

Performance and remuneration in investment banking in 2012

Findings of an industry study by McLagan

December 2013

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EXECUTIVE SUMMARY

The reform of remuneration in investment banking continued in the 2012 compensation year, driven by change within the industry and by regulation. This report focuses on the key trends in remuneration in banking and capital markets (BCM) activity in 2012. The findings in this report build on our previous study which examined the key trends in remuneration in the 2007-2011 period. However, the sample of firms surveyed in this year's study is different to last year, which limits the scope for direct year-on-year comparison for some variables.

The report's main findings for the 2012 compensation year are:

Total remuneration awarded fell in 2012 despite improving financial performance

Across the firms surveyed, total compensation awarded in respect of performance year 2012 fell by 4% year on year. Financial performance in firms' BCM activities improved in 2012: net revenue increased by 5% across the firms surveyed, while pre-tax profit increased by 29%.

Fixed pay awarded fell materially, driven by lower headcount, while variable pay awarded was marginally lower

Total fixed compensation awarded fell by nearly 6% in 2012, resulting in part from an average 4% fall in headcount. Variable pay awarded fell by 1% in 2012. Fixed pay awarded accounted for 57% of total remuneration in 2012, down from 58% in 2011.

Firms are continuing the trend of reform to the structure of variable pay:

- Compared to last year, more than three-quarters of the firms surveyed have strengthened risk adjustment of their bonus pools. Additional financial adjustments have been implemented both on an ex-ante and an ex-post basis.
- Vesting periods for deferred variable pay continue to rise, particularly for senior staff. The average combined period for vesting and retention for awards to board directors increased from 43 months in 2011 to approximately 51 months in 2012. The combined retention period for other 'identified' staff rose from an average of 42 to 47 months.
- Firms have increased the scope of malus provisions applied to deferred compensation. All firms surveyed already have malus provisions in place at parent level and during 2012 these were also increasingly applied at subsidiary level.

Governance of remuneration decisions continued to strengthen in 2012:

- Two-thirds of firms reported an increase on last year in the involvement of the risk function in remuneration decisions.
- Around 40% reported greater dialogue with shareholders and regulators on remuneration policies and decisions.
- Nearly half of firms reported that the workload of board-level remuneration committees continued to increase. RemCos placed a particular focus on the allocation of profit between employees, shareholders and capital; risk adjustment; and pay structures.

Viewed as a whole these findings confirm that the clear trend of reform and increased transparency in remuneration policy and decision-making, which was identified in our previous report, is continuing.

INTRODUCTION

This report focuses on the key trends in remuneration in banking and capital markets (BCM) activity in 2012, based on a detailed industry study conducted by McLagan. The findings in this report build on our previous study which examined the key trends in remuneration in the 2007-2011 period. The findings of that study are summarised in the box below. However, the sample of firms surveyed in this year's study is different to last year, which limits the scope for direct year-on-year comparison for some variables.

In broad terms, this study aims to answer three sets of questions:

- What impact has banks' financial performance had on remuneration outcomes in 2012, and how does this compare to the previous year?
- What changes have been made to the remuneration structures and incentives in 2012?
- How has the governance of investment banking remuneration developed over the past year?

The report is structured as follows:

- Section 1 sets out the scope and methodology of the study;
- Section 2 outlines financial performance and remuneration for BCM businesses in 2012, compared with 2011;
- Section 3 examines incentive and reward structures in investment banking in 2012; and
- Section 4 analyses remuneration governance and decision-making in 2012.

KEY FINDINGS OF THE McLAGAN STUDY ON BANKING REMUNERATION FROM 2007-2011:

Pay in investment banking dropped sharply after the financial crisis

On a per capita basis, total remuneration had fallen by 30% since 2007. Variable remuneration fell by 55%, while aggregate revenue and risk-weighted profit fell 3% and 15% respectively.

The balance between fixed and variable pay shifted dramatically

Fixed remuneration awarded in 2011 was 37% higher than in 2007. In 2007, fixed pay accounted for 30% of total remuneration awarded; by 2011 it accounted for 55% of the total.

Incentive structures in investment banking pay were being overhauled

Total variable remuneration paid out immediately after the year-end was down by 46% in 2011 and by 77% compared with 2007. Total variable remuneration awarded in cash fell by 35% in 2011 and was 63% lower than in 2007.

Firms were significantly strengthening governance and transparency on pay

All the firms surveyed had pay-at-risk arrangements and had implemented both 'malus' and 'clawback' provisions in deferred pay awards. In addition, compared to 2007, all firms surveyed had enhanced the role of their board-level remuneration committee and their risk management functions in determining pay.

Market fundamentals would continue to have a sustained impact on bank pay

Evidence from key products within firms' wholesale markets divisions suggested that higher capital costs were being passed through in lower remuneration. Further deleveraging and de-risking in the European banking sector was likely to sustain this trend over the medium term.

1. SCOPE AND METHODOLOGY OF THE STUDY

The scope and process for this year's study is similar to the approach undertaken last year. AFME commissioned the performance and reward consultants McLagan to undertake a confidential study of its board members' remuneration policies, outcomes and financial performance. McLagan asked each participating firm to complete a quantitative and qualitative survey. AFME has not seen any of the individual firm-level data obtained in the study.

McLagan received survey responses from 13 AFME Board member firms; a similar number to last year. However, 5 firms in the sample group for 2012 did not participate in the 2011 study. This means that the survey results for certain variables are not directly comparable to last year. However, in terms of the overall characteristics of the sample, the respondents offer broadly consistent market coverage in terms of business lines and geographic spread.

Scope

As per last year, the study focuses on each firm's 'banking and capital markets' (BCM) business, which mainly comprises equities, fixed income, currencies, commodities and investment banking. Data were requested from all AFME Board member firms on their global BCM business as many 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.

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, including identified staff; and
- 4) Financial performance for BCM, as well as constituent business areas, on a global basis

Performance and remuneration data were collected for 2011 and 2012. Where noted, the survey data have also been supplemented by proprietary data from McLagan. Information relating to governance, policies and practices has been collated based on structure to compare changes between 2007 and 2011 (i.e. broadly just before the financial crisis until last year) and then from 2011 to 2012.

Definitions

Throughout this report, 'total remuneration' refers to the awards made 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' represents the amount of remuneration that would be recognised in the accounts that year.

Other terms used in this report are defined below:

- *Short-term incentive (STI)* – Some or all of any STI award may be subject to deferral. Deferred STIs may vest subject to continued employment ('time-vesting') or the value vesting may be subject to a performance hurdle or adjustment during the deferral period ('performance-vesting').¹ If only clawback or holdback / malus are applied to the award then it is considered time-vesting.
- *Long-term incentive (LTI)* – This term describes the any additional LTI award (not deferred STI) and the data have been collated based on a grant-date fair value, factoring in any performance conditions based on expected percentage vesting.

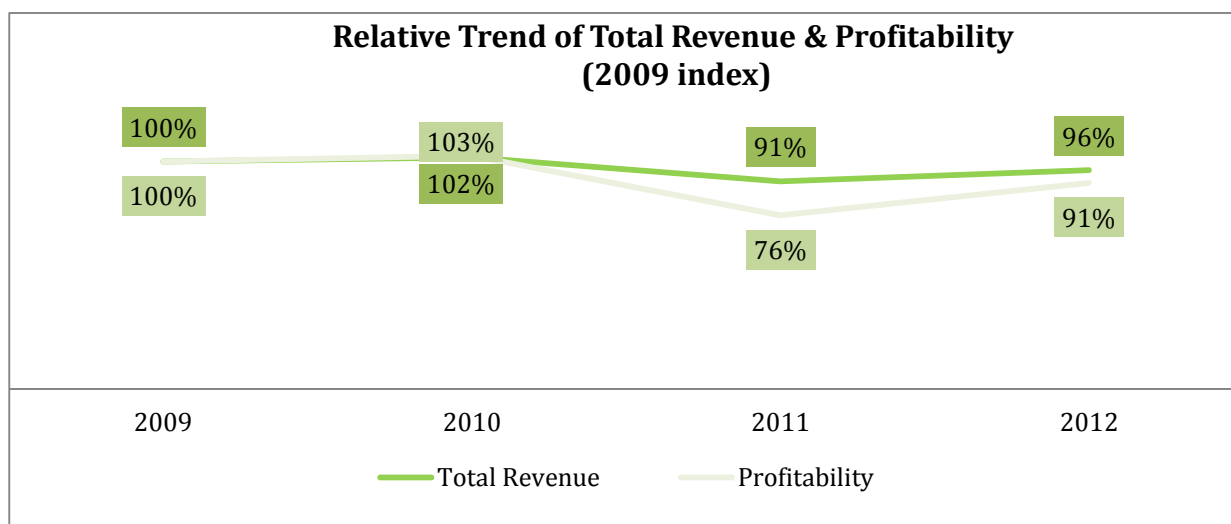
- *Deferred variable remuneration* – This term describes variable remuneration in respect of the performance year where payment or vesting is deferred beyond the normal award date; typically within 3 months of the end of the performance year. Remuneration paid or vesting around the normal award date and which is subject to a subsequent retention period should be treated as non-deferred variable remuneration.
- *Identified staff* – This term describes individuals (usually employees) identified as being key to decision-making and / or a firm's risk profile. In many regulatory jurisdictions, firms are required to identify a particular population of identified staff.

2. MAIN REMUNERATION & PERFORMANCE OUTCOMES

This section examines the main outcomes in remuneration for the BCM businesses of AFME Board member firms in 2012, compared with 2011 on remuneration versus performance. Because the samples in the 2011 and 2012 surveys cover different institutions it is not possible to provide continuous time-series performance data across multiple years. Therefore the survey uses performance data from McLagan, covering the 9 largest firms in the BCM area, in order to provide a more robust sample for time-series analysis of financial performance.

Main performance outcomes

Financial performance in BCM operations improved in 2012, with net revenue increasing by 5% on average across respondent firms. Looking at a broad range of global banking firms, there is an upward trend in performance from 2011 to 2012. Both revenue and profitability increased in 2012 but remain below the levels observed in 2009 and 2010.



The nine largest global banks on a BCM-wide basis reported an upswing in overall revenue between 2011 and 2012, driven by increases in Fixed Income and Investment Banking revenue.

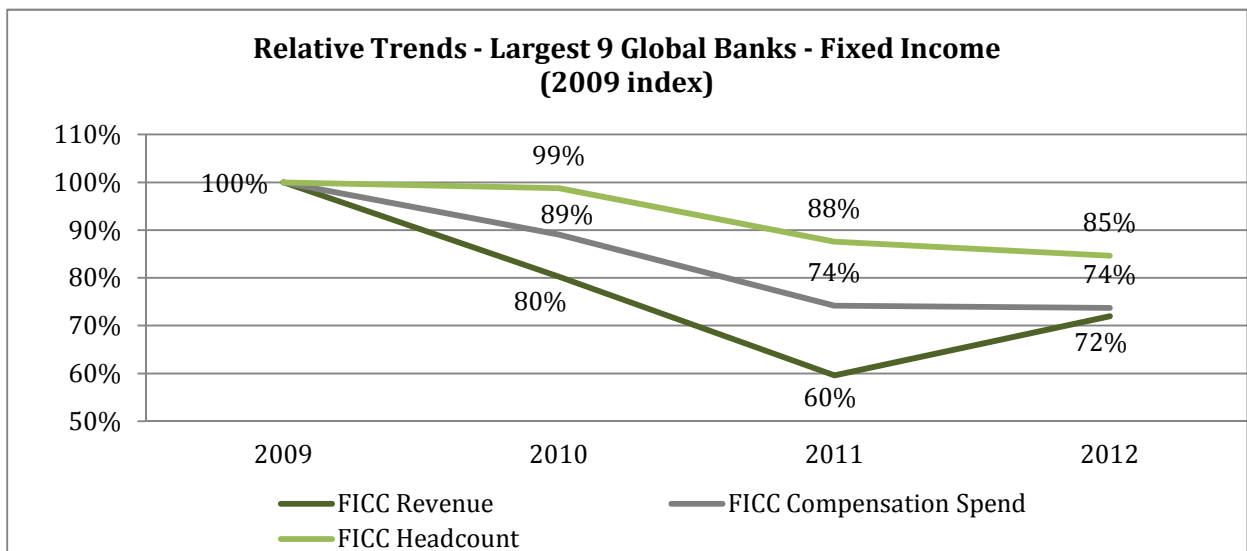
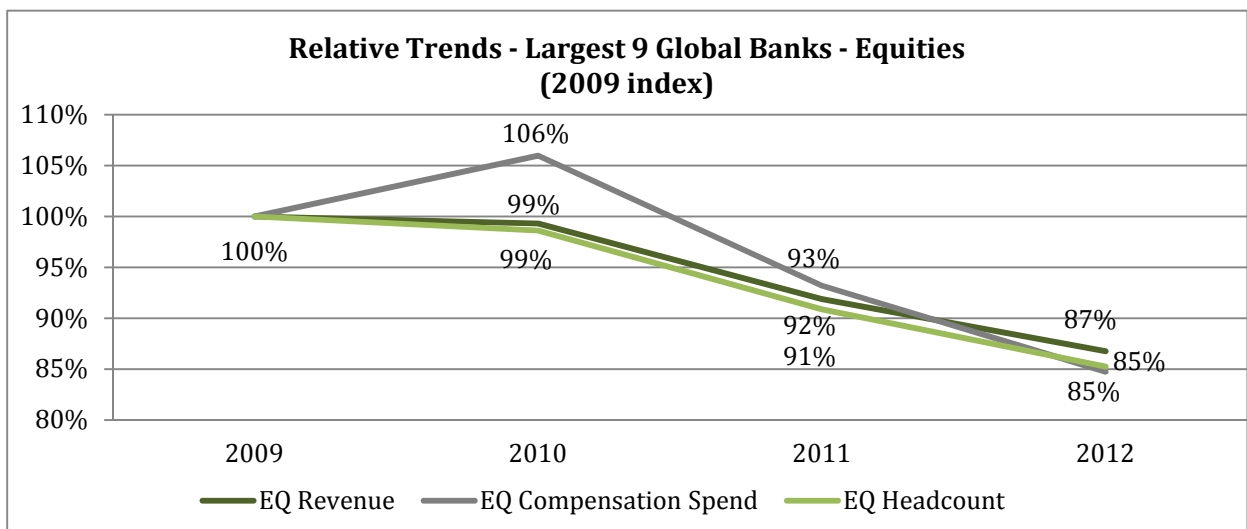
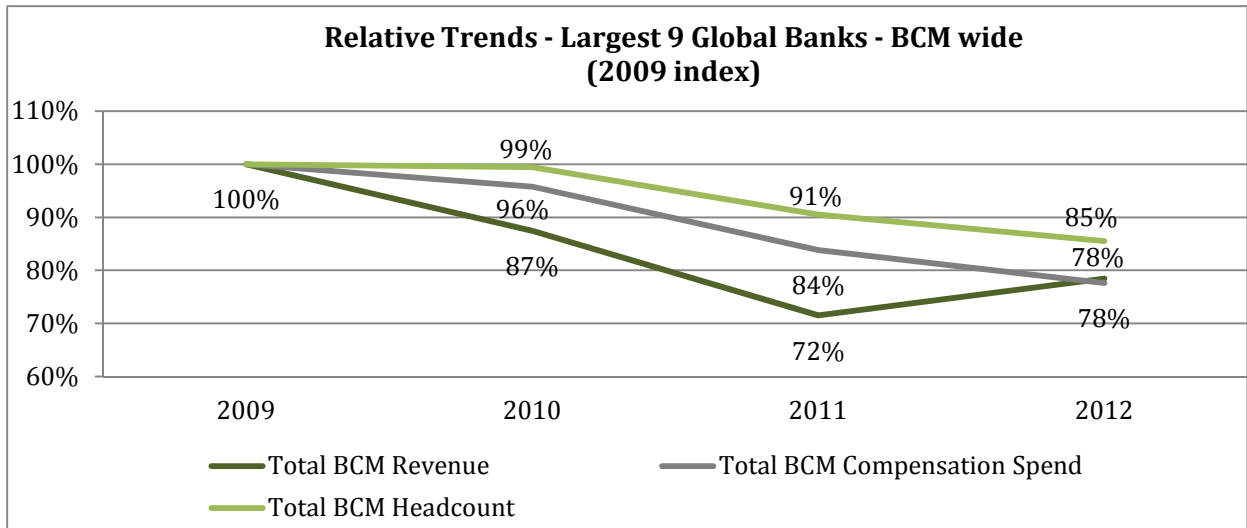
Main remuneration outcomes

Across the firms surveyed, total compensation awarded in respect of performance year 2012 fell by almost 4% year on year. With the combination of increased capital requirements and the fragile recovery in performance, variable remuneration pools amongst respondent firms fell by 1% across firms surveyed while fixed remuneration awarded fell by nearly 6% in 2012.

On average, headcount decreased by around 4% amongst respondents. This reduction is the result of banks adjusting to the impact of regulatory reforms, an uncertain economic outlook and continued restructuring in the industry. Looking more closely at the nine largest banks, by 2012 total headcount had fallen by 15% compared to the 2009 level, with the sharpest decline in headcount being observed in 2011.

In the nine largest global banks, total compensation fell by more than headcount, highlighting that on an aggregate basis employees were paid less in 2012 than in 2009. On a BCM-wide basis compensation spend in 2012 was 22% lower than in 2009.

The charts below provide data for the nine largest global banks operations for 2009 to 2012 and compare revenue, headcount and compensation awarded in three distinct areas of the business: (i) at the whole BCM level; (ii) for equities operations; and (iii) for fixed income operations.



For each of the business lines shown above, both revenue and compensation awarded have fallen significantly – and by similar magnitudes in each business area – compared to 2009 levels.

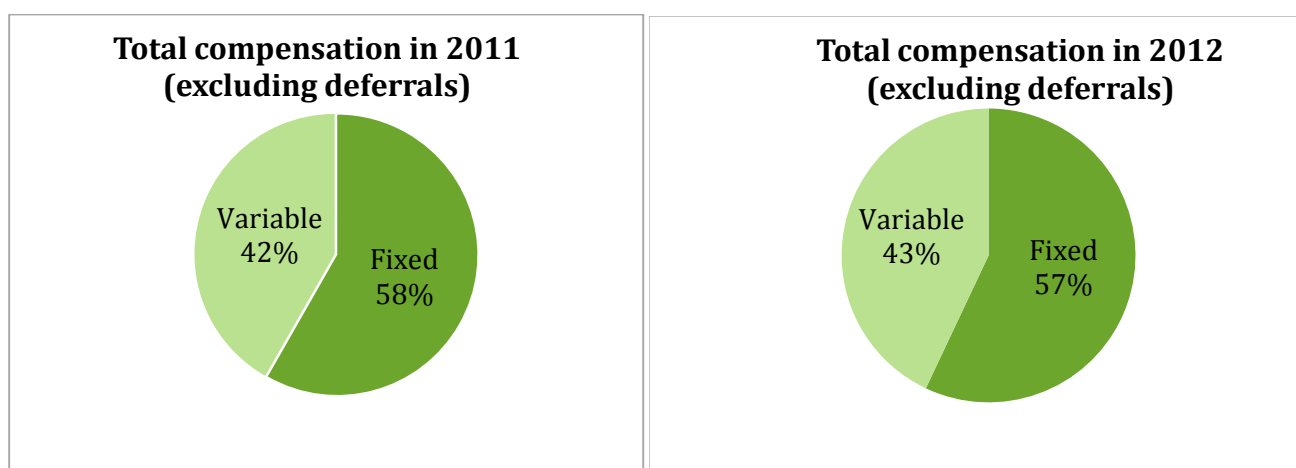
3. INCENTIVE STRUCTURES IN INVESTMENT BANKING

The role of incentives within financial institutions remains a key area of focus of the post-banking crisis reform agenda. Within Europe, regulations are continuing to shape the structure, governance and outcomes of incentive pay policies and practices within banks and firms themselves are spending considerable time and resources to ensure that variable pay is 'fit for purpose'. This section examines these changes, covering an analysis of:

- Trends in the variable and fixed components of remuneration;
- The structure of deferred remuneration;
- The instruments used for variable remuneration;
- Developments in risk adjustments to remuneration; and
- Changes in the vesting and retention periods for variable remuneration.

Trends in the variable and fixed components of remuneration

In 2007, fixed pay constituted around 30% of total compensation in banks' BCM businesses and that has risen significantly over time. Data from respondents in this year's study show that in 2011, 58% of total remuneration was fixed. That proportion fell marginally to 57% in 2012 as fixed remuneration fell faster than variable remuneration compared to 2011.



Deferral of variable remuneration

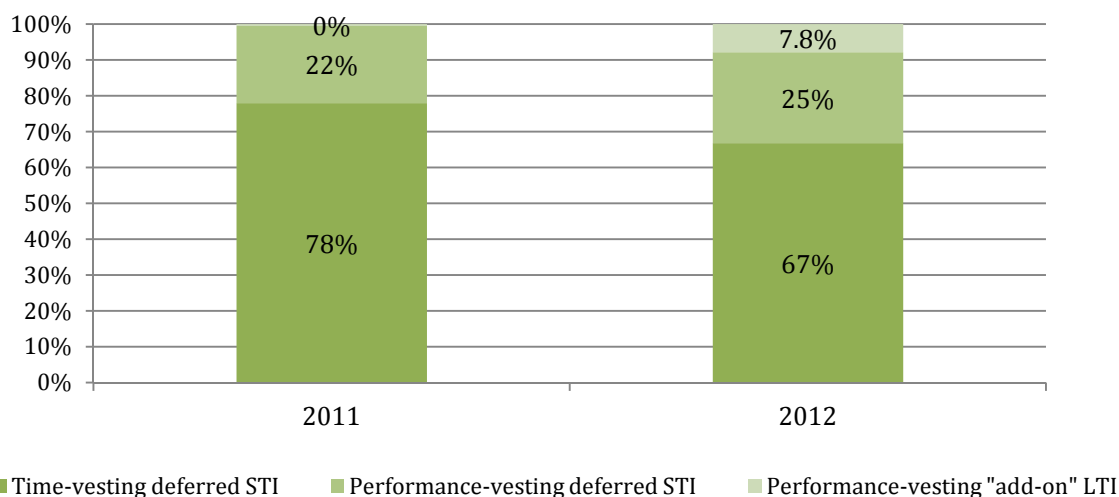
In 2007, at least 80% of total variable remuneration was paid shortly after year-end. In both 2011 and 2012 that proportion was around 55% of the total variable pay bill.

Time-vested deferred short term incentives (STI) remains the most common type of deferred compensation awards, in both 2011 and 2012 despite a slight shift towards more performance-based deferred award. In 2011, more than three-quarters of deferrals were time-vested STI. In 2012, this proportion has shrunk to just around two-thirds. Conversely, in 2012 there was a slight increase in the proportion of deferred variable pay which is delivered through add-on LTI¹ and performance-vesting deferred STI in 2012.

Overall, there appears to be a growing trend for firms applying performance adjustment during the deferral period (especially for more senior employees) so that payments in the future can be adjusted to business outcomes. This trend complements the increasingly widespread application of malus and clawback.

¹ In general, the provision of performance-vesting 'add-on' long-term incentives is not prevalent amongst survey respondents. Some firms only apply add-on LTI for top executives.

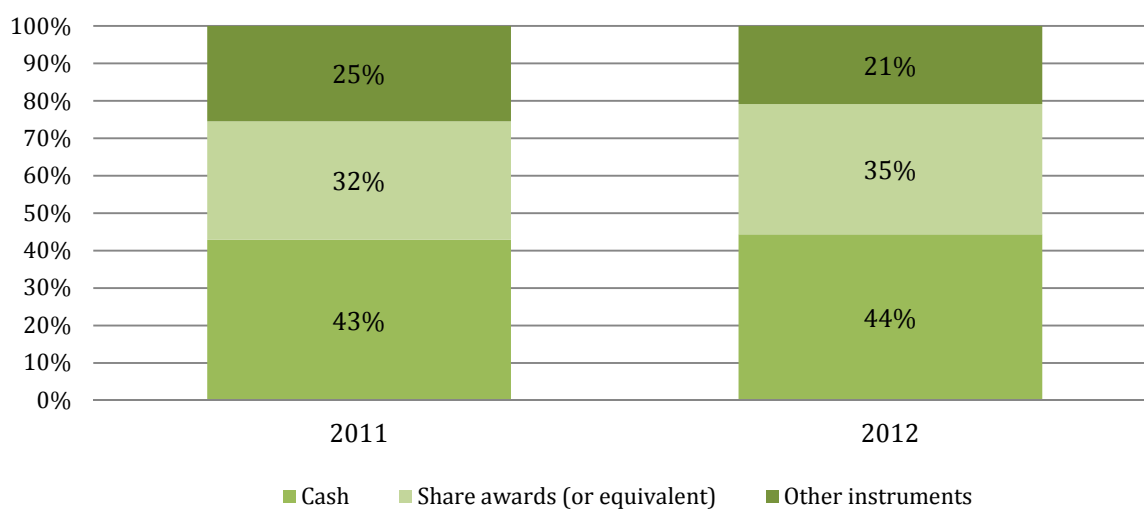
Deferred variable remuneration by type of award



Instruments used for variable remuneration

In terms of delivery vehicles for variable remuneration, cash remains the most commonly used vehicle, followed by share awards. In 2012 cash and shares made up over 80% of survey respondents' variable pay. There has been little change in the proportion of variable remuneration paid in cash between 2011 and 2012. Instead, the main change has been in a decrease in the proportion of other instruments used (e.g. phantom stock, options, fund units, or bail-in bonds etc.) The use of hybrid instruments has not picked up, despite an increasingly supportive attitude among policymakers towards using instruments such as bail-in debt for remuneration purposes. Several firms surveyed stated that these instruments remain complex and that overall their use would remain limited to select individuals.

Proportion of variable pay awarded by instrument



Developments in risk adjustments to remuneration

In 2007, less than a quarter of survey respondents had some form of risk adjustment provision. Ex-ante and ex-post performance adjustment provisions are now used by all firms surveyed.

Ex-ante risk adjustment

Ex ante risk-adjustment of remuneration, where firms adjust for risk as remuneration is accrued and awarded to factor in potential future adverse developments, has been an area of significant focus for firms since 2007. Firms in our study generally apply a combination of formulaic and discretionary adjustments for different kinds of risks and issues.

Over the past year, some respondents have sought to enhance the sophistication and effectiveness of the ex-ante risk adjustment by implementing additional financial adjustments. We also note that some firms have undertaken significant effort to tailor ex-ante risk measurements to the specific type of business (e.g. investment bank vs. asset management). A common ex-ante financial adjustment is taking into account risk-weighted asset allocation in cost of capital forecasting to ensure the maintenance of sufficient loss-absorbing capital.

Ex post risk adjustment

In 2007, the majority of firms did not have any holdback/malus or clawback provisions, nor take into account any performance adjustment during deferral period. Also, very few firms utilised “add-on” long-term incentives with performance-vesting criteria. Those that did only applied it to select groups of employees, typically only senior executives.

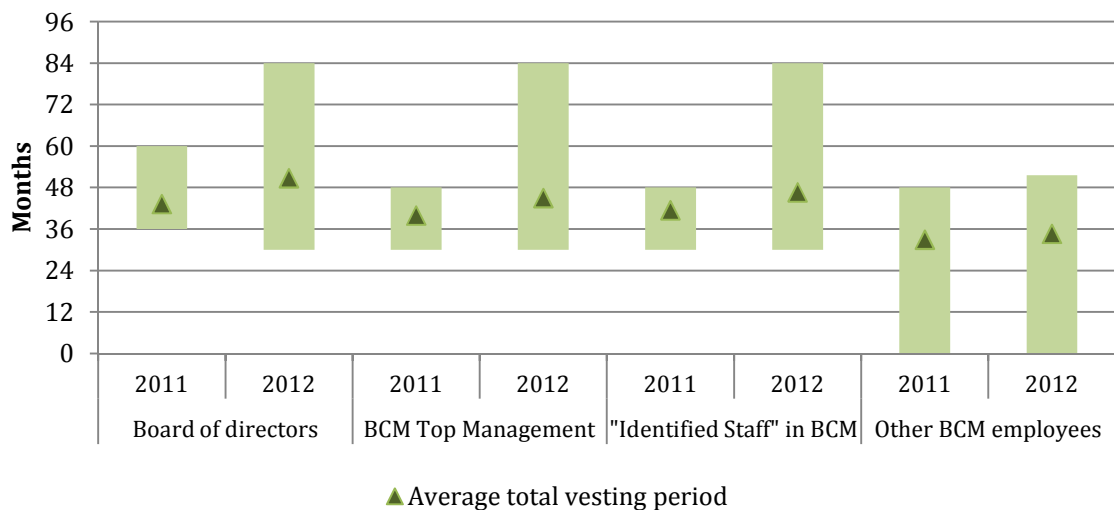
Progressing onto to 2011 and 2012, the firms surveyed all reported having in place robust malus and ex-post risk adjustment processes. These provisions effectively mean the deferral of awards allows firms to re-visit remuneration decisions where subsequent information comes to light:

- **Malus:** All firms surveyed have malus provisions. Increasingly malus is being applied to all employees. By 2011, 75% of firms applied malus provisions to all employees and it is likely that very few firms will retain a selective approach moving forwards. In some firms, the provision is potentially applicable even if an individual has not personally contributed to material financial downturn. Some firms are also extending malus triggers beyond Group level to subsidiary entity as well. In addition, firms reported an increase in the implementation of malus between 2011 and 2012.
- **Clawback:** There was little change in clawback provisions compared to 2011. Around half of firms apply clawback to all employees, whilst just under half surveyed do not use this provision at all. The remainder (a minority of firms) apply clawback to only some groups of employees. Part of the difficulty in developing and applying clawback provisions is the legal, tax and logistical difficulty of reclaiming paid remuneration. Firms noted that clawback is only effective where there is clear proof of serious misconduct, such as fraud or serious violation of company policies. As such, cases of clawback remain limited, but there are examples, particularly where the judicial system has been involved.

Vesting and retention periods for variable compensation

There were increases reported in vesting and retention periods for variable compensation for BCM staff, including the most senior staff. For senior staff and risk takers, average total vesting and retention periods are around 36 months. The average combined period for vesting and retention for awards to board directors increased from 43 months in 2011 to approximately 51 months in 2012. The combined retention period for other ‘identified’ staff rose from an average of 42 to 47 months.

Variable compensation vesting and retention periods



4. GOVERNANCE OF REMUNERATION POLICIES AND DECISIONS

Since the financial crisis, governance structures and decision-making processes have been fundamental to effective and prudent remuneration decisions within BCM. This section considers:

- the evolution of governance, oversight and decision making on remuneration;
- the changing role of various functions and committees in the remuneration process, particularly the Remuneration Committee; and
- how firms' dialogue with shareholders and regulators has changed.

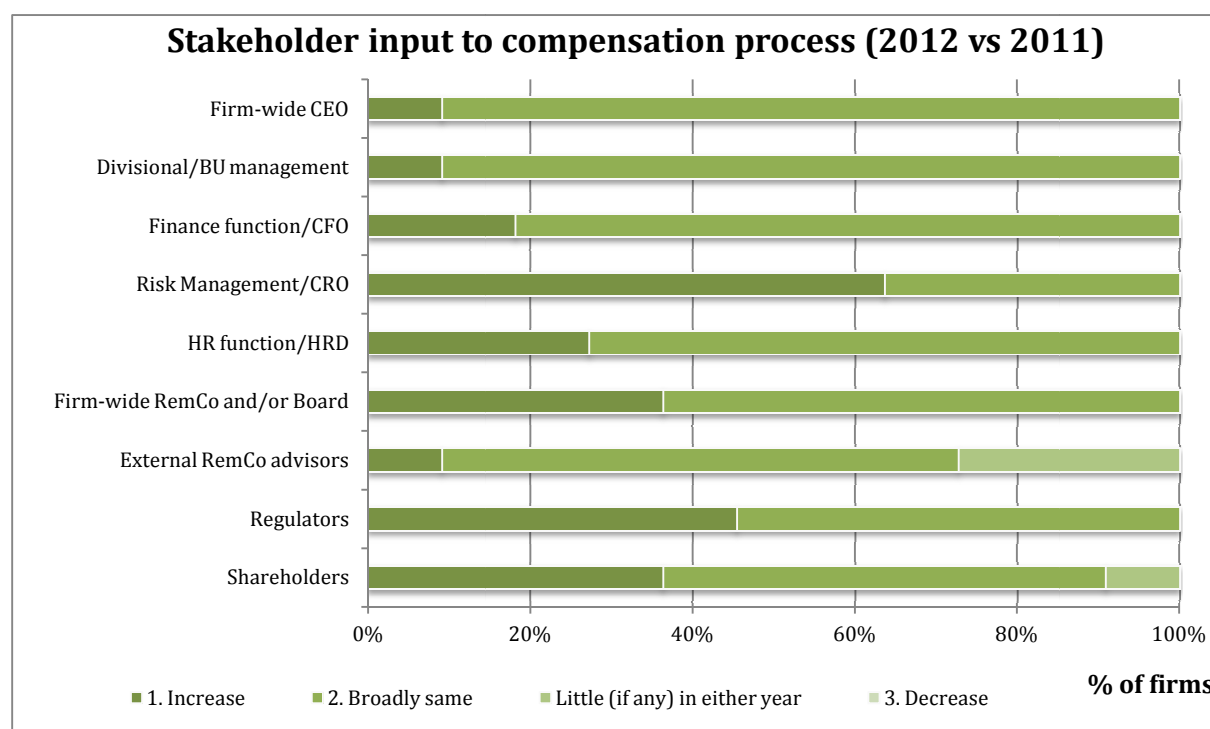
Corporate governance, oversight and decision-making

Overall, there has been much less change than in previous years regarding the governance and decision-making processes for remuneration. Instead the attention for 2011 to 2012 has been on consolidating, refining and embedding policies, practices and processes so that they become firmly established and increasingly effective. Some firms also noted an increase in the focus on tracking compliance and risks in relation to compensation.

Respondents reported that employees are adjusting to the new approach which firms are taking to managing remuneration. Several respondents also emphasised that they are training managers on their responsibilities regarding compensation decisions in order to improve remuneration governance and decision making throughout organisations.

Stakeholder input to compensation process

Firms surveyed reported a significant increase in the involvement of different stakeholders with regards to compensation processes between 2007 and 2012. This was particularly clear in relation to risk management, which now plays a central role in remuneration decisions. Nearly two-thirds of the firms surveyed cited an increase in the risk function's input to the compensation process over this one year period. The involvement of regulators, shareholders and firm-wide Remuneration Committee / board input also increased for more than a third of firms between 2011 and 2012.



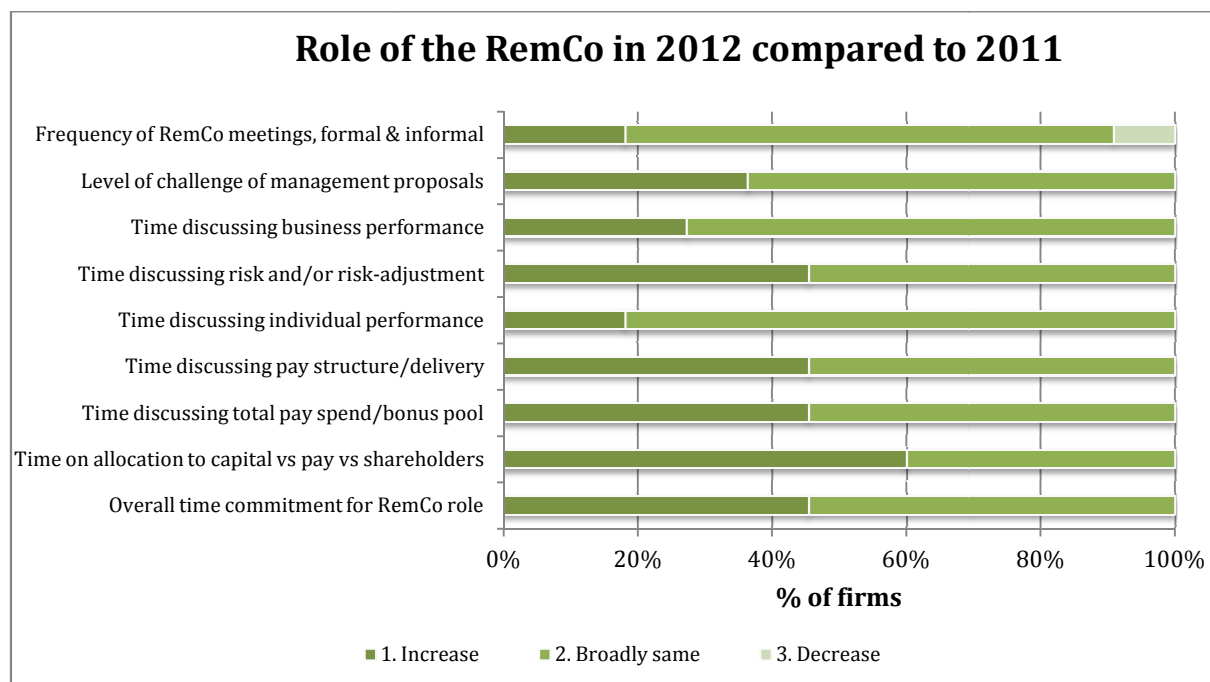
More broadly, the role and structure of control functions (Finance, Risk and Compliance) has changed significantly over the last few years. Over the past year many firms have shifted control functions away from their business lines. The new centralised structures are reported to be have growing influence and impact on business lines in areas such the development of scorecards, reviewing issues, accountability and enforcement of policy.

The role of the remuneration committee

The responsibilities of the remuneration committee (RemCo) have significantly increased since 2007. Over that period, 90% of firms responded that the time commitment for the RemCo had increased. Almost all firms reported that RemCo spent more time that in 2007 discussing risk and risk adjustments; remuneration awards; and bonus pools.

Between 2011 and 2012, the majority of firms report that the role of RemCo broadly remained unchanged. However, most firms noted that remuneration committees were discussing more topics (including identified staff and bonus pool setting); were discussing issues in more detail, based on better information; and that the RemCo was also providing greater challenge.

A majority of firms reported an increase in RemCo involvement between 2011 and 2012. The allocation of profit between the firms’ capital, employee rewards and returns to shareholder also remains a key decision for remuneration committees, and the overall board of directors, as ultimate approval is discretionary for most firms.



Dialogue with shareholders

Remuneration decisions have become a major area for dialogue with key shareholders. The majority of firms have increased discussions with shareholders since 2007, particularly with regards to business performance, risk and the methodology used to set individual compensation.

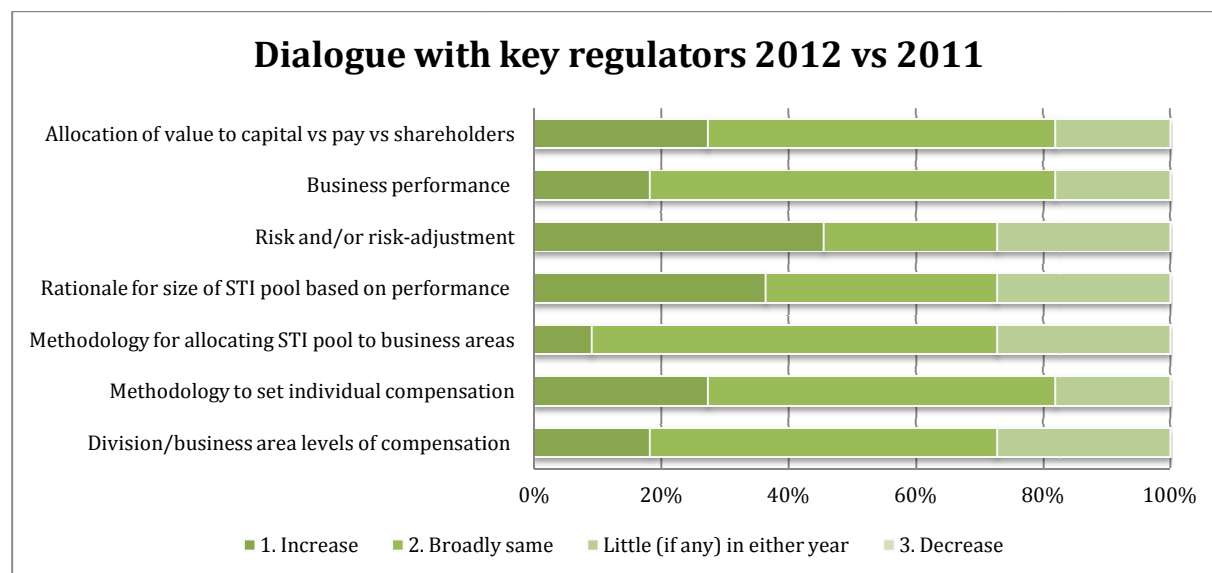
Between 2011 and 2012, there was a continued broadening and deepening of firms’ dialogue with key shareholders. More than half of the firms surveyed reported greater discussion with shareholders on the rationale for the short-term incentive (STI) pool risk and/or risk adjustment. The methodology used to set individual compensation and the allocation of bonus pools remain important issues: more than a third of firms increased discussion on these areas with their key shareholders in 2012.

The survey results highlight that the structure of STI arrangements has been an important issue for discussion with shareholders – both in terms of the size of the variable pool and how it is allocated. Many firms also cited recent enhancements in the quality and frequency of dialogue with shareholders – especially driven by ‘Say on Pay’ regulation and initiatives.



Dialogue with regulators

Since 2007, firms have engaged in much closer dialogue with key regulators, although there was little reported change from 2011 to 2012 in the level of dialogue. The chart below highlights that areas where more than a third of firms reported an increase in dialogue with their key regulators: (i) risk and/or risk adjustment; and (ii) allocation of the short-term incentive pool.



Some firms noted an increase in the closeness and level of dialogue with their key regulators. However it was also noted that with some supervisory authorities the level of dialogue had actually decreased; notably where that the supervisor was not in the lead for the firm.

Conclusion

Key findings in relation to the governance of remuneration policies and decisions are that:

- Two-thirds of firms reported an increase on last year in the involvement of the risk function in remuneration decisions.
- Around 40% reported greater dialogue with shareholders and regulators on remuneration policies and decisions.
- Nearly half of firms reported that the workload of board-level remuneration committees continued to increase. RemCos placed a particular focus on the allocation of profit between employees, shareholders and capital; risk adjustment; and pay structures.



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.

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