Starting Over:
The Rebuilding of Executive Pay Structures in Financial Institutions

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By Brian Dunn, President
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For a number of reasons—government scrutiny, shareholder backlash, undernourished balance sheets—bank management and boards are hearing the call to reform executive pay. Many are convinced that while pay did not cause the financial meltdown, it certainly exacerbated the problem. This has lead to a genuine interest in transforming executive pay. The devil, of course, is in the details.

We recognize that many 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.

Like any other reformation, there are many views on how to do 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?

In our view, 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 size 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.

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- 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.

Transforming these truisms into a workable pay structure must also start with the recognition that:

- The free market does work, and good people always have other opportunities. Systematically over or underpaying (in the eyes of the beholder) will result in the movement of talent.
- Regulations will inevitably (or directly) impact our freedom to design pay plans. We 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.

Having spent hundreds of hours speaking to executives, board members, HR professionals, regulators, proxy voting advisors, lawyers and even academics has resulted in a deep appreciation for the difficulty of this task, but, at the same time, it has created a tremendous enthusiasm to tackle this challenge. Please remember that in designing an executive comp plan, it is impossible to address all the nuances and considerations of a real company in a brief paper, but the goal is to create a foundation which can be built upon and tailored for specific firms and their unique circumstances.

We must first start with deciding the range of value for given positions. This can be accomplished with an understanding of position value based on a market clearing price coupled with a good sense of a “fair” sharing rate of value 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.

The next step is breaking the total into pieces. How much is part of 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 we have the basis for answering the “how much” question, we must tackle the “how” question. Our proposal would be to 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.

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We are suggesting that an incentive amount or pool (for the executive being measured) be calculated each year. 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. These measures would be evaluated at year-end on an absolute basis and relative to peers and historical performance. Based on the holistic review of performance (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 (e.g. custody), we would distribute 60% of the pool—those where the return takes longer (e.g. complex credit derivatives) 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.

Incentive Pool Funding (in millions)

	COMPLEX/LONG-TERM				MEDIUM-TERM				SHORT-TERM			
	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 1	YEAR 2	YEAR 3	YEAR 4
STARTING BALANCE	-	$75	$137	$264	-	$50	$94	$114	-	$25	$31	$35
PERFORMANCE ADJUSTMENT	-	50%	140%	90%	-	75%	110%	100%	-	90%	110%	95%
ADJUSTED INCENTIVE POOL	-	$38	$192	$237	-	$38	$103	$114	-	$23	$34	$33
ANNUAL INCENTIVE POOL FUNDING	$100	$145	$160	$40	$100	$150	$125	$100	$100	$100	$105	$80
TOTAL INCENTIVE POOL	$100	$183	$352	$277	$100	$188	$228	$214	$100	$123	$139	$113
RISK-ADJUSTED DISTRIBUTION %	25%	25%	25%	25%	50%	50%	50%	50%	75%	75%	75%	75%
CURRENT YEAR DISTRIBUTION	$25	$46	$88	$69	$50	$94	$114	$107	$75	$92	$104	$85
CASH INCENTIVE POOL (70%)	$18	$32	$62	$49	$35	$66	$80	$75	$53	$64	$73	$59
EQUITY INCENTIVE POOL (30%)	$8	$14	$26	$21	$15	$28	$34	$32	$23	$28	$31	$25
OPTION KICKER	$4	$7	$13	$10	$8	$14	$17	$16	$11	$14	$16	$13

Like any new idea, this one 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.

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It 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, we 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 done on a discretionary basis by management and/or the Board.

We are sure that you can think of many other complications with this design 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 is way ahead of risk management, accounting and incentive plan design.

Give it some thought and let us know what you think. ■

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 global 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*, *AsiaBanking* and *Equities Magazine*.

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