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Finance: Cut down to size

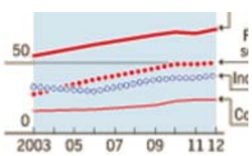
By Daniel Schäfer in London

Experts believe that the days of vast bonuses, particularly in Europe, are numbered

Just after Easter two years ago, a delivery truck lowered a silver Aston Martin V8 Vantage roadster on to a shaded street beneath the skyscrapers of London's Canary Wharf. Hardly anyone stopped to take note. Three years after the collapse of Lehman Brothers and the anti-banker clamour that followed, deliveries of £90,000 sports cars to Canary Wharf during the spring bonus season were still commonplace.

Today, however, the climate seems to be changing in London's steel, glass and concrete financial centre. "I see fewer of these trucks these days ... in fact, I haven't seen one in ages," says a banker at "the Wharf".

Bankers' pay



It may take a while before those Aston Martin deliveries pick up. Last year, investment banks in Europe – and to a lesser extent the US – imposed pay cuts that appear to be far more structural than cyclical. "Bank pay has fallen further and faster than many people think, and 2012 has seen a material reallocation of returns from employees to shareholders," says Tom Gosling, a rewards practice partner at PwC, the professional services firm.

Although it went largely unnoticed by the public, banks cut pay last year even as profits rose markedly. Median profits before tax at nine of the world's largest investment banks are up 28 per cent in 2012 when the quirky effect of the valuation of their own debt is stripped from the equation. At the same time, overall pay has fallen by 6 per cent.

Experts say this could mark the start of the biggest change in European banker pay in a generation, closing the wide gap between investment banks and other professionals such as lawyers, doctors and engineers. Research compiled by PwC exclusively for the Financial Times shows that this shift is already under way. In 2006, the average pay per head at a sample of nine global investment banks was 9.5 times higher than a cross-sector average taken from the FTSE 100. Since then, it has fallen to a multiple of 5.8 times last year.

European politicians are hoping that this trend will be accelerated by pending EU legislation for a strict bonus cap for top-flight financiers and star traders. But bankers and pay experts say the cap will merely shift the emphasis towards higher base salaries in Europe. London-based headhunters say bankers are already beginning to lose their obsession with large bonuses because it is no longer assumed that new employers will pay them. "I have never had so many candidates ask me about the prospective base salary. Even a few years ago most wouldn't even have known what their base salary is – the bulk of their pay was in bonuses," says one headhunter.

The divide between pay in the financial services sector and almost everyone else began in the late 1980s. A research report four years ago by Thomas Philippon, an economist at New York Stern School of Business, and Ariell Reshef of the University of Virginia, charted the rise of the US finance sector in the past few decades. In that time, bankers' pay relative to non-banking professional salaries swelled from almost parity to 1.7 times by 2007. This happened through higher starting wages but, more importantly, bankers enjoyed bigger average pay rises plus hefty bonuses during their careers.

This wage premium was made possible by a wave of deregulation and a credit boom. It prompted investment banks such as Goldman Sachs to ditch partnership models and become listed entities. This kept generous pay structures for employees but relieved them of the burden of shouldering the risks.

Clifford De Souza, a former Citigroup banker who now heads the international securities business of Mitsubishi UFG, says bankers had forgotten what decades ago used to be their prime purpose. "You wanted to get paid well but with a strong view that your job is protecting the bank. Over the 1990s, somehow that got lost. And certainly in the early 2000s that got lost completely when people just said if it boosts revenues then we are expected to get paid," he says.

In 2009, Prof Philippon predicted that banker pay would start moving back towards parity with other white-collar professions that require similar skills – just as it did after the Great Depression in the 1930s. The academic, who works as adviser to the French economics and finance minister, says this is now starting to take shape. "Bankers' pay in the US will go down by 30 per cent relative to the private sector. But this process takes many years."

In the first years of the financial crisis, banks slashed bonuses but it looked like another cyclical blip. Business bounced back in 2009 and 2010, and bonuses went up again.

As it became clear after 2010 that new capital rules and other regulations would dent returns, banks cut tens of thousands of jobs. While this adjustment is continuing, it has its limits. "You can reduce staff to a certain level but ultimately the level of money available to staff will go down," says Mark Quinn, a partner at Mercer's rewards practice.

With investors last year raising the pressure on banks' top managers to redistribute more of the spoils, banks moved from cyclical to structural adjustments on pay. "It is coming down simply because banks still aren't making enough money," says Tom Gosling, a partner at PwC.

In Europe, multiple scandals and the resultant political heat have added pressure on pay. After large fines paid by Barclays, UBS and Royal Bank of Scotland for manipulation of the Libor interest rate, each bank cut back investment banking bonus pools by about 20 per cent and clawed back previously promised awards. Governments have been exerting pressure on all banks where directors fear a public backlash. "Everyone who thinks that politicians are not the most powerful force lives in dreamworld," says the UK head of an international bank.

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There is also a more subtle, cultural change at play. Investment bankers have long dismissed any criticism of their pay structures as driven by envy. Now, some acknowledge that pay structures have spiralled out of control. "In Barclays and in financial services generally there was a phase of what I think is now seen to have been excess," Sir David Walker, Barclays' new chairman, said.

The head of a European-headquartered investment bank says: "The problem is that bankers control their means of production. A farmer can also keep the grain he produces but there is a limit to how much grain this guy can eat. With money, there is no such limit."

Junior partners wait longer for their share

At the height of the mergers and acquisitions boom seven years ago, top UK lawyers regarded themselves as poorly paid bag-carriers to their corporate finance brethren on takeovers that regularly topped tens of billions of pounds. They moaned that while they toiled just as hard on mega deals, they would never receive the kind of bonuses that have now come to typify banker excess.

Partners at law firms would instead take home a share of their practices' profits, which at the 10 most elite global firms averaged $2m per equity partner in 2006, according to research by *The Lawyer* magazine.

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Bankers on Wall Street, where pay has fallen much less, view pay differently. "Businesses should be able to pay people what businesses choose to pay," an executive at an investment bank says. "This isn't a manufacturing business. We don't have goods to be sold. We just have people."

In Europe, there is a sense of resignation after years in which bankers have drawn public ire, seen bonuses slashed, received less upfront cash while at the same time still being forced to work crazy hours. One investment banker at a US bank in London says he wants to shout "don't do it, go elsewhere!" when he sees droves of trainees excitedly starting their banking careers.

Where bankers used to splash out on Gucci handbags and Bollinger champagne in the weeks after bonus day, the number of people receiving a "doughnut" – slang for zero bonuses – has exploded. At Barclays, for example, 45 per cent of investment bankers received no bonus at all for last year.

"When you work in an area where the bank is cutting back, they will tell you that your job is your bonus." says Stephane Rambosson of Veni Partners, the executive advisory search firm. Headhunters say guaranteed bonuses have mostly vanished. The days are also numbered for hedge fund-style contracts that give traders a certain percentage of revenues.

Banks have even begun to reduce base salaries, starting at the top. Last year, the average base salary for a managing director in the City of London fell for the first time by 29 per cent to £167,364, according to data by Astbury Marsden, a recruitment firm. Banks achieved that by slashing the number of senior bankers and partly refilling those posts with juniors. Credit Suisse last year chopped more than a quarter of its senior positions in its advisory and underwriting units in London. Vice-presidents who have been promoted to managing directors typically receive less pay than their predecessors. Bankers who are lucky enough to clinch a job at a rival after being fired elsewhere often have to swallow a 10 to 15 per cent lower base salary, Mr Rambosson says.

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Such pay cuts are far more prevalent in Europe than in the US, where most banks, with the exception of Morgan Stanley, continue to pay higher salaries and bonuses with more upfront cash. This was highlighted by recent data showing that average cash bonuses paid to Wall Street employees jumped 9 per cent last year, thanks to rebounding profits and dramatic job cuts. “It is clear that there is a split opening up between New York and London,” Mr Gosling says.

Bankers and pay experts fear the EU’s plan to limit bonuses to the same size as salaries will widen the rift to the detriment of the City. They say the reform will push up basic salaries for the highest echelon of bankers while damaging a process to make bankers more accountable through deferrals and clawbacks of bonuses.

Politicians such as Philippe Lamberts, the Green MEP from Wallonia who pushed through the EU bonus cap almost single-handedly, have argued that overall staff pay has continued to rise in relation to revenues at many banks. Pay experts claim this remuneration ratio was inflated by payouts for sacked employees and past-year deferrals, thus obfuscating the trend of falling pay.

With investment banks’ average return on equity about half of what they pay for their shareholders’ capital, investors and analysts say the structural changes in pay will continue. Despite marked reductions, investment banks globally still paid their staff an average of £212,000 last year – higher then a decade ago and 4.6 times the remuneration in the insurance sector. “To restore the industry as a whole to clear double-digit returns, either pay would have to fall by a quarter or productivity rise by a third,” Mr Gosling says.

Mr Philippon says the pay gap with sectors that require similar skills will close slowly as it takes time for lower entry salaries and slower relative wage growth to work through the system. “Bankers have in the past not only been hired with a higher starting salary, but they have also enjoyed a faster growth rate. But what you will see in the next decade is slower wage inflation than in other sectors.”

The global head of a medium-sized investment bank says: “Bankers are kidding themselves if they think they are worth what they are making.” Another London-based executive adds: “Banking has to go back to being a normal profession rather than the quasi-entrepreneurial business it has been in the past decades.”

Additional reporting by Tracy Alloway

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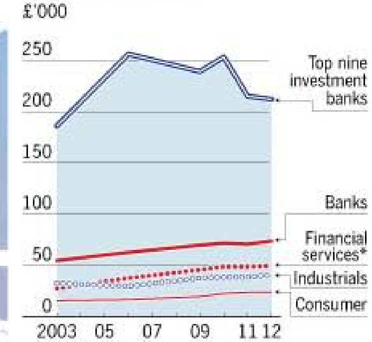
US wage in the financial industry

Ratio between financial services to non farm private wage

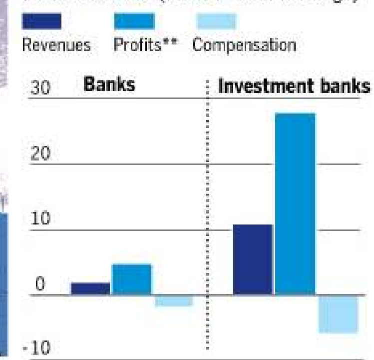
Sources: T. Philippon; A. Reshef; Wages And Human Capital In The U.S. Financial Industry: 1909-2006, National Bureau Of Economic Research (2009)

European and US pay expense per head



Performance and pay, 2012 v 2011

Big European and US international banks and investment banks (median annual % change)



* Excluding banks

** Profit before tax adjusted for fair value of own debt

Source: PWC