

## **Difficult Financial Services 2001 Year-End Compensation Process**

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The cyclical downturn across major parts of financial services has clear implications for compensation funding and levels, and contains elements that are both “old” and “new” in relation to prior difficult periods. The decline in business volumes and spreads across an uncomfortably large number of units and geographies has been encountered before. Yet, the credit and real estate losses that are a natural part of a recessionary environment have not yet been major factors, and their impact will likely stretch into 2002. However, there are new elements including the expectations hangover from 1998 – 2000 regarding ever increasing bonus levels, and the idea firm size and geographic reach were themselves strong positives. In addition, at year-end 2000, staffing and cost levels were widely recognized as bloated across virtually all business segments. Importantly, and perhaps surprisingly, financial services firms have not yet altered their longer-term outlook regarding the business model. Therefore, we believe any short-term business improvements will lead to a partial reversion to 1998 – 2000 practices.

We believe year-end 2001 compensation process, for a variety of reasons, will prove to be far more difficult than a simple cyclical downturn would suggest. It is clear firms are in various states of business disequilibrium, making it difficult to address a confusing year-end environment. However, it is possible to learn from the compensation and process actions taken in prior downturns. At this stage of industry maturity, there is really little excuse for not responding appropriately to predictable issues. The following table briefly highlights expected year-end 2001 compensation issues:

### **Issues**

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- Normal cyclical business downturn and shortage of compensation funding
- Large staff build-up in 1999-2000 continuing through beginning 2001
- 2001 mid-year compensation accruals may not reflect actual levels needed at year-end in aggregate or by business

### **Potential Directions**

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- Compensation decisions based on performance, articulated philosophy, and anticipated market rates
- Requires difficult strategic and tactical decisions on continuing emphasis applied to various businesses
- Quickly reconcile aggregate and unit compensation needs with available funds. Have candid discussions and decide, now, on trade-offs between businesses leading to a difficult but proactive year-end process

### Issues

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- Wavering commitment to equity as a major part of compensation in 1999-2000
- Potential need to supplement compensation without incurring additional 2001 accounting charges
- In 1999-2000 industry took a backward step in varying compensation with individual performance
  - Kept and rewarded marginal performers to meet business demands
- Lack of clarity on role corporate and business unit results should play in compensation funding across performance scenarios
- Unclear role of capital utilization and risk in compensation funding particularly for trading businesses
- 2000 compensation survey data does not provide good 2001 reference points
- Pressure to not honor compensation guarantees and employment offers

### Potential Directions

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- Renewed commitment to equity with clearer terms and vesting provisions
  - For executives and senior professionals substantial long-term incentives and high % of total compensation
- Heavy dose of stock options (and restricted stock if charge taken over vesting period) with longer than normal vesting. Quality design and communication drives participant acceptance
  - Decide if simply additional current compensation or value/vesting linked to future performance or strategy
- Limited funds necessitate greater performance differentials. Focus on top performers with risks taken elsewhere. Recognize only partial progress in 2001, with 2002 requiring stringent performance reviews, and greater compensation linkages to actual contribution
- For 2002, clearer understanding and modeling of relationships between firm and business results
- “Fine tuning” of compensation accrual formulas to fairly incorporate capital and risk along with cost allocations
- Utilize variety of sources to estimate 2001 marketplace. Recognize raw data may provide little guidance unless analyzed in context of individual businesses, overall performance, and expectations
- To renege on commitments usually makes little medium/long-term sense. Need more creativity in using excess talent since future utilization patterns likely volatile

### Issues

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- Pressure to renegotiate employment contract terms to minimize 2001 obligations
- Recognize in mid-2001 firm has only partial understanding of mid- to longerterm business opportunities. Real analysis of longer-term demand trends and margins likely not completed until early 2002
- Lack of understanding by Board of Directors or parent firm on year-end 2001 compensation dynamics. Confusion surrounding meaning of bonus and incentive in this industry versus elsewhere in the U.S. and global economy
- Revenue producers who had a good 2001 will be looking for guarantees, formulas or contracts for next year if “took one for the firm” in 2001
- Determine how the “pain” will be distributed

### Potential Directions

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- Where possible link to future competitive reference points rather than absolute rates. Avoid over mortgaging the future
- Manage 2001 compensation against a conservative template of future business demand. Reality is usually easier to add staff than to effectively shrink organization
  - Must determine sustainable volumes (i.e., some clients using 1998 levels as “normal” until analysis complete)
- Begin now to **clearly** communicate with Board of Directors or parent on compensation realities. Explain in detail real fixed vs. variable compensation in aggregate and by group
- Be prepared; resist making “one-off” deals; develop business-wide methodology. Repair structural problems to compensation mechanics and philosophy
- Spread across organization but likely heavier weighting to senior levels
  - Avoid actions done simply for “revenge” (i.e., payback for being “held up” by junior professionals in 2000)

With the upcoming year-end strains, it is critical to prepare and communicate now. Open, candid communication with the board/parent, business heads and employees avoids many uncomfortable and badly timed “surprises”. Tailor communications to each audience explaining likely year-end compensation mix/levels given the environment, philosophy, and continued commitments to particular businesses and people.

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