McLAGAN
FACT-BASED ADVICE

So What Should We Do Now?

Any firm that is in the business of underwriting, syndicating and/or investing in credit vehicles is witnessing times like never before. Stock prices have tumbled, earnings are challenged and investments have turned toxic.

By Brian Dunn, President, McLagan
October 6, 2008

We have spoken to hundreds of firms over the last 60 days and they are all asking—"so what should we do now?" Existing executive compensation programs won't/aren't working and executives' net worth has declined dramatically. There is the very real prospect of zero bonuses, underwater (drowning) options and performance plans that don't have a prayer of paying out now or in the foreseeable future. To top it off, many executives are no longer in compliance with their ownership guidelines and will have to purchase additional shares. Underlying this is a sense of fatigue and uncertainty, and the worry that executives are rudderless. It must also be recognized that the vast majority of those individuals who created the mess are gone and we must deal with those in place to pick up the pieces. This begs the question of not only "what should we do?", but "how should we start?"

LEVERS TO PULL

Executive compensation, broken into its component pieces, shows that there are a limited number of levers to pull. They are:

1) **How much is enough?**
It is critically important that the level of compensation be "right" for the level of contribution and performance. If one thing is certain, the free markets do work and any imbalances will be corrected by the movement of talent. This is especially true in banking where roles are fungible across institutions. The good news is that this is the easiest problem to solve. There is lots of data available and a competent advisor can help you sort out the how—based primarily on historical patterns and relationships between profits and compensation. But, it is important to recognize that last year's data is not the floor for this year's discussion.

2) **What currency do we use?**
By this we don't mean dollars, pounds or yen—but rather cash, stock, options or convertible stock. Quite simply, there are only a few ways to pay people—we can provide cash, restricted stock or options. One new tool that is being considered is a convertible stock vehicle that pays a fixed coupon, but can be converted to stock if certain performance criteria are met.

3) **How do we measure performance?**
There are really only two ways to evaluate performance—on an absolute or a relative basis. Both methods have their challenges. The benefit of a relative measure in today's uncertain environment is that it is reassuring to executives to know that they only have to be better

CHICAGO
Aon Center
200 East Randolph Street,
Tenth Floor
Chicago, IL 60601-6421
Tel: 312.381.9700
Fax: 312.381.9920

DUBAI
Dubai International Finance Center
The Gate Village, Building 07
2nd Floor, Unit 9
Dubai, United Arab Emirates
P.O. Box 506706
Tel: 971.4365.0196
Fax: 971.4361.1999

HONG KONG
Unit 1406, 14/F
Low Block, Grand Millennium Plaza
181 Queen's Road Central
Sheung Wan, Hong Kong
Tel: 852.2840.0911
Fax: 852.2840.0966

LONDON
Lloyds Chambers
1 Portsoken Street
London E1 8BT
England
Tel: 44.207.680.7400
Fax: 44.207.481.3210

NEW YORK
199 Water Street
12th Floor
New York, NY 10038
Tel: 212.441.2000
Fax: 212.441.1967

STAMFORD
1600 Summer Street
Suite 601
Stamford, CT 06905
Tel: 203.359.2878
Fax: 203.323.9851

TOKYO
Akasaka Kato Building
2nd Floor
22-15, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
Japan
Tel: 813.5549.1850
Fax: 813.5549.1857

www.mclagan.aon.com

CHICAGO
Aon Center
200 East Randolph Street,
Tenth Floor
Chicago, IL 60601-6421
Tel: 312.381.9700
Fax: 312.381.9920

DUBAI
Dubai International Finance Center
The Gate Village, Building 07
2nd Floor, Unit 9
Dubai, United Arab Emirates
P.O. Box 506706
Tel: 971.4365.0196
Fax: 971.4361.1999

HONG KONG
Unit 1406, 14/F
Low Block, Grand Millennium Plaza
181 Queen's Road Central
Sheung Wan, Hong Kong
Tel: 852.2840.0911
Fax: 852.2840.0966

LONDON
Lloyds Chambers
1 Portsoken Street
London E1 8BT
England
Tel: 44.207.680.7400
Fax: 44.207.481.3210

NEW YORK
199 Water Street
12th Floor
New York, NY 10038
Tel: 212.441.2000
Fax: 212.441.1967

STAMFORD
1600 Summer Street
Suite 601
Stamford, CT 06905
Tel: 203.359.2878
Fax: 203.323.9851

TOKYO
Akasaka Kato Building
2nd Floor
22-15, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
Japan
Tel: 813.5549.1850
Fax: 813.5549.1857

www.mclagan.aon.com

than their peers—in other words, making the most of a difficult environment. Critics would question how much you should pay for lousy performance even if it's better than *really* lousy performance. The positive part about absolute measures is that you can make a reasonable commitment to shareholders, and if you outperform, you are appropriately rewarded. The downside in today's world is that no one has any idea whether or not they can achieve what has historically been a reasonable return. Therefore, it makes the most sense that we use some form of hybrid that rewards top relative performance as long as it is above some reasonable threshold.

4) What measures make sense for executives and shareholders?

Historically, financial institutions have used shareholder-friendly measures such as EPS, ROTE and TSR. Each has its pluses and minuses even in a more stable environment. Clearly, shareholders want their return *a priori* (before) executives, so no reasonable compensation committee can ignore some number of these measures. Having said that, it is also reasonable for the Board to explicitly focus the executive team on factors that are critically important and achievable. These things include workout/recovery of bad debt, increase in core earnings, increases in deposits, improvement in loss reserves, etc. This is easier said than done—such things are difficult to measure and can put the executive team at odds with risk control. The solution is to use discretion in evaluating these factors after the fact rather than setting tight metrics at the start of the year. Firms are also looking at internal measures such as cash generation (or EBITDA) and margin. What *must* be avoided is including mark-to-market income on illiquid securities. Simply, a balanced scorecard may be the best solution.

5) Over what time period is performance measured?

Historically, we have had short-term (1 year) and long-term (typically 3 years) incentives. This has worked reasonably well as the one-year incentives coincide with the annual planning, budgeting and reporting processes. There seems to be little rationale for changing the short-term measurement period. In terms of long-term incentives—there seems to be more of a dilemma. On the one hand, no one seems able to predict beyond the current quarter, so setting long-term goals seems particularly problematic. On the other hand, few are predicting that there is going to be a quick return to normalcy—meaning award cycles of less than 3 years are unlikely to end up in the money. This is one place that some new, creative design comes into play (*see page 4*).

6) How much weight should be given to short vs. long-term incentives?

Recently, long-term incentives have been weighted one-and-a-half to two times the value of short-term incentives. It may be appropriate to shift that weight even further toward long-term compensation. If we use stock-based vehicles, some of the cash flow may be mitigated by dividends. The rationale for moving to a greater weight for long-term compensation is twofold. First, given current and projected results,

there will be little appetite—nor justification—for much short-term compensation. Secondly, long-term vehicles provide greater flexibility to recognize long term results.

THINGS TO REMEMBER

When entering into the fall planning and award determination cycle, there are a few things that must be considered. This is a year unlike any other, so new thinking will be required. The factors that must be considered by Compensation Committees, independent consultants, compensation professionals and executives include:

- The "more is better scenario" must be rejected. Pay will go down this year across the board. Anyone who believes differently is either out of touch or a contrarian. The old benchmarks must be thrown away, and new creative thinking about how to calibrate the "right" levels of pay must be developed.

- The number one message from shareholder advocates is that pay and performance should move in the same direction. Old excuses such as "market pressures" and "extraordinary effort" to justify pay that moves in a different direction than performance simply will not hold water.

- Despite countless studies that prove the significant value of options, large classes of employees grossly undervalue options, especially when the stock has been trading down. If you plan on using options, recognize that it is a devalued currency in the eyes of all but the most senior executives.

- This is the year to be creative. Instead of waiting around to see what everyone else is doing—be proactive and take this opportunity to get ahead of the curve.

- Focus performance measures on what can actually be controlled—especially for short-term incentives. To get people's attention, use new forms of incentive compensation as a powerful communications tool. Executives can't control stock price (in the short term), but they can control earnings, credit quality, margins, etc.

- Segment the population. Most organizations have historically used the same tools for all levels of professional employees; they just varied the magnitude and the weightings. This is a time to spend compensation dollars efficiently—target measures, form and mix to specific levels of employees.

FOOD FOR THOUGHT

It is impossible to prescribe specific plans in a general article—there are too many circumstances that demand tailoring to an organization's specific circumstances and needs. Having said that, we have outlined below a series of concepts that may make sense in the right environment. Of course the devil is in the details, but we hope that these will invoke some creative thought.

CHICAGO
Aon Center
200 East Randolph Street,
Tenth Floor
Chicago, IL 60601-6421
Tel: 312.381.9700
Fax: 312.381.9920

DUBAI
Dubai International Finance Center
The Gate Village, Building 07
2nd Floor, Unit 9
Dubai, United Arab Emirates
P.O. Box 506706
Tel: 971.4365.0196
Fax: 971.4361.1999

HONG KONG
Unit 1406, 14/F
Low Block, Grand Millennium Plaza
181 Queen's Road Central
Sheung Wan, Hong Kong
Tel: 852.2840.0911
Fax: 852.2840.0966

LONDON
Lloyds Chambers
1 Portsoken Street
London E1 8BT
England
Tel: 44.207.680.7400
Fax: 44.207.481.3210

NEW YORK
199 Water Street
12th Floor
New York, NY 10038
Tel: 212.441.2000
Fax: 212.441.1967

STAMFORD
1600 Summer Street
Suite 601
Stamford, CT 06905
Tel: 203.359.2878
Fax: 203.323.9851

TOKYO
Akasaka Kato Building
2nd Floor
22-15, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
Japan
Tel: 813.5549.1850
Fax: 813.5549.1857

www.mclagan.aon.com

SHORT-TERM COMPENSATION

1) Fund Bonuses as a Percent of Profit

Create a bonus pool for executive officers that is funded as a percent of earnings above a threshold (which increases each year). This eliminates the pressure on the budget process, provides some level of compensation as long as earnings are positive, allows for discretion in how those funds are allocated, and by virtue of the ever-increasing threshold, recognizes shareholders' primary right to the first chunk of earnings.

2) Reward Cumulative Performance

Rather than requiring that bonuses be paid at the same time every year, calibrate a "reasonable bonus" for reasonable performance and let the time period over which that bonus is paid float. For example, provide a bonus of $250,000 for the achievement of cumulative EPS. If the EPS goal is achieved in one year, the award is more valuable than if it takes seven quarters to achieve the goal. When the goal is ultimately achieved, a new award is granted.

3) Bonuses Tied to Relative Performance (above a threshold)

Reward executives for being the "best in class" versus a specific peer group. For example, award bonus targets of 100% of salary for a #1 ranking, 75% for a top 3 ranking, and 50% for being in the top half. This would all be contingent on the fact that the actual measure achieved was above a "reasonable" threshold for that metric.

LONG-TERM COMPENSATION

1) Load Up on Options

Despite what was said earlier about options being undervalued, there are classes of executives who need to be linked to the stock price and should be highly motivated to see the stock price appreciate. This could be one of those homerun years for those bold enough to "double down" on options. Forget Black Scholes values for this year. Take last year's grant (in terms of number of shares), multiply by one-and-a-half or two times, and add a performance-vesting feature. In other words, only allow the options to vest if certain stock price appreciation thresholds occur.

2) Transformation Plans

Issue a large grant of restricted stock to the executive team. The award has a seven-year duration and will survive all forms of termination except "for cause" or leaving to work for a competitor. The award will be prorated to reflect actual years worked. The award, denominated in the number of shares, will vest at the end of seven years on the achievement of strategic goals such as balance sheet efficiency (inventory vs. return), liquidity (lines open and healthy) and restoration of reasonable credit ratings.

CHICAGO
Aon Center
200 East Randolph Street,
Tenth Floor
Chicago, IL 60601-6421
Tel: 312.381.9700
Fax: 312.381.9920

DUBAI
Dubai International Finance Center
The Gate Village, Building 07
2nd Floor, Unit 9
Dubai, United Arab Emirates
P.O. Box 506706
Tel: 971.4365.0196
Fax: 971.4361.1999

HONG KONG
Unit 1406, 14/F
Low Block, Grand Millennium Plaza
181 Queen's Road Central
Sheung Wan, Hong Kong
Tel: 852.2840.0911
Fax: 852.2840.0966

LONDON
Lloyds Chambers
1 Portsoken Street
London E1 8BT
England
Tel: 44.207.680.7400
Fax: 44.207.481.3210

NEW YORK
199 Water Street
12th Floor
New York, NY 10038
Tel: 212.441.2000
Fax: 212.441.1967

STAMFORD
1600 Summer Street
Suite 601
Stamford, CT 06905
Tel: 203.359.2878
Fax: 203.323.9851

TOKYO
Akasaka Kato Building
2nd Floor
22-15, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
Japan
Tel: 813.5549.1850
Fax: 813.5549.1857

www.mclagan.aon.com

3) **Performance Shares that Pay Current Dividends**
Make a large grant of dividend paying shares that only vest on the achievement of performance targets (*see* Table 1 *for an example*).

4) **Convertible Units**
Grant fixed value, coupon-paying units that have the ability to convert to shares at the end of three years based on the achievement of performance targets (*see* Table 2 *for an example*).

TABLE 1: PERFORMANCE SHARES THAT PAY CURRENT DIVIDENDS

GRANT DATE	
TOTAL AWARD OF VALUE	$2,000,000
STOCK PRICE	$20.00
NUMBER OF SHARES	100,000

	YEAR 1	YEAR 2	YEAR 3	TOTAL
DIVIDEND PAYMENTS *	$60,000	$60,000	$60,000	$180,000

3 YEAR PERFORMANCE TARGETS	WEIGHTING	TARGET PERCENTAGE	ACTUAL PERCENTAGE	% OF GOAL ACHIEVED	WEIGHTED RESULTS
CUMULATIVE EPS GROWTH	40%	50%	53%	106%	42%
RETURN ON TANGIBLE EQUITY	40%	23%	17%	74%	0% **
GROSS OPERATING MARGIN	20%	30%	32%	107%	21%
% OF SHARES EARNED					**64%**
# OF SHARES EARNED					**63,733**

END OF 3RD YEAR	ASSUMPTION A	ASSUMPTION B	ASSUMPTION C
STOCK PRICE	$15.00	$20.00	$25.00
VALUE OF AWARD	$956,000	$1,274,667	$1,593,333
VALUE WITH DIVIDENDS	$1,136,000	$1,454,667	$1,773,333

*** The dividend is 15 cents a share, paid quarterly**
**** If the performance target is not at least 80% achieved, 0% of that metric's allocation is awarded**

TABLE 2: CONVERTIBLE UNITS WITH COUPON PAYMENTS

GRANT DATE	
TOTAL AWARD OF VALUE	$2,000,000
STOCK PRICE	$20.00
NUMBER OF UNITS	100,000

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	TOTAL
COUPON PAYMENT (8%) *	$160,000	$160,000	$160,000	$160,000	$160,000	$800,000

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	CUMULATIVE EPS	% OF TARGET CEPS ACHIEVED	# OF UNITS RECEIVED AT YEAR 5
EPS GROWTH TARGET	10%	10%	10%	10%	10%	50%		
EPS GROWTH SCENARIO 1	8%	9%	6%	12%	10%	45%	90%	**90,000**
EPS GROWTH SCENARIO 2	4%	6%	9%	9%	8%	36%	72%	**0****

END OF 5TH YEAR	EPS GROWTH SCENARIO 1			EPS GROWTH SCENARIO 2		
STOCK PRICE	$15.00	$20.00	$25.00	$15.00	$20.00	$25.00
VALUE OF AWARD	$1,350,000	$1,800,000	$2,250,000	$0	$0	$0
VALUE WITH COUPON PAYMENTS	$2,150,000	$2,600,000	$3,050,000	$800,000	$800,000	$800,000

*** The coupon payment is only received if the firm's divided and capital ratios are maintained**
**** The cumulative EPS Growth must be at least 80% of Target or the principal is not paid and the incumbent only receives the annual coupon payments**

CHICAGO
Aon Center
200 East Randolph Street,
Tenth Floor
Chicago, IL 60601-6421
Tel: 312.381.9700
Fax: 312.381.9920

DUBAI
Dubai International Finance Center
The Gate Village, Building 07
2nd Floor, Unit 9
Dubai, United Arab Emirates
P.O. Box 506706
Tel: 971.4365.0196
Fax: 971.4361.1999

HONG KONG
Unit 1406, 14/F
Low Block, Grand Millennium Plaza
181 Queen's Road Central
Sheung Wan, Hong Kong
Tel: 852.2840.0911
Fax: 852.2840.0966

LONDON
Lloyds Chambers
1 Portsoken Street
London E1 8BT
England
Tel: 44.207.680.7400
Fax: 44.207.481.3210

NEW YORK
199 Water Street
12th Floor
New York, NY 10038
Tel: 212.441.2000
Fax: 212.441.1967

STAMFORD
1600 Summer Street
Suite 601
Stamford, CT 06905
Tel: 203.359.2878
Fax: 203.323.9851

TOKYO
Akasaka Kato Building
2nd Floor
22-15, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
Japan
Tel: 813.5549.1850
Fax: 813.5549.1857

www.mclagan.aon.com

CONCLUSION

Just as this is an unprecedented time in terms of the challenges facing the business, it is an equally unprecedented time in terms of pay design. There is just this one chance to get it right. Like the business side, this requires bold and innovative thinking and the breaking of the old rules and platitudes. This is not a time to tinker around the edges of your existing plans. A blank sheet of paper and creative thinking is the order of the day. The time to do that is now. ■

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*.

CHICAGO
Aon Center
200 East Randolph Street,
Tenth Floor
Chicago, IL 60601-6421
Tel: 312.381.9700
Fax: 312.381.9920

DUBAI
Dubai International Finance Center
The Gate Village, Building 07
2nd Floor, Unit 9
Dubai, United Arab Emirates
P.O. Box 506706
Tel: 971.4365.0196
Fax: 971.4361.1999

HONG KONG
Unit 1406, 14/F
Low Block, Grand Millennium Plaza
181 Queen's Road Central
Sheung Wan, Hong Kong
Tel: 852.2840.0911
Fax: 852.2840.0966

LONDON
Lloyds Chambers
1 Portsoken Street
London E1 8BT
England
Tel: 44.207.680.7400
Fax: 44.207.481.3210

NEW YORK
199 Water Street
12th Floor
New York, NY 10038
Tel: 212.441.2000
Fax: 212.441.1967

STAMFORD
1600 Summer Street
Suite 601
Stamford, CT 06905
Tel: 203.359.2878
Fax: 203.323.9851

TOKYO
Akasaka Kato Building
2nd Floor
22-15, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
Japan
Tel: 813.5549.1850
Fax: 813.5549.1857

www.mclagan.aon.com