# 2008 Compensation and Required Paradigm Shift

***Wall Street Compensation and Benefits Association***

**March 2009**

JOHNSON ASSOCIATES, INC.
19 West 44th Street, Suite 511, New York, New York 10036
(212) 221-7400 • Fax (212) 221-3191

# Introduction

- Discussion of current compensation issues for financial services firms

# Johnson Associates

- Independent financial services compensation consulting firm.  In-depth expertise and candor across businesses and labor markets.  Sound practices and philosophy, incentive designs and goals/measures, market levels and funding, and equity/carry distributions

- Diverse Clients
  - Investment and commercial banks
  - Asset management firms
  - Hedge funds/Private Equity/Alternatives
  - Insurance companies
  - Brokerage firms
  - Trading organizations

# Profound Changes Requires Paradigm Shift

- Disaster in financial services requires significant changes:
  - Substance of programs and approaches
  - Perceptions by regulators/politicians, press, shareholders, and employees
  - Unhelpful nomenclature
- Complicated , expensive business models unsustainable
  - Far too many expensive professionals (i.e., on support side 40% above $500k too many)
  - Overstaffing generally (i.e., 20%)
  - Offices, products, and technology
- Continuing  global government influence
  - Compensation and spectrum of other issues
- Compensation mix evolves
  - Base salary and incentives

# 2008 Broad Re-Cap

- Dramatically reduced compensation versus 2007
  - Significant reductions across virtually all businesses and support
  - Many firms paid above aggregate levels earned from performance. Impact of mergers/government support

- Overstaffing continues to unwind

- Difficult and erratic year-end process

- Awards of restricted stock and "one-time" grants
  - Extra large deferrals as part of needed compensation
  - Incremental expense continues to be pushed into future

- Beginning of direct government involvement
  - Continuing oversight and questioning of compensation magnitudes and approaches

# 2008 Broad Re-Cap

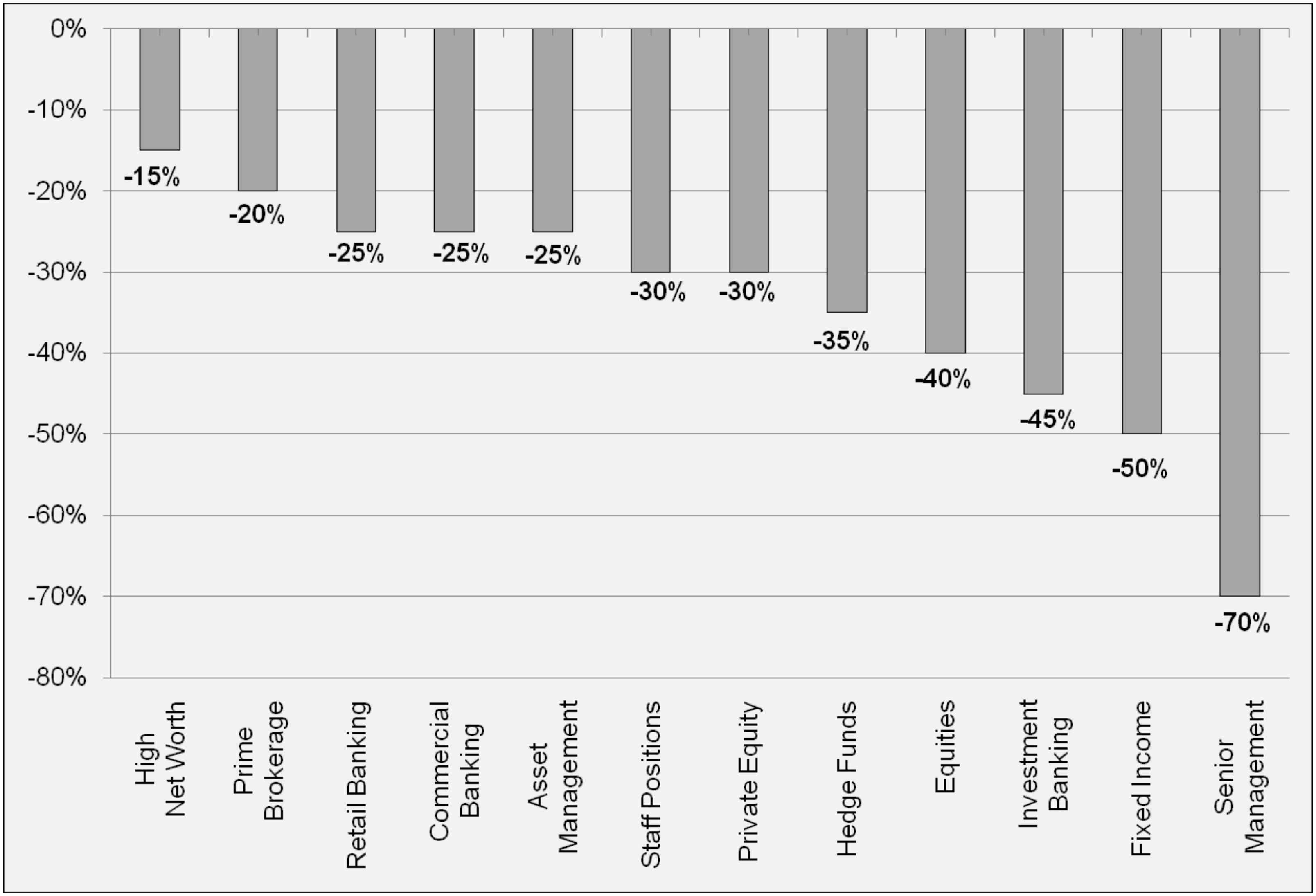
- Massive and continuing breakdowns in risk and governance
  - Hundreds of billions, at least, of losses as yet unrecognized
  - Enron-type accusations and implications
  - Industry tone deaf regarding government and public relations

- 2008-2009 collapse of high cost asset management model
  - Excessive number of funds, strategies, and products
  - Role of alternatives comes into question

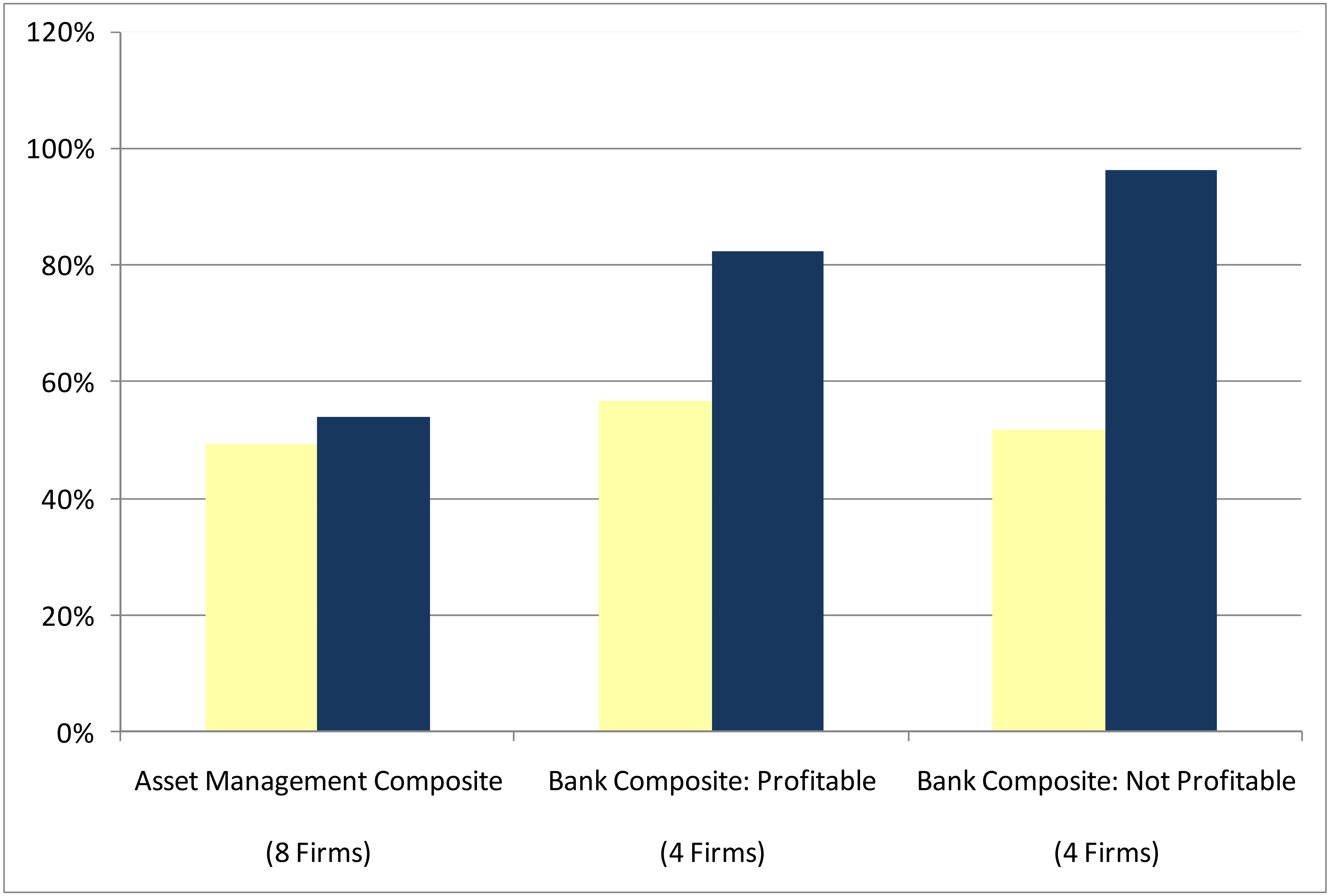
- Credit disaster continued to obscure dramatic slowing  in core businesses
  - October 2007-March 2009 has clearly been slow period

- Significant questioning of broad pay paradigm
  - “How can firm lose billions and still pay…?”
  - Need to have more durable and transparent models

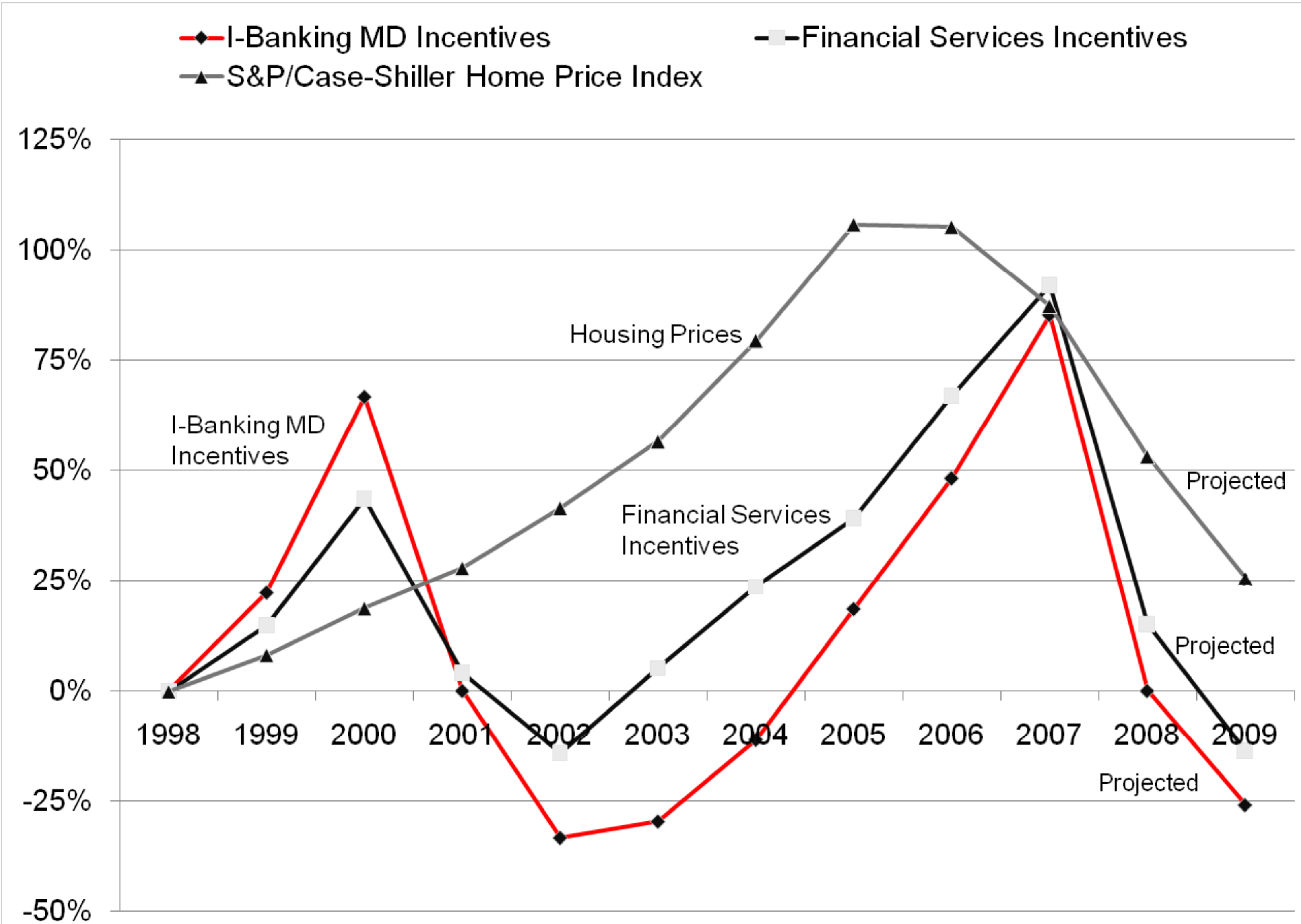
# 2008 Typical Incentive Changes (Value of Cash Bonus & Equity)



# 2008 vs. 2007 Compensation as % of Pre-Tax Pre-Comp Income



# Incentives from 1998-2009



# 2009 Fearless Predictions

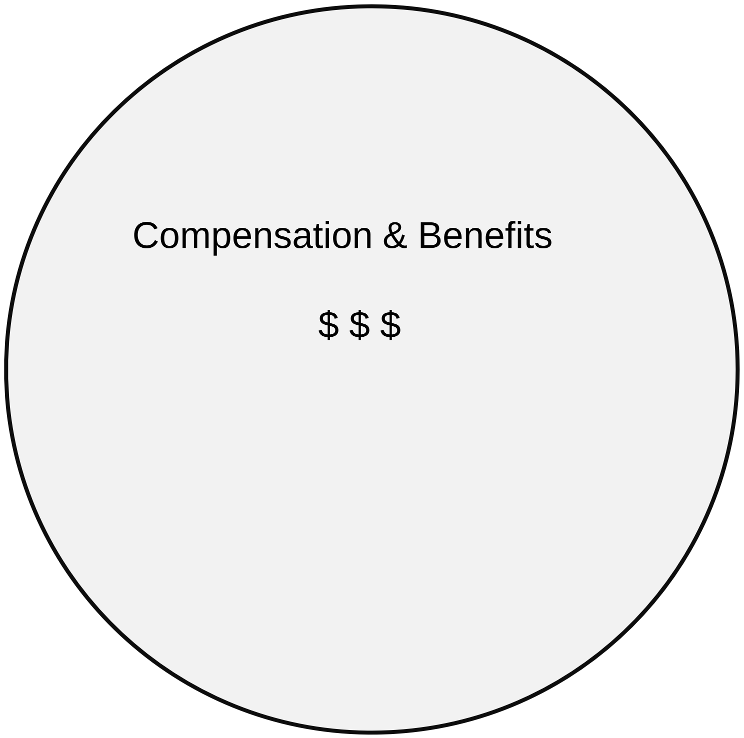
- 2009 will be another poor compensation year
  - Reduced revenues across major businesses on high cost base
  - Continuing and new credit problems (i.e., credit cards, car loans, alt-A mortgages, private equity, commercial real estate, subprime mortgages, business loans, etc.)
  - Incentives down significantly vis-à-vis 2008 (i.e., 20%)
- Business fundamentals weak for all of 2009
  - Investment banking and equities struggle
  - No trading momentum (i.e., risk aversion and higher cost of capital)
  - Retail brokerage hurt significantly by declines in clients net worth
  - Asset management environment extremely difficult
  - Prime brokerage in free fall (i.e., reduced assets and leverage)
  - Commercial/retail banking with credit issues
  - Hedge fund shakeout continues
  - Private equity portfolio problems loom large
- Significant headcount decrease (i.e., 15% -20% below 2008 high)

# Incentive Funding-Change Ahead

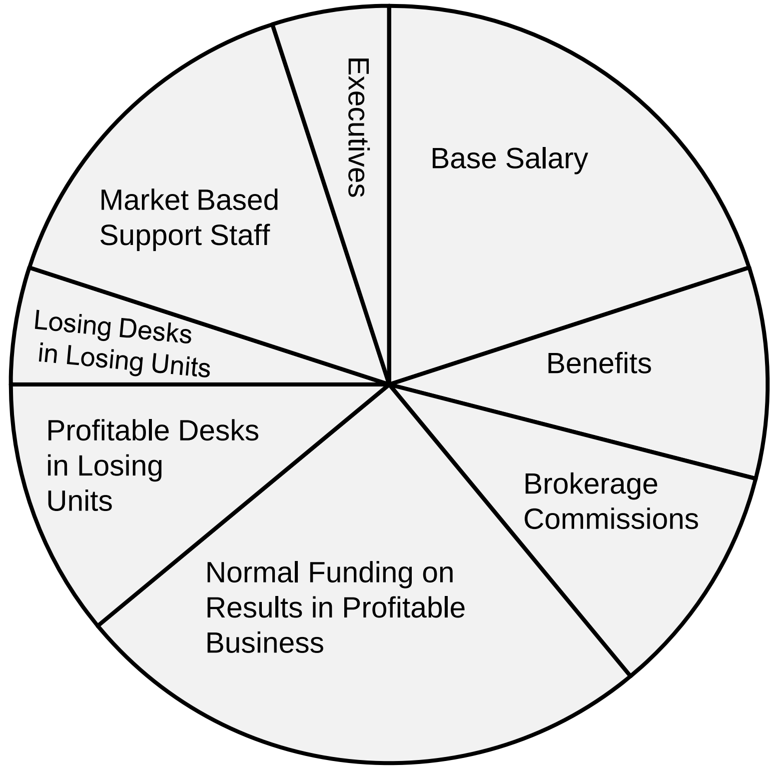
| TODAY (2009) | FUTURE (2010 and Beyond) |
| --- | --- |
| • Discretionary | • More objective |
| • Market driven | • Market focused |
| • Accruals by business | • Flexible formulas by business |
| • Unclear compensation philosophy | • Clear compensation philosophy |
| • Totally unexplainable to external audiences | • Program explainable, and explained, to external audiences |
| • Failing to adequately address risk and clawbacks | • Hopefully rational risk and clawback provisions |

# Compensation Transparency and Communication

**Today (2009)**




**Future (2010 & Beyond)**




Current model cannot be explained or justified. It is necessary to have compensation system that is both rational and can be explained and defended.

# Base Salary Levels – Finally Progress

- Long-standing artificially low base salaries remarkably unhelpful
  - No one believes major financial services firms don't have fixed costs
  - Larger incentives to makeup for base salaries (i.e., 2x shortfall)
  - At odds with desired risk profile
  - Inflates incentive pools and need to justify to external audiences

∴ Benefit impact of base salary increases are moderate/plans can be modified

# Clawbacks and Risk Adjustments

- Compensation clawbacks mentioned repeatedly in regulator reports/legislation
  - Appropriate for violating legal or risk standards
  - Difficult to recognize future loses due to shared decision making / selective application documentation

- Best broad "clawbacks" can involve three fundamentals:
  - Heavy stock ownership by professionals
  - Plain vanilla stock options (i.e., "poor mans" adjustment for future income declines)
  - Stock retention beyond termination for senior executives

- Risk adjustments difficult to implement formulaically
  - Risk fiendishly hard to measure before-the-fact
  - Key subjective component for incentive pools

# Executive Compensation

- TARP compensation rules are destabilizing
  - Ever changing and unpredictable
  - Penalizing firms vs. rational practices
  - Limiting highest-paid employees is problematic
  - Recruiting targets for non-TARP impacted firms

- Nationalized firms at major disadvantage
  - Difficult to pay anyone at high levels due to political dynamics
  - Unofficial U.S. nationalizations at same disadvantage

- If able, need to develop viable strategy for year-end 2009
  - Environment may well remain toxic/unpredicatable
  - Consider mid-year awards

# Long-Term Incentives

- Very heavy deferral rates continue
  - Significant accruals from 2007-2008 hit financials
  - Need planned approach addressing amounts and vesting
- Badly shaken confidence in firm equity as attractive holding
  - Equity will be restricted stock and “one off awards”
  - Stock options out of favor due to high Black Scholes (volatility) , but good for “clawback” advantages
- For large diversified firms, effective single stock difficult
  - Deferrals into funds by asset management participants
  - Fund ownership by alternative professionals
  - Growth of subsidiary plans
  - Grants into asset pools
- More sensible and specific termination provisions
  - Finally addressing early retirement issues

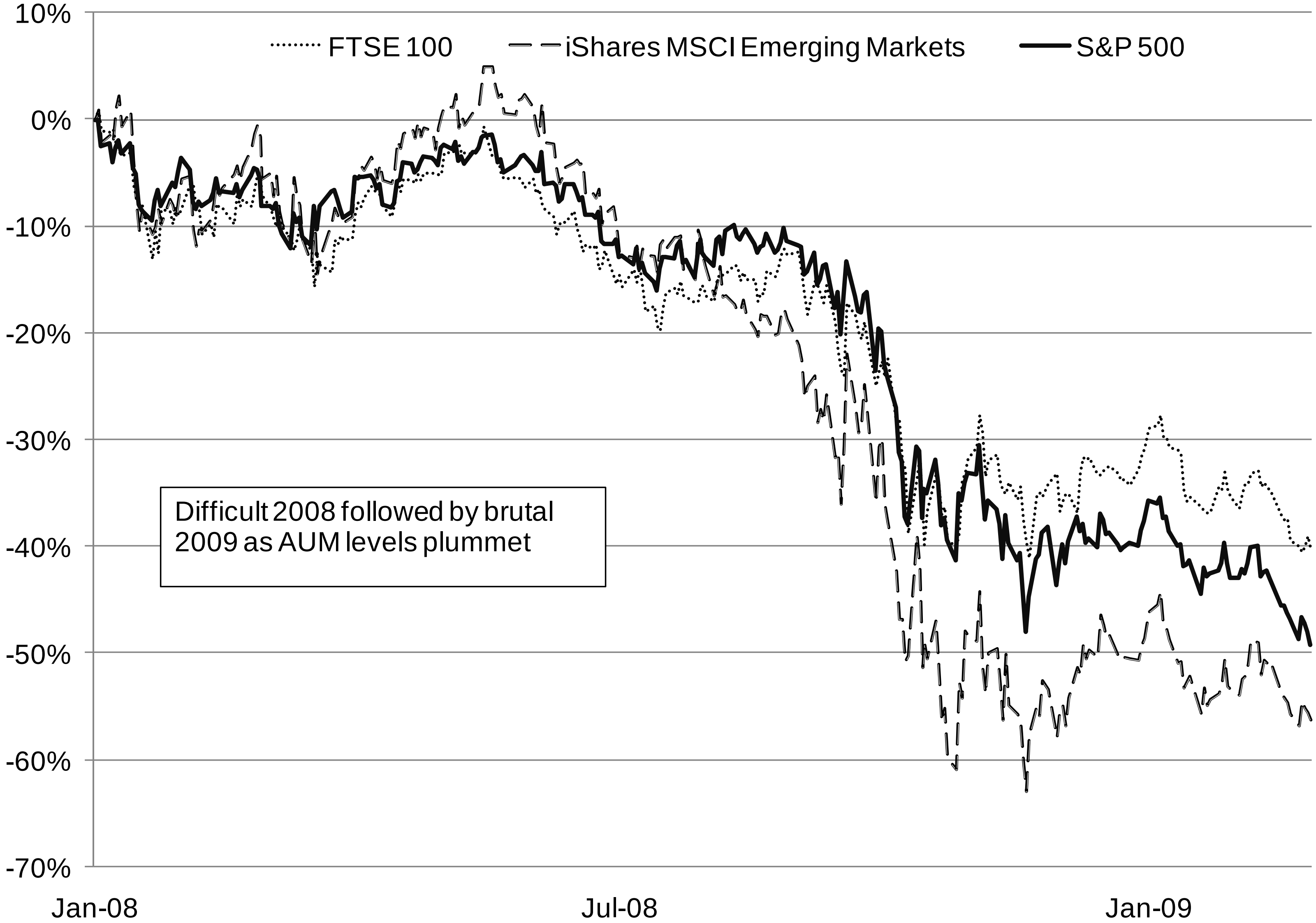
# Investment Banking

- 2008 compensation for senior professionals much lower
  - 2009 incentive compensation will decline again (i.e., 20%)
  - Subsidy from trading gone – must be viable on own revenues
- Weak pipeline in 2009 on built-out teams and resources
- Equilibrium in research
  - Two-tiered market of few visible seniors and number of lower-level. Increasingly few mid-level professionals
  - Buy-side research pays better with enhanced careers
  - Hedge funds influence weakens
- Staff reductions reflecting excess capacity
  - Resizing the “factory” rather than trimming at the margin
  - Fundamental reassessment of business prospects

# Asset Management

- Dramatic drop in 2009 revenues drives major incentive decline
  - Down 40%+ from 2008
- Trying to jam asset management into Wall Street/Insurance pay and business norms creates underperformance
  - Long-tailed business with heavy mix of structured pay
- Partner pay model common
  - Pre-agreed % of operating profit for incentives
- Investment management
  - Structured program at individual/team level on multi-year returns against benchmarks and peers
  - Deferral into funds in lieu of firm equity
- More subsidiary equity programs required
  - Investor and consultant requirements
  - Lure of independent firms

# Asset Management



# Private Equity – Significant Problems

- Major structural problems in industry
  - Questionable transactions completed and huge funds raised
  - Carry in new funds generally underwater
- Long-tailed businesses and compensation
  - Appropriate carry design and governance crucial (i.e., vesting, investment and business decisions, etc.)
  - Carry at institutional firms often 10-15 points reflecting firm economics and importance of fund raising support
- Viable independent competitors drive market
  - Without perceived/real conflicts-of-interest
  - Fund sizes provide ample compensation resources
- Difficulty in financing new transactions
- 2005-2008 investment vintages will suffer major losses and sweep in brand name funds. Transaction debt trades at large discounts.  Major spillover to fund-of-fund investors

# Hedge Funds – Bubble Burst Continues

- Hedge Fund returns down ≅20%+ in 2008
  - Exposes real value proposition and importance of leverage
  - Reduced leverage provided by prime brokers
  - Difficult to produce adequate risk adjusted returns

- Expectation of firms closing and fleeing investors
  - Some believe 50% of firms will disappear….
  - Will find out if asset class <u>or</u> simply a fee schedule looking for investors
  - Perverse impact of "high-water mark"

- Important to have viable 2009 pay model
  - Many firms have to reconsider historical pay practices
  - May require firm principals to operate firms at loss in 2009-2010
  - Need to be creative with "high-water mark" problems

- Design details such as measuring results at fund/product/firm level has <u>crucial</u> impact on potential risk profile and culture
  - Need to have blend of transparency, stability and flexibility

# Summary and Advice

- 2009 will be another difficult compensation year
- Major changes needed to compensation paradigm
  - Initial indications mixed at best
  - Must have explainable program
- Compensation /Human Resources must be proactive
  - Help avoid morale killing initiatives
- Communications with compensation committee and external audiences must improve
- Executive compensation under unprecedented scrutiny
  - Changing rules and perspectives
- Clearer but flexible unit incentive funding

∴ Once in a generation series of challenges that must be aggressively and quickly addressed