Performance and remuneration in investment banking

Findings of an industry study by McLagan

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Executive summary

The issue of remuneration in investment banking has acquired a high profile in the debate on regulatory and financial reform in Europe. AFME commissioned the performance and reward consultants McLagan to undertake a study of industry remuneration policies and outcomes and to examine how these have changed since 2007, using data provided by AFME Board member firms. This report captures the main findings of the study and examines the longer-term outlook for bank remuneration in Europe.

Pay in investment banking has dropped sharply since the financial crisis

McLagan’s analysis shows that aggregate total remuneration across banking and capital markets is down 16% on 2010, compared to a 7% reduction in published staff expense figures (as accounting standards smooth year-over-year pay movements), while revenues were down 12%. The amount of variable remuneration awarded for performance in 2011 was 31% less than for 2010, compared to risk-weighted profitability which fell by 28%. On a per capita basis, total remuneration has fallen by 30% since 2007 and variable remuneration by 55%, while aggregate revenue and risk-weighted profitability are down 3% and 15% respectively.

The balance between fixed and variable pay has shifted dramatically

While total remuneration has fallen sharply since 2007, the balance between the fixed and variable components of pay has also moved considerably. Fixed remuneration in absolute terms rose 3% in 2011 but has increased by 37% since 2007. In 2007, the fixed component accounted for 30% of total remuneration awarded; by 2011 it accounted for 55% of the total. In practice this reduces banks’ ability to manage costs in line with performance.

Incentive structures in investment banking pay are being overhauled

Total variable remuneration paid out immediately after the year-end was down by 46% in 2011 and by 77% compared with 2007. The remainder of variable remuneration is deferred, typically over a period of three years or more. Total variable remuneration awarded in cash fell by 35% in 2011 and is 63% lower than in 2007.

All the firms surveyed now have pay-at-risk arrangements and have implemented ‘malus’ and ‘clawback’ terms in deferred pay awards so that awards can be reduced or recovered entirely if appropriate. A number of high-profile cases in 2011 demonstrated how firms have made use of these terms to reduce unvested awards. More than two-thirds of firms surveyed use risk-adjusted measures such as return on risk weighted assets (RWA) or return on economic capital as a key determinant in their remuneration decisions.

Firms are significantly strengthening governance and transparency on decisions regarding pay

Compared to 2007, all firms surveyed have enhanced the role of their board-level remuneration committee and their risk management functions in determining pay. All banks now take decisions on the pay of employees in the risk management function independently of the business line which those employees support. Public disclosure of decisions and policies on remuneration has also increased significantly.

Changing market fundamentals will continue to have a profound and sustained impact on bank pay

Total remuneration in investment banking is increasingly set by reference to performance on a risk-adjusted basis. Variable remuneration awarded in 2011 fell by 31% compared with a 28% reduction in risk-weighted profitability. Evidence from comparing key products within firms’ wholesale markets divisions suggests higher capital costs are being passed through in lower remuneration. Further deleveraging and de-risking in the European banking sector is likely to sustain this trend over the medium term.

The global programme of regulatory reform will continue to shape change

Europe’s banking sector is moving into a phase of heavier and more intrusive regulation, requiring additional capital, greater liquidity, lower leverage and tighter restrictions on business models, products and market structures. 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.
1. INTRODUCTION

The issue of remuneration in investment banking has acquired a high profile in the debate on financial reform in Europe. It is an important economic issue which can impact parties outside the banking system; most notably, investors and corporates. Remuneration is also a key variable on which global investment banks compete to attract and retain staff. AFME commissioned the performance and reward consultants McLagan to undertake a study of industry remuneration policies and outcomes and how these have changed since the financial crisis, using data provided by AFME Board member firms. The AFME Board has 21 member firms, each of which is active in global investment banking markets.

In broad terms, the McLagan study aims to answer three questions:

- What impact has banks’ financial performance had on remuneration outcomes?
- What changes have been made to incentive structures in investment banking?
- Has the governance of remuneration policies and decisions been strengthened since the crisis?

The report is structured as follows:

- Section 1 discusses the rationale for the study and the methodology used;
- Section 2 outlines the key outcomes in remuneration since 2007 and the link to firms’ financial performance;
- Section 3 examines the incentive structures in investment banking over the period;
- Section 4 analyses remuneration governance and decision-making; and
- Section 5 considers the key factors which are likely to shape the longer-term outlook for bank remuneration in Europe.

Scope and methodology of the study

In order to provide an up-to-date and representative evidence base on investment banking pay, AFME commissioned the performance and reward consultants McLagan to undertake a confidential study of AFME members’ remuneration policies, outcomes and financial performance. McLagan approached each member firm directly to complete a quantitative and qualitative survey. The survey data were supplemented by in-depth interviews with senior HR executives, which were conducted by McLagan. AFME has not seen any of the individual datasets provided by firms participating in the study.

The McLagan study focused on each firm’s ‘banking and capital markets’ (BCM) business, which mainly comprises equities, fixed income and investment banking. Firms were asked to provide data on four aspects of their BCM business:

1) Remuneration governance and decision-making processes;
2) Remuneration policies;
3) Remuneration outcomes for BCM staff; and
4) Financial performance within the BCM business.

Notes on the study

Data were requested from all AFME Board member firms on their global BCM business. This was necessary because some firms do not report specifically on their ‘European’ operations. Moreover, remuneration policies and outcomes in a number of participating firms are set on a global rather than European basis. This latter point provides assurance that the findings on remuneration in global BCM activities largely describe the reality of the European market.

A total of 13 out of the 21 AFME Board member firms participated in the study, ensuring that the study offers broad market coverage in terms of business lines and geographic spread. The study enables a sharper focus on changes in

¹ For example, reporting may be done on a global product-line basis or in relation to EMEA (Europe, Middle East and Africa) operations.
remuneration than is possible through the consolidated accounts of firms with investment banking operations. The approach also allows consideration of remuneration on the basis of amounts actually awarded in a specific year as well as on an accounting basis, which 'smoothes' variations in remuneration amounts each year².

Throughout this report, ‘total remuneration’ refers to the awards awarded in respect of a particular year. Other terms such as ‘fixed remuneration’, ‘variable remuneration’ or ‘remuneration paid in cash’ are on a similar basis. By contrast, the terms ‘staff expense’ and ‘accounting expense’ represent the amount of remuneration that would be recognised in the accounts that year.

Data were collected for each financial year from 2007 (i.e. broadly ahead of the financial crisis) through to the end of 2011. The data used in Section 2 of the report, linking performance and remuneration, are shown for 2009 to 2011 to filter out the considerable noise arising from the volatility in performance in 2008 and 2009; and substantial changes were made by several firms to remuneration policies in this period which resulted in changes to the timing of staff cost recognition. Sections 3 and 4 – covering incentive structures and governance – use survey data from 2007 to 2011. On a small number of issues – and where noted – the survey data have been supplemented by proprietary data from McLagan.

² Banks must disclose in line with internationally mandated accounting standards. Accounting rules mean the remuneration expense in a particular financial year includes costs in respect of amounts deferred from previous years and excludes some of the cost of awards made that year. This has the effect of smoothing year-on-year variations in remuneration.
2. MAIN REMUNERATION AND PERFORMANCE OUTCOMES

This section examines the main outcomes in remuneration for the BCM businesses of AFME Board member firms for the period 2007-2011. The analysis covers:

- Trends in total remuneration;
- Developments in the variable and fixed components of remuneration; and
- The relationship between remuneration and financial performance in BCM activities.

i. **Trends in total remuneration**

In 2011, total remuneration in aggregate across survey respondents’ banking and capital markets businesses was down 16% from 2010 and 18% from 2009. Total remuneration was down 24% from 2007, or 30% on a per capita basis. In terms of the published view, staff expense recognised in 2011 (calculated in line with international accounting standards) varied less, down 7% year-over-year and only 2% from 2009.

ii. **Variable and fixed components of remuneration**

While total remuneration has fallen sharply since 2007, the structure of pay has also shifted dramatically. The amount of variable remuneration awarded for performance in 2011 was 31% less than in 2010 and down 51% compared to 2007.

Variable remuneration allows firms to manage costs dynamically, varying the level of remuneration awarded each year in line with performance / affordability. It also allows banks to set incentives aligned to the different characteristics of the various product and business lines within each firm.

Many firms sought to adjust the balance of fixed and variable pay for employees in their BCM business between 2007 and 2011, actively seeking to increase the proportion of total remuneration that is fixed. Fixed remuneration (salaries, pensions and benefits in kind) rose 3% in 2011 but has increased by 37% since 2007.

As a result of these changes, as shown in Figure 2, study participants reported that 30% of total remuneration in 2007 was fixed, whereas in 2011 that figure had increased to 55%. In other words, the total quantum of remuneration has fallen but banks now have higher fixed pay costs, in absolute terms and as a proportion of total pay.
This represents a real structural shift in remuneration. Although variable remuneration tracks performance, Figure 3 suggests a general downward trend over and above year-on-year performance variations. Across study respondents, the aggregate ratio of variable remuneration awarded to fixed remuneration paid for 2011 was 82%, down from 111% in 2010 and well below the level of 229% reported in 2007.

**iii. Remuneration and financial performance**

A key criticism of remuneration practices in the banking sector has been that remuneration does not appear to be clearly aligned to financial performance. For example, publicly available data suggest that remuneration has not reduced significantly from 2010 to 2011. However, this picture owes more to accounting rules than the actual remuneration decisions made in 2011. The information gathered by McLagan for this study suggests a better alignment than is apparent from published accounting data.

**Analysis of financial performance relative to remuneration expense**

Figures 4 and 5 compare firms’ net revenue (for all activities firm-wide, and then for BCM activities) with staff expense based on an accounting measure.

Figure 4 shows that aggregate net revenue and staff expenses at the firm level were both broadly flat in 2011 compared to 2010, while both increased (by 6% and 10% respectively) from 2009 to 2010. Staff expense and net revenue were broadly aligned in 2011, whereas in 2010 the apparent pattern from accounting figures (in line with publicly available data) was that staff expense increased significantly more than net revenue performance.

Figure 5 focuses on BCM businesses and shows a 12% fall in net revenue and a 7% fall in staff expense (again on an accounting basis) in 2011. For, 2010 it shows a 3% fall in net revenue and a 6% increase in staff expense. Again, the apparent movement in pay based on accounting figures is less than the movement in revenue over the same period.

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**Figure 3:** shows the evolution over time of the ratio of variable remuneration as a percentage of fixed remuneration.

**Figure 4:** compares firm-wide net revenue with staff expense (on an accounting basis).

**Figure 5:** compares banking & capital markets net revenue with staff expense.
Analysis of financial performance relative to remuneration awarded

Studying financial performance relative to total remuneration awarded provides firmer evidence of alignment of reward to performance than measuring remuneration expense. The charts below demonstrate this.

Figure 6 compares net revenue in BCM with the actual total remuneration awarded. In 2011, remuneration fell 16% year-on-year compared to a 12% decline in net revenue. In 2010, total remuneration fell by 3%, in line with net revenue. Therefore, although public data appeared to suggest that remuneration did not decline significantly from 2010 to 2011, examination of total remuneration awarded rather than the remuneration expense provides a much stronger sense of the alignment.

Figure 7 compares movements in variable remuneration awarded with profit before tax in BCM. From 2010 to 2011, pre-tax profit fell 27%, while variable remuneration awarded fell 31%. From 2009 to 2010 the falls were 12% and 21% respectively. In both years variable remuneration fell faster than pre-tax profit.

Finally, Figure 8 shows movements in return on risk-weighted assets (RWAs) and variable remuneration – which presents a similar picture. The graph also includes ‘non-deferred variable’ remuneration, the element which is paid immediately after year-end. Return on RWAs fell 28% from 2010 to 2011, compared to a 31% fall in variable remuneration – and a 46% drop in bonuses paid shortly after year-end.

iv. Conclusion

McLagan’s analysis shows that by 2011 total remuneration in banking and capital markets had fallen significantly: 16% lower than in 2010, and 24% lower than in 2007. On a per capita basis, total remuneration has fallen 30% since 2007 and variable remuneration by 55%.

Total remuneration has fallen sharply since 2007, while the balance between the fixed and variable components of pay has also shifted dramatically. In 2007, the fixed component accounted for 30% of total remuneration awarded, whereas in 2011, it accounted for 55% of total remuneration. Fixed remuneration rose 3% in 2011 but has increased by 37% since 2007.

Assessing the correlation between performance and reward can be difficult if based solely on published results because the accounting impact of deferrals will tend to smooth changes in remuneration over time and factors such as differences in the mix of business activities further mask relative performance between firms. However, the information gathered by McLagan for this study suggests a much closer alignment than is apparent from published accounting data. In particular, total remuneration in 2011 fell 16% year-on-year compared to 2010 while net revenue declined by 12%. Meanwhile, variable remuneration fell 31% while risk-weighted profit fell 28%.
3. INCENTIVE STRUCTURES IN INVESTMENT BANKING

The role of incentives within financial institutions has been a central theme in policy discussions on the causes of the financial crisis and the post-crisis reform agenda. This section examines that issue, using data on AFME member firms’ remuneration policies for their BCM operations. The analysis covers:

- The scale of deferral of variable remuneration;
- The composition of variable remuneration in cash, shares and other instruments; and
- The extent to which remuneration in BCM businesses remains ‘at risk’ following pay awards.

i. Deferral of variable remuneration

Since the financial crisis began, firms pay less variable remuneration up-front. Instead the remainder is deferred, typically over a period of three years or more, so does not get paid to the employee until the firm can see how performance has developed over time. In most firms the proportion of bonus that is paid up-front decreases as the bonus increases.

Figure 9 illustrates the proportion of variable remuneration paid up-front for individual awards made in respect of performance in 2006, 2008 and 2011 (taking the median of a sample of large international banks with banking & capital markets operations). There was a material increase in bonus deferral in 2011, so less variable remuneration was paid out shortly after the end of the performance year than in previous years.

The impact of this, in aggregate, can be seen in Figure 10. For every Euro of variable remuneration awarded in 2011 only 35 cents was paid out shortly after the year-end, with the remainder deferred. Across respondents, non-deferred variable pay fell by 46% from 2010 to 2011 and 77% from 2007.

![Figure 9: percentage of individual bonuses paid out shortly after the year-end (with the balance deferred).
Based on McLagan’s proprietary data.](image)

![Figure 10: variable remuneration paid shortly after the year-end as a % of total variable remuneration.](image)

ii. Instruments for variable remuneration

There has been a marked change in the form in which variable remuneration is paid, whether paid out shortly after year-end or deferred. Firms increasingly pay in the form of shares, rather than cash, helping align the interests of employees with those of shareholders and the firm as a whole.

Figure 11 shows how the delivery of variable remuneration in different instruments has evolved over time (aggregated across all BCM employees). In absolute terms, variable remuneration awarded in cash is down by 63% since 2007. The proportion of variable remuneration paid in cash fell from 77% in 2007 to 57% in 2011. In 2011, 35% of variable remuneration was paid in shares, with the remainder in other financial instruments.

![Figure 11: variable remuneration indexed back to 2007; within that the evolution of how variable remuneration is delivered in different instruments.](image)
iii. Pay at risk, malus and clawback

Many firms deferred an element of variable remuneration even before the financial crisis, typically citing either retention or shareholder alignment as the rationale. However, deferred remuneration amounts are increasingly subject to "performance-adjustment" provisions which allow pay to be risk-adjusted after the event if need be. All of the firms surveyed have now implemented these kinds of features whereas in 2007 less than a quarter of firms did so.

The most prevalent performance adjustment approach is 'holdback' or 'malus', which provides the facility to delay the vesting of an unvested deferred remuneration award or to reduce the award value, based on subsequent performance or other factors. Other approaches include:

- Clawback – allows remuneration that has already been paid to be reclaimed, usually based on factors such as negligence or other malfeasance;
- Performance-adjustment of deferred remuneration value – which links the value of unvested deferred remuneration to subsequent performance, over and above any linkage by awarding the deferred remuneration in shares (for example, the value or number of shares awarded varies by an amount equal to the business's return on equity over the deferral period);
- Performance-vesting long-term incentives – where the value vesting is subject to a hurdle or adjustment based on performance during deferral period, so in effect it is earned based on performance over that longer time scale.

iv. Conclusion

The industry has made far-reaching changes to the way in which remuneration is structured since the financial crisis began. The proportion of variable remuneration awarded in shares has increased significantly since 2007, although the majority of variable remuneration is still paid in cash. Deferral of variable remuneration has also increased significantly, in many cases beyond the minimum regulatory requirements. Together with the introduction of performance-adjustment provisions into deferred remuneration plans, this means more pay is at risk.
4. GOVERNANCE OF REMUNERATION POLICIES AND DECISIONS

The governance structures and decision-making processes that firms have in place are essential to the development of efficient and sustainable approaches to remuneration. Since the financial crisis began, the industry has worked to strengthen these structures in order to ensure effective oversight and balanced decision-making for financial sector remuneration. Regulators have also placed significant emphasis on this. This section considers:

- Compliance with regulatory requirements on governance;
- The role of risk functions, boards and remuneration committees;
- Incorporating risk into performance measurement; and
- Transparency of remuneration policies and outcomes.

i. Compliance with regulatory requirements on governance

At the heart of reforms of banking remuneration regulation are the Financial Stability Board (FSB) ‘Principles for Sound Compensation Practices’ (April 2009) and the supporting ‘Implementation Standards’ (September 2009 – together the ‘FSB Principles & Standards’). These have been adopted in Europe by making amendments to the Capital Requirements Directive (CRDIII) and in the U.S. via the Interagency Guidance on Sound Incentive Compensation Practices.

In October 2011, the FSB published a ‘Thematic Review on Compensation’. This concluded that firms have generally made good progress in implementing the FSB Principles & Standards. The report concludes that the 20 largest internationally active banks are “on average... broadly consistent with nearly all of the elements of the [Principles & Standards]”.

In April 2012, the European Banking Authority (EBA) published a survey of the implementation of the EU guidelines on remuneration policies and practices which underpin the requirements of CRDIII. The report concluded that there has been considerable progress on firms’ governance of remuneration, while risk alignment should be further developed. Concerns were raised around the guidance on, and identification of, material risk takers within firms. The EBA called for further guidance on risk-alignment practices and on the principle of proportionality in complying with these requirements.

McLagan’s research and interviews with senior Human Resources executives from AFME Board-member firms suggest that best practices have progressed beyond these regulatory standards.

ii. The role of risk functions, boards and remuneration committees

Based on data gathered by McLagan, it is clear that risk management is now much more central to reward decisions. Both the Risk Management function itself and the Board Risk Committee provide more input to remuneration processes at all firms, and significantly more input in most.
Evidence from the McLagan study suggests that Board remuneration committees also have a stronger role. Committee chairs and members have seen a substantial increase in the volume and indeed the quality of data that they receive. Responses from firms suggest that committees are providing more input in remuneration processes and are taking a more hands-on and directive stance over remuneration processes and decision-making, as well as specific remuneration outcomes.

Firms have also changed decision-making processes to reinforce the independence of the Risk Management function from the businesses that it supports. In all firms the variable pay decisions for individual employees in Risk Management are now made by the central control function, rather than being made by management in the division or business that they support. Similarly, almost all firms fund variable pay for Risk Management separately from the performance of the business.

**iii. Incorporating risk into performance measurement**

McLagan’s interviews with senior HR executives suggest that firms are taking a more sophisticated and more rounded view of performance when determining total remuneration levels. Increasingly the focus is on profit rather than revenue, taking into account the costs of doing business, the capital and liquidity required.

A range of methods are used to factor in the degree of risk to the business. Specific risk-adjustments are being factored into financial performance-measurement, to ensure that the extent to which different products expose the firm to different amounts of risk is better captured.

An increasing proportion of banks are looking at return on risk weighted assets (RWAs) or return on economic capital as a more systematically embedded risk-adjusted performance approach. More than two-thirds of the firms surveyed use return on RWAs or return on economic capital as a key determinant in their remuneration decisions. In a number of firms other explicit risk adjustments are made, such as qualitative adjustments to factor in stressed risk profiles or risks that are less easily quantified.

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**Figure 13:** responses to ‘Please indicate how the following internal stakeholders’ inputs to remuneration processes have changes between 2007 and 2011.

**Figure 14:** pay decision-making for employees in Risk Management.
Through this kind of approach, performance-measurement takes better account of the true costs of doing business and the risks to the firm and therefore remuneration decisions are more risk-aligned. The figure below represents the evolution of firms’ methodologies for adjusting remuneration for risk. The McLagan study shows clear evidence of continued strengthening in this area.

**Figure 15**: the evolution of approaches to performance-measurement and adjustment for risk.

### iv. Transparency around remuneration policies and outcomes

The level of transparency from banks about remuneration has increased significantly since the crisis. In part this is a result of disclosure requirements set out in the FSB Principles & Standards and mandated by the regulatory requirements in many jurisdictions, including across Europe via CRDIII. The FSB Principles & Standards require annual disclosure around remuneration decision-making processes, remuneration design characteristics, performance measurement and risk-adjustment criteria, remuneration deferral policy and requirements for that deferred remuneration to be released. There is also a requirement for significant quantitative disclosure, at an aggregate level, of the amount of total remuneration for the year and its composition.

Many firms have not only met these regulatory requirements, but have made additional voluntary disclosures that seek to further illuminate remuneration decision-making and outcomes. Best practice disclosures provide investors with information that goes well beyond the regulatory requirements and the accounting disclosures, showing the actual remuneration awarded in respect of the year and how this then aligns with the mandatory staff expense included in the Profit & Loss account. Figure 16 shows how firms reported their transparency changing from 2007 to 2011.

**Figure 16**: responses to ‘Please indicate how your firm’s approach in the following areas has changed between 2007 and 2011’.
In addition to increasing disclosure, many firms have gone further and have also increased their dialogue with key shareholders. Bank shareholders have also come in for criticism over bank remuneration, accused by some politicians and other commentators of failing to rein in bank remuneration levels. Increasing disclosure and dialogue provides shareholders with the opportunity to influence remuneration within the existing corporate governance structure of the banks.

v. Conclusion

Significant industry progress has been made in strengthening remuneration governance and decision-making. Banks have broadly implemented the key regulatory requirements and both firms and national regulators continue to work together to drive improvements and propagate best practices. The reforms implemented by banks often go beyond regulatory requirements, driven by the desire within firms to ensure appropriate compensation design, oversight and outcomes, taking appropriate account of performance and risk and reinforcing the firm's general approach to risk management.

Many firms are focusing on top management and at board level in terms of how better to align remuneration with shareholders’ and customers’ interests. Remuneration Committees are exerting more control of remuneration processes and are working ever more closely with Board Risk Committees to ensure information flows are timely and effective. Performance measurement and management are considered in ways that are more risk-sensitive and the risk management function itself is much more involved in compensation policy and decision-making.
5. FUTURE DRIVERS OF INVESTMENT BANKING PAY

The concluding section of the report considers two important factors – industry structure and the level of regulation – which drive remuneration in investment banking. The discussion considers the influence that those factors may have on the future direction of remuneration in the sector. The broad conclusions in this section, which uses data from the McLagan study and evidence from other sources, are offered to help inform the economic and regulatory debate on financial services remuneration in Europe.

i. Structural change in the investment banking industry

Following a sustained period of expansion and rising profitability during much of the previous decade, since 2008 the investment banking industry has experienced considerable volatility, contraction and falling returns. It is becoming increasingly clear that the economic and financial crisis of 2007-08 represents a structural break for investment banking. At the industry level there is evidence that a profound and prolonged restructuring is underway, both within Europe and globally.

In terms of commercial strategy, several trends result, which are evident both across the investment banking sector in Europe and in the business strategies of individual firms. These trends include:

- **Regionalisation** – investment banking remains a truly global industry. However, a number of firms have to some extent retreated from overseas operations in order to focus more on their domestic market. Some of these cases involve overseas divestments – particularly those made by European firms – which may also have been made in order to increase banks’ capital ratios.

- **Narrowing scope** – a number of firms appear to be retreating from a ‘full service’ investment banking model in order to concentrate on business lines where they have significant scale or other sources of competitive advantage.

- **Deleveraging** – leverage ratios have reduced significantly compared to the pre-crisis period as firms have reduced the size of their balance sheets and sought to rebuild their capital base. This trend is firmly aligned with the direction of the Basel III banking reforms.

- **De-risking** – the financial crisis has significantly reduced the risk appetite of institutions and investors and banks have been moving towards smaller and safer balance sheets.

The investment banking industry is dealing with two significant, and linked, financial pressures:

- **Higher funding costs** – generally the cost of capital for the financial sector has risen significantly compared to the pre-crisis period. This may reflect a number of factors including an increase in the risk premium for investment in financial institutions; lower liquidity, particularly in inter-bank markets; and the (anticipated) impact of regulatory change.

- **Lower returns** – profitability in the investment banking industry is down significantly from pre-crisis levels, both in absolute terms and based on relative measures such as return on equity. The medium-term expectations for the industry are based on a sustained period of generally lower profitability, though returns may be higher for scale players or smaller firms with clearly defined areas of competitive advantage.

Figure 17 offers some insight into the impact of higher funding costs on key capital markets business lines. The charts show the proportion of net revenue paid in remuneration for two business lines: foreign exchange and credit, where the latter has become substantially more capital intensive since 2007. Credit products have had a much greater reduction in the pay-out ratio (the percentage of net revenue paid in compensation) than foreign exchange and this ratio may not return to pre-crisis levels.
ii. The impact of regulation on the investment banking industry

Since 2008, governments and regulators worldwide have been working on a broad and detailed programme of financial regulation, in order to address weaknesses in market operations that were highlighted by the financial crisis. The group of G20 nations has played a leading role in shaping and coordinating this regulatory programme, which has a number of important elements. These include:

- **A stronger prudential framework**, built around Basel III, which introduces new rules on capital, liquidity, leverage and counterparty credit risk. The framework also designates global systemically important banks (G-SIBs) which are required to maintain higher levels of regulatory capital. In Europe this framework will be implemented through CRDIV.

- **Broad reform of financial markets**, in relation to market structures, market operation, investor protection, transparency and supervisory powers. In Europe these reforms will be made through MiFID II. In the U.S. they will be implemented through the Dodd-Frank Act.

- **Reform of derivatives markets**, in line with the agreed G20 goal of mandatory clearing of over-the-counter (OTC) transactions. This is being implemented through the European Market Infrastructure Regulation (EMIR).

- **Reform of the credit rating agencies**, which in Europe will be implemented through the Credit Rating Agencies Regulation, CRA3. The rating agencies will also come under the scope of the European Supervisory Authorities.

- **A regulatory regime for the hedge fund industry**, to be implemented in Europe through the Alternative Investment Fund Manager Directive, AIFMD.

- **Structural reform or ring-fencing of financial activities**, which is being implemented in specific areas of banking activity through the Volcker Rule in the U.S. and the Vickers reforms in the United Kingdom. The EU has asked a High Level Expert Group to examine the case for similar structural reforms on a pan-European basis.

It is clear from the stated intentions of international policymakers and from the detail of the reforms already being implemented that the regulatory regime for financial services is becoming significantly tougher, more prescriptive and less trusting of markets and institutions. This new regulatory settlement will intensify the already strong structural forces (described above) which are driving the financial services industry to reduce leverage, increase capital and de-risk, and so will reduce profitability, and therefore remuneration.

Historical evidence supports this expectation: that in periods of increased financial regulation, there is significant downward pressure on levels of remuneration in banking. The box below outlines robust economic analysis of the effect of regulation on the U.S. banking market over the past century which illustrates the dynamics of this process.
All the indications are that similar forces are at work in Europe today. Most industry analysts believe that the tighter regulation of financial services is likely to reduce returns in investment banking and so continued downward pressure on remuneration is a likely result. In addition, the expectation of reduced returns is prompting shareholders to focus anew on the division of rewards between themselves and bank employees, adding further downward pressure on pay levels.

In summary, the extensive programme of regulatory reform being implemented in the European Union and throughout the G20 countries is profoundly changing the economics of the investment banking business, and with it the structure and level of financial services sector remuneration. This change is secular, not cyclical, and is hard-wired into the decisions being made by senior management and boards of global banking institutions – including on remuneration.

### iii. Conclusion

It is becoming increasingly clear that the economic and financial crisis of 2007-08 represents a structural break for investment banking. At the industry level there is evidence that a profound and prolonged restructuring is underway within investment banking in Europe and globally. This is being driven by many factors including lower returns, increased capital costs, and the broader programme of regulatory reform being implemented in the European Union and throughout the G20 countries. These changes are secular, not cyclical, and are being hard-wired into the decisions being made by senior management and boards of global banking institutions – including on remuneration.

The economic evidence suggests that over the long term the level of regulation is a key driver of remuneration in the financial sector. Europe’s banking sector is clearly moving into a new phase of heavier and more intrusive regulation requiring more capital, greater liquidity, lower leverage and tighter restrictions on business models, product lines and market structures. The historical evidence suggests this regulatory wave will exert continuing downward pressure on banking remuneration.

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AFME, the Association for Financial Markets in Europe, represents the leading participants in Europe’s wholesale financial markets on a wide range of market, business and prudential issues. AFME advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society.

McLagan is the leading performance and reward consulting and benchmarking firm for the financial services industry, helping their clients make the best decisions by providing fact-based advice.
The Association for Financial Markets in Europe advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society.

On behalf of our members, we:

- Offer a single voice for the European capital markets participants and advocate their views at national, European and global levels;
- Develop a constructive dialogue on market and regulatory policy with legislators and regulators;
- Contribute policy and advocacy expertise to help achieve a balanced and stable regulatory environment; and
- Promote the contribution of the financial sector to society.