Rebuilding bank exec comp means more than compliance (September 3, 2009)

The one certainty is that executive compensation will change

Establishing the new normal is the uncertain part, but here’s a potential blueprint

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Government scrutiny, shareholder backlash, undernourished balance sheets, and other factors are pushing bank management and boards to reform executive pay. Many are convinced that while pay did not cause the financial meltdown, it certainly exacerbated the problem.

This has led to a genuine interest in transforming executive pay.

The devil, of course, is in the details.

It’s important to recognize that certain banks must first comply with TARP regulations, and, for that reason, some executives may not be able to participate in incentive plans for a period of time.

However, we do not want to confuse compliance with effective pay design.

A foundation for reform

Like any other reformation, there are many views on how to go about it. What has become clear is that tinkering around the edges won’t do the trick. This is not the time to try to introduce complex controls and adjustment factors, and it is certainly not the time to impose limits.

So, where does that leave us?

There are a few fundamental truths in pay design. We must start with the belief that:

• Pay structure influences behavior, but it does not control it.

• People are smarter than formulas, and we cannot delegate pay decisions to formulas or simple payout ratios.

• No single measure can adequately capture the true performance of a financial institution. Share price, EPS, and ROE are not sufficient to understand long-term performance. Multiple measures from multiple perspectives must be examined and balanced against one another.

• Incentive pay should be delivered only when there is a high certainty that revenue/profits will be realized. In the event that compensation was delivered for performance that never materializes, there should be a mechanism to recover it.

• Success and failure should be shared across the business. No single person or business unit is solely responsible for success or failure.

• We should build our pay plans around the assumption that we want quality people over a long horizon. Those who do not remain or perform over the long-term should be relatively disadvantaged. We should not design pay plans that are “fair” for those who leave after a short stay.

• One plan will not fit all types of employees. Different plans and pay mixes should be crafted for different levels and types of employees.

• A portion of pay should be delivered for doing the job adequately and a portion should be reserved for exceptional results.

• Perquisites or special benefits that provide value to the individual exclusively (as opposed to the institution) have no place in the pay mix. Institutional benefits include such things as tax benefits, greater efficiency, or value in excess of cost.

• Individuals can add great value to an organization, and not adequately rewarding them constitutes an institutional risk.

Building on the foundation

How does a bank transform these general principles into a workable pay structure? I believe you must begin with four concepts:

• The free market does work, and good people always have other opportunities. Systematically overpaying or underpaying (in the eyes of the beholder) will result in the movement of talent.

• Regulations will inevitably (or directly) impact banks’ freedom to design pay plans. Firms must learn to live with government oversight and work within those restrictions.

• People like simplicity and predictability. Complexity can come at a cost.

• Employees inherently understand the time value of money—the further it is away from receipt, the less it is worth.

It is impossible to address all the nuances and considerations of a real company in a brief paper, but my goal here is to establish a platform to build on.

A step-by-step progression

Nothing this complex is as simple as putting together a set of shelves from your local home center, but the process can still be broken into key steps:

1. Start by determining the range of value for given positions.

This can be accomplished with an understanding of the value of each employee’s position in the corporate mix, coupled with a good sense of a “fair” means of sharing value produced between the owners of the firm and those who work there. This process is more complicated than looking up pay levels in surveys. But it is not impossible and can be achieved by a thoughtful review and analysis of current and historical data.

2. Break the total into pieces.

How much represents baseline performance for a job? How much is surplus for exceptional performance, which results in excess returns to the owners? How much should be in the form of salary? How much should be in current versus deferred cash? How much should be in company equity? Is there a role for special benefits or perquisites?

This process isn’t simple either, but it isn’t impossible and can be accomplished with a thoughtful open debate.

Now that you have the basis for answering the “how much” question, you must tackle the “how” question. Here are three more steps:

3. Create a new incentive mechanism which funds each year based on performance versus a set of metrics designed to capture the true performance of the institution.

I am suggesting that an incentive amount or pool (for the executive being measured) be calculated each year.

4. Board’s Compensation Committee sets annual metrics.

At the start of the year the Compensation Committee would approve a set of metrics to evaluate performance that would include measures of financial performance, risk management, capital adequacy, operational effectiveness, and shareholder return.

5. Board’s Compensation Committee evaluates outcomes at yearend.

These measures would be evaluated at year-end on both an absolute basis and relative to peers and historical performance. Based on this review (conducted by the Compensation Committee with independent advice) a factor would be applied to the “target” award. This would result in generation of an amount of incentive compensation for current-year performance.

This amount would be added to a deferred account (including any balance from previous years). This aggregate amount would be adjusted each year based on a look back on the quality of earnings (e.g. write ups or write downs would adjust the deferred pool). A portion of this fund would be distributed each year based on the time period over which earnings are expected to be realized.

For businesses where the earnings are realized in the same year, I would distribute 60% of the pool. In those lines where the return takes longer (e.g. complex credit derivatives) I would only distribute 20%-25% of the total pool in any given year.

Each distribution from the pool would be subject to a “tax table” split between cash and company stock. The stock would be fully vested but the net proceeds (after payment of taxes) would need to be held for at least three years. An option grant would accompany the stock grant and would be set to equal 2-3 options for every share held after taxes. The following table illustrates this idea.

Incentive Pool Funding (in millions)

(Click on image to enlarge chart)

Will this work?

Like any new idea, this will take some getting used to. It has the advantage of being structured and having upside opportunity based on actual results over time. The upside exists through potential positive adjustments to the pool, equity grants, and stock options. It is well balanced because the funding is based on a set of balanced measures but requires informed judgment to determine if the results are achieved.

This approach delays income realization (and makes it less certain) for complex businesses with a long time horizon before realization.

It will be perceived less favorably by traders and others than a plan that pays them currently for mark-to-market income. Early adopters could be at risk if others do not follow suit because employees and candidates will view it as less certain. It does have the advantage, though, of self-selecting those individuals with a long-term perspective. It will inevitably defer highly leveraged earnings with a longer payout period and put it more at risk. Many would argue that that is a good thing.

This system would be very complex to administer for individuals, especially those who are mobile inside the organization. Therefore, I would suggest that this essentially be a mechanism to fund a bonus pool for a given management team of the corporation, business unit, or segment. It could, for example, be used for the capital markets group or the executive leadership team. In that case, individual allocations would be made on a discretionary basis by management and/or the Board.

There would be many other complications with this design, once we go beyond the conceptual level, as it would apply to your organization, including how to handle the accounting of deferred compensation.

However, complications can be overcome if we buy into the concept that traditional annual incentives with a separate long- term equity plan may no longer be effective in today’s financial institutions where product complexity can be way ahead of risk management, accounting, and incentive plan design.