Financial Services Compensation

Compensation Challenges During a Talent Struggle

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Discussion Topics

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Johnson Associates is a leading independent financial services compensation consulting firm specializing in strategic advice, innovative design, and a full range of data-enhanced benchmarking. Much of our consulting practice is project-based assignments for senior firm management across a wide range of issues. We also have extensive experience advising Compensation Committees across business cycles.

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  - Full Range of Competitive Market Benchmarking
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  - Funding Rate / Fee Allocation Assessments
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- **Global Clients across Financial Services**
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  - Hedge Funds / Alternative Products
  - Private Equity / Illiquid Investment Strategies
  - Wealth Management and Family Offices
  - FinTech
  - Investment and Commercial Banks
  - Institutional and Retail Brokerages
  - Insurance Companies

2021 Incentives: Industry Incentive Changes (same store % ▲)

Major 2021 Takeaways:

- Incentives up as impact of pandemic continues affecting back to work and employee fatigue accumulates
- Optimistic "bubble" in financial services and broader economy
- Building base salary pressures at year-end

Segment	YoY % Change	Commentary
Asset Management	*Up 12% to 20%*	▪ Surging markets ▪ Active strategies continue battling fee pressures and outflows ▪ Emphasis on alternatives and technology solutions
Illiquid Investments	*Up 12% to 18%*	▪ Record fundraising, deal-making and exits. Frenzy on all things carry-related ▪ Industry not experiencing fee pressures ▪ Venture capital frenetic pace continues ▪ Real estate rebound from 2020 but impact of systemic changes not yet fully realized
Hedge Funds	*Up 10% to 15%*	▪ Strongest performance in several years ▪ Industry inflows and increased new fund launches
Major Banks	*Up 10% to 20%*	▪ Wide variation by business segment ▪ Record M&A activity and healthy investment banking ▪ Equity underwriting strongly positive on scorching IPO market (up 30%+) ▪ Retail and commercial banking up 5%
Insurance	*Up 5% to 10%*	▪ Improved performance for core insurance functions vs. 2020 ▪ Corporate roles and headcount under continued stress ▪ Impact of InsurTech driving market rates for select functions

Existing Issues Continue and Build in 2022

Financial Services / Economic "Bubble"	▪ Inflation and rising interest rates ▪ Historically economic landing has been bumpy and difficult
High-End Talent / Experience Scarcity	▪ Less need for average talent with technology compounded by attractiveness of other industries / professions ▪ Decline of foreign banks as a talent source ▪ Political opposition to immigration
Rapidly Increasing / Unpredictable Base Salaries	▪ Legacy of fixation on low salaries out of sync with broader economy / markets ▪ Combination of compensation increases and pay mix changes ▪ Future changes will vary by industry segment and level
Predictable Turnover Increases	▪ Catch-up from 2020-2021 ▪ Elongated pandemic and "back in the office"
D&I / ESG Emphasis	▪ Continued momentum in D&I and ESG with business and societal drivers ▪ Among private firms, still pockets of denial
Compensation Impact from Other Opportunities	▪ Far-reaching impact of alternatives / fin-tech / high-end technology ▪ Compensation levels and expectations
Compensation Implications of Hybrid / Remote Work	▪ Direct compensation implications of hybrid / remote work unresolved ▪ Difficult for broad approach considering different jobs / situations ▪ Natural tendency to wait amid talent struggle

Compensation Toolbox: More Focus on Attracting and Retaining Talent

Base Salaries	▪ Importance of fully competitive base salaries ▪ Little / no cost if managing total compensation
Deferred Compensation	▪ Larger deferrals with longer vesting / use of company products ▪ Forfeitures directly reallocated to remaining participants
Restrictive Covenants	▪ Reconsider non-compete practices ▪ Balance objectives and cost
Bonus Payment Schedule	▪ Potential to pay bonuses 2x a year (i.e. July payment (1/3) without performance review process) ▪ Differences of opinion on effectiveness, but attractive from employee perspective
Benefits / Titles Assessment	▪ Evaluate benefits and titles ▪ Tweaks to reward tenure at the margin (i.e. 401(k) vesting, vacation, timing of promotions)
Increased Compensation Alignment	▪ More focused programs with less reliance on overall firm results (challenging for diversified firms with one-firm view) ▪ Long-term compensation key tool for retention
Aggressive Pay Differentiation	▪ Skew turnover further towards lower performers ▪ Weighted evaluation of turnover (i.e. 5x for top performer, 3x for good performer, 1x for average performer)
Pandemic Influence	▪ High-quality professionals have viable choices across and outside the industry ▪ Increasingly, market competitive compensation won’t overcome bad jobs, culture and poor leadership

Base Salary Directions

- Year-end standalone base salary increases 5% - 6%+
  - Intermingled with structural adjustments and pay mix changes
  - Base salary pressures and confusion will continue throughout 2022

- Fundamental to establish base salary at full market levels
  - Reliance on tiny merit pools (i.e. 3%) is often dysfunctional and out of step with markets
  - Artificial base salary caps is a concept 15+ years out of date

- Significant noise in current base salary data
  - Mix of normal adjustments, low levels adjusted upward, and pay mix changes
  - Examples of startling increases (i.e. 20%+) in mid / senior operations roles
  - Requires careful benchmarking / refreshing and a clear philosophy

- Considerable energy spent on individual base salary levels, often with little impact
  - Consider same base salary by level / title (i.e. all Managing Directors in investments $500K)

- Many delink base salary from incentive targets
  - If incentives X% of base salary, pressure not to increase salaries
  - Target incentives can be separate $ amount

Industry largely manages pay levels on a total compensation basis

Antiquated views of low base salaries often backfire and difficult to defend

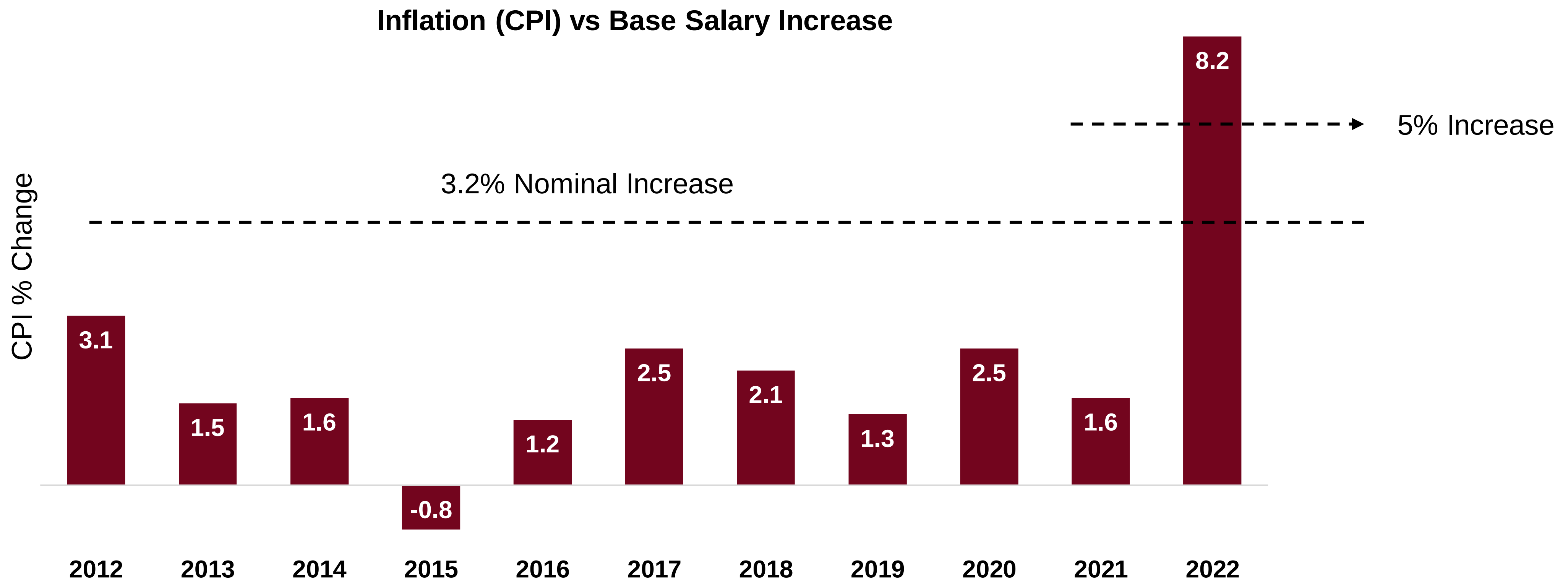
In almost all situations, firms that can't really afford competitive base salaries have too many people

How Not to Address Inflation

- Compensation should be linked to market levels and performance (not inflation)
  - Industry compensation fluctuates across cycles regardless of inflation
  - Difficult to separate out results from inflation or other factors

- Adjusting for inflation is a no-win proposition
  - Inconsistent with results if performance / markets decline, Often renege on promises you shouldn't have made
  - How to measure and allocate (i.e. U.S. coasts, broad U.S., global, select countries, etc.)

Potential Philosophy:
- Commitment towards competitive levels that reflect performance
- Real pay in financial services has increased over time and remains an attractive industry to work in
- Cannot guarantee level of real compensation



Long-Term: Issues and Alternative Approaches

Main Objectives:
- More effective long-term program that meets business needs and objectives
- Ability to clearly define / measure effectiveness (i.e. alignment, retention, motivation, etc.)
- Be open to innovation and opportunity to gain advantage

- **Not maximizing impact** across public and private firms, long-term approach often an afterthought. Less participant alignment and considered almost totally from a retention / market prevalence perspective
  - Often passive approaches lack creativity
  - Need greater link to value creation
  - Consider various approaches to address different needs

Public Company Issues	→	Alternative Approach
Broad deferral schedule linked to marginal compensation levels		Focus equity at senior levels with increased holding requirements
Heavy use of RSUs with 3-year pro-rata vesting		Increased growth components with longer vesting
Forfeitures revert to firm		Recirculate forfeitures
Most participants have no line of sight to stock price		Potential for subsidiary equity plans
Sporadic use of products / other vehicles		Far greater use of products and variety

Private Company Issues	→	Alternative Approach
Opaque philosophy around long-term purpose		Formalize partnership sooner on sound fundamental equity terms
Transfer mechanics unclear and often small episodic grants		Regular purchases and grants of shares / growth units
Deferrals into products, but less uniform schedules		Utilize product variety with longer vesting / recirculated forfeitures
Often confusing economics on contributions vs. ownership %		Separate amounts from ownership and standard compensation

Incentive Carry: Frenzy and Issues

- Explosion of AUM in incentive carry vehicles
  - Everyone wants carry often without full appreciation of value or terms

- Observing more outlier carry splits between professionals and firm
  - Variability in returns / fundraising / support
  - Partners receiving both professional and firm allocations
  - Between investment team and senior support

- Cadence of grants and holdback for performance / future hires
  - Up-front still dominates
  - Over time growing in usage

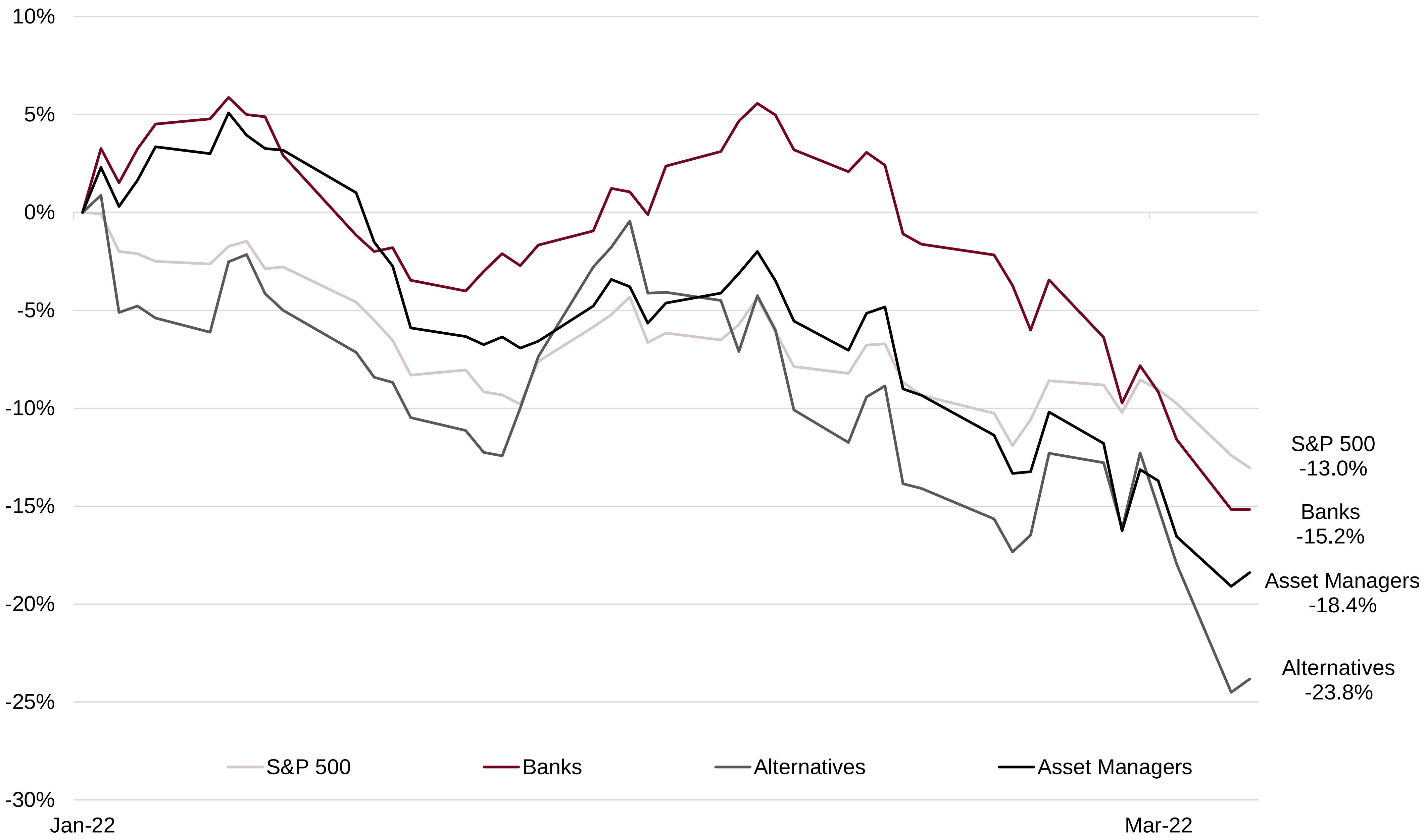
- Negative impact of elongated carry waterfalls underappreciated
  - Awards undervalued particularly by Senior Associates and Vice Presidents
  - Consider moderate carry advances to increase retention and perceived value

- Firms should carefully reconsider treatment of competition after leaving
  - Historical anomaly where compete and keep vested with future potential appreciation

- Need better communication of opportunity and progress
  - More meaningful projections across scenarios
  - Understanding of potential increases in carry awards by career level

Financial Services: Stock Price Declines Signal Business Issues

- Dramatic decline in YTD stock prices across financial services
- Impact of both broader economy and conflict in Ukraine



2022 Compensation Predictions

Economic "Bubble" Ends Poorly

- Federal Reserve interest rate increases and inflation
- Impact on housing sector
- Riskier stocks and positions display greater volatility

Same Store Incentives Down 10% to 15%

- Likely still higher than 2020
- Market declines amidst broad economic uncertainty
- Requires balancing higher salaries as part of total compensation

High Base Salary Increases Continue Pace

- Legacy of fixation on low salaries out of sync with broader economy / markets
- Combination of compensation increases and pay mix changes
- Future changes will vary by industry segment and level

Difficulties for Diversified Firms

- Funding by business more than overall firm
- Greater alignment needed from deferred equity and products
- Uncertain economy leads to uneven results across units – difficulties on managing pay and communications

Aggressive Retention Approaches

- Clawback of incentives for competition
- Longer vesting
- Treatment of vested carry for competition
- Revisiting of non-competes

Mid-Sized Alternatives Firms under Pressure

- Difficult to be fully competitive on annual compensation
- Highlights importance of carry allocations potential value / communication

2022 Compensation Predictions

Investment Banking Incentive Decline (15%+)	▪ Expected decline from record 2021 / exacerbated by economic uncertainty ▪ Difficult to manage expectations. Early signaling and communication key
Hybrid Work Compensation Impact Clarified Late 2022	▪ No fundamental changes in compensation trajectory for hybrid work ▪ Industry largely unsuccessful in paying by geography for remote work ▪ In overly traditional firms, informal practices will supplant formal hybrid schedules
Continued D&I Progress	▪ Unfortunately, process still mostly measured at aggregate level ▪ Initial questions arise whether performance evaluation outcomes skewed to diverse employees (i.e. managers overreact to being judged on quantitative process)
ESG Momentum Accelerates	▪ Rapid growth in assets and products ▪ Lack of rigor around true carbon reduction impact not an obstacle to business progress
Market-Driven Declines in Carry Payouts	▪ Predictable response to reduced attractive exits ▪ Impact on venture capital more significant ▪ Need to aggressively allocate reserve and forfeitures
Turnover Reaches Plateau at Higher Levels	▪ Delayed 2020-2021 turnover abates ▪ With more difficult economic landscape, less hiring in second half of the year ▪ Attracting high-end talent remains a challenge

Likely Year-End 2022 Landscape

2022 Incentives -10% to -15%

2022 Inflation +7%

Base Salary +5% over 2021

"Don't try to tell me it is cheaper to live in Charlotte, Austin, Atlanta, Tampa…"

Example of Impact:

2021:	$200,000 Base	+	$300,000 Incentive	=	$500,000 Total	
2022:	$215,000 Base	+	$270,000 Incentive	=	$485,000 Total	(-3% Notional Impact)
					$453,000 Total	(-9% After Inflation)

Likely scenario highlights importance of communication, data refresh, and early planning / analysis

ESG / D&I and Incentive Design

- Many firms, particularly public companies, will have 10% - 20% of incentives driven by ESG / D&I metrics and other similar measures
  - Difficulty is adopting a few measures that fairly capture progress
    - ESG doesn't easily reduce to carbon impact for a large company
    - D&I clearly has multiple dimensions and priorities

- It will be difficult to significantly over or underperform expectations
  - Payouts likely to average 100% to 110% of target
  - Less volatility than financial measures

- Important to select a few key measures to form an initial indication of performance
  - Pressure to have fully objective approach even if oversimplified
  - Difficult to end up with meaningful outcome on purely quantitative basis

- The evaluation of performance will change over time
  - Recognize not everything can be captured today
  - Goals and metrics are evolving

Structured Compensation Designs Continue Under Stress

Compensation Design Approaches

Target-Based / Structured	Discretionary
▪ Grade levels with integrated base salary, cash bonus, and long-term targets	▪ Base salary bands with wide / very wide variations in actual total incentives
▪ Ranges that usually adjust upward annually by about 3%	▪ For most individuals reference point is prior year compensation and market
▪ Relatively limited deviations from target bands	▪ Levels adjust quickly up or down
▪ ≅90% of American industry uses some variation on this approach	▪ Prevalent approach in financial services

- In 2021 and 2022, "structured" programs experience significant stress
  - Paying 2021 market levels and 2022 targets / outcomes
  - Difficult to administer when compensation market is volatile
    - Due to compounding of several strong years on more static targets / limits on pay bands
  - Non-uniform market movements (i.e., junior talent, critical roles, technology, business segment)
  - Pay affordability in organizations with heavy staffing
  - Base salary increases elsewhere far above merit budgets

- For 2022 year-end, may need to go off script
  - Higher base salary spend but not to "Steady Eddie"; allocate resources to "New Joan"
  - Additional incentives to select units outside normal plan
  - Revisit compensation philosophy and approach (i.e., corporate vs. unit vs. individual)

2022 Evolving into Difficult and Confusing Year

Diversified Businesses and Employee Engagement

- Increasingly, there are few “pure” organizations with a single business focus
  - Traditional asset management firms with alternative investment strategies
  - Multi-strategy alternatives firms spanning private equity, venture capital, hedge funds, real estate, and credit
  - Banks and insurance companies with asset management units / subsidiaries
  - Rush to incorporate technological advantages across all areas

- Volatility of business economics creates compensation and cultural issues
  - Need clear compensation philosophy by business
  - Importance of meaningful alignment
  - Customized funding metrics and appropriate degree of autonomy

- Engagement has become increasingly difficult
  - Must foster engagement at both the unit and broader firm level in a hybrid world

- Job content and career development receive more focus
  - Industry has often lagged on these factors

- Unlikely that engagement will have same meaning going forward
  - Hybrid / remote work creates more superficial relationships
  - Technology (i.e. Zoom, LinkedIn) provides increased ability to explore opportunities
  - Growth in sheer firm size also hinders engagement

Impact of Hybrid / Remote Work on Compensation (Reminder Illustration)

For most, best course to delay compensation adjustments until market directions clearer (most likely late 2022)

- Important topic without clear current direction
  - Increased discussion around cost-of-living pay adjustments with selective remote work
  - Recognize economic, equality, and cultural issues abound
  - Hybrid / remote model may allow for broader workforce participation that helps achieve D&I goals

- Short list of implementation issues
  - Standard cost-of-living schedule for typical US family less on point for financial services
    - Standard ratios usually adequate for family income up to ≅$200,000
    - Similarly, evolving tax policies in areas such as NY, CT, and NJ further complicate issues
  - Individual negotiations vs. broader policies
  - Implementation in existing offices
  - Cultural dynamic of “employee” vs. “contractor” mentality
  - Remote workers may be some of your most productive and in demand employees

“Senior Executive” Cost of Living Comparison	Chicago	New York City
City Price Index (Bureau of Economic Analysis)	101.3	125.7
Home Purchase (per square foot)	$250	$820
Michelin Star Tasting Menu	$350	$800
Private School Tuition	$35,000	$55,000
Football Tickets	$360	$1,000

Final Thoughts

- 2022 year-end incentives down ≅10% - 15% but still above 2020 for many
- Higher base salary increases continue at least through 2022
- Firms get "tougher" on leavers, especially those who compete
  - Non-competes are reassessed and strengthened
- More deferrals in long-term products and some subsidiary equity plans
  - Stock options and other growth approaches still underutilized
- Firms reassess carry vesting length and terms
- Hybrid / remote impact on compensation decided late 2022 (maybe)
- Some firms ultimately regret making inflation protection promises
- ESG / D&I progress continues but incentive impact clearly work-in-progress
- Turnover stabilizes at a higher level with particular impact on firms with job content, culture, and leadership issues
- Structured compensation programs continue under stress

2022 will be a difficult year that requires flexibility and refreshing of market data and ideas

It is unlikely that the historic playbook will be as effective in 2022 and beyond

Clarity and creativity will be rewarded