COMPENSATION

Aligning Executive Pay with Risk Management

Recent director surveys indicate bank directors find current legislative and regulatory actions unwarranted, and that existing plans do not encourage imprudent behavior or excessive risk. These opinions are diametrically opposed to global public perceptions that a serious problem exists with bank pay practices, and that substantial regulation is required. With governments racing to shape policy around public perceptions, bank directors will soon be left scrambling to retain talent if they do not use this current turmoil as an opportunity for proactive re-evaluation of the entire bank executive pay process.

Let us start by clarifying: executive pay practices did not cause the current crisis. In fact, our research indicates business unit incentives (e.g., trading, mortgage origination) were far more influential in the crisis than executive pay. Regardless, public perception is the board's reality and, upon closer review, there are some changes that could be made to bank executive compensation programs that would better align pay with sound risk management.

As we have been reminded, banks have an exceptional obligation to operate for the long-term benefit of all stakeholders, not just maximizing shareholder return. Capital safety is the cornerstone of bank performance and the bank's executive officers are uniquely positioned to manage the balance between risk and reward. These are the individuals (e.g., the CEO, CFO & Chief Risk/Credit Officer, etc.) that develop strategies and monitor risks, and are who the Board counts on to "see around the corner" in balancing current initiatives with long-term financial security.

To reassure the bank's various stakeholders, executive pay should be revisited starting with a blank sheet of paper. For most of line management, use of salary, bonus and stock pay arrangements are likely still appropriate. But for the limited group of senior executive officers described above, who are directly responsible for managing to the long-term interests of investors and the public, we believe there is a very simple and powerful approach to employment, compensation and incentives that will provide a stronger incentive to deliver results for all stakeholders.

Remove key executive officers from the annual bonus plan, adjusting salaries to provide competitive total cash compensation. Free executives to more objectively set tough but prudent goals for the operating officers that appropriately balance risk and eliminate any perceived moral hazard associated with executives developing their own performance hurdles.

Establish an immediate, one-time equity stake for key executive officers upon accepting their role. Award this one-time grant in an amount comparable to the present value of awards an executive might receive for the role for remainder of their careers (e.g., for a CEO, perhaps 1% of the company in full-value shares), with vesting over the remainder of their careers based on time and relative company performance.

This one-time grant would provide an immediate, substantial financial incentive to operate for the long-term benefit of stakeholders. This approach reflects the investor-perspective, consistent with the practices of many private equity and venture capital investors. By establishing an ownership interest rather than an annual "pay" opportunity, banks can also eliminate the need for supplemental retirement, severance, life insurance and related income protection schemes. Critical to this approach, even vested portions of the award would remain non-transferable until a year or two after the executive's employment ends, eliminating any opportunity to benefit from market timing or short-term appreciation in company equity.

By eliminating annual bonuses and annual incremental equity awards, and instead offering the executive officer fixed cash salary and an immediate investment stake, boards will recognize the unique role bank CEOs and other key executive officers play in managing toward the long-term health of the organization. Boards will also eliminate a number of performance and ethical obstacles created by existing arrangements. Executives would no longer "earn" their equity based upon annual assessments of short-term performance, the bias in goal-setting and selection of performance measures will be minimized, and the CEO would now evaluate risks and rewards in light of long-term value creation—without the added bias of personal short-term performance payoffs.

Properly communicated, this pay approach—simple, transparent and aligned with investors and public interest—will take an important step in changing the negative public perception of executive pay in financial institutions and signal that the CEO and the leadership team are committed to managing risk and reward for long-term value. While this may not be the perfect solution for any one bank, it provides directional guidance in responding to the justifiable public concerns and investor sentiments regarding managing bank risk.

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