

**INDUSTRY WHITE PAPER:**

Pay-for-Performance at Financial Services Firms is in the eye of the storm.

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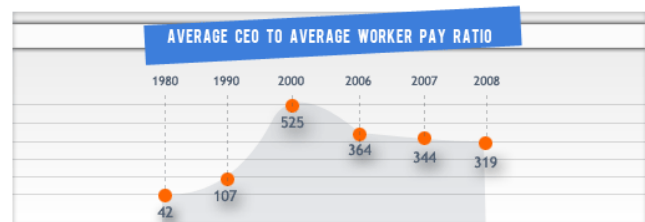
Amidst new regulations pay-for-performance at financial services firms is in the eye of the storm.

The story line was in some ways “better than fiction”. While the US economy is mired in a “great” recession and Main Street is hurting, the government began to target pay-for-performance abuses in the financial sector.

“Wall Street bankers had given themselves \$20 billion worth of bonuses — the same amount of bonuses as they gave themselves in 2004 — at a time when most of these institutions were teetering on collapse and they are asking for taxpayers to help sustain them. That is the height of irresponsibility. It is shameful.” President Obama, source [USA Today](#)

The storyline had intrigue, drama, populist anger, suspense, and of course political utility. Will the newly appointed pay czar claw-back the bonuses of fund managers and bankers for firms that have accepted TARP funds? Will the new financial regulation bill curb the “abuses”? Perhaps the reason this story line is better than fiction is because in many ways the storyline lacks any meaningful context to most passer-by's. It also lacks principled debate and a consideration of the ramifications of policy decisions.

Many people don't realize that the Treasury Department, the Federal Reserve, and the FDIC all [put pressure](#) on financial institutions to accept bailout money. The government even pressured institutions which were adamant



Source: Institute for Policy Studies (2009 data not yet available).

that they didn't need the funds. And though the “better than fiction story” compares the bonus funds to 2004, the bonus pool in question, 2008, actually declined 44% from the year prior, and was in fact the [largest decline in wall street bonuses on record](#) in absolute dollars.

If the administration's goal is to identify and control compensation excesses, there are plenty of fair targets which also have stories to tell. For example, the ratio of CEO pay to average worker pay has grown dramatically in recent decades. But, why did CEO pay grow so quickly?

In the early '90s, U.S. tax authorities capped executive salaries at U.S. \$1-million (Section 162m Internal Revenue Code); any compensation above that had to be linked to performance” ([source](#)). Interestingly, CEO pay in Canada has not climbed as high as it has in the United States. Why? There may be multiple reasons but it is interesting that Canada [did not institute](#) a cap on base salaries. Reviewing the broader context allows us to see that the regulation which capped base salaries corresponds with the beginning of the spike in the total compensation of CEO's in the U.S. Since the outcome was the opposite of the stated goal of the salary cap, we can see a story taking shape that there may have been serious unintended consequences to the regulatory changes that were made. Perhaps we should spend more time considering the unintended consequences of regulation.

On June 30, the Restoring American Financial Stability Act (H.R. 4173) passed the House of Representatives. The Senate is expected to approve it on it July 15<sup>th</sup>. But what unanticipated

consequences may lurk beneath the surface of the [complex regulation](#) that weighs in at over 2,000 pages, over 1,600 sections and more than 400,000 words?

Aspects of the legislation are likely to have a profound impact on compensation policies, shareholder relations, the elections of board members, and perhaps most significantly the implementation of pay-for-performance strategies. For instance, [“Say on Pay”](#) is likely to cause publicly traded companies to scrutinize offers of institutional money to determine what “strings” are attached and could impact the criteria for election and re-election of board members. The [“Clawbacks”](#) may cause pay-for-performance metrics to be re-calibrated to rely more on company performance than individual or unit performance because in the event of a claw back the compensation would be recalculated according to the restated financials of the entity in question.

Already some firms are getting a head-start anticipating the passage of the proposed legislation. See this from the June 2010 article entitled [Fund Managers Overhaul Pay Policies](#) **“Asset managers are changing the way they pay their staff by linking remuneration more closely with group-level results. The changes come as the funds industry fends off the threat of regulatory pressure on financial services pay in the wake of the crisis...Spokesmen for Standard Life and AllianceBernstein said the changes were to encourage staff to focus on the performance of the wider business.”**

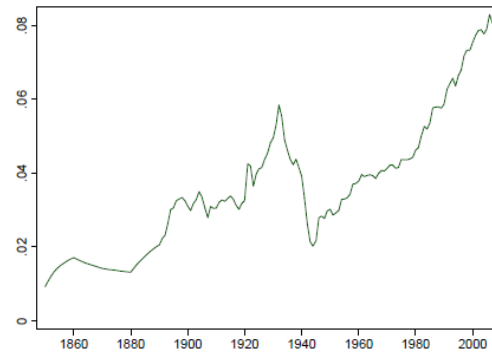
To what extent will pay-for-performance strategies be impacted by the proposed legislation? Almost all participants in a recent Financial Services Industry [Mercer survey](#) noted that they have changed the weighting of components in their pay packages. The companies surveyed are largely increasing base salaries (70%) and decreasing annual bonuses (94%). To restate the obvious, financial services firms are raising base pay during the most significant economic turbulence since the great depression.

In contrast, a recent multi-industry [Hay Group Survey](#) found that 26% of US companies are increasing the proportion of variable pay in their employees pay programs. Reducing base pay and increasing variable pay may be the more natural reaction to the macro-economic conditions for most firms. So what does that indicate about the regulation induced shifts which are occurring? If the shifts occurring are unnatural and counter-intuitive, might they also be counter-productive? Indeed, the sweeping changes to the regulatory environment and the corresponding adjustments to pay policies seem likely to have considerable unforeseen consequences.

Many experts are critical of the administration’s regulatory track record and are not expressing confidence that the financial reform package will solve the underlying causes of the excesses. Harvard Historian, Naill Ferguson opined “I don’t buy the argument that more regulation will fix the problem. It may be forgotten that it was the most highly regulated institutions that caused most of the trouble: commercial banks and [Fannie Mae](#) and [Freddie Mac](#).” And William Wright, Editor of the [Financial News](#) publication weighed in saying “Politicians in the US appear to be behaving in the same way as the bankers and traders that they believe caused this crisis: act now, and ask questions later.”

The financial sector is obviously important to the US economy, representing from a low of around 2% (1947) to as high as around 8% (2006) of GDP. The role of finance is particularly important when firms with low cash flows also have the best investment opportunities. This means that the finance industry will certainly play an especially important role in helping us come out of the current economic difficulties.

Figure 1: GDP Share of U.S. Financial Industry



Source: Author's estimation based on U.S. Annual Industry Account, Kuznet (1941), Martin (1939), U.S. Census, and Historical Statistics of the U.S. (2006).

The performance of the financial sector is materially impacted by both regulation and compensation policies. Growth, profitability, talent retention, and long term shareholder value are all influenced by the incentives that are put in place and the measurements used to quantify performance. It is therefore critical to the US economy, the health of the financial services industry, and ultimately the timing and durability of the recovery that we find balance while curbing excesses and creating incentives.

As noted, the US experience of capping executive salaries has been disastrous and has unexpectedly produced the opposite of the desired outcome. Is there a risk that we will see similar results from capping bonuses and short term incentives? Even now, financial services firms in other countries are analyzing their own incentives mix for the financial sector and they are eyeing their ability to compete with the U.S. for our top talent. A recent report "The Sun Also Rises, Growth Strategies for Japanese Asset Managers" by [Noruma Research Institute](#) and [Casey Quirk & Associates](#), has some interesting findings:

- "Clearly regulation and culture drives part of the compensation system at many Japanese fund managers...Nevertheless, these structures are less competitive than those at global fund managers and consequently Japanese asset managers cannot compete for top investment, marketing, and executive talent in the industry"
- The Japanese fund management industry is less profitable than their US counterparts with 20% operating margins vs. 31% in the U.S on an asset weighted basis.
- Nearly 75% of a Japanese Fund Manager's compensation is salary, vs. about 50% in the US.

So, in conclusion, it is not at all clear what the outcome and or consequences will be from the new regulation. What is clear is that the Financial Services industry must adapt to the new regulations and probably should attempt to anticipate and mitigate the risk of potential unintended consequences. Many companies will need to recalibrate their pay-for-performance strategies. The increased regulatory oversight will also make it more important to have clear linkage between business performance and incentives. Some Financial Services firms are finding it helpful to implement flexible compensation software that can automate the link between business performance data and compensation policies. Perhaps that is why over the past two years [HCR Software](#), makers of CompensationXL, has seen 67% of its new customers come from the financial services industry.

*HCR Software provides solutions for compensation planning and incentive administration. Our flagship product, CompensationXL is used by many leading financial services firms such as Alliance Bernstein, Acadian Asset Management, Associated Bank, Loomis Sayles, Natixis and many others. We believe people are motivated by achievement, rewarding work, and rewards for work that produces excellent outcomes. We also believe that ultimately **Talent Wins** so we provide software and services to ensure that our financial services clients [get compensation right](#).*