View from the Top:
What Should We Do About Executive Pay?

By Brian Dunn, President, McLagan
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Boards and senior leaders of financial institutions from around the world are struggling to decide what to do about pay this year-end, and time is running out. After an impressive run of staggering business results and pay to go with it—everything came tumbling down. Now is the time that compensation/remuneration committees must decide how and what to pay top executives this year. While there are few benchmarks to guide these decisions, there are many loud and conflicting voices expressing opinions from the sidelines. Traditional tools like surveys, payout ratios and market trends provide useful intelligence, but there is even more to consider.

Media, politicians, regulators and the "man on the street" are very vocal about what they perceive as "excessive compensation" and "ill-gotten personal gains". Some contend that the shareholders (and all their supposed advocates) were quite happy to enjoy their gains when the stock prices made a historic and monumental run up—very few complained about pay then. Putting these arguments aside for the moment, the dilemma is what to do now. These are not straightforward or simple decisions. On one side of the "pay-or-don't-pay" conundrum, there are those that say "don't pay":

- Shareholders say senior executives should not take any incentive pay since performance and share prices are down dramatically.
- Politicians like President Nicolas Sarkozy, Chancellor Angela Merkel, Prime Minister Gordon Brown, US Congressmen Barney Frank & Henry Waxman and NY Attorney General Andrew Cuomo are threatening public hearings, legislation, regulation and even criminal charges if there is "excessive" pay.
- Regulators like the US Treasury, the UK FSA and their counterparts across Europe have independently "suggested" changes to both pay structures and levels.
- Taxpayers and politicians don't want the nearly 70 firms worldwide, who have already taken government money, to use that money to pay bonuses.
- The "man on the street" and labor unions find it objectionable for top executives to take "extra" compensation in a year when thousands are being laid off and stock prices (and retiree accounts) have plummeted.

In this context, the voices favoring bonuses as usual for executives at firms that have taken government money or have no profits seem somewhat hollow when they advocate:

- Much of the leadership is new and should receive bonuses because rather than causing the mess—they were brought in to fix it.
- Executive salaries are artificially low and at least some portion of the bonus is really "deferred salary".

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- If the best people aren't paid, they will leave and take their profit-making skills to someone willing and able to pay for them.

For those firms actually showing a profit this year (albeit a diminished one) the dilemma is deeper:

- They can afford to pay, and under the historical sharing ratio, there are bonus funds available.
- There are also people within these firms that have made major contributions to creating those profits and/or preserving the firm who, one could argue, more than deserve bonuses for their heroic efforts.
- There are business segments that have increased revenue and profit.
- Executives, because of their considerable stock holdings, have suffered along with the shareholders—maybe more so, because of their forced under-diversification.

In some ways, for those firms that have lost money the decision may be easier. If they don't have profits, they don't have the ability to pay—or do they? They can be acquired, use shareholder money, debt or even taxpayer capital to "fund" bonuses. To make matters more complicated, these are most likely the firms that have brought in new talent to turn the business around (with compensation guarantees) and that are the most vulnerable to the poaching of their best talent. Not paying their top talent and/or living up to their promises to new hires could be tantamount to signing the firm's death warrant.

So, we must ask ourselves once again—what should be done? Clearly the decisions made at this year-end will have a momentous impact on the future of our industry. In countless discussions with regulators, CEOs, Heads of HR, compensation committees and senior managers there is one common theme—the situation is without historical precedent and no one knows what to do. To fill that void, we suggest the following as it relates to the senior executives of the firm:

- Start by doing the right thing; be conservative.
- Pay executive bonuses only if they were earned—no profits, no bonuses.
- Do not exceed traditional payout ratios.
- Renegotiate/restructure guarantees or commitments where possible.
- The most senior people should stand up and take the lead.
- Do not rationalize undeserved levels of pay due to "market pressures".
- No salary increases for senior executives.
- Where incentives are warranted, minimize the use of cash and emphasize equity with performance vesting conditions.
- Begin, immediately, to design and communicate pay plans that reflect the new business paradigm including longer term performance and payout relationships putting pay at risk for future performance.

In this way firms will be seen—appropriately so—as doing the "right" thing. Those at the top of the firm will be able to lead by example and we may be able to forestall nonsensical and unnecessary government regulation. It will be painful, but the

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alternative (socialized/regulated pay) will be so much worse. We need to buy time for there to be a stabilization of the markets and a reset of the compensation levels in the industry. But these resets should be market driven (and better tied to the long-term financial performance of the company), not legislated. Firms should do what they would have done if they were still private partnerships (who have fared the best in this crisis)—forgo cash to rebuild capital, have the partners take the biggest hit and regroup to live and fight another day.

It remains to be seen what will actually happen, but we sincerely hope that Chief Executives and independent Directors will be bold and take the high road to avoid the potential of regulated pay. ■

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