

The Bonus Dilemma

Jon Jacobs

INTRODUCTION

As bonus time looms, the financial services industry around the world faces an unprecedented situation of government financial participation and intense political scrutiny. Both 2008 compensation and the pay paradigm for future years are being reshaped under this spotlight.

This White Paper focuses on public relations aspects of the dilemma confronting U.S. investment banks over reformulating compensation – both near-term and long-term, from the C-suite to the operations staff. Due to recent and ongoing injections of taxpayer funds, decisions that traditionally aimed to balance employee retention needs with budgetary constraints must now also weigh the interests of a daunting array of stakeholders, including Congress, the U.S. Treasury, the news media, and the taxpaying public. Meanwhile, rivals both traditional (other bank holding companies) and non-traditional (boutique and mid-market investment banks and alternative investment firms) are waiting in the wings, eyeing opportunities to poach star contributors.

Broad reforms in compensation models are in store for 2009 and beyond. The direction of change is suggested by UBS's newly announced pay paradigm for its senior ranks, which follows recommendations issued earlier this year by a group of global bank leaders and regulators. The new paradigm aims to discourage excessive risk-taking and better align employee incentives with shareholder interests.

THE CHALLENGE

During the second half of 2008, the financial and legal landscape of American investment banking underwent changes that threaten to obsolete the industry's traditional compensation model, in which most of employees' cash compensation was determined and paid close to year-end. The major transformative influences are:

1. Government capital injections into a range of financial institutions under the banner of the Emergency Economic Stabilization Act (EESA) and its Troubled Asset Relief Program (TARP).
2. The disappearance of several former first-tier banks through forced mergers or bankruptcies.
3. Conversion of the remaining standalone investment banks into regulated bank holding companies.

The staggering size of the bank rescue legislation enacted in early October (\$700 billion) and the Treasury Department's deployment of a substantial portion of it via capital purchases, stirred up a groundswell of fury against financial institutions in general and recipients of EESA aid in particular. Voter outrage quickly flowed through to Congress, where key committee chairs have demanded all institutions receiving bailout funds provide detailed accounting of how this year's bonus pools are determined and allocated, and certify that taxpayer funds will not be used to augment bonus pools. Some highly-placed elected officials have gone further, publicly urging banks to refrain from paying any bonuses for this year.(1)

On Nov. 12, the four major U.S. banking regulatory bodies issued a rare joint statement (2) that included an order for banks to "regularly review their management compensation policies to ensure they are consistent with the longer-run objectives of the organization and sound lending and risk management practices."

While incentive pay for corporate-level officers (whose individual compensation amounts are disclosed in public filings) is most vulnerable to this onslaught, it's important to note that many critics are urging a clampdown on year-end cash payouts for all levels of employees (3, 4). In this hothouse environment, many firms are holding bonus decisions in abeyance, and the outcome is shaping up as a game of chicken.

An important break came on Nov. 17, when Goldman Sachs and UBS revealed their respective top executives would take no bonuses for 2008. UBS also unveiled a new incentive structure for future years, which will apply to its group executive board, the executives one step below, and all other employees who exercise "key functions," such as "using risk capital and assuming significant financial risks."

The new UBS paradigm utilizes a "bonus/malus" system in which each year's bonus is deferred for a few years

and can be clawed back in case of future losses. However, the Swiss bank said that for most of its employees, "the current system of variable compensation will basically not change." (5)

CURRENT YEAR'S BONUS CALCULUS

The political spotlight on compensation poses both near-term and longer-term risks to financial institutions. An obvious near-term risk is an institution reining in year-end incentives more severely than its peers might lose talent to competitors early in 2009. Any perceived inequities that arise between similarly positioned firms are a potential trigger for defections. Even hobbled banks and hedge funds will seize opportunities to scoop up top talent that's disaffected with their current employer.

Thus, even more than usual, recruitment staff should spend this period seeking real-time information about what their closest counterparts are doing in terms of year-end incentives. Internal recruiters can provide valuable intelligence to divisional and department heads and other compensation decision-makers.

Besides risking defections in the near term, an institution perceived as letting public officials dictate its compensation procedures runs a risk of gradually metamorphosing into something like a government agency itself. In public agencies, salaries often are set by published charts rather than managers' discretion, and bonuses don't exist. To the extent a bank drifts in that direction, risk-takers and innovators will look elsewhere for work, and its ranks will slowly fill with individuals comfortable with high levels of transparency and public oversight of their own compensation packages – in other words, the kind of individuals who seek public service-type careers. After five years, it might no longer be practical to return a partially nationalized bank to the rough-and-tumble private sector.

Given government's new role as activist shareholder, along with the prospect of worsening industry-wide losses this quarter, compensation expenses accrued to date might shrink in the final year-end tally. Moreover, a high proportion of year-end awards will be paid in shares and other deferred compensation. (6)

Yet, a significant minority of employees are unprepared to see their compensation decline. An eFinancialCareers survey of some 1,400 employed Wall Street professionals, conducted in mid-October, found 36 percent of respondents expected a larger bonus this year than last. Thirty percent expected a smaller bonus than last year, and 34 percent expected no bonus at all. (7)

THE EVOLVING COMPETITIVE LANDSCAPE

The finance industry's scorecard of competing players is in flux. Three broad factors we see impacting compensation decisions are:

1. The widespread push toward commercial banking.

With Merrill Lynch subsumed within Bank of America and Goldman and Morgan Stanley becoming bank holding companies that will seek stable retail deposits, resources are shifting from the institutional to the retail and commercial banking side. For instance, Morgan Stanley recently announced it's ramping up its nascent commercial bank operation (including hiring two senior executives from Wachovia), while laying off 10 percent of its institutional securities workforce.

2. Diminished vigor within the alternative investment space.

Hedge funds look to be less of a recruiting threat in 2009 than in previous years. While funds continue to recruit from investment banks, they are offering far smaller pay guarantees than a year ago. Prospective fee revenue – a powerful determinant of compensation levels for portfolio managers, analysts and support staff – is restrained by the predominance of negative portfolio returns, high-water marks, a poor outlook for markets next year, and continued absence of leverage to push returns. Add in the impact of asset market declines, redemptions cutting into management fees, and the prospect of diminishing inflows as investors remain risk-averse, and we see why sector experts are predicting one-third to two-thirds of all hedge fund firms currently in business will exit within a few years.

3. Boutiques and mid-size investment banks are emerging as a greater competitive threat.

The news media remain rife with reports of staffing moves by decades-old firms such as Jefferies Group and Piper Jaffray, as well as relative newcomers like Moelis & Co., Evercore Partners and Thomas Weisel

Partners. Many of these firms say they avoided serious damage from the mortgage meltdown. Now their executives openly proclaim their intention to poach top performers from bulge-bracket institutions whose compensation packages previously placed them beyond reach of a second-tier employer.

HR, SHAKE HANDS WITH PR

Anecdotal evidence from many sources indicates 2008 bonuses on the whole will shrink by 30 percent or more from last year's levels. Nevertheless, many financial markets professionals will see something in their envelopes.

Institutions that do not bow to demands for a company-wide and industry-wide bonus moratorium face a public relations challenge. If the industry really cares to defend compensation, "it has to be articulated in bumper-sticker sized phrases," declared Cognito, a prominent financial services PR and marketing firm (8).

The industry's message should begin by educating the public about the critical distinction between C-suite executives and hard-working pros in the trenches, and between banking and most other industries whose employees work primarily for fixed salaries rather than highly variable salary-plus-bonus packages.

To do this, banks should emphasize that the word "bonus," is a misnomer. Year-end incentives constitute the meat of most banking professionals' compensation packages. Few on Wall Street work primarily for the salary (what's called "base" - a word that perfectly describes how people in the business view it).

Firms also can emphasize that most finance professionals neither make seven- or eight-figure incomes, nor were involved in creating or selling "toxic" products such as asset-backed CDOs. Nationwide, about 850,000 individuals are employed in securities dealing, trading or investment management. Many work in administrative and support roles, and earn incomes that – although above what other industries typically pay for similar work – show a human side of banking the industry's critics are working hard to obscure. By presenting concrete, detailed, real-life portraits and testimony from such individuals, the industry can counterbalance the cartoon-like caricature of Wall Streeters as Porsche-driving, Rolex-wearing, island-hopping tycoons.

A third promising tack is to point out the bailout program's temporary nature has direct implications for firms' compensation practices. Having invested taxpayer funds in the industry, the government needs an exit strategy that keeps banks functioning well enough to have a strong chance of returning to full private ownership. If total compensation is slashed and every banker's pay is effectively subject to congressional review, will banking careers continue to attract creative, driven, highly educated people?

At the moment, the idea of turning Wall Street into a clone of Washington seems to give some voting taxpayers a pleasant feeling of schadenfreude. By awakening these taxpayers to the fact Wall Street would consequently remain a permanent ward of Washington, the industry can help them recognize where their true interests lie.

LONG-TERM REFORMS

Over the next 12 months, we expect more institutions to overhaul compensation as UBS has done. Starting in 2009, UBS will hold at least two-thirds of each executive's annual bonus in an escrow account whose balance will be reduced by any losses in later years. The new model applies to top executives and operating-level employees in a position to risk the bank's capital. The precise scope of the affected group "will be defined presently," according to UBS; the Times of London says it will cover about 2,000 of the bank's nearly 80,000 employees.

Antecedents of the UBS incentive plan are evident in proposals emanating from the Institute For International Finance (IIF), a global umbrella group that combines bank leaders from the private sector, central bankers and regulators. IIF's chairman, Deutsche Bank Chief Executive Josef Ackermann, has been an active and visible proponent of compensation reform.

An IIF "Best Practices" report published in July (9) linked the current financial turmoil to "excessive risk-taking resulting in part from incentive compensation tied to revenue or short-term profitability." Bonuses sometimes were awarded "without sufficient regard for the risk and revenue profiles of products that often span several years," the report stated. Among its recommendations:

- Base bonuses not on a trader's raw profit, but on profit adjusted for risk and capital costs,
- Pay the lion's share of bonuses in the form of "deferred or equity-related components,"
- Time payouts to correspond with the period in which a firm's capital is at risk, and
- Make incentives for risk-takers as comparable as possible across different business groups within a firm.

The ideas in this White Paper draw upon three commentaries published on eFinancialCareers News (aimed at Wall Street job-seekers) during October and November, 2008. (10)

Footnotes:

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 8. "Wall Street Bonuses II," Cognito, <http://financialpr.blogspot.com/2008/11/wall-st-bonuses-ii.html>
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- "Our Take: I'm Cinna the Poet. Don't Kill Me!" (Nov. 7, 2008) http://news.efinancialcareers.com/Blogs_ITEM/newsItemId-15934
- "Our Take: Repairing the Pay Model" (Nov. 14, 2008) http://news.efinancialcareers.com/newsandviews_item/newsItemId-16067