Compensation
Advisory Partners

Industry Report // 2019-2020

Investment Banking

Compensation Advisory Partners (CAP) examined executive compensation levels and design practices at 12 publicly traded, U.S. investment banks. CAP also reviewed executive pay levels and practices at three major Wall Street Banks for comparison purposes. This report summarizes the study findings and the impact of the COVID-19 pandemic on the investment banking industry.

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Compensation Advisory Partners (CAP) examined executive compensation levels and design practices at 12 publicly traded, U.S. investment banks. The 12 companies in the study are independent, advisory-focused investment banks, and they have a revenue range of $100 million to $7.7 billion. As an additional reference point for comparison purposes, CAP also reviewed executive compensation levels and practices at three large, diversified financial institutions ("Wall Street Banks") with significant investment banking operations. Revenue at the Wall Street Banks ranged from $35.5 billion to $110.0 billion.[1] CAP also assessed the impact of the COVID-19 pandemic on the investment banks' performance and pay programs.

Key Takeaways:

- The COVID-19 pandemic has stifled mergers and acquisitions activity – both in the United States and globally – since early March. The outlook for the rest of 2020 remains uncertain.
- The investment banking industry's approach to incentive compensation is significantly different than standard practice in most other industries. It is important to understand the investment banking pay model to effectively evaluate market data.
- Median pay levels for chief executive officers (CEOs) decreased 6.5 percent, in line with the modest decrease in operating margin among these companies from 2018 to 2019. Pay levels for chief financial officers (CFOs) increased 7.8 percent because of incumbent changes, while pay levels for other named executive officers (NEOs) decreased 5.6 percent.
- The median compensation and benefits ratio increased by 4 percentage points, from 59.9% to 63.9%

The Impact of COVID-19 on the Investment Banking Industry

The pandemic jolted the global economy and derailed mergers and acquisitions activity. *Barron's* recently reported that second-quarter mergers-and-acquisitions deal value was down 83 percent in the United States and 52 percent globally. Of note, results are not down in all business areas at investment banks. For example, 2020 has been a busy year for restructuring groups and in trading operations.

Compensation and benefits are the largest expense category for investment banks, and the biggest component of compensation is annual year-end bonuses. This variable cost structure provides investment banks with more flexibility than companies in other industries to better understand (i.e., wait and see) the full-year impact of the pandemic before taking broad-based employment actions, such as potential reductions in headcount.

In response to COVID-19, two investment banks announced pay cuts at the executive level, although one action was disclosed as being volunteered by the CEO. To date, the remaining employment actions in response to COVID-19 were positive, such as increased paid time off and new virtual health benefits. Two investment banks announced plans to honor analyst and associate employment offers, either now or in 2021. The bank that proposed 2021 start dates offered a deferral bonus for new hires.

Publicly Disclosed COVID-19 Actions	Specific Companies
Executive Compensation Reduction	Greenhill, Piper Sandler
Enhanced Employee Benefits	Goldman, JPMorgan Chase, Stifel
Honor Employment Offers	Evercore, Stifel
Employee Salary Continuation	Raymond James
Reduced Dividends and/or Suspended Share Buybacks	Goldman, Moelis, Piper Sandler, Raymond James,

1 When summary statistics are reported in this study, medians are used for the 12 public investment banks, while averages are used for the three Wall Street Banks.

Results during the remainder of 2020 will be significantly impacted by the course of the pandemic, the execution of backlogged deals and the appetite for new deals, whether opportunistic or strategic. Currently, consensus analyst estimates project more than a 25 percent decline in profits and a one percent decrease in revenue, at median, among these investment banks from 2019 to 2020. Should these projections materialize, they will trigger a corresponding decrease in year-end incentive pools. Targeted headcount reductions would also be likely, with variation by firm.

A Unique Industry

From economic, performance and compensation perspectives, independent investment banks stand apart from general industry and other financial services firms. The unique aspects of the industry are important to understand when looking at executive compensation levels and practices.

Human Capital Focus. The investment banking industry has a strong human capital focus: The industry's most valuable assets are its people. Most individuals in the industry are highly educated, trained and compensated. A firm's success depends on its ability to attract, reward, and retain highly skilled bankers with strong business networks and deal-execution skills. Given the industry's human capital focus, the largest expense category is compensation and benefits.

Year-to-Year Results. Like most professional services firms, investment banks focus heavily on year-to-year financial metrics, such as revenue growth, operating margin, and profitability. The industry tends to be cyclical and sensitive to overall economic conditions. In addition, a firm's results for the year can be skewed by factors such as a large deal closing in January instead of prior to December 31.

A key metric in the evaluation of most senior, non-corporate investment-banking professionals is annual revenue generation. Long-range planning is largely limited to senior corporate executives, and firm investments often generate returns more quickly than in capital-intensive industries.

The Investment Banking Pay Model. Investment banks approach executive compensation in a manner that is distinct from general industry norms. At investment banks, each year a total incentive is determined based on an often-discretionary review of prior-year performance. The total incentive is then delivered to executives as a mix of annual cash bonuses and deferred, long-term incentive compensation. Of the investment banks in CAP's study, all but one use this investment banking pay model for top executives, as do all three Wall Street Banks.

The investment banking pay model contrasts with the broadly used, traditional compensation model where annual and long-term incentive components are separate and determined independently. In most other industries, the annual cash incentive is often determined in a structured, formulaic manner, and the annual long-term incentive grant value is largely market-based, with the target grant value being typically independent of prior-year performance.

While executive incentive awards in the investment banking industry tend to be more discretionary in nature when juxtaposed with the more formulaic approach used in general industry, the investment banks do base their year-to-year incentive decisions on specific criteria, such as revenue and profitability. In fact, several of the investment banks in the study disclosed information about their incentive decision-making processes, which can be thought of as following a "structured discretion" approach.

2019 Industry Performance

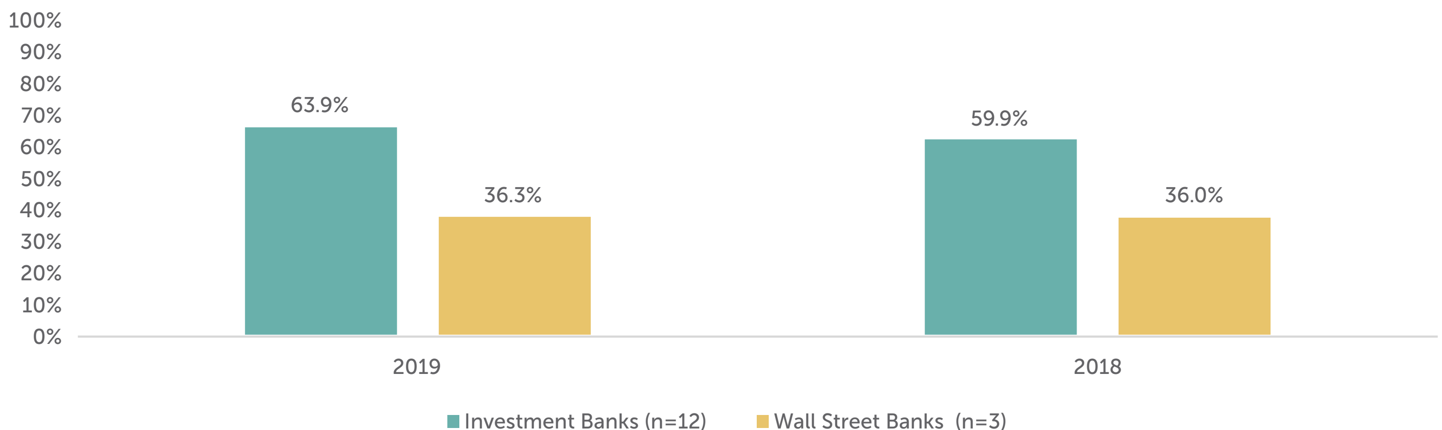
The investment banks in CAP's study reported mixed operating results for 2019. Revenue increased 2.5 percent, and pre-tax operating income increased 5.2 percent. Notably, operating margins decreased 3.0 percent, while return on equity (ROE) was flat. Total shareholder return (TSR) – which quantifies stock price appreciation and dividends – was up 17.5 percent during 2019, buoyed by a strong stock market.

Investment Bank Industry Peers: Financial Summary

Metric	Median Percent Change	
	Year Ended December 31, 2019	Year Ended December 31, 2018
Revenue	+2.5%	+14.8%
Pre-tax Operating Income	+5.2%	+33.3%
Operating Margin	-3.0%	+2.5%
Return on Equity (ROE)	-0.7%	+3.5%
1-Year TSR	17.5%	-19.8%
3-Year TSR (compound annual growth rate, or CAGR)	+5.7%	+5.7%

Source: S&P Capital IQ financial database

In addition to financial and market-based performance measures, investment banks also track and report a human-capital metric, the compensation and benefits ratio. This ratio expresses compensation and benefits expenses as a percentage of revenue. The median compensation and benefits ratio among CAP's investment banking sample increased by 4 percentage points for full year 2019 versus full year 2018. The increased compensation and benefits ratio reflects the industry's modest revenue growth being outpaced by human capital costs.



Source: S&P Capital IQ financial database

As expected, the compensation and benefits ratio is higher for the investment banks in the study relative to the Wall Street Banks. The Wall Street Banks have a more diversified workforce in terms of employee roles and pay levels.

Named Executive Officer (NEO) Compensation

CAP analyzed 2018 and 2019 pay levels for the five NEOs disclosed in proxy statements by each of the investment banks. We assessed compensation by position for the CEO and CFO, and as a group for the remaining NEOs. From 2018 to 2019, base salaries were flat across all NEO roles. Base salaries are often not increased on an annual basis for senior leadership roles at investment banks.

Incentive pay, which includes annual bonuses and long-term incentives, decreased 7.1 percent from 2018 to 2019, at median, for CEOs and 6.3 percent for other NEOs. Similarly, total direct compensation decreased 6.5 percent, at median, for CEOs and 5.6 percent for other NEOs. These pay decreases are significant as they include a decrease in the grant-date value of long-term incentives, the largest component of compensation. The investment banking pay model resulted in incentive awards aligned with financial results.

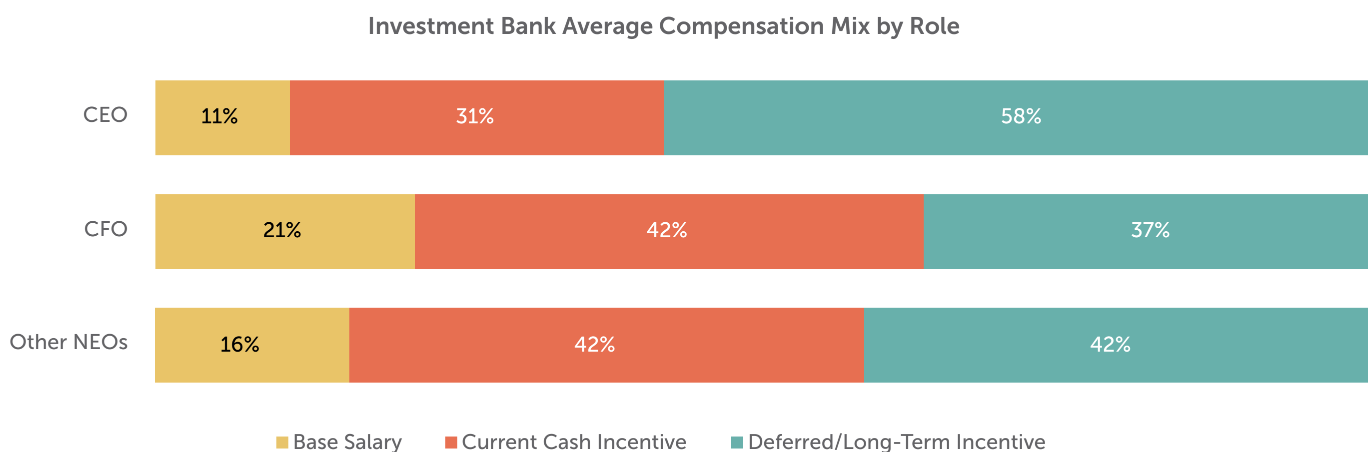
In contrast, incentive pay increased 8.4 percent from 2018 to 2019, at median, for the CFO role, and total direct compensation increased 7.8 percent. The increase in CFO incentive pay for 2019 can be primarily attributed to incumbent changes and recognition of contribution to successful completion of a merger/acquisition.

2018 to 2019 Changes in Executive Compensation

Compensation Component	Median Percent Change		
	CEO	CFO	Other NEOs
Base Salary	No Change	No Change	No Change
Incentive Pay	-7.1%	+8.4%	-6.3%
Total Direct Compensation	-6.5%	+7.8%	-5.6%

Pay Mix and Incentive Compensation

As shown in the pay-mix charts that follow, the investment banking industry places significant emphasis on performance-based, variable incentive compensation. Annual CEO compensation was 89 percent performance-based in 2019, on average. CFO compensation was 79 percent performance-based, and other NEO compensation was 85 percent performance-based. Annual incentives represented 42 percent of total compensation for investment banking CFOs and other NEOs. In contrast, CEO compensation focuses more heavily on long-term incentives, with the grant-date value of long-term incentive awards making up 58 percent of total compensation.



Investment banks deliver incentive compensation using a mix of cash and deferred equity vehicles, such as restricted stock, restricted stock units (RSUs) and performance share units (PSUs). The long-term incentive component adds a retention hook by deferring payment of a portion of annual incentive pay, most typically for three years. It also provides a link to the company's long-term shareholder value creation. A significant portion of compensation for investment banking NEOs is deferred and delivered through restricted stock, RSUs and PSUs. Approximately two-thirds of incentive pay is deferred for CEOs, while about half of incentive pay is deferred for CFOs and other NEOs.

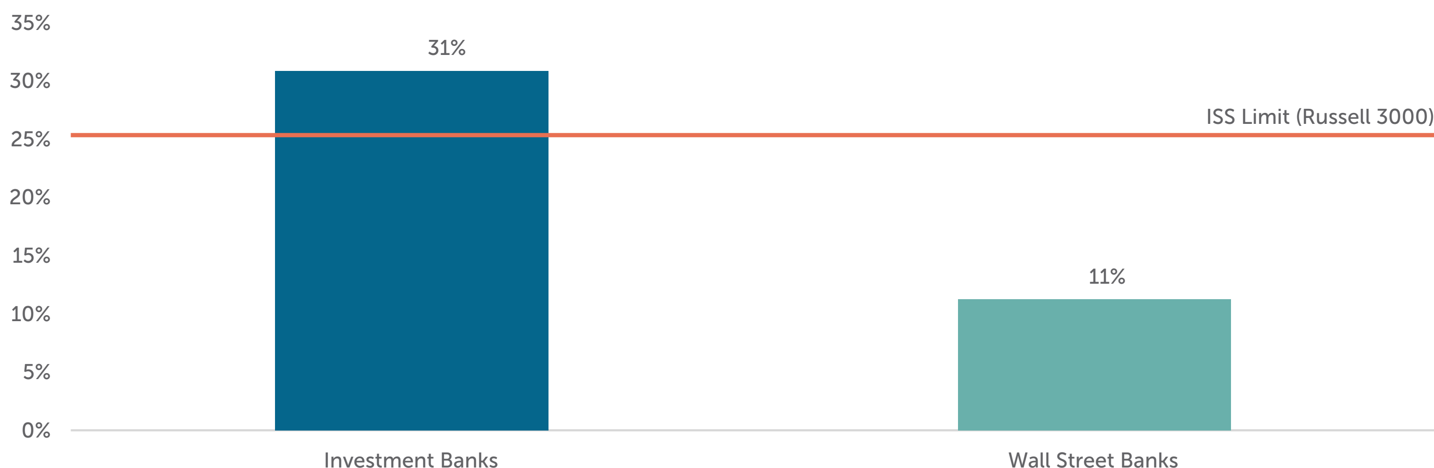
The investment banks in this study have been gradually shifting their mix of long-term incentive vehicles to include PSUs. Most CEOs in the study group now receive annual PSU awards, with prospective, generally three-year performance requirements. Among the CEOs who receive PSUs, close to half of long-term incentive compensation is provided through these awards. The most common performance metrics associated with PSUs in the investment banking industry are TSR and return measures, such as return on equity (ROE), followed by revenue growth and operating margin. Performance-based long-term incentive vehicles such as PSUs, with prospective multi-year goals, are favored by Institutional Shareholder Services (ISS) and Glass Lewis, the two most prominent proxy advisory firms.

Specific to 2020, while the full economic impact of the COVID-19 pandemic will not be known for quite some time, compensation committees should evaluate their "in flight" PSU awards. As of July 2020, the stock prices for the investment banks studied are now near, equal to, or above where they were before the COVID-19 pandemic. In contrast to the shareholder experience—recognizing that two of the investment banks temporarily reduced dividend payments—in-flight PSU awards that have absolute performance goals are now projected to pay out below target or not at all. Compensation committees should consider whether this reflects the intended pay-and-performance alignment.

Compensation should be used as a management tool to support business strategy. Accordingly, PSU performance goals are often based on financial metrics, such as ROE, revenue growth, or operating margin, that are aligned with the companies' business plans. Also, many companies' compensation plans try to correct for events that are outside management's control. The pandemic disrupted many companies' annual and long-term business plans. Compensation committees may want to evaluate their in-flight PSU awards and consider improvements that better align pay and performance. Adjustments to consider include relative performance measures instead of absolute measures, the implementation of pre-defined or discretionary adjustments to the calculation of metrics so that management is not penalized for events outside its control, among other alternatives.

Equity Overhang

CAP also analyzed equity overhang, which is a measure of potential shareholder dilution. Median equity overhang for the investment banks was 31 percent, up from 28 percent last year. Notably, the median equity overhang among the investment banks studied exceeds ISS "excessive dilution" thresholds. The ISS thresholds do not consider industry-specific factors, such as investment banking's human-capital focus and the partnership model from which these public companies emerged. In contrast, the average equity overhang for the Wall Street banks was 11 percent.



ISS uses its Equity Plan Scorecard (EPSC) model to determine its shareholder vote recommendation for new share requests for equity and incentive compensation plans. The EPSC includes certain "overriding" factors, one of which is "excessive" dilution. This factor, which applies to S&P 500 and Russell 3000 EPSC models only, will be triggered by ISS when the company's equity compensation program is estimated to dilute shareholders' holdings by more than 20% (S&P 500 model) or 25% (Russell 3000 model). This overriding factor may warrant an ISS "against" vote recommendation, despite an acceptable overall EPSC score. All but one of the investment banks in the study are in the Russell 3000, while only two of the companies are in the S&P 500. All three Wall Street banks are in both indices.

Two-thirds of the investment banks studied have equity overhang levels that would exceed the ISS "overriding" factor threshold. This indicates that, for a majority of publicly traded investment banks, ISS would likely recommend that shareholders vote against a new share request, no matter what the plan features are or what the benefits of maintaining an ongoing equity compensation plan are to various stakeholders, including the company, employees and shareholders. The ISS "overriding" factor threshold does not make sense for the investment banking industry and exemplifies why industry-specific understanding is important when designing and evaluating compensation programs.

When publicly traded investment banks seek shareholder approval for new share requests, shareholder outreach is advisable, and the resolution should include information that makes a strong case for the share request. Also, setting internal expectations for the likely (low, but passing) level of shareholder support is important. For example, among non-S&P 500, Russell 3000 investment banks, median shareholder support for such new share requests during the past three years was 68 percent. ISS recommended that shareholders vote against all but one of the proposals, but each time the proposals passed with majority shareholder support (albeit, with lower support than broader market norms).

Equity Run Rate

CAP also analyzed the equity run rates for the investment banks. The equity run rate measures shareholder dilution from equity grants made in a particular fiscal year. In recent years, the median annual gross run rate for the investment banks has ranged from 3.2 percent to 4.5 percent. The three-year average gross burn rate is 4.3 percent at median.

Given its human-capital focus and approach to incentive compensation, this industry often focuses more on the net run rate, which takes into account forfeitures and repurchases, than on the gross run rate used in most industries. For example, the net run rate is frequently the only version of run rate discussed in new share request proposals in this industry. Among the investment banks studied, the median net run rate has ranged from approximately -3.0 percent to -0.2 percent in recent years, with a three-year average net run rate of -1.0 percent, at median. In this industry, buybacks are often viewed as a tool used to limit or net-out annual shareholder dilution from compensation programs.

Peer Groups for Compensation Benchmarking

CAP assessed the size and composition of the peer groups used by investment banks for compensation benchmarking purposes. Publicly traded companies generally disclose the peer groups they use for compensation benchmarking purposes in their annual proxy statements. Relative to most other industries, the peer groups used by the investment banks are smaller and more industry focused.

Among the investment banks studied, the median peer group size is 12 companies, while the 75th percentile is 13 companies. The peer group size for the Wall Street banks is even smaller, with an average of 6 companies. In contrast, a recent Equilar and CAP study of 500 companies across different industries found the median peer group size to be 17 companies.

The investment banking peer groups are smaller than those used in most other industries because the executive compensation programs in this industry are unique (see "Investment Banking Pay Model" above), and companies choose to compare themselves mostly with publicly traded direct competitors – of which a limited number exist. This is very different than how peer groups are approached in many other industries where companies are screened more broadly for size and other operating metrics. In the 500-company general industry sample noted above, only 8 percent of companies maintained a peer group where at least 75 percent of constituent companies were from the same industry classification, and only 30 percent of companies maintained a peer group where 100 percent of constituent companies were from the same industry sector classification.

CEO Pay Ratio

The CEO pay ratio, which most public companies are required to report annually in the proxy statement, is the ratio of CEO compensation to that of the median employee. For the investment banks, CEO compensation in 2019 was 40 times the compensation of the median employee at their companies. This is significantly less than the median CEO pay ratio among Russell 3000 companies, which was 80 times the compensation of the median employee. The lower CEO pay ratio at investment banks is driven by much higher median employee pay relative to general industry.

CEO Pay Ratio – Investment Banks and Russell 3000

	Investment Banks	Russell 3000
2019 Median CEO Pay Ratio	40x	80x
2019 Median CEO Pay	$7,478,814	$5,627,449
2019 Median CEO Pay Change	-8.3%	n/a
2019 Median Employee Pay	$185,719	$66,237
2019 Median Employee Pay Change	6.2%	n/a

Note: 2019 median CEO pay is calculated using the Securities and Exchange Commission's proxy disclosure rules. This differs from the way investment banks view annual pay and pay changes.

The average CEO pay ratio for the three Wall Street Banks was 282 times in 2019, much higher than both the investment bank and the Russell 3000 pay ratios. Among the Wall Street Banks, CEO pay averaged $30 million, and the average median employee pay was nearly $105,000. CEO pay at the Wall Street Banks reflects the size and complexity of the organizations, and the lower median employee pay reflects the greater variety of business lines and employee roles.

Conclusion and Looking Ahead

During 2019, the investment banks in CAP's study rewarded executives commensurately with operating performance outcomes. Looking ahead, we expect to see an increasing prevalence of PSU awards – with prospective, pre-defined, multi-year performance goals – for corporate leaders at public investment banks. We have seen the industry heighten its focus on gender pay equity and representation by women in the management ranks; this trend will continue.

The industry outlook for the rest of 2020 remains uncertain and depends on the course of the pandemic, the execution of backlogged deals and the appetite for new deals, whether opportunistic or strategic. Unless business results significantly improve during the balance of the year, 2020 incentive funding will be down, likely double digits for advisory and, to a lesser extent, for underwriting.

Even during economic downturns, top talent will be sought. Companies can choose to compete or fall behind. Given the industry emphasis on year-end incentives, further cost-cutting and headcount reductions will be increasingly likely — especially if a quick recovery is not the consensus expectation — with variation by firm and across different business lines and areas of industry focus and expertise.

Lastly, designing an effective executive compensation program in investment banking requires real-time industry insights, deviation from the market practices that are common in other industries, and a compensation-focused shareholder communication strategy that specifically addresses industry-specific distinctions.

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Appendices

Key Terms Defined

Term	Definition
Compensation and Benefits Ratio	Compensation and benefits expense as a percent of revenue.
Equity Dilution or Overhang	Represents maximum potential dilution from equity-based compensation (i.e., the sum of all outstanding or available shares/units under equity plans divided by the sum of the company's common shares outstanding and all outstanding or available shares/units under equity plans).
Equity Run Rate (also called "Burn Rate")	Represents equity grants (including full-value shares and stock options) made during the year divided by the company's average common shares outstanding.
Investment Bank Compensation Model	Reflects an often highly discretionary compensation structure where all / most incentive compensation is based on prior-year performance and then split between immediate cash and equity awards with prospective vesting requirements.
ISS Excessive Dilution Threshold	ISS policy to vote against new share requests when the company's equity compensation program is estimated to dilute shareholders' holdings by more than 20 percent (S&P 500 company) or 25 percent (non-S&P 500, Russell 3000 company).
Net Run Rate (also called "Net Burn Rate")	Represents equity grants (including full-value shares/units and stock options) made during the year minus forfeitures and repurchases divided by average common shares outstanding.
Operating Margin	Measures how much profit a company makes on each dollar of revenue. The calculation is operating income, or earnings before interest and taxes, as a percent of revenue.
Total Direct Compensation (TDC)	The sum of base salary, annual incentive (cash bonus), and long-term incentives, such as restricted stock, stock options, and cash- or share-based performance plans.
Total Shareholder Return (TSR)	TSR measures the change in stock price over time, with dividends assumed to be reinvested at the time they are paid.
Traditional Compensation Model	Reflects a compensation structure where annual and long-term incentive components are separate and determined independently. The annual cash incentive is determined in a structured, formulaic manner, and the annual long-term incentive grant value is largely market-based, with the target grant value being typically independent of prior-year performance.

Investment Banks

Cowen Inc.
Evercore Inc.
Greenhill & Co., Inc.
Houlihan Lokey, Inc.
Jefferies Financial Group Inc.
JMP Group LLC
Lazard Ltd
Moelis & Company
Piper Sandler Companies
PJT Partners Inc.
Raymond James Financial, Inc.
Stifel Financial Corp.

Selected Wall Street Banks

The Goldman Sachs Group, Inc.
JPMorgan Chase & Co.
Morgan Stanley

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