Where Are the Villains Now?

As is true in every downturn on Wall Street there is a search for the obvious villains—those that caused firms to fold, investors to lose their money and countless innocents to lose their jobs.

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By Brian Dunn, President, McLagan
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In this current crisis, pain is widespread and where there is pain there is a search for villains. As a result, there is likely to be broad and deep investigation into Wall Street's compensation plans. The outcome of this work could be the most significant shift in the compensation philosophy and plans since firms went public. It is clear that regulatory bodies are taking a hard look at this topic at this very moment.

What we are witnessing, and will continue to see, are traders, bankers and executives of banks and securities firms bearing the brunt of the criticism for the fallout. This attention is not entirely unjustified, because at this point in time, there is a clear mismatch between performance and pay. This mismatch, combined with the massive losses, has agitated regulators, shareholders, the media and the man on the street. All are clamoring for action. Amid all the noise, there must be some clear thinking and an effort to separate out the real issues.

We must also acknowledge that regulation alone is not the answer. It is clear that markets, not regulators, are superior governors of pay. That having been said, pay plans, improperly constructed, can encourage bad behavior and decisions made with inadequate information.

The bottom line is that rogue traders, fueled by ill-conceived incentive plans, were not the cause of this crisis. In reality, shareholders craved returns, management opened the door to esoteric (and seemingly profitable) ideas and with that, traders and bankers created "sure thing" instruments under a virtual green light.

Also, rating agencies, risk management systems and managers' instinct failed to do their job and put the brake on their flawed strategy. In this crisis, these "sure thing" investments were bundles of mortgages and other loans, packaged in special purpose vehicles (SPVs) or structured investment vehicles (SIVs) and sold to investors under positively enhanced credit ratings. These instruments worked initially and there was a seemingly unlimited ability to syndicate them. With high returns and little perceived risk, the demand for new loans to feed these vehicles became insatiable. This led to the lowering of origination standards, which became problematic when the SIVs/SPVs were kept on, or near, the balance sheet. As the market started to become saturated, firms held on to debt too long and ultimately there was the well-documented collapse.

But what really caused this collapse in the first place? We believe there were four root causes:

1) The individuals with the ultimate accountability for making the decisions to be involved in these products were too distant from the actual activity to truly understand the mechanics and the risks. They were managing a massive global enterprise with hundreds of locations, thousands of people and billions of transactions. No one person could be on top of everything, and unfortunately the layers of management between the transaction and the top diluted understanding and muffled risk concerns. The real culprit was not incapable or inadequate management, but rather the organizational size, structure and complexity that had too many degrees of separation between the true decision makers and the architects of these vehicles. However, rating agencies who gave these vehicles superior rating and the guarantors who "insured" them along with internal risk management controls all contributed to this failure.

2) Proper pricing of risk—market, credit and liquidity—seemingly did not occur. When risk is under-priced, institutions will inevitably originate, retain and trade too much of it. Traders and bankers convinced managers that these vehicles were not only profitable, but that they could either be kept either off or on balance sheet (for even more profit) or could be syndicated readily and therefore there was no risk. Bankers ignored how much capital or balance sheet these vehicles or products required and weren't securing against it or charging for it. Without these proper charges, banks also did not shut down their origination engines when the market began its path to illiquidity in mid 2007, thus increasing the inventory, while the risk built and built, until it pulled the whole house of cards down.

3) When the regulating agencies insisted that all securities be "marked to market", they failed to fully account for the volatility of markets and the fact that for some of these securities there never was a "real" robust trading market. Forced by the regulators to come up with a value, firms made good faith estimates, used limited trading results and created proxies. Ironically, the regulators gave "value" to securities whose value could not be established. This validated the belief that changes in the value of these securities created income that could be reported to shareholders and used to pay bonuses.

4) Last but not least is the inescapable fact that compensation guides behavior. Most financial institutions are sophisticated enough to avoid direct-drive compensation plans (e.g., commissions) where current cash is paid to employees on the basis of the income they personally generate. However, bank's incentive compensation plans were originally constructed at a time when it was possible and desirable to remunerate a business for its current year production.

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These plans were highly correlated to what was then largely a cash business environment. Today, great percentages of firm's origination and trading profits are from securitized and derivative businesses that have risk, inventory, contracts and revenue spanning multiple years, not annually. It is this disconnect between the actual realization of earnings and the pre-payment of compensation that has caused the greatest concern. In the end, there is no question that when a person, business unit and/or firm show greater profits (or profit contribution) there is greater pay. The correlation is not 1:0, but it is surely statistically significant. Being very bright and very driven, bankers and traders will follow the money. While compensation was not THE cause of the problem it certainly can be viewed as a significant contributor.

Regulators have begun to speak of a perceived "perfect storm" of bad practices, leading to the massive losses:

1) Relatively high percentage of compensation delivered based on current year business results

2) Performance measured on revenue (i.e., not profits, not risk adjusted)

3) Lax or insufficient risk controls (i.e., not applying risk-adjusted cost of capital, not pricing liquidity, or market and credit risk properly)

4) Accounting policies that credit current income for the value of illiquid assets whose ultimate value is yet undetermined

5) Shareholder driven, and management enabled, demand for aggressive growth in profits

6) Direct drive/commission-oriented incentive plans

While not all of these factors were in place at all firms, I think we can also safely say that many of these factors were, and continue to be in place.

So that begs the question, what should be done about it?

First and foremost, action must be taken quickly to get ahead of the regulators. There is a long history of well-intended (and politically popular) legislation designed to prevent bad outcomes from repeating themselves. What often happens is that new problems are created without solving the existing ones. Despite this, failure to act on the part of banks will surely result in a flood of new corrective proposals. In fact, the US Congress, the Federal Reserve, the SEC and the FSA have all indicated that there needs to be "reform". These words have not fallen on deaf ears and many CEOs have already begun to talk about changes.

Key regulator concerns and thoughts about compensation construct:

- Excessive compensation is an unsound and unsafe practice
- Compensation is an important management tool, but it should not undermine the interests of shareholders.
- “Mark to market" valuations should not be used for compensation purposes until the illiquid asset is actually sold
- Compensation models should "price" risk.
- Compensation should not be paid out until revenues are actually realized.
- Institutions should be concerned by the combination of the trading of illiquid and esoteric vehicles *and* large incentives.

The first action step is to fully and publicly audit incentive plans to identify and remove, to the extent possible, those features that incent short-term behavior. This audit can be internal or one driven by a self-governing body of financial institutions.

Second, proactively communicate, both internally and externally, about why the existing incentive plans are business driven and prudent. Justifying compensation strategies because they are “market competitive” rings hollow if everyone else is making the same mistake.

Finally, and most importantly, use the partnership model as a touchstone in redesigning plans. This means:

- Expect and ensure that executives have significant personal capital at risk.
- Change the balance of current cash and long term reinvestment in the firm to better match firms’ lines of businesses that create its revenue and profit (i.e., increase the amount of pay delivered as stock and match the duration of vesting to company/unit performance over the full cycle).
- Delay payment for, or provide real deferrals and claw backs, on compensation if real profits never materialize.
- For senior executives, create mechanisms that demand true understanding and ownership of risk as if it was their own. Break down the layers and the distance between those designing and those taking risk. Don’t allow for these decisions to be delegated.
- Create an environment where there is the ability to benefit over the long run for investments made today. This will be very challenging,

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because it requires a long term perspective (i.e., a "sticky contract") and is in stark contrast to the current climate, where employees view themselves as free agents available to the highest bidder. For example a risk adjusted carried interest plan which provides for a "share" in the profits when they are actually realized.

- Measure performance at the firm level and do not allow businesses to get a first call on "their" profits.

But let's be clear–"fixing" the compensation problem will not prevent this from happening again. There are a number of changes needed to be made in concert. In fact, many of the compensation changes suggested above were in place at a number of the firms that had the biggest problems. The solution lies with a combination of comprehensive changes including:

PAY

- Matching the timing of payouts with the actual realization of profits
- Living an "ownership" culture
- Measuring performance at a cross-department level

RISK MANAGEMENT

- Don't separate risk assessment from decision making
- Include an accurate "price" of risk in all profitability calculations
- Get better insights from rating agencies

PEOPLE MANAGEMENT

- Resist the temptation to employ "hired guns"
- Build talent from within with a heavy emphasis on collaboration
- Build a "long-term" culture

Easier said than done. Those firms that take the lead and expect the others to follow will be the ultimate winners. Those firms who fear that change will result in staff departures must examine why they are afraid of losing people who do not want to be there for the long term. If it is accountability these employees fear, wouldn't firms be better off without them?

Brian Dunn is the President of McLagan, a subsidiary of Aon Corporation. He is also the CEO of Global Compensation for Aon Consulting Worldwide. He specializes in incentive and executive compensation and has advised a number of major U.S. and foreign institutions. Mr. Dunn's articles have been published in *Benefits & Compensation Digest*, *Chief Executive*, *American Banker*, *Personnel*, *ABA Banking Journal*, *Compensation Planning Journal*, *Bankers Magazine*, and *AsiaBanking*.