

Review of the Reward Environment in the Banking Industry

Prepared for the Association for Financial Markets in Europe

January 2016



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Executive Summary

Throughout the report, McLagan has highlighted several insights and findings with respect to the evolution of the reward environment in the banking and capital markets (BCM) industry since the crisis. In particular, we have noted the following:

- Industry pay has in general become much more stable since 2007 and will continue to remain so in 2015, in line with more sustainable industry performance.
- Total compensation within EMEA has fallen significantly over past years, decreasing by 31% from 2009 to 2014. This trend is expected to continue into 2015. Total compensation within the UK at MD level, is significantly below that of the US (-21% in 2014).
- The portion of fixed pay in total compensation increased from 30% in 2007 to 65% in 2014.
- 2015 bonus pools are expected to decline faster within EMEA than on a global basis, leading to a widening gap between European and US total compensation.
- Bonus pay-out ratios (bonus as a percentage of net revenue) have decreased more at European banks versus US banks (-18 vs -12 percentage points for European vs US banks, from 2007 to 2014).
- Since 2007, bonus deferral rates have increased significantly, especially for higher earners.
- BCM MD total compensation has moved below other financial sectors and the gap increases when looking at total cash compensation (22% and 18% lower than average cash compensation in Private Equity and Asset Management respectively). BCM continues to defer more pay than these sectors .

Introduction

This report focuses on the key trends in remuneration in banking and capital markets (BCM) activity in 2014 and provides 2015 estimates where available, based on a detailed study conducted by McLagan. For the analysis McLagan used data from 18 of the AFME Board-members firms, which have a combined 2014 BCM revenue of €148bn (from published accounts) and make up 87% of the 2014 BCM revenue of all AFME Board-members firms.

This study aims to give insight into how the following have changed in the period since the financial crisis:

- Size of total compensation and bonus pool, and the total compensation and bonus pool per capita.
- How remuneration is structured between various pay elements – share of allowances; make up of bonus; variable to fixed ratio.
- A clear understanding of how the nature of that variable remuneration has changed in recent years in response to regulation. For example, the size of deferral, how long remuneration is deferred for and the change in upfront cash bonuses .
- The global context – how does total and variable remuneration compare, in other financial centers across the world and other industries?
- The relationship of remuneration with bank performance – looking at compensation to income ratio.

Contents

Definitions	5
Compensation Pools	6
Structure of Compensation	11
The Global Context – Regions, Financial Sectors and Other Industries	14
Compensation Relationship with Performance	18
2015 Trends	21
Appendix	26

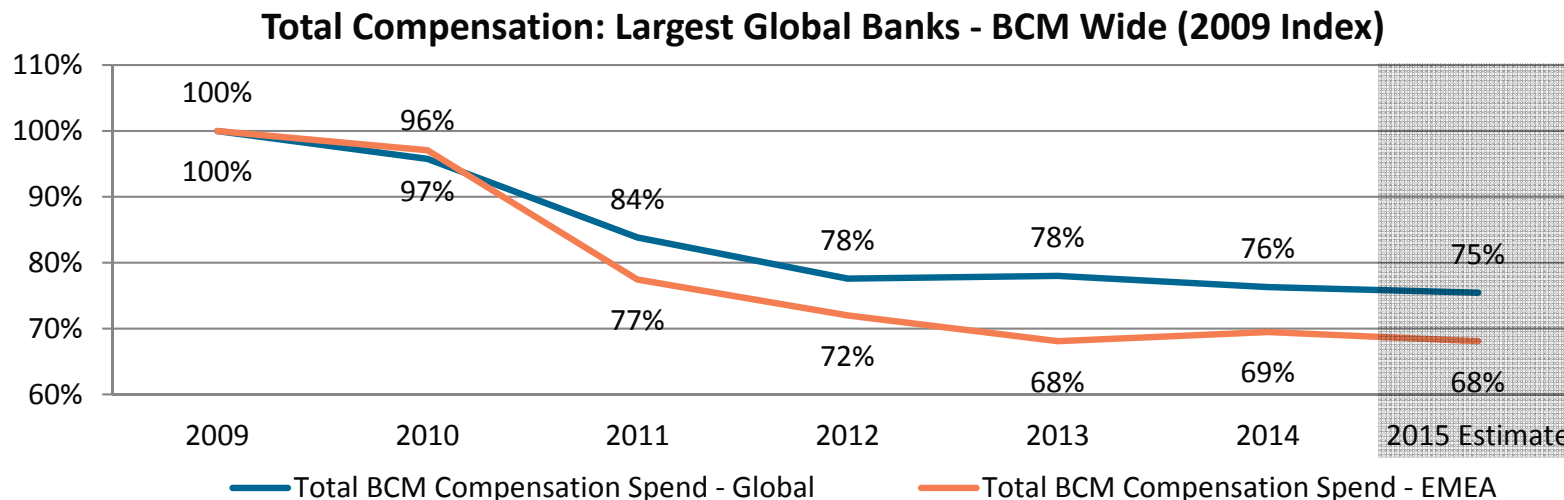
Definitions

- **APAC** – Asia Pacific geographical region.
- **BCM** – Banking and Capital Markets (primarily equities, fixed income and investment banking), also described as the Investment Bank.
- **Bulge** (bracket) – Comprises of the industry recognised largest top 9 global banks.
- **EMEA** – Europe, Middle East and Africa geographical regions.
- **MD** – Managing Director or equivalent level within an organisation.
- **Net Revenue** – All revenue including nonrecurring, net of interest expense.
- **Officer Levels** – Staff with corporate titles of Vice President (or equivalent) and above.
- **Role-Based Allowance** – Is a cash and/or equity allowance paid alongside base salary to Material Risk Takers (MRTs)/Identified Staff, in response to CRD IV regulation.
- **Total Cash** – Is the summation of base salary and non deferred cash bonus in a given year.
- **Total Compensation** – Total compensation is the summation of all applicable compensation elements (base salary, cash bonus, long-term/deferred incentives). This amount should reflect the total amount communicated to an employee for a given performance year.
- **Total Compensation / Total Bonus Pay out Ratio** – Is the total compensation / total bonus pool as a percentage of net revenue.

Compensation Pools

Change in the size of Total Compensation

- On a global BCM-wide basis, total compensation awarded for the 2014 performance year is down 1% (2pp) from the 2013 level, which is mainly due to the increase in fixed pay and large drop in bonus pools.
- This is 24% below the level of total compensation awarded in respect of the performance year 2009, with the average year-on-year decline at approximately 5%.
- EMEA basis BCM-wide total compensation awarded in 2014 has increased by 2% (1pp) versus 2013, with total compensation down 31% from 2009 and the average year-on-year decline at approximately 7%.
- The quicker decline versus the Global level is in part caused by pressure from various stakeholders, including shareholders and the public as well as regulators. CRD IV-linked increases in capital charges reducing risk adjusted profitability have been more impactful in reducing total compensation than direct CRD compensation regulations (e.g. bonus ratio cap, deferral requirements).
- In 2015 we expect the total compensation spend to decrease in line with flat to down revenues, with EMEA affected more than global total compensation.

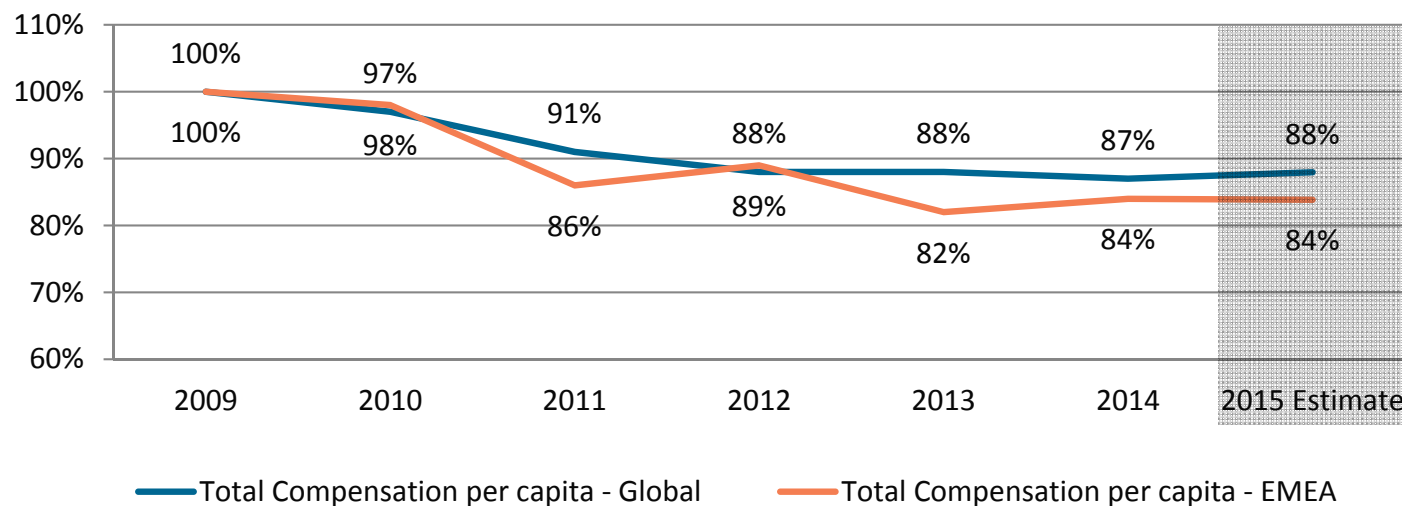


Scope: 8 AFME firms with combined Global BCM revenue of €123bn.

Change in the size of Total Compensation per capita

- On a global BCM-wide basis total compensation awarded per capita, in respect of the 2014 performance year has dropped to 13% compared to 2009.
- This is 1% lower than the level of total compensation per capita seen in 2013 and represents an average year-on-year decline of 3% since 2009.
- EMEA BCM-wide total compensation per capita levels have fallen sharper compared to global levels, down 16% since 2009. And this represents an average year-on-year decline of 3% since 2009.
- We expect with total compensation predictions being slightly down and reductions in headcount, that total compensation per capita will increase for 2015.

Total Compensation per Capita: Largest Global Banks – BCM Wide (2009 Index)

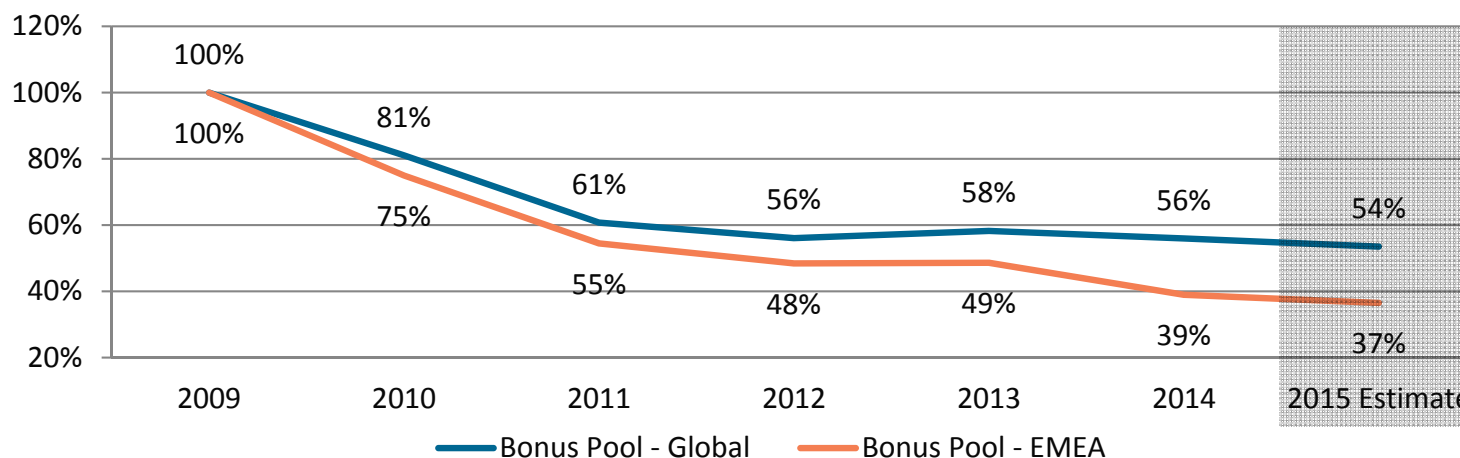


Scope: 8 AFME firms with combined Global BCM revenue of €123bn.

Change in the size of Bonus Pool

- Global BCM-wide bonus pools have seen a rapid decline in their size since 2009, with the 2014 bonus pools down 44% from 2009.
- The 2011 to 2014 bonus pool sizes have remained relatively stable after a circa. 40% drop in size between 2009 and 2011.
- EMEA BCM-wide bonus pools have declined even further from 2009 levels, with 2014 bonus pools approximately 60% lower than in 2009.
- With revenues flat to down in 2015 and fixed pay increasing, we expect to see bonus pools decrease. The impact of this will be seen more in EMEA, due to Role-Based Allowances being in place.

Bonus Pool: Largest Global Banks - BCM Wide (2009 Index)

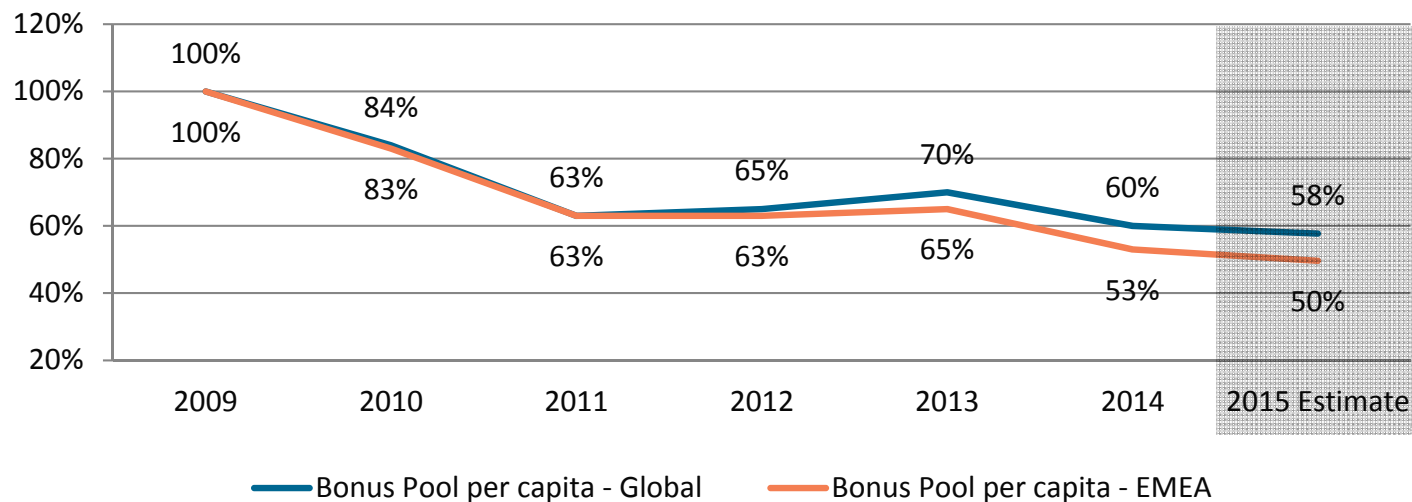


Scope: 8 AFME firms with combined Global BCM revenue of €123bn.

Change in the size of Bonus Pool per capita

- The global BCM-wide bonus pool awarded per capita in respect of the 2014 performance year, has declined by 40% since 2009.
- 2009 indexed levels increased from 63% in 2011 to 70% in 2013 after sharp year-on-year falls between 2009 and 2011.
- The bonus pool awarded per capita in EMEA, has seen a very similar decline from 2009 performance year to 2011. But has not recovered to the global 2014 level and trails the 2009 performance year (47% vs. 40% below).
- Due to higher fixed pay and some decline in performance in 2015, we expect the bonus pool per capita to decrease.

Bonus Pool per Capita: Largest Global Banks - BCM Wide (2009 Index)



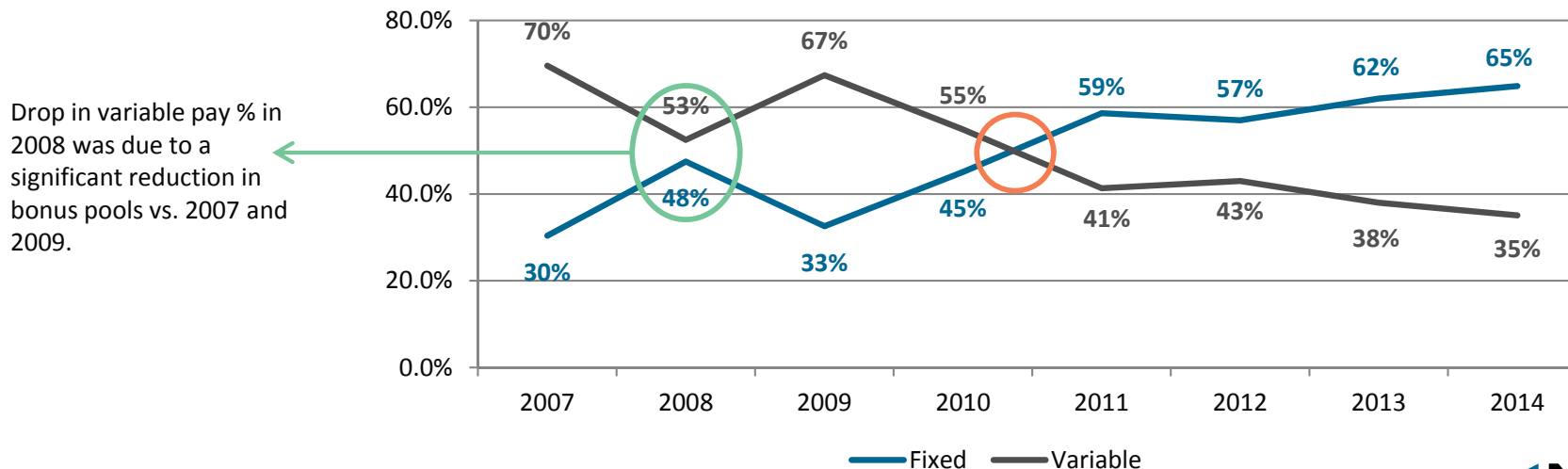
Scope: 8 AFME firms with combined Global BCM revenue of €123bn.

Structure of Compensation

Total Compensation awarded in Fixed Pay has rapidly increased from 2007

- Pay has become much more stable since 2007 and has continued to do so in 2014, in line with more sustainable and predictable performance.
- Fixed pay as a proportion of total compensation has increased from 2013 as a result of heightened regulatory pressure to limit variable compensation and the introduction of Role-Based Allowances for Material Risk Takers. With the percentage of total compensation that is paid as fixed pay in 2014 up to 65%, from 62% in 2013.
- This is a significant increase to the levels of fixed pay seen in 2007, when fixed pay constituted 30% of total compensation.
- The level of fixed pay is just over 1% higher in 2014, when looking at EMEA versus Global BCM. Which is a small increase from 2013 when it was just under 1%.

Proportion of Total Compensation awarded in Fixed vs Variable Pay for AFME Members



Scope: 18 AFME firms with combined Global BCM revenue of €148bn.

Higher deferral rates seen since 2007

- Since 2007 effective deferral rates have increased significantly across all levels of bonus and in particular for higher paid staff.
- Effective deferral rates in 2014 remain similar to the levels seen from 2011 to 2013 for most staff, due to the majority of firms have not made wholesale changes to their broad-based mandatory deferral programs. There has been a shift in the deferral rates at the highest earners in 2014 vs. 2013.
- UK / EMEA headquartered firms typically have higher deferral rates than firms that are headquartered in the US and Asia Pacific.
- UK / EMEA based firms generally defer ~10-25% more than their peers in other locations and this differential is even more significant at the highest incentive levels (up from ~5-10% in 2013).

Median Mandatory Deferral as a Percentage of Bonus

	Bonus in Euros			
	75k	375k	750k	1.5M
2007	0%	23%	26%	29%
2014	10%	40%	58%	60%

Scope: 16 AFME firms with combined Global BCM revenue of €136bn.

2014 Median Mandatory Deferral as a Percentage of Bonus by Firm HQ Location

	Bonus in Euros			
	75k	375k	750k	1.5M
UK / EMEA	0%	46%	61%	69%
Non UK / EMEA	12%	27%	35%	44%

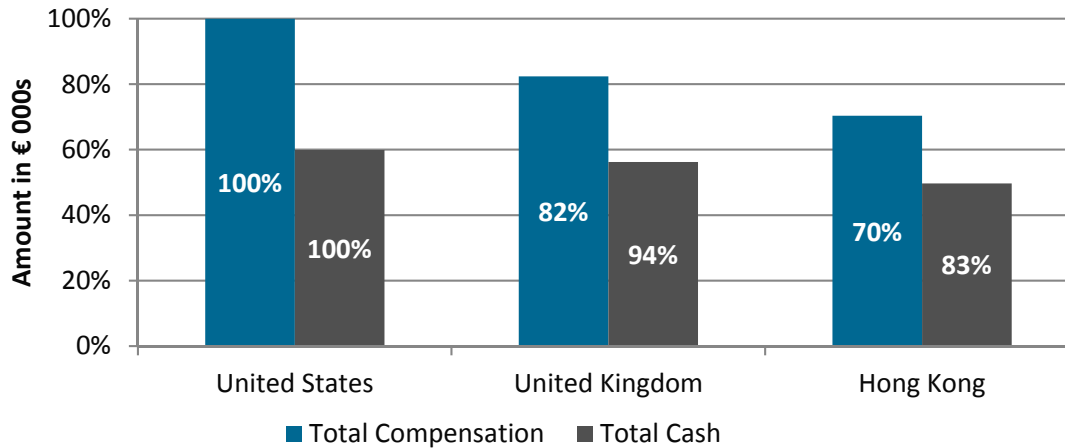
Source: McLagan mandatory deferral / LTIP study.

Scope: 36 firms, with a mixture of US, European and Asian headquartered banks.

The Global Context – Regions and Financial Sectors

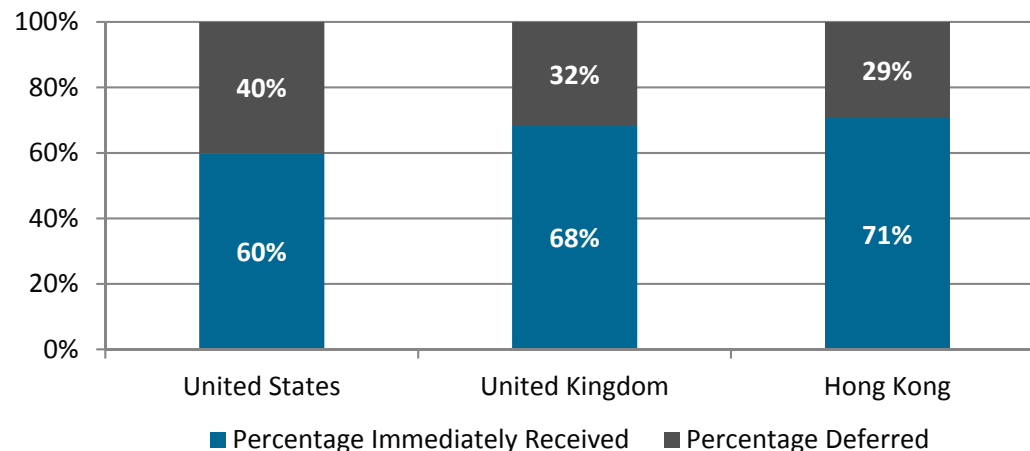
2014 Regional differentials in pay for AFME members

2014 BCM-wide Remuneration Differentials for AFME Members Managing Directors



Note: United States indexed to 100%

2014 Percentage of Total Compensation Deferred for AFME Members Managing Directors

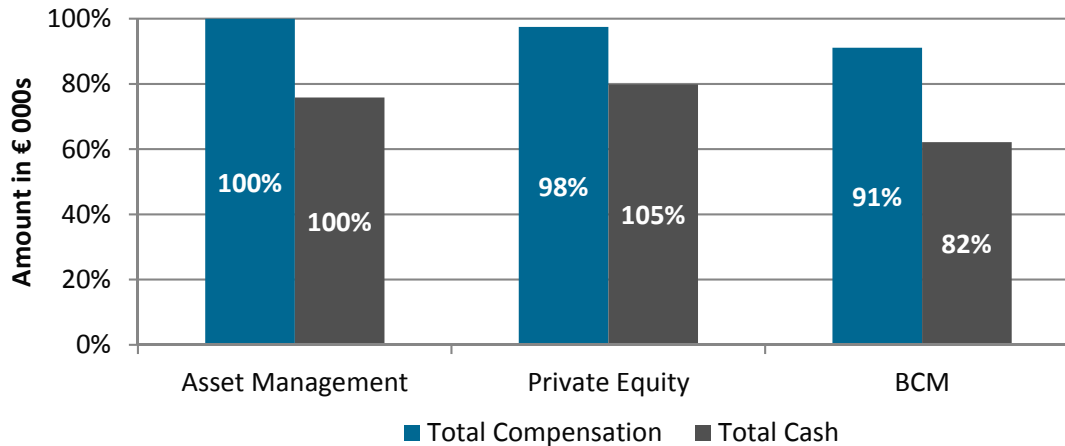


Scope: 18 AFME firms with combined Global BCM revenue of €148bn.

- MDs used for analysis, as they are the most comparable title commanding the largest proportion of total compensation.
- BCM-wide total compensation varies significantly across the different regions, with the United States seeing the highest levels of total compensation across the MD population.
- US BCM-wide total compensation 18pp above the UK.
- UK BCM-wide total compensation 12pp above Hong Kong.
- BCM-wide total cash varies less significantly than total compensation across the different regions, due to higher variable awards being subject to higher deferrals.
- UK BCM has lower levels of deferred pay vs. the US. This is due to the lower pay levels in the UK.
- The highest rate of income tax in Hong Kong is 17% compared to the 45% in the UK.

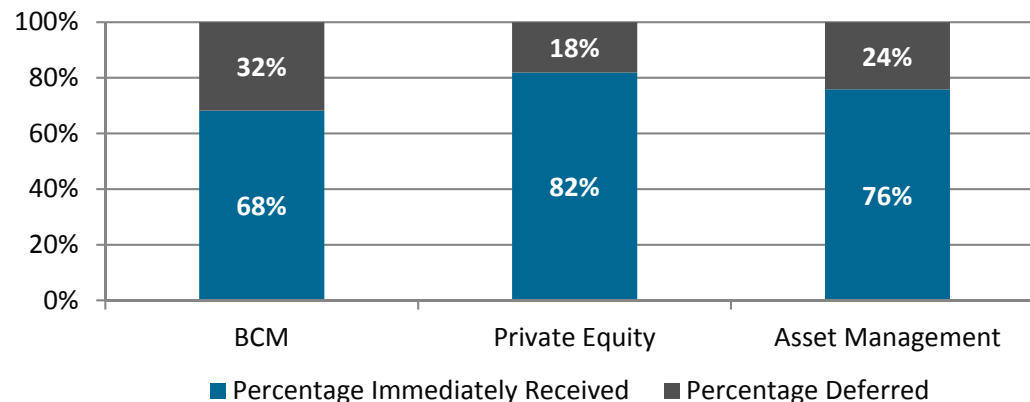
2014 Differentials in pay versus other Financial Sectors

UK Managing Director Remuneration BCM comparison to other Financial Sectors



Note: Asset Management indexed to 100%

UK Managing Director Percentage of Remuneration Deferred, BCM comparison to other Financial Sectors

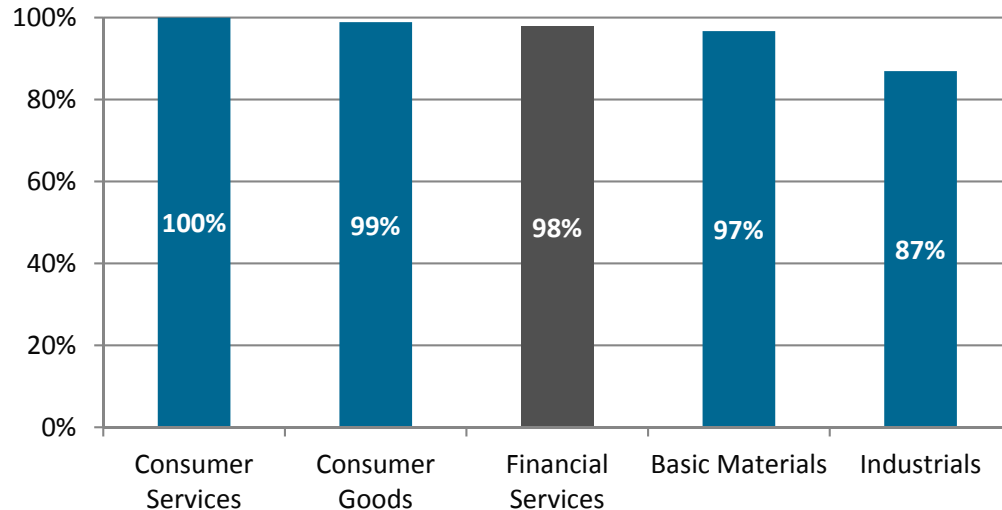


- BCM total compensation for UK MDs trails both Private Equity firms (7pp difference) and Asset Management firms (9pp difference).
- The gap increases when looking at total cash compensation, which is due to the impact of higher deferral rates within BCM.
- UK BCM MDs within the AFME member firms have on average 32% of total compensation deferred, versus only 18% in Private Equity firms and 24% in Asset Management firms.
- Due to Private Equity and Asset Management firms facing less regulation than BCM firms.

Scope: 18 AFME firms with combined Global BCM revenue of €148bn, 58 Private Equity firms and 83 Asset Management firms.

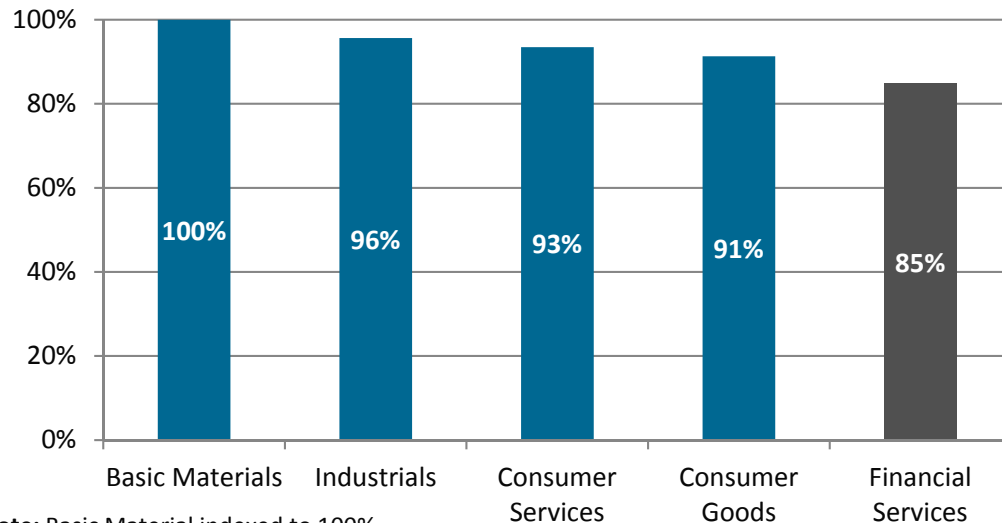
FTSE 100 Pay Levels for the Highest Paid Director (HPD) by Industry

2015 Target Total Compensation



Note: Consumer Services indexed to 100%

2015 Base Salary



Note: Basic Material indexed to 100%

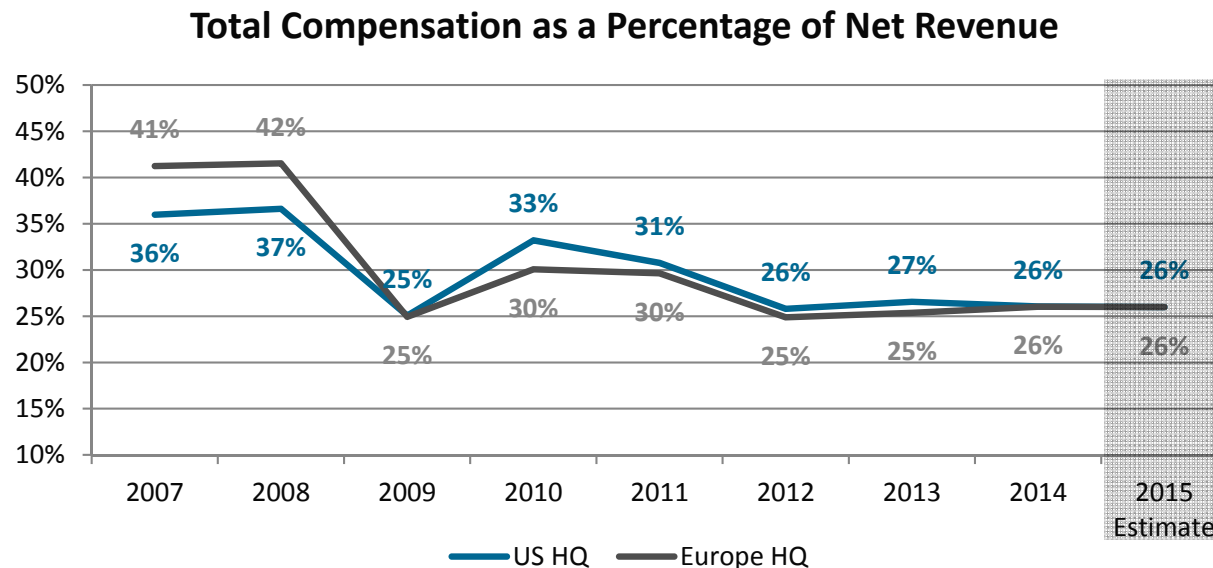
- Comparison of pay for HPD roles in the FTSE 100 brings into question the premium for financial services
- Base salaries are 6 – 15pp lower in Financial Services vs. other industries
- Target total compensation is 1 – 2pp lower than Consumer Goods and Consumer Services levels, but 5 – 10pp above Basic Material and Industrials.
- Leaders in other industries do not face the same issues as banking executives:
 - Regulation
 - Risk / Personal Liability
 - Claw-backs / Downside only of LTI's

Source: New Bridge Street - FTSE 100 Report on Directors Remuneration 2015

Compensation Relationship with Performance

Total Compensation Pay-out Ratios have decreased more at European banks

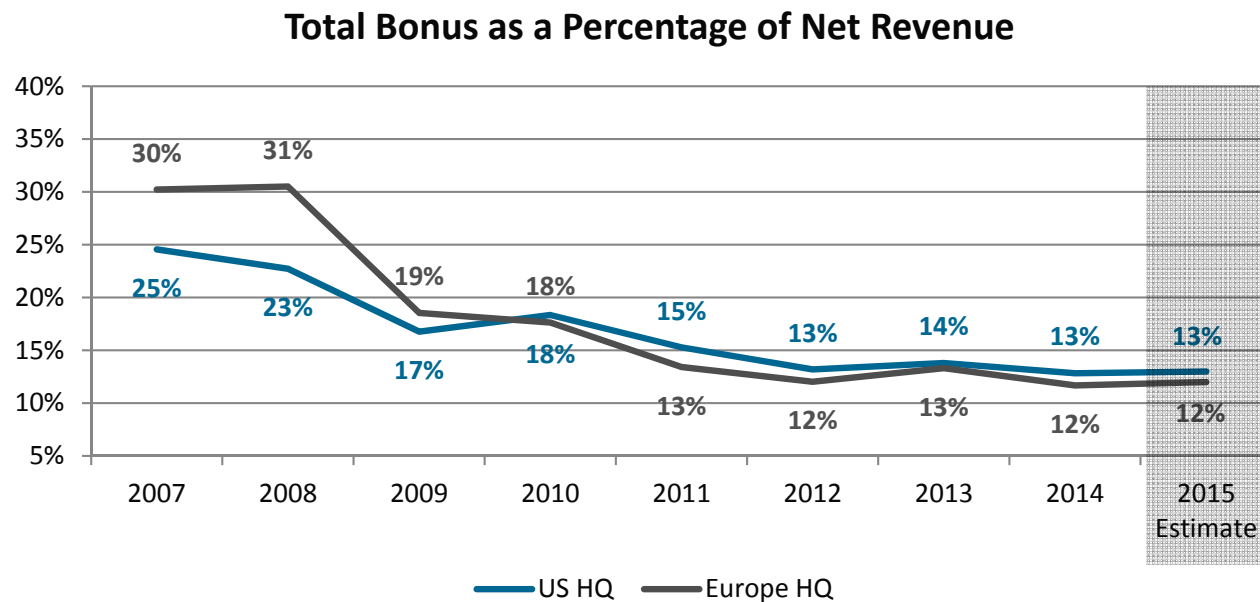
- Global total compensation as a percentage of revenue have decreased by 13 percentage points since 2007.
 - European banks have seen a larger decline compared to the US banks (15 vs. 10 percentage points).
 - The rapid decrease seen from 2008 to 2009, was largely due to the large increases in revenue in 2009. This trend did not continue in 2010 / 2011 and with total compensation spending declining at a slower rate, the percentage of revenue spent on total compensation increased.
- For 2015 we expect the trend to be flat against 2014. This is due to expectations that total compensation spend will be in line with flat to down revenues.



Scope: 10 AFME firms with combined Global BCM revenue of €105bn.

Bonus Pay-out Ratios have decreased more at European banks vs. US

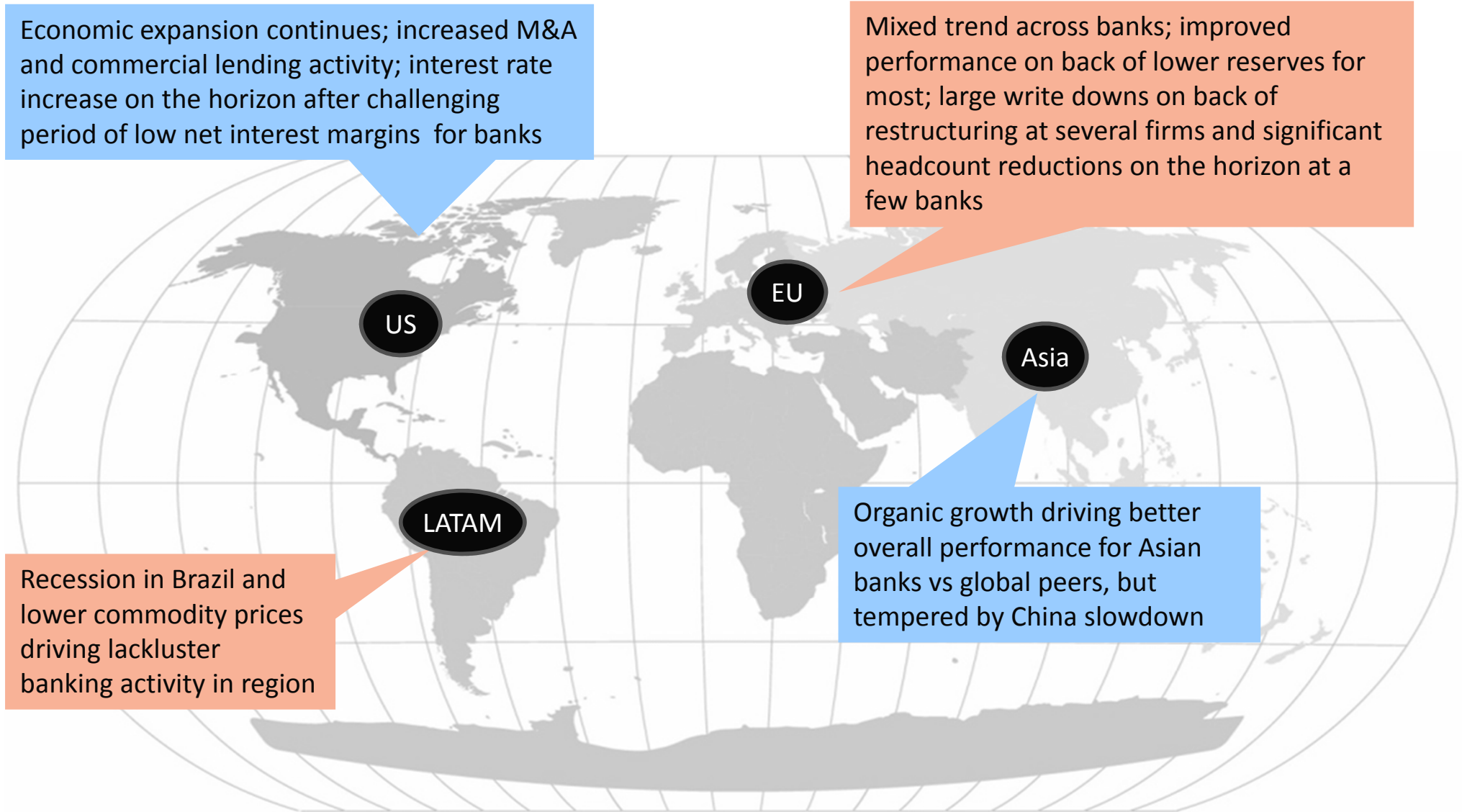
- Global bonus pools as a percentage of revenue have decreased by 17 percentage points since 2007.
 - European banks have seen a larger decline in pay-out ratios than US banks (18 vs. 12 percentage points).
- For 2015 we expect the trend to be flat or down marginally against 2014. This is mainly due to revenue predictions being flat to down and the anticipation that bonus pools will be reduced, with the increases in fixed pay levels already seen.



Scope: 10 AFME firms with combined Global BCM revenue of €105bn.

2015 Trends

Economic and structural factors impacting global performance



Fixed Income Pay and Business Trends

Business Trends

- First half revenues were flat across the largest firms but Q3 results tempered trends
- Broad range of 9 month YOY performance trends across the bulge (-15% to +15% excluding outliers); US universals more consistent (down 5-10%)
- Modest headcount reductions at a few banks
- Significant performance differences by product:
 - FX and Rates up on the back of increased volatility
 - Credit & Securitization down

Pay Trends

- As the largest division across most firms, FI performance will drag down overall front office pay trends
- Variances by product aligned to results; Credit professionals down for 2nd year in a row
- Rates projected to be top paid FI product in 2015
- Low-end pay trends will be seen in distressed credit areas

Equities Pay and Business Trends

Business Trends

- Divisional revenue among the global banks up 15% on average through 9 months
- Derivatives and Prime Brokerage driving results; Cash ~flat (Asia Q2 Cash very strong)
- Cheaper commission products including ETFs and Program Trading becoming larger portion of commission pool – favours bulge bracket model
- Year started out difficult for US mid market firms (many down 10%+ in 1Q) but improved in later 2Q and 3Q trended positive)
- Equity Capital Markets (ECM) commissions weaker vs. previous two years (down ~5%) YoY
- Regulatory changes, particularly in Europe, forcing institutions to pay for ‘best execution’ and limiting pay for relationships – execution driven firms will benefit

Pay Trends

- Derivatives trend above Cash
- Cash in Asia projected to be up with commission volumes, Europe down and US slightly down, but will depend on banking performance by firm

Investment Banking Pay and Business Trends

Business Trends

- Global M&A fees up ~30% YTD; record deal making levels seen in the US and Asia Pacific
- Global Debt Capital Markets (DCM) activity lagging last year: record US High Grade issuance but High Yield down globally as investors have less appetite for risk
- ECM activity was flat to down YOY following slow Q3
- Significant variances in firm revenue through 9 months (+10% to down 15%)
- Boutiques and Consulting firms are gaining incremental market share

Pay Trends

- Increase to VP and below salaries create issue for year-end 'net-neutrality'
- M&A, Healthcare, TMT on higher end; oil & gas / energy on lower end
- Regional trends follow performance with US and Asia bankers faring better than Europe
- Firms with +3 to +5% IB trend would result in MD's up ~2-3% after junior increases
- Differentiation will be key within firms – some MD's up, others down

Appendix

Appendix A: Summary Table of Key Metrics with Year Comparisons

Metric	Performance Year 2007	Performance Year 2009	Performance Year 2014	Estimate for Performance Year 2015	Slide
Global BCM Total Compensation Pool as a proportion of 2009	-	100%	76%	75%	7
EMEA BCM Total Compensation Pool as a proportion of 2009	-	100%	69%	68%	7
Global BCM Total Compensation Pool per Capita as a proportion of 2009	-	100%	87%	88%	8
EMEA BCM Total Compensation Pool per Capita as a proportion of 2009	-	100%	84%	84%	8
Global BCM Bonus Pool as a proportion of 2009	-	100%	56%	54%	9
EMEA BCM Bonus Pool as a proportion of 2009	-	100%	39%	37%	9
Global BCM Bonus Pool per Capita as a proportion of 2009	-	100%	60%	58%	10
EMEA BCM Bonus Pool per Capita as a proportion of 2009	-	100%	53%	50%	10
Fixed pay as a proportion of Total Compensation for AFME members	30%	-	65%	-	12
Variable pay as a proportion of Total Compensation for AFME members	70%	-	35%	-	12
Proportion of pay deferred at €1.9M	29%	-	60%	-	13
Europe HQ firms, Total Compensation as a % of Net Revenue	41%	25%	26%	26%	19
US HQ firms, Total Compensation as a % of Net Revenue	36%	25%	26%	26%	19
Europe HQ firms, Bonus as a % of Net Revenue	30%	19%	12%	12%	20
US HQ firms, Bonus as a % of Net Revenue	25%	17%	13%	13%	20

Note: The basis of calculation for some of the figures above differs depending on the metric / availability of data and therefore the scope / source can be found in the body of the report.

Appendix B: 2014 Other Metrics

Regional differentials in pay (slide 15)

Metric	US	UK	HK
2014 BCM Managing Directors Total Compensation	100%	82%	70%
2014 BCM Managing Directors Total Cash	100%	94%	83%
2014 BCM Total Compensation Deferred	40%	32%	29%
2014 BCM Total Compensation Immediately Received	60%	68%	71%

Financial Sector differentials in pay (slide 16)

Metric	Asset Management	Private Equity	BCM
2014 BCM Managing Directors Total Compensation	100%	98%	91%
2014 BCM Managing Directors Total Cash	100%	105%	82%
2014 BCM Total Compensation Deferred	24%	18%	32%
2014 BCM Total Compensation Immediately Received	76%	82%	68%

Note: The basis of calculation for some of the figures above differs depending on the metric / availability of data and therefore the scope / source can be found in the body of the report.

Appendix C: Corporate title level guidelines (Officer levels)

	Managing Director	Director	Vice President
Core Functional Responsibilities	<p>Incumbent has the highest level of relevant experience and / or skill of all staff that is not primarily management-focused.</p> <p>In client relationship management roles, incumbent has primary responsibility for developing, maintaining and generating revenue from the most important clients. Handles all aspects of client interaction, including directing and coordinating execution of transactions.</p> <p>In trading / capital commitment roles, incumbent is the most seasoned incumbent in assigned securities, independently handles the most complex transactions and may be viewed as a partner by management in establishing commitment limits.</p> <p>In research roles, incumbent has extensive knowledge and experience / skill that enables independent company-specific, economic or trend analysis. Publishes written research and strategy reports.</p>	<p>Responsibilities are similar to Senior I, however incumbent has less relevant experience and / or skill and smaller scope of activities.</p> <p>In client relationship management roles, incumbent has primary responsibility for medium and smaller sized clients, but is often No. 2 on relationships with larger clients.</p> <p>In trading / capital commitment roles, incumbent may contribute to the formation of firm's strategy. Has primary responsibilities for the firm in assigned securities and works with a large degree of independence.</p> <p>In research roles, incumbent has seasoned and proven judgment in research sector and publishes written research and strategy reports. Continues to develop sources of research information on topics covered.</p>	<p>Works with a large degree of independence, however, requires management oversight on most complicated issues / situations.</p> <p>In client relationship management roles, incumbent may be the No. 2 or No. 3 on relationships with the most important clients, but may be the key contact with mid-sized clients. Has begun to assume some important business development responsibilities.</p> <p>In trading / capital commitment roles, incumbent may have primary responsibilities in a given security but will have less relevant experience and/or skill than Senior II. Increasingly assumes responsibility for independently handling complex transactions.</p> <p>In research roles, incumbent is developing seasoned and proven judgment in research sector and may publish written research and strategy reports. May provide ideas and help to enhance client relationships.</p>
Supervisory	May oversee staff within the business area.	Limited staff management responsibilities.	May supervise more junior staff. Manages day-to-day work of associates and analysts.
Experience Guideline	An individual in this position typically has a minimum of 10 years of experience since graduation from an MBA program or has an equivalent combination of experience and education.	An individual in this position typically has a minimum of 7 years of experience since graduation from an MBA program or has an equivalent combination of experience and education.	An individual in this position typically has more than 5 years of experience since graduation from an MBA program or has a comparable combination of education and related industry experience.