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Re-Aligning Performance / Reward in Investment Banking

By Warren Rosenstein and Steven Hurd
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OVERVIEW

2001 to 2007 was a remarkable time for the investment banking business. Firms felt they could do little wrong, and saw a steady increase in share price, revenue and compensation spend. A new set of professionals came of age in this era and it now appears that some of the rigor in rationalizing pay versus contribution has fallen by the wayside. In this article, we will focus on the investment banking advisory business, although some of the thinking may also apply to other lines of business in the securities sector.

As we evaluate the current pay model, we see two key problems:

1. Pay for entry level employees that is in excess of market requirements and is not in alignment with current or likely future contribution
2. Upward pay pressure based on "buffers" between class years and titles, rather than actual contribution

MAKING SENSE OF ANALYST COMPENSATION

Recent news of one top tier firm changing its policy for analysts is likely to be the tip of the iceberg. When "first mover" fear is removed from the equation, we may see a significant shift in how entry level employees are compensated across the investment banking business.

It is critical for firms to go to market for the best and the brightest – this is clear. It is vital to energize the firm with young talent, motivated and ambitious graduates who will work long hours, and get a significant amount of work out the door. The following are less clear:

- Is the culture we are breeding one of boot camp and face time rather than efficiency and value creation?
- Are we training these analysts for careers at our firms, or will the vast majority be cycled out of the industry?
- Are we paying these analysts based on actual contribution – is there some measure of their workload (pitch book creation, for example) that can be done much more cost-effectively?

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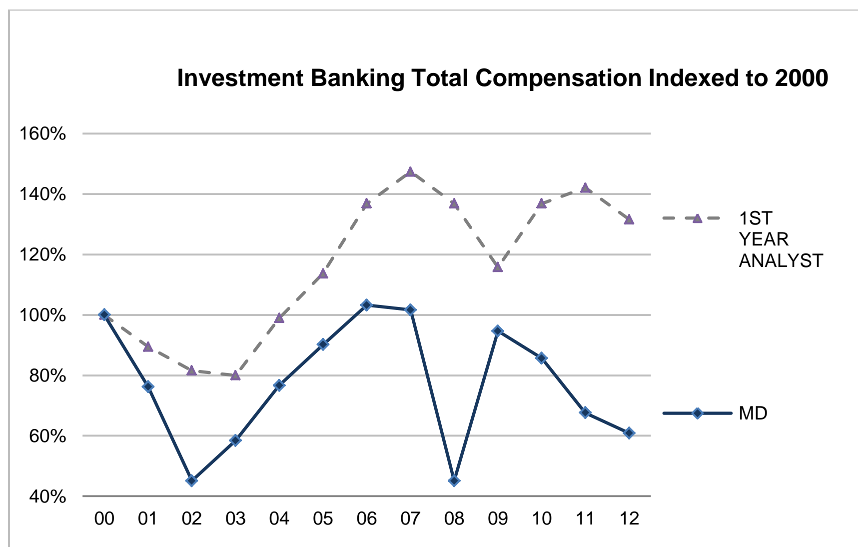
- While third year analysts appear to be very productive even compared to their high compensation costs, is the aggregate spend for three years of analyst pay simply excessive?
- What are the cost implications of paying this population as the pay pressure ripples upwards?

TRAINING FOR WHOM, EXACTLY?

Over the last few years, we have seen some increases in firms focusing on converting a higher percentage of third year analysts to associates. Firms enjoy the opportunity to cherry pick the top talent, and promote the smartest, best and most efficient into associates, where they are often valued more, at least in the short run, than incoming MBA graduates. The third years have already stockpiled institutional knowledge. They know how to navigate the organization, and often have productive relationships with senior bankers, making them great execution partners. Clients have indicated that promoted analysts are extremely productive as first year associates, whereas associates hired directly from graduate programs tend to have a considerable ramp-up time.

Just how prevalent this analyst to associate conversion is, however, is open for discussion. In truth, while the percentage of conversions may be increasing, a significant number of these analysts return to business school, and ultimately jobs at hedge funds, private equity firms, or competing investment banks. This factor alone demands reconsidering the pay rates, which are based in part on the rationale that a premium is paid for these people, because they are the future leaders. Future leaders – perhaps. But the real question is future leaders of which firm?

The chart below shows how entry level pay has held ground while managing director pay decreased.



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While the chart above shows a dip in pay for entry level analysts, bear in mind that these are decreases in the rate paid for the job, not for individual employees. Even in the midst of the recent financial crisis, many firms thought they were sending a stern message by keeping compensation "flat" for their junior to intermediate staff. That is to say, even when things could not get any worse for a firm, many analysts, associates, and in some cases vice presidents did not see their pay decrease.

In some instances, it appears that firms have bid up the price for entry level talent by recruiting at a limited number of schools, rather than casting their nets wider and getting people without the credentials, but with the intelligence and work ethic to be successful contributors. In fact, some firms have already changed their recruitment strategies to shift focus away from "Tier 1" schools, and have attracted great analysts at more reasonable price points.

THE HIGH COST OF BUFFERING

The first few paragraphs of this article focused on the absolute cost of entry level pay yet a more significant question, and more material in assessing the overall spend of a division, is the gap between the premium for title and the incremental contribution.

Both compensation professionals and business managers alike have long assumed that there must be a reasonable buffer between pay rates for various levels of seniority. Why? Many compensation professionals maintain that establishing a gap provides motivation to work hard to "step up" through the organization.

RELATIVE CONTRIBUTION SHOULD EQUAL RELATIVE PAY

While the investment banking advisory model varies from bulge bracket firms to small boutiques, certain truisms exist across the board. Managing directors tend to source most of the revenue. At the largest firms, some directors have relationship management responsibilities and source some deal flow, while at smaller firms, that is purely managing director territory.

The responsibilities and expected contributions at bulge bracket firms are also different because more deal flow comes to the firm, whereas at smaller firms, the managing directors need to be more active in pursuing business. These differences notwithstanding, let's consider the contribution each title makes, and how the corresponding pay is aligned.

In a recent roundtable discussion with approximately twenty investment banks, including middle market firms, premier boutiques, and smaller specialty shops, we posed the question: "Which position is hardest to recruit for and which is the most productive."? There was an almost unanimous response: "senior associate". The senior associate is often the workhorse of the business, a solid, seasoned executor.

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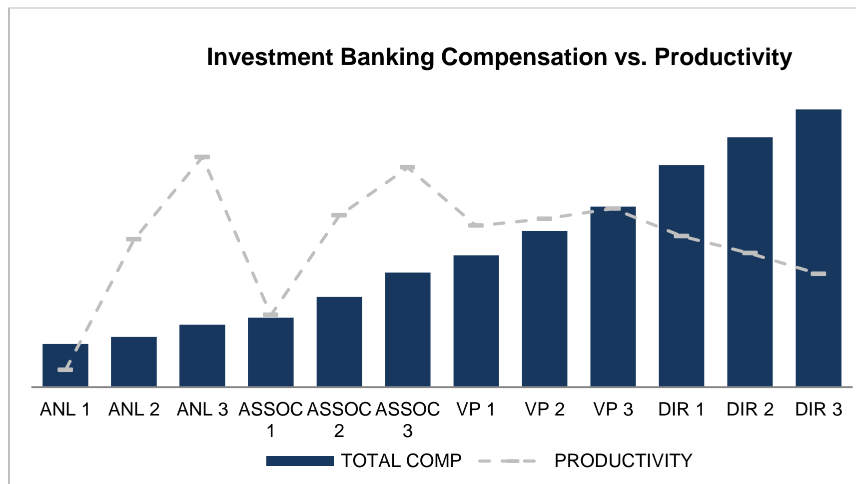
In further polling the group, we asked them to rate the contribution of each title level below managing director, regardless of compensation. The results are shown below:



There is a perception that the entire cost structure below managing director is inflated. That having been said, in spite of concerns about analyst pay, firms indicated they get the most productivity out of 3rd year analysts and 3rd year associates. Bear in mind that the largest firms may get greater value out of their vice presidents and directors.

As firms look to do more with less compensation spend, it is critical to challenge convention on where the money is spent, grade pyramids, title structures, and more. Some firms have very valuable vice presidents and directors and should reward them appropriately. At a firm where a senior associate is more productive than a director, paying the director 2-3 times more than the associate may not make sense. We are not suggesting inverting the pay scheme, and compensating associates at a higher level than directors. But it may be sensible to lower the starting point for analysts, and then make incremental increases tied directly to their productivity, and less to a "class year" approach.

CONCLUSION

Perhaps the upward pay progression for the vice presidents and directors is necessary to retain and engage these professionals as they get closer to becoming revenue generators, or take increasingly large roles in client facing during project execution.

Perhaps the seemingly overstated entry level pay is necessary to provide senior bankers with the top talent they need to efficiently deliver on mandates. The question is less whether the assumptions or inputs to the model are correct, but rather, whether the pay levels reflect thoughtful decisions or the perpetuation of a bad habit.

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Imagine a firm where the current median pay rates for associates is $300K, vice presidents $500K and directors $700K. Imagine the cost / culture impact of changing baseline expectations to $300K, $400K, and $500K, respectively, and hyper-rewarding star performers. You may still wind up with directors over $1 million in this scenario, or highly compensated vice presidents, but it would be driven by outstanding performance. You may even wind up with some associates getting paid more than vice presidents but you would almost certainly save some cost, and have the opportunity to better reward your star players, at all titles / levels.

Do we expect to see a complete re-vamping of pay this year, whether for analysts programs in investment banking, analyst programs in general, or even across financial services more broadly? Probably not. Reluctance to be the first mover will slow down the evolution. Will firms start to rethink what they are getting for their spend in a time of scarce resources? Absolutely!

ABOUT THE AUTHORS

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