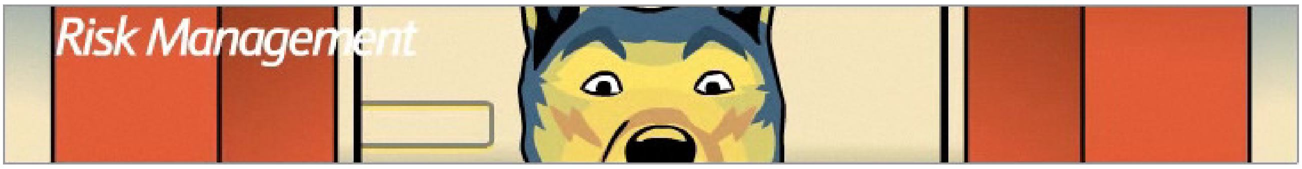

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A shake-up year looms for pay and bonuses

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The level and structure of pay and bonuses have – with a few minor tweaks – remained remarkably robust since the credit crunch first hit. But that could all change in 2012, according to experts, as pressure from the public, politicians and shareholders is brought to bear on those banks that fail to moderate compensation.

Pay shake-up

UK prime minister David Cameron pledged in his New Year message to “tackle excess in the City” this year. He said: “A few at the top get rewards that seem to have nothing to do with the risks they take or the effort they put in.”

Bonus payments will drop this year. The Centre for Economics and Business Research predicts that around £4.2bn in bonuses will be paid out for 2011 by UK financial services firms, a level – not seen since 2002 – that compares with £6.7bn paid out in 2010 and a 2007 peak of £11.6bn.

According to data provider Dealogic, revenue generated by investment banks operating in the UK reached $3.26bn in 2011, down 15% on the $3.84bn generated in 2010.

Bankers have already been warned by the Association of British Insurers, one of the most influential shareholder groups in the UK, that setting pay bonus levels this year could “no longer be business as usual”.

In a letter to the banks, it said its members “expect to see significantly lower bonus pools and individual awards given the current market circumstances”.

The head of investment banking at one European bank recently told Financial News that “a million dollars is a lot of money”, and that the industry needs to go back to a time when a $1m bonus was a big deal.

The level and structure of pay at financial services firms have come under increasing scrutiny from regulators and politicians since the 2008 crisis, amid a public backlash over bankers' bonuses.
In late 2011, the industry began to recognise the problem – brought on by commercial pressures as much as criticism from politicians and regulators – and started to look at ways to reduce and restructure pay.

Jeremy Edwards, partner at Baker & McKenzie, said: "The first couple of months of 2012 are going to be the same as the end of 2011, in that it's all going to be a bit grim. There's going to be a heightened focus on the quantum and structures of remuneration – especially with the need for banks to raise more capital, so there will be real pressure on the bonus pot."

Pressure on pay disclosure is also likely to heighten following the UK Treasury's launch of a consultation paper last month to improve bank bonus transparency.

Under these proposals, the 15 largest banks operating in the UK – including the UK operations of foreign-owned international banks – would be forced to publish the pay packages of their eight highest-paid executives. There is no need to disclose this under current rules.

The consultation closes on St Valentine's Day, with the first set of disclosures due with the announcement of 2011 bonus payments this year.

Bruno de Saint Florent, partner at Oliver Wyman and author of a joint Institute of International Finance report into 2011 remuneration trends, said: "Not having flexibility on the cost base is a problem, particularly as the revenue of the industry has been volatile."

Tom Gosling, remuneration partner at PricewaterhouseCoopers, said banks would reduce costs through redundancies, then offer new hires contracts with a lower basic pay element.

He said: "Historically, banks have focused on reducing headcount rather than reducing pay-per-head. They're getting much more focused on understanding who the real contributors are, who the people are and where they individually add value, versus people benefiting from the franchise."

Clawback of bonuses is likely to be a much more prominent component of any remuneration package drawn up this year to draw closer the link between performance and pay.

Lloyds Banking Group took action last month to retrieve some of a £1.45m bonus paid to its former chief executive, Eric Daniels, in 2010. Commentators say the mechanism could be applied more widely across the industry in future bonus handouts.

Gillian Chapman, head of employment and incentives at law firm Linklaters, said: "To date, as a generalisation, clawback provisions have been drafted relatively restrictively – so they only apply to events during the relevant bonus year. But I do think that, as things evolve, clawbacks will develop and we might see what was just a short-term annual bonus morphing into something much more long term."

If the banks are too slow to reform or redress the payout balance between executives and shareholders, the asset management industry – where more focus has been placed on better aligning pay with performance – will increase the pressure.

Tim Kirk, head of financial services at accountancy and consulting firm BDO, said: "Banks need to be cognitive of the balance between the amount paid out on bonuses and the level paid out in dividends. If bonuses keep being paid while dividends are being reduced, then there will be pressure from shareholders."

Kevin Pakenham, co-founder of advisory firm Pakenham Partners, said: "The asset management industry is achieving with common sense what the investment banking industry is being forced to do by the government. You don't align on the buyside if you're paying out a yearly cash bonus in an industry that is built over years."

Investment banks initially responded to restrictions in the amount and way in which bonuses are paid by hiking base salaries. But, according to headhunters, this rise in base salaries at a time when markets are shrinking has just increased the cost of redundancies.

Higher bank salaries have not been mirrored in the independent asset managers and hedge funds industries.

Performance fees

By its nature, compensation on the buyside, and in particular hedge funds, is less standardised and based on fee income. According to the latest data from Hedge Fund Research, the average hedge fund lost 5.17% last year. As a result, many managers may not receive a performance fee for last year, normally 20% of any gain.

A managing director in prime services at a large bank said: “Straight down the middle, ‘two and 20’ is still the norm, but newer funds tend to have a founder’s share class that offers fee concessions, and funds that have struggled to retain assets may also have to compromise on fees.”

The founder of a hedge fund advisory firm said that, given the underperformance by some brand-name firms last year, performance fees ought to come under pressure. He said: “I don’t see why we should pay premium prices for sub-premium products.”

But management fees – normally 2% of assets – are likely to be slightly up, given that overall industry assets have increased from $1.92 trillion at the end of 2010 to $1.97 trillion at the end of the third quarter of 2011, according to the latest available data. Hedge Fund Research will publish its full-year data for 2011 on January 19.

A partner at a search firm, who focuses on hedge funds, said: “The main change is that a greater percentage of bonus payouts are being deferred over a longer time-frame. There is a lack of guarantees and a lack of buyouts. It’s not nearly as aggressive as it was.”

She said that there was no uniform model but, as an indication, while historically hedge funds might defer up to 25% of a bonus for a year, now 33% to 50% of the bonus might be paid out over up to four years.

Deferred bonuses

In mainstream asset management, remuneration is linked to investment performance on a one, three and five-year basis, and in most cases, headhunters say, it is discretionary.

One headhunter said that, on a three-year basis, many mainstream managers would reap rewards this year for the outperformance of 2008, but this could negatively impact staff in sales, infrastructure and support.

A headhunter for mainstream asset managers said: “We’re seeing a greater amount put into stock or vesting over a three-year period. While there has been a slight increase in long-term incentive pay, base salaries continue to be level.”

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