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The Psychology of the Take-Away

By Warren Rosenstein and Brian Dunn
August 4, 2010

As firms consider ways to deliver pay that are motivating, conform to regulatory guidelines, factor in multi-year performance, and discourage risk, there has been increasing thought and energy devoted to expanding clawbacks, holdbacks, performance hurdles, etc. In some cases these provisions are largely window dressing. Most clawback provisions are linked to employee malfeasance or conduct that is deliberately detrimental. When you consider the recent credit crisis, very little of the conduct would have actually triggered any of these provisions.

Newer thinking is that since performance determination doesn't necessarily fall into a neat annual time interval—neither should pay. Some element of performance payment should be contingent on true after-the-fact assessment of whether or not the bank ultimately earned money. This eliminates the reliance on mark-to-market determination of income.

So, why is the focus of much of the redesign based on take-aways? If we pause and consider this for a moment, the answer seems pretty straight forward: it is more palatable to keep compensation levels roughly static, with provisions creating forfeiture or clawbacks, than it is to communicate lower basic pay rates combined with potential upside compensation based on future results. No one wants to be the early adopter on this one.

Consider a job that historically paid a million dollars a year. In the new paradigm, firms are loathe to lower this rate significantly due to concerns about competing for talent. As we move through the summer, firms will scramble to think about ways to keep this rate constant, but create provisions that reduce this amount should business not meet expectations. Ultimately, while a few firms came up with performance provisions that were sensible, many firms will continue to use or implement new clawback provisions that do not address a very realistic concern: disappointing profits. These approaches will fall short of shareholder and regulatory expectation.

Firms will continue trying to convince employees that they could get a million dollars for that job, despite the fact that firms are uncertain of whether the profits will exist to support such a rate. They will also attempt to assuage the concerns of their shareholders, regulators, and the public at large, by pointing out their (albeit imperfect) clawback provisions.

While it is a challenging message to deliver to employees (who wants to tell “employee x” that their baseline pay has moved from $1 million to $700K), it would seem more sensible to lower baseline pay by creating a "remix", which includes tangible targets that when achieved would allow employees to receive top-up awards. In some ways, firms that have implemented salary increases have already started down this path, if you consider that new salary rates more and more reflect basic fixed pay for a given job. It would seem that the logical extension of this thinking would be to significantly lower the expectations for the annual bonus (thus re-aligning the word with its intended meaning), and create a secondary vehicle that recognizes future performance, thereby eliminating the need for these provisions (clawbacks) that are cumbersome and unlikely to be triggered.

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Consider the following example:

	SALARY	CASH BONUS	DEFERRED BONUS	BASELINE TOTAL COMP	CONTINGENT FUTURE COMP	PROVISIONS
HISTORIC	200,000	500,000	300,000	1,000,000	0	none
RECENT	400,000	300,000	300,000	1,000,000	0	clawback
PROPOSED	400,000	200,000	100,000	700,000	300,000+	none

Given the volatile talent market in which we are operating, it is critical to explore structures for “contingent future compensation” that are attractive to employees, so that early adopting firms are not disadvantaged. Real upside linked to unexpectedly good long term performance can provide incremental opportunity for employees. Real downside linked to poor performance provides incremental protection for shareholders.

While employees would have to make peace with having a lower “expectation”, it seems reasonable to think that clawbacks, performance hurdles, forfeiture provisions, etc., will need to get stricter and stricter over time, in order to create real potential for reducing comp when performance doesn’t support it. Would it not be more straightforward to lower rates to coincide with expected baseline performance, and then deliver incremental compensation to recognize outstanding performance over time?

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