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

DUBAI
Dubai International Financial Center
Gate Village, 2nd Floor, Unit 9
P.O. Box 506706
Dubai
United Arab Emirates
Tel: +97 144 255 747
Fax: + 97 144 255 746

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, 5th Floor
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.com

# The Brave New World of Executive Compensation

## What do we do now?

By Brian Dunn
March 19, 2009

This is a year like no other in the world of executive compensation. Everything has turned on its head and the challenges for professionals in the field are staggering. The bad news is that things will never again be like they were before and we are going to have to get used to it. The good news is that we have an opportunity to, within very real constraints, reinvent executive compensation practices in this critical industry.

Let's face it—we had become pretty comfortable with tools, metrics and pay levels. With a few minor glitches here and there, we could benchmark pay, measure performance, grant equity and work around nuisances like 162(m). All the while pay increased most years, wealth (through equity grants) accumulated and executives, Boards and even most shareholders were happy. Then the credit crisis hit and all that vanished in an instant. The new world we live in has a number of very real challenges including:

### FINANCIAL

- Equity prices are down dramatically. This not only devastated historical holdings but devalued one of the tools that we used to pay executives. Worse still, it angered shareholders, employees, regulators and the media creating an environment that is not very accepting of traditional pay packages.
- Earnings are severely challenged. Without earnings, most of our favorite performance measures like EPS, ROE and NOI were no longer producing bonuses and serving as the basis for escalating pay. This reduction of earnings reinforced stakeholders' feelings about executive pay.
- Investment capital is hard to come by. In order to turn things around, firms need capital to shore up the balance sheet, invest in new businesses and build the right teams. Without outside capital, all of these initiatives will be delayed at best or tabled at worst. It will be hard to turn things around without the capital to do so.
- Dividends have been slashed. In order to preserve capital and to restore reasonable dividend yields, many financial firms have cut their dividends. This usually has a negative impact on share price (see above), but in addition it has collateral impact of reducing cash flow on executive stock holdings.
- Leverage is gone. While many will argue that the de-leveraging of financial firms is a good thing, it does have the effect of reducing the potential future stream of income, making a return to historic earnings levels and stock prices improbable. This means that millions of outstanding options will continue to cause overhang issues without having a realistic possibility of ever ending up in the money.

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

DUBAI
Dubai International Financial Center
Gate Village, 2nd Floor, Unit 9
P.O. Box 506706
Dubai
United Arab Emirates
Tel: +97 144 255 747
Fax: + 97 144 255 746

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, 5th Floor
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.com

## STRUCTURAL CHALLENGES

- **Option valuation is nonsensical.** Our historical valuation models are producing values for options that simply don't pass the "sniff test"— with performance options being worth more than regular options and valuations that are triple last year's valuations, due largely to significant share price drops, low interest rates and the elimination of the dividend. This will make it hard to report values to shareholders that seem reasonable to recipients.

- **Share availability is significantly diminished.** Because of reduced share prices and a reluctance to go to shareholders for more shares, many firms are not able to grant shares at prior levels and/or to as many employees.

- **The pay mix is out of kilter.** Over the last decade we have migrated to salaries that were only a very modest percentage of total compensation. Annual and long-term incentives made up the rest. For reasons outlined above, annual incentives have been significantly reduced or eliminated and previously granted shares are greatly diminished in value and options are underwater. All this adds up to a pay mix that is over-weighted towards an artificially low salary.

- **162(m) plans may not fund or be sufficient.** Most firms worked around 162(m) limitations by creating an overly generous incentive funding that could be brought back to reason through negative discretion. Because of the recent financial turmoil, many of these plans are not producing the air cover that they previously did. Explaining to shareholders why you ignored a previously approved plan will be tricky in today's world.

## REGULATORY

- **Government imposed limits on cash incentives.** At the time of this writing, we don't know the full extent of the limits imposed by Congress and regulators. At the very least it will be difficult (or impossible) to pay some number of executives what the free market says they are worth. If the past is prologue, the final regulations will have some "wiggle room" to allow some amount of "additional" compensation, but the result will be inefficient or illogical pay programs.

- **Limits on amount and form of equity.** The same unissued rules will also likely apply to equity. Limits on the amount will have the same nonsensical outcomes but provisions on performance vesting and/or holding periods may have some merit.

- **Limits on parachutes and perquisites.** There will be a call for the elimination of "stealth compensation" delivered through overly generous parachute payments and perquisites. Many shareholder advocates and Company Boards have been trying to eliminate many of these benefits that are no longer tax effective and don't provide any real value to the corporation. This will be a good way to overcome inertia and accomplish that change.

- **Greater accountability and compliance standards.** Compensation Committees have been increasingly on point for truly representing shareholder interests when it comes to the level and form of compensation. While they may have erred on the side of caution, providing compensation levels designed to ensure the institution has top talent available, they will now have to understand and manage risk and play shareholder advocates against management interests. It will not be a comfortable position for them.

## ENVIRONMENTAL

- **Executives are the new villains.** The media knows that they can create headlines with stories of "executive excess" even if they are factually incorrect. We must operate in

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

**DUBAI**
Dubai International Financial Center
Gate Village, 2nd Floor, Unit 9
P.O. Box 506706
Dubai
United Arab Emirates
Tel: +97 144 255 747
Fax: + 97 144 255 746

**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, 5th Floor
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.com

an environment where the presumption is that executives are greedy, overpaid and underperforming.

- **New benchmarks.** $500,000 has become the new standard of being "well paid". The public perception that a half a million dollars should be sufficient pay will be a hard one to break. While pay will undoubtedly come down—it will not come down to that level unless we are willing to accept less capable and under qualified people running our financial institutions.
- **Stronger (and angrier) shareholder voice.** Say on Pay is a reality for TARP takers and will inevitably be more broadly adopted (or regulated). With that, there will be a demand to have pay and performance (especially stock price) move in the same direction. There will be no tolerance for what are perceived to be excuses for paying for underperformance.

## THE NEW REALITY

This means that we must begin our work redesigning how executives are paid with the understanding that there is a new reality and the old assumptions, tools and practices simply won't work. The new reality will consist of the following constraints:

- **The government will be involved.** The government will loom large over all pay design and the execution of those plans. Not only that, but the government will not speak with one voice. It will be more like a many headed hydra coming at us from innumerable directions. There is Congress who writes imperfect laws, Treasury who must issue regulations and the SEC and the IRS who must enforce them. Then, of course, there are the Fed and the FDIC who are the banks' primary day to day contacts and have their own view of the world and what constitutes safe and effective banking practices.
- **Shareholders will have a voice and they will use it.** Shareholders will make their preferences known through "Say on Pay", but more importantly through the election of Directors and the approval of stock plans. The latter can be a very powerful force constraining pay design and levels.
- **Aggregate pay has gone down and will be slow to rebound.** In 2008 we have seen real pay decline dramatically and there are few ways to see it come back soon. The tools at our disposal include salary increases, option grants (at low prices) and incentive compensation. Each carries its own challenges but none of them can be "dialed up" sufficiently in the short term to return compensation to its former levels.
- **Compensation Committee members will be extremely cautious.** While Compensation Committees have historically been quite cooperative, they have become much more cautious because of regulatory scrutiny and shareholder activism. A healthy tension between management and the committee will be positive but we hope that the committee members will not become paralyzed and afraid to act.
- **Management may get fed up and quit.** We will need to be concerned that at some point low pay, public vilification and an incredibly tense and demanding work environment may cause CEOs and other executives to go to non-public firms or take their pensions and SERPs and retire.

## SO WHAT DO WE DO NOW?

The sixty-four thousand dollar question is "what do we do now?" The first step in this process is to accept and embrace the new reality. Letting go of our old practices and structures will be difficult but essential if we are to readjust to the new reality. After shedding our old standards and guidelines, we must first start by truly understanding

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

DUBAI
Dubai International Financial Center
Gate Village, 2nd Floor, Unit 9
P.O. Box 506706
Dubai
United Arab Emirates
Tel: +97 144 255 747
Fax: + 97 144 255 746

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, 5th Floor
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.com

the new rules of the game. At this point those rules are not yet written. They will be released over the next few weeks (hopefully) and then dissected, challenged and revised over the next few months.

For now, there is little to do until we know the rulebook we must play by. If Treasury's rules are as restrictive as Congress proposed, then TARP-taking banks will clearly need to find a way to work around it if they are to remain competitive. All firms will need to be creative and follow a few important guiding principles:

- Abandon the past levels of pay as a benchmark for the future
- Recognize that performance cannot be measured by a single measure
- Risk management will be an essential measure/factor in determining performance
- Compensation Committees will have to become more comfortable with making hard assessments and judgments when determining pay. There will be no easy roadmap to follow
- Long-term incentives will become truly that—long-term holdings of equity earned based on real performance (both before and after the grant)
- Recognize that there are a number of constituents who will have a say in the ultimate delivery of executive compensation. Each constituent's opinion must be heard, their interests weighed and degree of influence judged. These constituents include executives, other employees, institutional shareholders, retail shareholders, regulators and board members

## WHERE DO WE START?

As I mentioned, until the rules are clear it is hard to do much of anything except scenario planning. But, once the dust settles and the rules are clearer, there are a number of critical steps to be taken.

- Recalibrate pay. Given the new reality of declining revenue and profits as well as a shrinking organization in terms of business mix and employees, pay will have to be reset. This can be done by looking at traditional top down ratios (e.g., C&B/Revenues) as well as bottom up analysis of what specific jobs are worth in today's environment.

- Remix pay. Let's take a hard look at steady-state pay mix and acknowledge how much of the bonus is really "salary in drag". Start by making that shift. Next, recognize that much of what was the annual incentive will need to be stretched out into a longer term payout period. Finally, equity will become the currency that part of the bonus is delivered in and the terms of that grant will change. Sale provisions will be tightened and it will need to be re-earned over the performance period. Options could and should have a significant role in the mix. This will effectively mean that the pay mix will look more like 40% salary/20% annual cash incentive distribution/40% long-term incentives.

- Create new incentive models. These new models will recognize the impact of risk and the difference between realized and unrealized gains/earnings. It will do so through some form of bonus bank that holds and adjusts bonuses based on performance over time. Compensation Committees will also have to consider a number of metrics (see Exhibit 1) compared to multiple standards (e.g. versus peer performance, versus plan and versus last year). With a broad based dashboard of metrics, performance can fully and comprehensively be assessed.

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

**DUBAI**
Dubai International Financial Center
Gate Village, 2nd Floor, Unit 9
P.O. Box 506706
Dubai
United Arab Emirates
Tel: +97 144 255 747
Fax: + 97 144 255 746

**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, 5th Floor
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.com

## Exhibit 1

| | TIER 1 CAPITAL RATIO | TOTAL CAPITAL RATIO | DEPOSIT GROWTH | NET CHARGE-OFFS (mm) | NET CHARGE-OFFS AS % OF LOANS | LOAN-LOSS RESERVES (mm) | NET INCOME (mm) | EARNINGS PER SHARE | RETURN ON EQUITY | RETURN ON ASSETS | TOTAL SHARE-HOLDER RETURN |
|---|---|---|---|---|---|---|---|---|---|---|---|
| FIRM XYZ 2008 | 7.2% | 10.7% | 0.3% | 516.3 | 0.36% | 1,872.0 | 3,425.8 | $4.01 | 16.7% | 1.8% | 22.0% |
| | | | | | | | | | | | 22.0% |
| PEER GROUP | 9.0% | 11.8% | 4.0% | 610.0 | 0.50% | 1,670.3 | 2,541.0 | $3.49 | 14.8% | 2.4% | 24.4% |
| DIFFERENTIAL | -1.8% | -1.1% | -3.7% | -15.4% | -0.14% | 12.1% | 34.8% | 14.9% | 1.9% | -0.6% | -2.4% |
| FIRM XYZ 2007 | 7.9% | 11.3% | 5.7% | 335.8 | 0.24% | 1,456.6 | 3,944.9 | $4.85 | 21.1% | 1.4% | 19.9% |
| Y-O-Y | -0.6% | -0.6% | -5.4% | 53.8% | 0.12% | 28.5% | -13.2% | -17.3% | -4.4% | 0.4% | 2.1% |
| FIRM XYZ BUDGET | 8.2% | 11.5% | 3.0% | 350.0 | 0.22% | 1,300.0 | 4,112.8 | $5.10 | 24.1% | 4.0% | 24.0% |
| VARIANCE | -1.0% | -0.8% | -2.7% | 47.5% | 0.14% | 44.0% | -16.7% | -21.4% | -7.4% | -2.2% | -2.0% |

- **Stay with stock.** Options are the ultimate link to shareholders and should remain in the mix. Restricted stock should have time and performance vesting features and there should be limits on resale after vesting. These limits should extend for some period beyond termination.
- **Eliminate perquisites.** Perquisites have a negative impact that is disproportionate to the value delivered. Since there no longer are any tax advantages to these benefits, they should be eliminated. If necessary, consider their elimination when resetting salary levels.
- **Take a hard look at change-in-control agreements.** CIC agreements do serve shareholders if they are properly structured. They should protect key executives only in the event of actual (or forced) termination after a real change in control. They should include reasonable multiples of pay and the participation should be limited to a few key executives.
- **Look outside for guidance.** The U.S. financial services industry pay practices are a bit like the Galapagos Islands in terms of how insular they have become. There are ideas out there from general industry and abroad that should be considered. We have included in Exhibit 2 a set of thoughtful guidelines developed by the UK's FSA. They focus on process, not amount, and put real accountability into the hands of those most able to deliver it. They have also identified risk management as the single most important metric.

## Exhibit 2

### Ten Guiding Principles from the UK's FSA:

1. Remuneration committees should exercise independent judgment and demonstrate that their decisions are consistent with the firm's situation and future prospects.
2. The procedures for setting compensation within the firm should be clear and documented, and they should include measures to avoid conflict of interest. Risk and compliance functions (in conjunction with HR) should have significant input into setting compensation for business areas.
3. Compensation for staff in the risk and compliance functions should be determined independently of the business areas.
4. Assessment of financial performance to calculate bonus pools should be principally based on profits. The bonus pool calculations should include an adjustment for current and future risk and take into account the cost of capital employed and liquidity required.

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

DUBAI
Dubai International Financial Center
Gate Village, 2nd Floor, Unit 9
P.O. Box 506706
Dubai
United Arab Emirates
Tel: +97 144 255 747
Fax: + 97 144 255 746

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, 5th Floor
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.com

5. Firms should not assess performance solely on the results of the current financial year.
6. Non-financial performance metrics, including adherence to effective risk management and compliance with regulations, should form a significant part of the performance assessment process.
7. The measurement of performance for long-term incentive plans, including those based on the performance of shares, should be risk adjusted.
8. The fixed component of remuneration should be a sufficiently high proportion of total remuneration to allow the company to operate a fully flexible bonus policy.
9. The major part of any bonus which is a significant proportion of the fixed component should be deferred with a minimum vesting period.
10. It is highly desirable that the deferred element of variable compensation should be linked to the future performance of the division or business unit as a whole.

## CONCLUSION

The world has changed and those that evolve to meet the new reality will emerge from this crisis in the strongest position. There is no doubt there were a number of flaws in our old system—we need to identify what those were and eliminate them. We have been given a unique opportunity to rethink pay in a way that drives the business over the long term.

Simply being "competitive" or consistent with the rest of the market is no longer a sufficient guideline to follow. Those companies that seize the opportunity to improve the pay model will improve their relative performance, attract executives and shareholders and will avoid unwanted regulation or government intervention.

The time is now. Be bold. ■

---

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*.

Mr. Dunn can be reached at bdunn@mclagan.com.