EU bonus cap

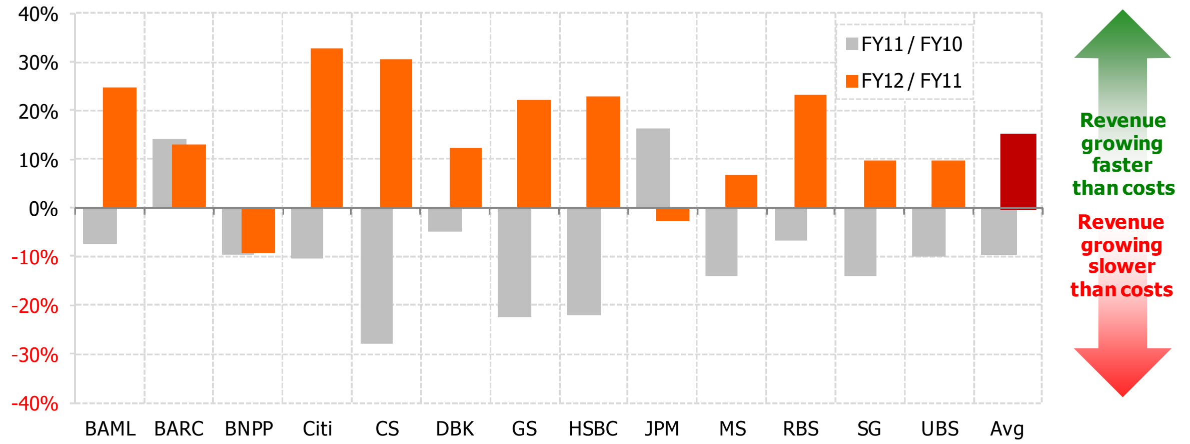
- The EU Parliament's proposal to impose a 1:1 bonus:salary ratio for 'bankers' is not merely pointless. Ignoring great changes that banks have already made in aligning their pay with market conditions, it damages banks' ability to adjust their cost structures to inevitable revenue fluctuations *and* sidelines stakeholders that are rightly tasked with making such decisions.
- The bonus cap, as defined in the proposal, includes relatively junior staff, thus going far beyond the stated aim of discouraging 'excessive' risk-taking. The comparably constructive proposal by Cyprus was, in Nov-12, described as 'totally unacceptable'.
- We expect the result will be an increase in banks' fixed costs and/or extended redundancies.

Yesterday, the EU Parliament secured an agreement on a mandatory 1:1 bonus-to-salary ratio for banking staff, rising to 2:1 with an explicit approval from shareholders. Early reports suggest that the final agreement may allow up to a quarter of variable bonus to be issued in instruments that defer pay for more than 5 years; the value of such deferred pay would be discounted, thus effectively lifting the final bonus-to-salary ratio above 2:1. The proposal covers EU banks' international staff and EU-based units of non-EU banks. The only 'sweetener', so far as we can tell, is that side effects of the legislation may be reviewed after two years.

The key proponent of the bonus cap, MEP Philippe Lamberts, recently described[1] how a bonus cap in line with the base salary would discourage 'excessive' risk-taking. He then all but equalised such risk-taking with plainly illegal (chiefly, the Libor scandal and mis-selling of financial products by the UK banks) and 'dubious' tax-evading activities. To us, it is Lamberts' argument that is dubious, and that's without even addressing his suggestion that banks' management, through pay structures, habitually encourage(d?) illegal activities.

It is not hard to see why specialised commentators are almost unanimously opposed to the proposal. The proposal ignores great strides banks have already made in balancing the distribution of profits and therefore their levels of capital. It also ignores the industrywide realignment of pay structures to reflect regulatory pressure and revenue dynamics: non-cash (and/or long-term) component of bonus has risen considerably over past couple of years, and bonus clawbacks have become a new reality[2]. The resulting improvement in banks' comp/revenue ratios is shown in Figure 1. In 2012, the Top 13 banks[3] increased their capital markets revenues by 8% (weighted average, in US$), while reducing comp & benefits by 7%. The equivalent figure for top-quartile performers (principally BAML, Citi, CS and HSBC) was 23%. This is in stark contrast to 2011/2010, when average revenues fell by 17% y/y, while comp & benefits declined at a comparably modest 9% y/y.

Figure 1: Operating Revenue(1) vs Total Front Office Comp & Benefits(2) (Global, FY10-FY12)



Source: Bank reports, Tricumen. Notes: (1) Revenue is post-writedowns, excludes CVA/DVA/equivalent and one-offs. (2) Total calendar-period front-office staff compensation & benefits: includes salary, discretionary bonus, amortised equity awards and equivalents, and severance costs.

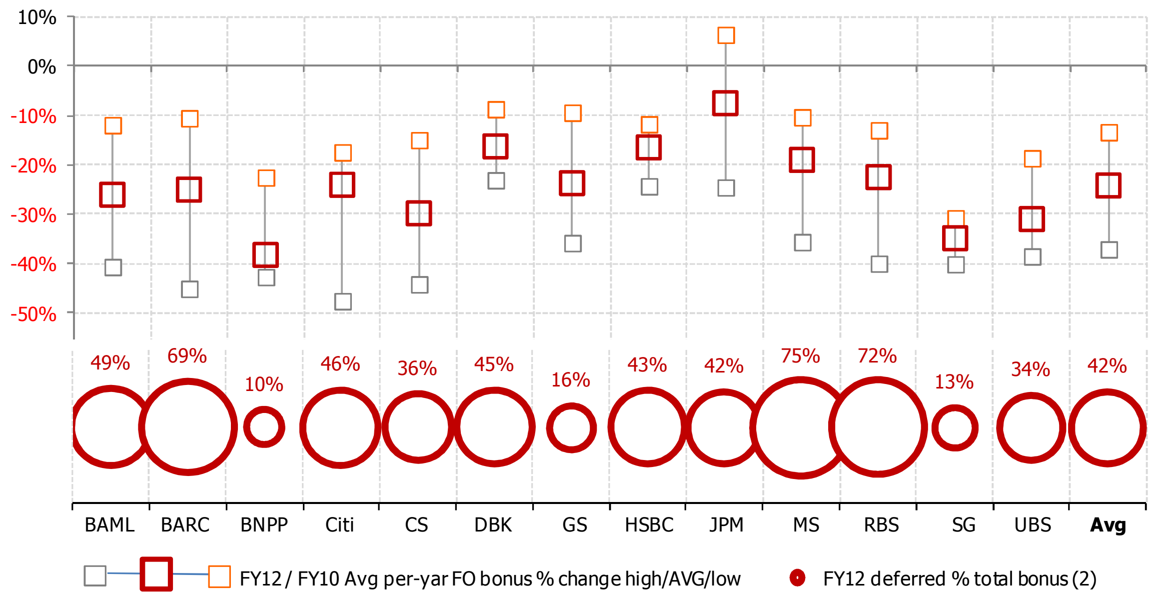
[1] http://www.guardian.co.uk/commentisfree/2013/feb/25/how-to-fix-banking

[2] *To date, few banks have exercised clawbacks, but we expect this will change: in late Feb-13, FT reported that Barclays recouped £300m/$476m in bonuses already promised, and we don't imagine Barclays will be the exception in its peer group.*

[3] *Bank of America Merrill Lynch, Barclays, BNP Paribas, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Morgan Stanley, Royal Bank of Scotland, Societe Generale, and UBS.*

During the same period, we estimate that, on average, comp & benefits paid out by 'our' 13 banks to front-office staff declined from 33% of overall costs in 2011 to 28% in 2012, while a deferred component of the overall comp stayed roughly unchanged from 2010 and 2011, at c.40% (though the range widened in 2012, to 10-75% – bubbles in Figure 2 below). On average, banks in this report cut their FY12 bonus pool by 16% from 2011, adding to the FY11/FY10 average reduction of 32%. The cumulative effect of bonus reduction during 2010-12 period is shown in high/low lines below.

Figure 2: Operating Revenue[(1)] vs Total Front Office Comp & Benefits[(2)] (Global, FY10-12)[(3)]



Notes: Bank reports, Tricumen. (1) Revenue is post-writedowns, excludes CVA/DVA/equivalent and one-offs. (2) Total period front-office staff compensation & benefits includes salary, discretionary bonus, amortised equity awards and equivalents, and severance pay. (3) The FY12 figures for HSBC and RBS are estimated based on our 9m12 analysis.

Favouring the fixed component of pay structures in any business is put very politely, unwise; this is doubly true in dynamic industries dependent on specialised personnel - like investment banking. As shown in the chart below, we estimate that the variable comp due to middle-ranked and senior staff in lieu of 2012 performance and previously deferred pay was, on average, 2.2x greater than base salary, though within a wide 1.6-2.8x range[4].

Our simplified calculation, based on 2012 numbers, suggests that the imposition of a 1:1 bonus:salary cap would force banks to cut bonuses by little over 50% *on average*, though this would have a disproportional impact on banks which – prudently![5] – favour variable pay: chiefly, BARC, DBK and JPM.

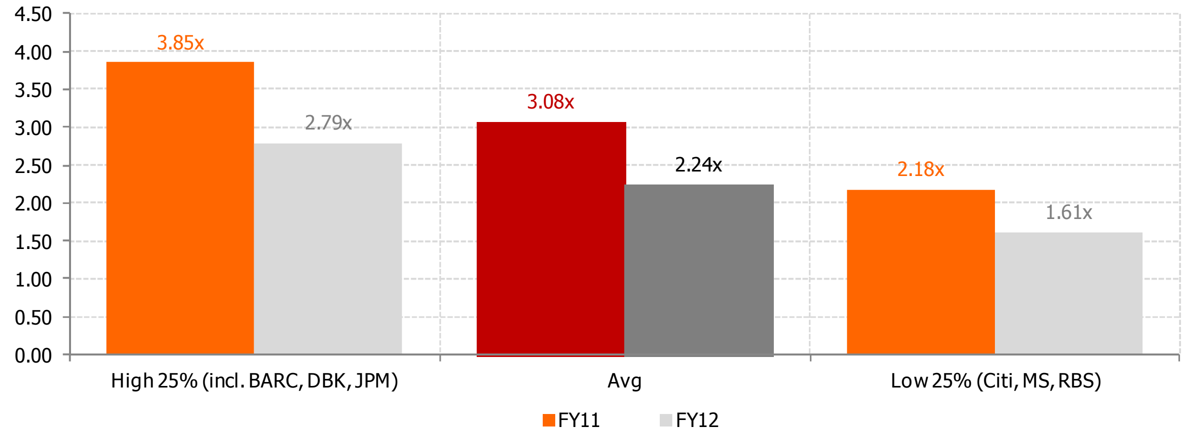
Considering the scale of cut already made since 2010 (Figure 2), we do not think the bonus reduction will play a leading role in compliance. More likely, banks will extend redundancy programmes and/or increase fixed salaries. In our view, even a near-term improvement in revenues would merely postpone the fallout.

(cont.)

[4] *A considerable across-the-board reduction in this ratio from the previous year we attribute to revenue weakness due to Eurozone crisis (in no small part caused by European Governments' inability to control national budgets), and regulatory pressures.*

[5] *Disclosure: at Tricumen, the variable compensation has always formed a vast majority of the overall comp. It is based on performance and, we are happy to state, works rather well.*

Figure 3: Variable Comp VP+ level(1) / Base salary(2) (W Europe, front office, FY11 and FY12)(3)



Notes: Bank reports, Tricumen. (1) Front-office staff bonus, including unamortised equity awards and equivalents. Excludes salary, severance costs, amortised equity awards and clawbacks. (2) Includes salary, discretionary bonus, amortised equity awards and equivalents, and severance pay. (3) Staff below VP level are excluded.

Finally, Lamberts' actions over the past few months seem to contradict his stated aim of curbing excessive risk-taking culture. In Nov-12, Cyprus, which held the EU's rotating presidency at the time, reportedly put forward a proposal to limit 'bankers' bonuses to 5x base salary, with the shareholders approval; or to 3x without it. Under the circumstances, this was a sensible compromise, which addressed Lamberts' *stated* key concerns and market realities. According to public disclosures from the 13 banks in our core coverage, only the most senior/profitable bankers (sometimes referred to as 'material risk takers' – MRTs) come anywhere near the 5:1 bonus:salary ratio. Definitional differences between banks' classifications aside, MRTs are the most senior/profitable staff on their banks' payroll and so, following Lamberts' argument, curbing their tendency at 'excess' (as defined by Lamberts), would at the very least, have gone a long way in 'tackling the most egregious' of bankers' actions.

Lamberts promptly branded Cyprus' proposal as 'totally unacceptable' and instead pressed for a 1:1 ratio – thus casually sidelining shareholders and Boards of Directors (who are far better placed to determine the level and structure of pay at firms they own/run) and even the regulators who already scrutinise bankers' pay in key financial centres of Europe.

The damaging aspects of this populist legislation will probably become apparent soon. Identifying beneficiaries will, we suspect, take rather longer.

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