FINANCIAL TIMES

June 13, 2012 4:44 pm

Battles may bring bankers' pay down to earth

By Daniel Schäfer

The heated public debate over bankers' pay has spread from the political realm to the boardrooms this year, with a series of investor revolts at banks in Europe and the US.

Executives at Citigroup, Barclays, UBS and Credit Suisse were confronted at their annual meetings with an investor backlash over what shareholders view as inflated and non-transparent pay schemes.

This shareholder pressure is set to become yet another downward force on bankers' pay, in what will exacerbate an already prevalent drop in remuneration.

Pay levels at investment banks, known for their generosity before the financial crisis, have dropped by 30 per cent globally in the past four years on a per-capita basis, according to a recent study by the Association for Financial Markets in Europe (Afme), a lobby organisation.

Bankers' pay has been weighed down by lower returns and a host of regulatory measures that increase the cost of capital, and force banks to shrink their balance sheets.

But will bankers' pay drop even further and if so, what will be the impact on society as a whole?

Bankers and analysts are unanimous in their view that the downward adjustment of remuneration levels is far from over yet.

For one thing, the fragile economic and financial market environment is set to dent banks' revenues for years to come. Global investment banking fees – which include mergers & acquisitions advice, and debt and equity issuance – stood at $30.6bn at the beginning of June for the year so far, the lowest level since 2005 according to data by Thomson Reuters.

With governments and banks seeking to shrink debts, many bankers expect those weaknesses to persist.

Joseph Leung, founder of executive search group Aubreck Leung, says: "Given this relatively low starting point compared to previous years and the overall shrinking investment banking revenue pools we've seen so far, I think it's fair to say that remuneration expectations for this year remain muted."

But besides such cyclical issues, long-term forces are under way that will structurally dent pay in the financial services sector, perhaps for decades. In a study last year, academics Thomas Philippon and Ariell Reshef found that during two eras of financial market euphoria – the 1920s and from 2000 onwards – the finance sector paid a "wage premium" of 70 per cent above the private sector average.

Crucially, they found that the level of bank regulation is the most robust determinant of this wage premium.

With regulators and governments around the world putting the screws on banks, some industry insiders say this premium may be eroded further.

"Long-term historical evidence suggests that the level of regulation is a key driver of remuneration in the financial sector, so this regulatory wave is likely to exert continued downward pressure on banking pay in the years ahead," the lobby group Afme said in its recent research.

Probably the most sweeping structural change for investment banks is the much higher levels of regulatory capital they will be required to hold.

Tom Gosling, a partner at PwC in London, says many investment banks will need to double their return on equity to get back above their cost of capital. He says banks will need to reduce staff costs but at the same time retain capacity for a possible upswing in market and client activity.

"Cutting people's pay will be hard for banks to do – they will find it easier to shed further jobs. But this may be tough to square with keeping the level of capability that they need," he says.

In fact, fixed remuneration at the world's largest investment banks has even increased in the past four years by 37 per cent as banks sought to retain staff and bypass regulation.

The lever that banks are likely to pull further will be bonuses and other incentives. On a per capita basis, such variable pay has dropped by 55 per cent between 2007 and 2011.

Politicians are preparing laws that would further curb bonuses. In the EU, a proposal is under discussion to limit them to a maximum of 100 per cent of fixed salary.

Investors are pushing for similar changes, asking for the spoils to be divided more equally between remuneration, payouts and retained earnings.

They point out that banks' share prices have fallen faster than total pay. The FTSE Eurofirst banking index, for example, has dropped more than two-thirds in value since 2007.

Bonuses are not only expected to shrink: they are also more often deferred and even subject to a clawback if present profits turn into losses in the future.

Such measures are already taking hold. A recent poll by the executive-search firm Options Group showed the proportion of investment bankers who received no bonuses at all last year more than doubled to about 14 per cent.

With investment bankers' pay on a steady downward trajectory, bankers and advisers say the wider economic and societal consequences are more profound and structural than before.

"A few years ago, a smaller bonus round would have mainly hit the Bentley dealer in Berkeley Square," a senior adviser to the sector says. "But now people do not see this as a one-off, so they start cutting back on spending for things such as cleaners, restaurants – or even charity donations."