions are either untrue or limited to a few bad apples, the fact is that they are widely held and usually have some basis in fact.

- Pay in financial services favors the employee over the shareholder. This perception is based on a number of observations:
  - In good years, banks pay a percent of the upside and, in bad years, they pay "competitively"
  - Because there are no barriers to free and fluid movement of staff, banks must always pay at least the market rate if key employees are to be retained
  - The most common benchmark of what someone should be paid this year is what they got paid last year
  - There are no secrets on Wall Street when it comes to pay and, therefore, the market is brutally efficient
- Wall Street acts differently than other industries by giving employees ownership rights without actually owning the company. This view is supported by the fact that:
  - Incentive funding is often expressed as a percent of revenue/profits
  - Revenue producers (i.e., brokers) get a clear line of sight between their results and their pay
- People on Wall Street see themselves as different/better. This observation is based on:
  - The insistence that there are very few people who are qualified to work on Wall Street and that they must come from a very select number of schools and MBA programs
  - The conspicuous consumption that typically follows bonus payouts

Whether these perceptions are broadly true or not, there is no disputing that pay on Wall Street took on a life of its own. The incendiary facts include individual payouts that passed the $100 million mark, multi-year guarantees of millions of dollars that producers received, and social pages that were riddled with examples of excessive purchases or celebrations. Banks were held hostage to minimum levels of pay with the real threat that an employee would go to a competitor. Individuals got credit for generating hundreds of millions of dollars in revenue while leveraging the balance sheet. Even investment bankers who historically were paid for their advice became conduits of the bank's capital. As firms generated outsized profits and stock prices soared, there were few willing to challenge the equation -- it seemed like everyone was winning. The latest financial crisis changed all of this. The question is, have we reached a tipping point where there will be a fundamental restructuring?

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THE WORLD IS CHANGING

There have been many times when it appeared that pay had reached the peak (i.e., Big Bang, the tech bubble) and that there was no way that pay levels could continue increasing. In every one of these cases, we were wrong. So what is different now?

- The vast majority of the "bulge bracket" that were the engines of this compensation juggernaut are either gone or have been acquired by banks. Banks--US or international-- have a different DNA. Even those that survived as independent firms have been reined in by becoming bank holding companies subject to the oversight of the Federal Reserve.
- For the first time there is no major "irrational player" willing to buy their way into the business and prop up pay levels. For many years, commercial banks, insurance companies and other financial institutions were so enamored by the revenues generated by banking and trading that they were lining up to buy their way into the business. No more.
- Regulatory reform around the world has placed a heavy hand on both the earning potential of the securities business and the allowable forms and levels of compensation. In the US, Dodd Frank (including the Volker Rule) has raised capital requirements and severely constrained proprietary trading. The net effect is that firms simply cannot generate nearly as much profit. At the same time, regulators around the world are limiting the form and, sometimes, the level of pay.
- Due to the economic transformation of these firms, there is less "mad money" on Wall Street available to pay exceptionally high bonuses. Less prop trading and less leverage means that there is less money to fund the bonus pools. Stocks have ended their relentless increase in value. Social and political pressures on management and boards have become considerable. It is very hard to justify the rates of pay commanded on Wall Street both individually and collectively. For the first time there is a very healthy "skeptic" in the pay determination process.
- As firms have become bigger and the relationships with customers broader, the individual "ownership" of customers has diminished. In other words, there are fewer and fewer individuals who can claim that they "control" the revenue from customers. This institutionalization of the customer revenue stream has made it more difficult for individuals to demand high levels of compensation.
- The new post-crisis management teams and their boards seem much more willing to call the bluff of employees who threaten to quit if they do not get paid what they want. This is happening for a lot of reasons, not the least of which is that these individuals have few, if any, places to go to get what they want.

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- Based on the experience with equity analysts in the post settlement era, banks have a real example where pay restructuring can work. People got paid less, and yet they remained.

BACK TO THE FUTURE

So, where does that leave us? There is ample evidence that both the environment and justification for change exist. Some of the changes that can and should be made include:

- Start graduate level pay at a "reasonable" level. Looking at other parts of the professional service sector shows that outstanding, highly qualified individuals (the best from so called second tier schools) can be had for much less than the six figure starting salaries commanded by graduates entering the banking sector from top tier schools. Starting with reasonable five digit pay levels for undergraduate and graduate hires will lower the base that has propped up the pay for more experienced associates and directors.
- Pay infrastructure jobs more like their industrial peers. Staff functions—finance, legal, HR, IT, etc.—have all commanded a financial services premium. The notion should be challenged that doing the same job in a different sector should command a premium. While there are clearly cases where specialized skills should command a premium, it is equally true that this premium should not be universally applied. This will likely mean a fundamental shift in the mix of pay where salaries are higher and incentives lower.
- Challenge the notion that pay has to go up in line with revenue. For many years the industry has measured the fairness of pay as a consistent percent of revenue/profits. With more leverage, the rates stayed flat (or even were reduced) but individual pay levels went up exponentially. We must reevaluate the value of employees relative to a more static benchmark as opposed to simply a percent of earnings.
- Understand the perceived value of the various components of pay. For many years the industry has valued cash salary, variable incentives and equity at par and has communicated a total compensation number as a sum of the parts. In today's world, each of those components is valued differently, and there are efficiencies to be gained by maximizing the perceived value of the total package by trading less valued components at a discount for the more valued. In that way, the total perceived value can be increased while the total cost is reduced.
- Reset the "sharing rates" between businesses and the parent to better reflect a truer understanding of: (1) individual versus institutional prominence in the successful execution of the transaction, (2) the cost of capital (broadly defined) required to be in the business and/or execute the transaction and (3) the true risk charge associated with executing the transaction.

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PUTTING IT ALL TOGETHER

We must first recognize that these changes should not be driven by a shift in power allowing the institution to cut the pay of the employees simply because they can. Rather, it must be seen as necessary to ensure the future viability of the institution. Without change, the industry will find that it will suffer a significant decline in profitability and the attendant loss of equity capital. It is preferable to proactively make changes in a thoughtful and deliberate manner rather than having them mandated due to the economic crisis and/or regulatory compliance. Given the choice, self-reform is infinitely preferable to having change mandated by external forces.

A good place to start is the pay model employed by the partnerships that created the industry. These partnerships had the following characteristics:

- Since the partners were spending their own money, they were very judicious in how much they spent on all expenses including entry level and support staff.
- Mid-level employees worked at a discount to their contributions because they believed that the expected value of their career would be quite high if they were to become partners. In other words, those below partners were systematically underpaid relative to their direct contributions while those who achieved the coveted partnership were systematically overpaid relative to their direct contribution. This equation worked because more people below the partnership divide thought they would make it than actually did.
- Partners were wealthy but not rich. In other words, the partners' cash distributions were modest as their wealth was tied up in the firm's capital base and could only be realized post retirement. This had the double benefit of managing cash distributions (and putting a ceiling on non-partner pay) and making the partners very mindful of how that capital was deployed.

In a large global public financial institution, many of these concepts may seem quaint and largely impractical. Not necessarily. Firstly, the notion of critically examining what entry level and non-revenue producers get paid exists today in non-financial public companies. Secondly, target levels of total pay are also possible and practical if mid-level employees see a clear path to success and prosperity. Finally, the regulators are already enforcing that the partners/code staff/covered employees must defer significant portions of their pay.

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CONCLUSION

We need to be mindful not to throw the baby out with the bath water. The banking industry is built upon the backs of creative and highly motivated staff. To attract, retain and motivate the best of the best, the industry must retain the opportunity for outsized pay opportunities. The challenge is: (1) recalibrate what is meant by outsized and (2) systematically limit the rewards to those that actually deserve them. Pay should be adequate for the rest and the gap between those that truly create wealth for the shareholders and those that support the process should be wide enough that there is real motivation to adopt the behaviors and results required to jump the divide. To fund “partner” pay, we must prune the pay levels of all those that support but do not drive the success of the business. Given the fundamental changes facing the industry the time is ripe to reexamine the tenants of the existing pay programs and to create new structures that will carry the industry forward.

ABOUT THE AUTHOR

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