FAMILY WEALTHREPORT

GUEST ARTICLE: Compensation Trends In Wealth Management: Lessons From The Wirehouses - Part 2

Allan Starkie, March 25, 2015

Here is part two of a guest article by Allan Starkie, a partner at Knightsbridge Advisors, about compensation trends within the wealth management industry. It reflects the presentation he made earlier this month at the annual American Bankers Association, Wealth Management and Trust Conference.

See the first part here.

Starkie specializes in executive recruiting in wealth management, and also provides management consulting and merger and acquisition support for clients. Prior to joining Knightsbridge Advisors, he served as a partner at the executive search firm Riotto-Jones, where he led CEO and high net worth sales searches. Starkie is a graduate of West Point and Harvard Business School.

The views expressed below belong to the author, but *Family Wealth Report* is grateful for the right to publish them, and welcomes reader responses.

If we study how these aging high-performers are paid, we find that, if we average the production grids of the top five wirehouses, we see that a producer of $3 million or more will earn 45 per cent of regular business and 48 per cent on wrap products – on a recurring basis, with additional kickers for new revenues (called net new money).

From the perspective of trying to recruit these people to non-broker platforms, they are used to significant sign-on bonuses to move. The bonuses paid as Employee Forgivable Loans (EFLs) are based on the last 12 months of total revenues – often referred to as “Trailing Twelve (T-12)”. A large portion of the bonuses is paid upfront with success-triggered “back-end” components that yield a total of up to 325 per cent of T-12; or $3,250,000 for each million dollars of production. These EFLs amortize typically over a nine-year period, and the FA or hiring company would be obligated to repay the unamortized portion.

Yet, there is a further wrinkle that makes matters even more restrictive, if one wishes to hire a top FA. After decades of costly litigation back and forth, the large wirehouses created “The Protocol,” which allows portability of clients among the participants of this Wall Street Geneva Convention. FAs are still obligated to sign non-solicitation agreements, in the event they are recruited by a non-protocol firm; in which case they will be strongly prohibited from soliciting clients for a period of one year. Although the participants of The Protocol now include non-wirehouses, and even some RIAs, I am always amazed at how few firms seem to even be aware of its existence or ramifications.

So, in answer to The American Bankers Association’s request that I construct a compensation model capable of recruiting from the wirehouses, here would be the list of reasons why I feel such a move might be unwise:

- They are highly paid professionals; so highly paid that their firms do not break even until after year nine (45 per cent of revenue paid annually);
- Probably less than ten years left to work;
- Probably has not attracted significant new assets in a very long time;
- Comes from a legacy of transactional business;
- Probably not comfortable with holistic wealth management;
- Used to receiving enormous sign-on bonus to leave (over 300 per cent of T12); and
- Restricted in portability of assets if moving to non-protocol firm.

The conclusion, therefore, would be:

We do not want to construct a compensation plan that competes with the wirehouses as they are currently conducting business. We need to construct a compensation plan that attracts top producers away from all peer groups of wealth management, to include the wirehouses, in the way they will conduct business in the next five years.

Future wirehouse models

As the brokerage community continues to age, the wirehouses will be forced to find ways to retain the assets/clients. The most likely scenario will be that retiring brokers will sell their books to their firms and fade away, and young brokers will be assigned these books with compensation models resembling private banks. Banking, T&E and planning will be more integrated into their offerings.

The wirehouses of the future will begin to resemble the major money-centers and regional banks, and their compensation models will morph into those used in banks. There is much to be said for improving the compensation models currently used among all peer groups of wealth management, without skewing them in a way to attract brokers.

For discussion purposes, let us divide the remaining members of the wealth management community into the following peer groups: International money centers, regional banks, trust companies/asset management companies, and RIAs/MFOs.

As a general rule, virtually all international money centers have migrated, during the last decade, from partially formulaic bonuses to purely discretionary bonuses, for their private bankers. As a result, they have been forced to pay ever-increasing base pays (in some cases exceeding $350,000) and are forced to offer one and sometimes two-year minimum guarantees.

This yields the predictable responses of uncertainty, and ultimately attrition. We witness this in the almost daily game of musical chairs among money-center bankers. I call this type of compensation “A Night at the Oscars.” For, like the annual Academy Awards, the winners and losers first learn of their fate when the envelope is opened; and only a few have reason to thank The Academy.

On the other hand most regional banks, trust companies, and asset management companies use formulaic incentives to reward revenue-producers. Almost all regional banks and trust companies still use “The Business Development Officer Model,” in which the BDO garners the new client assets and hands them over to a team. The top-tier formulaic incentives for these professionals often exceed 50 per cent of first year revenues.

There has been a movement among a number of super-regional banks to eliminate the pure “hunter” BDO and increase the sales responsibilities of the relationship managers. In about half of these cases the incentive has become formulaic. Although it does not crescendo at over 50 per cent of revenues (as do many BDO models), it does offer a transparent link between success and reward, which is essential in today’s challenging environment.

Three of these super-regionals have adopted trailers for their revenue-producing relationship managers, which I believe to be the single most innovative and motivating trend we have seen since the crash.

The final peer groups to address are the RIAs/MFOs. There are over 20,000 RIAs and less than 100 MFOs and the only thing they have in common from a compensation standpoint is their extreme diversity.

If there are any major trends, they would include the use of equity to augment cash compensation; however, in the frequent absence of a clearly articulated monetization strategy, the perceived value of this illiquid asset soon fades. Only one firm focusing on rolling up RIAs has created a mechanism in which partners may borrow against their ownership shares, or sell them back to the company using a pre-determined metric. In this case, the equity becomes a viable form of compensation. Too often, however, overly-caffeinated entrepreneurs sell naïve candidates unrealistic business plans, and overly optimistic valuations – often complicated by incomprehensible classes of shares. It is perhaps the exaggerated expectations of most RIA shareholders that result in the miniscule and decreasing number of RIA transactions each year. Last year, under 35 were sold nationally.

So, we have discussed a number of things not to do:

- Refrain from recruiting brokers to private bankers
- Avoid discretionary bonuses for revenue producers
- Do not delude the trusting with illiquid equity

Let us conclude by suggesting some things that we should be doing:

- Pay obscenely for first year revenues;
- Allow business development officers to keep select relationships;
- Allow private bankers a release-valve for swollen books;
- Pay a “real” life-time trailer;
- Pay a fair base pay (but not so rich that it eliminates the drive for high incentive);
- Keep them “whole” when they arrive (do not short-change them and begin a negative perception);
- Creative alternatives to guarantees (double first-year payout for example); and
- Create “golden handcuffs” with life-time trailers and restricted stock.

In conclusion, we must point out that there is no compensation model that fits all institutions, and all producers. It is, however, a sad fact that unless revenue-producers are paid formulaically, they will fall prey to the unfortunate trend of allowing their success to subsidize enormous back-office costs. They need not be paid as extravagantly as FAs have been compensated; yet, the elements that attract solid sales personalities to the wirehouses can be modestly utilized among all peer groups of wealth management.