

Editor's Brief: Credit Market Troubles Pressure Headcounts, Compensation – But Not For All Sectors

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Executive Summary

Mortgage-related losses are driving most investment banks to curtail risk in a number of areas — including their hiring and retention plans. To date, headcount reductions have centered on fixed-income trading and structuring activities, but we expect further layoffs as institutions further mark down book values of troubled assets. Over the next six months, the magnitude of these markdowns will determine the trend of business investment and hiring decisions. However, we foresee increased investment and headcounts within private wealth management, asset management (both institutional and individual) and risk management areas. Campus hiring appears set to weaken.

Background

The bottom-line toll from fixed-income assets affected by the sub-prime mortgage meltdown stands at \$30 billion and counting. Equity analysts foresee more, possibly far larger, shoes poised to drop during the fourth quarter of 2007 and beyond. JPMorgan analyst Christopher Flanagan expects financial institutions will write down mortgage-related assets by at least another \$60 billion, based on future default levels implied by the closely watched ABX index. Royal Bank of Scotland's Bob Janjuah wrote that SFAS 157 — a new accounting rule set to take effect Nov. 15 — will require the industry to recognize "\$250 billion to \$500 billion of losses" on illiquid securities.

Losses on this scale give rise to at least three contractionary effects on the industry:

- They reduce a bank's capital — the fount of its legal authority to operate or expand business activities.
- They reduce reported income, revenue and/or balance sheet ratios — benchmarks for a bank's ability to access funds for operations.
- They depress share prices — thereby pressuring management to curtail activities that produced the write-offs, and possibly step back from risk-taking in general.

The Human Toll

Banks are already conspicuously pulling back from bond structuring, trading and lending activities associated with sub-prime mortgage exposure. This year, the industry has announced 141,442 layoffs through October, making 2007 a record year for financial services layoffs, according to Challenger, Gray & Christmas. Most of the lost jobs were for retail lending staff in bank branches and mortgage companies. However, since September the reductions have spread to corporate finance and trading desks that focus on mortgage bonds, asset-backed bonds, collateralized debt obligations and other derivatives built around these securities.

Some affected institutions haven't disclosed planned headcount changes. Merrill Lynch, whose \$8.4 billion third-quarter write-down was the largest reported by any institution thus

far, has not announced layoff numbers. What Merrill has said — as told by its since-deposed Chief Executive Stan O'Neal — is that it will redeploy capital from structured finance to higher-return areas such as private equity, and will sell "non-core" assets. We also expect Merrill to rededicate itself to risk management and expand headcount in that area.

Meanwhile, in response to a 93 percent profit plunge from investment banking and \$1.4 billion in trading losses — mostly in fixed-income instruments — Bank of America (B of A) is reconsidering its aim of achieving bulge-bracket scale for its Global Corporate and Investment Bank (GCIB).

Already, B of A has slashed 3,000 heads, or 15 percent, of its GCIB work force. While the majority of these were in commercial lending and administration, financial market activities were deeply affected too. The bank axed its London credit-strategy research team, its metals trading desks in London and New York, and the head of its successful currency trading business. It also replaced the GCIB's head with the former chief of the wealth management division. Look for B of A's global markets and investment banking staff to be downsized further, beyond the reported 500 positions eliminated so far.

A Few Bright Spots

While sub-prime losses have affected all major investment banks, some firms and divisions are faring better than others. Goldman Sachs and Lehman Brothers limited the damage to their third-quarter results by successfully hedging their sub-prime exposures, although that claim has met some skepticism in Goldman's case.

Among divisions, asset and wealth management continues to be a bright spot for most banks, including such hard-hit institutions as B of A, Merrill and Citigroup. Equities trading and alternative investments also remain profitable, although the proprietary risk they entail could discourage banks from ramping up in a risk-averse environment. Risk management, although not a revenue or profit center, is likely to attract added investment and headcounts as well.

Bonus Outlook

Losses tied to credit exposures will also impact firms' compensation and campus hiring.

The New York State Comptroller forecasts the aggregate bonus pool for 2007 will decline 10 percent from last year's record of \$23.9 billion. Here, too, the impact is likely to differ among individual firms and departments. "Some firms and some employees, such as those working in mortgage-related areas, will experience large declines while others, such as those in investment banking, may receive even larger bonuses than last year," the state's report said.

Compensation consultant Johnson Associates is more upbeat about 2007 bonuses, although pessimistic about the outlook for 2008. In its quarterly trends report issued Nov. 1, Johnson projected "small year-over-year increases in incentive compensation," compared to a very healthy 2006.

Of note, Johnson Associates sees year-end payouts for investment banking advisory gaining 10 to 20 percent compared with 2006, prime brokerage climbing 15 percent and asset management gaining 10 to 15 percent for equities personnel and 5 percent for fixed-income staff. On the downside, banks' "plain vanilla" fixed-income trading and structuring desks are

projected to pay 5 to 15 percent less than in 2006, even as fixed-income derivatives will pay 10 percent more. Johnson projects incentive pay for investment bank senior management will range from 5 percent higher to 15 percent lower than in 2006, with "staff" (back-office) payouts little changed, on average.

Diminished Campus Hiring

University career officials and students believe Wall Street firms will hire fewer MBAs than last year. While banks aren't disclosing hiring targets — and some officially proclaim their plans haven't changed — an Oct. 30 BusinessWeek article details widespread signs of a pullback. Johnson Associates' Alan Johnson expressed similar views to us. He looks for MBA hiring to be "down significantly" from a year ago. Remember: While banks may go ahead and interview second-year MBA students on campuses through the autumn and winter, they are not forced to make offers.