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Inside the Boardroom with Paul McConnell and Jeff McCutcheon

BD: Jack Milligan, associate publisher, *Bank Director* magazine
McCutcheon: Jeff McCutcheon, managing director and founder, Board Advisory LLC
McConnell: Paul McConnell, managing director and founder, Board Advisory LLC

BD: Federal banking regulators are beginning to focus more attention on executive pay. How will this impact the compensation committee?

McCutcheon: I don't believe it will substantially change actual pay levels. Historically the government has been extremely ineffective at regulating pay -- particularly executive pay. One could even argue that prior attempts to slow executive pay growth have had the opposite effect. However, regulations have been very successful in changing the vehicles used for pay delivery, as well as the form of pay and the governance process around pay. One would expect to see a transition from salary, stock options and annual bonuses to longer term less liquid stock grants. In addition, all the current attention that's being paid to unnecessary risk taking will likely result in greater focus on relative goals rather than only absolute performance targets, particularly in community banking where a peer institutions with similar business models exists. This has also affected how boards go about managing pay. In the past it has been a management-directed process, where management would look at its strategy and develop pay plans in support of that strategy. This analysis and decision making is very quickly shifting over to boards. Compensation committees are quickly becoming responsible for interpreting strategy and thinking about what pay tools are going to be most effective in executing those strategies.

McConnell: We've also seen rampant growth in independent pay advisors like our firm, that work only for the board. It's our sense that the independent firm is quickly replacing the older model of the multi-line consulting firm, where executive compensation was one of many services that were provided. For large, public companies, the market share held by the traditional large consulting firms has dropped from 73% to 58% in 2010 alone. This is a dramatic shift that recognizes the actual board advisor and the board advisor's relationship rather than the geographic footprint or sheer size of the specific firm.

Boards of directors are now more focused on advisor independence. One of the first questions we are asked by boards is "How independent are you?" The challenge for boards and advisors is to strike the right balance between working with management as opposed to for management. I think one of the things you're going to see as a result of the increased federal oversight is much more board independence. In the current environment boards cannot afford not to engage their own advisors.

BD: Will increased scrutiny of executive pay mean that bank compensation committees will have to look at pay practices for the entire organization rather than just the CEO and his or her senior team?

McCutcheon: In well-run banks the compensation committee has always been involved in compensation strategy down through the organization. Under current regulation this practice will need to become a standard process of the committee. In a lot of ways it's a good thing, because that's where a lot of the problems occurred that led to the financial meltdown in 2008. The problems were not necessarily originating at the top of the house. The excessive risk taking was occurring further down in the organization. However, I think the board's primary focus will remain with executive management pay. The board's charter is largely to hire the CEO, who in turn hires the rest of the management. And I don't think anyone wants the board involved in the day-to-day operations of banks, least of all, boards.

BD: Is the role of the compensation committee is changing? And if so, does that mean that firms like yours will also have to change?

McCutcheon: The role of the committee advisor is changing very quickly, just as the role of the compensation committee is changing. Compensation committees are now held far more accountable for managing the executive leadership risk - whether we are talking about succession, new CEO selection criteria, or the choice of performance measures used to link strategy execution and value creation with executive performance and wealth accumulation. Each decision requires fairly active management of business risks involving executive leadership.
At our firm, and I imagine this also applies to our peers, we are far more involved in working with committees to develop their executive leadership strategy. Our client committees are spending far more time defining performance, managing succession risk and understanding investor expectations. We no longer see committees spending the majority of their time interpreting market median compensation practices or implementing the most tax or accounting-efficient incentive arrangement. Instead, committees are investing their time in the actions that move the needle - both in terms of improving management's underlying performance results and in terms of clarifying the message to investors, influencing market valuations.

BD: In today's environment, where profitability is under pressure and stock prices are low for most organizations, what's the best way to compensate the executive management team?

McConnell: One thing they shouldn't do is emulate the large banks, where in my opinion the basic compensation process is flawed. They don't have any long-term incentives. Let me explain. What they currently have is a series of one-year plans that have a portion paid out in restrictive stock or options -- and that's the root of the problem. Most of the fixes the federal regulators have talked about would essentially space out the payment to create a "long term orientation," but a well-designed executive pay plan involves balancing long-term and short-term objectives. There's no balance in these plans. By focusing so much on the annual bonus pool they've created a what-have-you-done-for-me-today mentality that encourages the kind of excessive risk taking we have seen. In a well designed plan, top management - and top management in a large money center bank might extend down to a couple hundred people -- would be paid primarily through large equity grants that are earned over time through sustained performance on a couple of contrasting measures that are not easy to achieve simultaneously. It could be growth and profitability, growth and safety or profitability and safety. Achieving sustained performance on those two dimensions in a manner consistent with the strategy, and doing so over a period of time, would be the primary basis for stock rewards. That's how you create a long-term compensation orientation. Then your annual plan can be much more tactical in nature: It can be a reward for a good year. It can be a reward for achieving certain key objectives. In a small organization it might be a reward for achieving a key component of that long-term strategy such as installing new operating systems or completing a merger. But the executive focus should be first with the long-term piece and then secondarily with the annual bonuses.

BD: Will there be a role for stock options in the dawning era of increased government scrutiny, or are we going to seem them becoming increasingly unpopular with a shift towards restricted stock grants?

McCutcheon: I think there's an absolute role for options but we will have to rethink how options are used. Historically, options have been extremely liquid and they provide the holder with both the opportunity and incentive to time the market. When an executive times the market, they liquidate their holdings when the stock is at a peak -- and their gain is essentially financed by all other investors in the form of dilution. If options are going to continue to be used in the future as executive rewards, I think to a very great extent that ability to time the market will be limited, not so much as to the date of exercise, but specifically to the date of sale. It's my sense that future use of stock options will be restricted through a specific holding requirement, where net shares would have to be held for something like 10 years from exercise. This allows the company to reap the benefit of the compensation leverage of the option without pitting the executive against other investors.

McConnell: The real problem with options as a long-term incentive vehicle is the heads-I-win-tails-I-don't-lose kind of mentality that can lead to excessive risk in building a company because option holders don't lose anything if the company fails. There is no cash value in the options when granted and holders don't lose anything if they fail. That leads to a swing-for-the-fences mentality. Used alone, and particularly in large quantities, options can lead to excessive risk taking. I think where options will have a role in compensation plans going forward is as a balancing mechanism. If you have a sound annual bonus plan and a good long-term performance plan that's focused on sound metrics, an option can still be used to sweeten the deal on the up side, making the overall program more lucrative and responsive to gains in stock prices.

BD: Is the skill set for a successful bank CEO any different today given the difficult environment that we're in?

McConnell: Well, first they need a tougher hide. The underlying skill set required to run a bank is essentially unchanged. However, if we look a decade into the future bank CEOs are going to be operating in a far more complex regulatory environment and the required skill set may be - influenced by that. There is also the question of scale. A large and complex banking organization requires a fundamentally different skill set than a smaller community bank. As banks plan for their next CEO they should be mindful that some of these institutions are more than five times larger than they were 10 years ago.

BD: What's the biggest mistake that boards make in terms of managing the CEO succession process?

McConnell: In a nutshell, it's delegating the responsibility for doing it to the CEO.

McCutcheon: CEO succession is the most important single task that boards have, but it's one that has been really delegated away in many instances. If we look at just the large banks, Equilar (an executive compensation and board research firm) found 28% of the CEOs at the beginning of 2009 weren't there at the end of 2009. Certainly 28% of those people didn't have planned retirements with carefully chosen successors in place. Perhaps Bank of America might come to mind. CEO succession is a known and very real risk that directly impacts investors. Simply put, boards cannot assume any CEO will want to undermine his or her own personal negotiating power by developing a stable of competent successors to take the reins the first time he or she stumbles. Succession is something that boards have to own and manage as part of their risk management obligations.

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