FORTUNE
CNNMoney

By Eleanor Bloxham

June 2, 2011

Beware the perils of paying CEOs with stock

FORTUNE – If regulators are serious about addressing compensation and risk at financial institutions, they ought to pay much closer attention to paydays that come in colors other than green.

The comment period for a proposed multi-agency rule that addresses executive compensation practices at financial institutions ended on May 31, but the proposed rule left a gaping hole in its failure to address the potential impacts of stock and options incentives on a financial institution's risk profile and performance.

Research by professors Rüdiger Fahlenbrach and René M. Stulz in 2010, following the financial crisis, demonstrated why equity pay should not be ignored. While the knee jerk reaction is that if an executive is paid in equity, it will align that executive's interests with the company's shareholders, the research didn't demonstrate any such benefits.

According to the research, "banks where CEOs had better incentives in terms of the dollar value of their stake [in the company] performed significantly worse than banks where CEOs had poorer incentives."

"The top … equity positions at the end of fiscal year 2006 [were] held by James Cayne (Bear Stearns, $1,062 million), Richard Fuld (Lehman Brothers, $911.5 million), Stan O'Neal (Merrill Lynch, $349 million)[and] Angelo Mozilo (Countrywide Financial, $320.9 million)."

All of those firms fared poorly in the crisis. They were either sold in distress, or in the case of Lehman, went bankrupt.

This research suggests that the banks with CEOs who had smaller equity ownership stakes performed better -- and that perhaps equity ownership exacerbates rather than relieves problems with excessive risk taking by CEOs. Certainly, if a CEO has their eye on the stock price because they are paid in stock, that CEO has an incentive to soften bad news to shareholders and dampen full negative disclosures.

Regulators ought to pay attention to the fact that the evidence suggests that there is no positive relationship between a CEO's performance and his or her stake in the company, especially given the risks to bank performance and the huge consequences to stakeholders.

So why don't the regulators examine the issue of equity based pay more closely or address it in the proposed rule?

It's not as if equity is a miniscule part of CEO pay. A quick review of the summary compensation tables in the latest proxies shows that the current CEOs of JP Morgan (JPM), Bank of America (BAC), Citigroup (C) and Wells Fargo (WFC), received $127 million in equity and option awards over the last three years, which made up, on average, 80% of their total pay.

To address compensation at financial institutions, regulators need to examine all the reasons equity may create these perverse effects, including the fact that payments in equity may exacerbate the tendency to overpay executives (because of the false notion that equity and options are funny money and not real cash to the corporation).

Equity payments may also encourage managers to take risks, increase the volatility of returns, extract potential windfall benefits from timed sales, and manipulate stock prices. And it may do all of these things while diluting the stake of other shareholders, diminishing accountability to them, and distracting managers from the real business of managing the business.

If financial institution regulators examine the issues and carefully reflect on the impact of the proposed rule, maybe history won't repeat itself. If they fail, we'll be going through the same sad bailout saga all over again.

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July 1, 2011

Will Bank of America execs get to keep their bonuses?

The bank's proposed $8.5 billion settlement with investors will not lead to a financial restatement, so executives will not likely be required to give back their bonuses.

FORTUNE -- What would happen to you if you made an $8.5 billion "mistake" or contributed to one at your job?

Bank of America's (BAC) recently proposed $8.5 billion settlement with investors in its mortgage-backed securities certainly amounts to a decent chunk of change. Even so, some may argue it's rather small, given the damage that executives caused by not accurately disclosing the contents of the securities they sold.

But this $8.5 billion settlement -- in real cash, not just paper accounting losses -- brings some very large questions to the fore. What about all the executives who made bonuses based on the sale of those securities? And what about the executives who conducted the due diligence on Bank of America's purchase of Countrywide, which led them to take on this multi-billion dollar headache?

Should those executives have received the pay days and bonuses they received?

The Dodd-Frank Act requires so-called clawbacks for accounting restatements. Clawbacks force executives to return bonus monies if they were based on false financial statements and that accounting has to be restated later on.

But the financials aren't going to be restated in this case. And since this settlement does not involve a restatement, according to Bank of American spokesperson Jerry Dubrowski, no prior bonuses will be affected. Whether current executives will have to pay this year for the sins of the past "is too early to say," Dubrowski says.

So, what about these large "oops" moments? The ones that take several years to materialize? Is there no accountability for these mistakes? Just take the money and run?

Shouldn't those responsible for the losses be the ones to take a hit to their full bonus payments?

Clearly, they should, and that's why pay rules currently being considered and discussed by multiple bank regulators are so important.

At the very least, the new proposals should require banks to do the following:

- Measure the risks of different products -- and share that information with a bank's board so it can assess the riskiness of different business lines, and
- Implement bonus deferrals -- so executives have to wait to be paid the full amount of their bonuses. Bonus deferrals help ensure that pay is made on an accurate performance assessment and that there aren't any billion dollar "oops" moments lurking in the background. It's not like major settlements and penalties in banking are such a rarity these days.

You wouldn't expect to keep huge bonuses in the land of billion dollar errors – or would you? Let's hope some common sense prevails.

May 31, 2011

A toothless approach to reining in excessive exec pay

A recently proposed rule that addresses executive compensation at banks is a weak response to a problem that is larger than regulators seem to comprehend.

FORTUNE -- While the banks that managed to survive the financial crisis have largely mended their own balance sheets, they are far from out of the doghouse with regulators. Reports circulated last week that New York attorney general Eric Schneiderman's office is expanding its probe of bank mortgage operations, which already includes the likes of JPMorgan (JPM), Deutsche Bank (DB), and UBS (UBS). To understand the motivations at the banks that has paved the path to this probe, we need look no further than how the banks pay their executives.

Whatever changes financial institutions may have made to their risk oversight and compensation programs have been inadequate. That's clear just from the error-riddled foreclosure processes, which dragged on unimpeded (without even apologies until recently), causing multiple crisis aftershocks.

"State attorneys general told five of the nation's largest banks on Tuesday they face a potential liability of at least $17 billion in civil lawsuits if a settlement isn't reached to address improper foreclosure practices" a "figure [that] doesn't cover additional billions of dollars in potential claims from federal agencies," the Wall Street Journal reported on Wednesday.

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While there's been lots of talk from banks and regulators, there's been far less action to establish sure footing in the risk and compensation arenas at these institutions.

The slow pace of change began right after the financial crisis engulfed the banks. President Obama appointed a pay czar (Ken Feinberg), and while caps on pay were instituted, none of the banks delivered any meaningful systemic change. The banks that received TARP funds were obligated to discuss their compensation programs in SEC filings, explaining how their practices did not encourage excessive risk. But rather than actually change compensation, bank compensation committees generally relied on workers inside the bank (i.e. risk management personnel) to bless their existing plans.

Having internal workers approve compensation plans won't do much to change anything other than make a few people unwittingly feel better. What is a risk management person going to say to the CEO who signs his paycheck: "yours is too big, particularly for the risk you've taken on"?

Yet, a proposed multi-agency rule, including the Office of the Comptroller of the Currency, Federal Reserve, FDIC, National Credit Union Administration, SEC and the Federal Housing Finance Agency, would mandate that risk management personnel be involved in the development of banks' compensation plans.

Granted, this requirement is just one of many within the proposed rule, but it's a weak response to a problem that is larger than the regulators seem to comprehend. Comments on the multi-agency proposal close at the end of May, and because the issues are so important, regulators need to take a second look.

What is appropriate pay, anyway?

The proposed rule would require financial institutions to develop a report that outlines "the specific reasons why … the structure of its incentive-based compensation plan does not encourage inappropriate risks."

But what is inappropriate to you or me may seem quite appropriate to the bank next door. And internal management risks too often go unidentified and all compensation programs have their risks.

Regulators need to get financial institutions to identify their own internal management risks, how their compensation programs will ameliorate, rather than amplify, those risks, and why those remedies (as opposed to alternatives) are the best approach.

Perhaps if financial institutions had gone through this exercise immediately after the crisis, some of the foreclosure mess might have been avoided. Banks would have identified paperwork risks and ensured that the quality of processes mattered as much, if not more, to their employees than the speed of processing.

Also, regulators need to recognize that all compensation programs come with risks. Pay too little and you will have trouble hiring top talent. Pay too much, and for the wrong things, and you will attract candidates, but not ones with proper motivations. So instead of pretending compensation programs don't create risk in some form, regulators should recognize that all programs do. The question to be addressed, however, is whether a bank understands its own programs well enough to identify and minimize the risks.

The allure of giving yourself a raise

Money can be addictive, just as power and drugs and alcohol and chocolate can be. And excessive compensation can be a potent drug, leading to all kinds of unwanted behavior (See: Rajat Gupta).

The proposed rule would require banks to assess whether or not its compensation is excessive. One of the tests to determine whether a bank is giving out excessive compensation would be to examine what peer banks pay their executives. But if everyone is earning vast sums and taking great risks as a result, it doesn't mean that pay is on target. (Other metrics can be helpful. See "How can we address excessive CEO pay?")

Excessive compensation can also be monitored based on whether a bank is creating long-term economic value, for the bank itself and for its shareholders, employees, customers, and other stakeholders. That would involve measuring the long-term risks versus the rewards of a bank's financial decisions.

While the proposed rule encourages financial institutions to measure their businesses based on the risks they assume and use those measurements in their compensation, they should mandate it instead. Financial institutions are in the business of trading risk for reward. If a manufacturing firm didn't measure its costs but only its revenues, you'd know something was amiss. The same holds true for banks.

How do corporate boards fit in?

The requirements related to the role of the board need to be strengthened under this rule. For example, the proposed rule suggests that boards should receive data to perform its compensation oversight but does not provide clear guidance on the kinds of information boards should receive.

In addition, the proposed rule says the "board of directors, or a committee thereof, should review and approve the overall goals and purposes of the ... incentive-based compensation system and ensure its consistency with the institution's overall risk tolerance."

The mindset of "review and approve" is one of rubber-stamping, the last thing regulators should be encouraging from boards of directors at financial institutions.

No time for a rushed job

The proposal aims to have its requirements implemented within a six-month period. While it's important to move quickly, regulators should heed the admonition "measure twice, cut once" if they desire real change. Now is not the time for rushing but for careful thinking about a sustainable plan. Now is the time to seriously address risk and compensation at financial institutions. The foreclosure crisis has shown that the status quo is untenable. The way forward will require real work.

July 5, 2011

How to get paid like a U.S. CEO

While millions are still out of work, U.S. CEOs received a 28% pay raise this past year. A lot of factors are driving the increases. Job performance isn't one of them.

FORTUNE -- Did you get a decent raise last year? How about 28% without having to change jobs, vie for a promotion or outperform your peers?

If you were a CEO of an S&P 500 company last year and your pay only went up 28%, then sorry, but half your peers did better than you.

So with millions out of work, how do U.S. CEOs keep their pay rising in good times and bad? The short answer is an army of support and a few small distinctions.

Here's how it's done.

Step One. Ignore global benchmarks in setting pay.

While outsourcing may be negatively affecting your pay as a non-CEO or your ability to find work, U.S. CEO salaries are soaring in part because of the failure of boards to compare the pay of U.S. CEOs against their global counterparts.

Exxon's (XOM) board, for example, doesn't use other global energy firms when setting their CEO's pay.

And Wal-Mart's (WMT) board compares its CEO's pay mainly to CEO pay at other U.S. firms and fails to include no. 2 world retailer Carrefour, no. 3 Metro AG, , or no. 4 Tesco among their benchmark companies.

Why does that have an impact?

Recent research by professors Nuno Fernandes, Miguel Ferreira, Pedro Matos, and Kevin Murphy finds that, on average, U.S. CEOs earned double their non-U.S. counterparts between 2003 and 2008. And, adjusting for firm size and industry, U.S. CEOs still earn around 80% more than their non U.S. based peers.

Step Two. Convince your bosses that pay need not be based on your performance. In fact, they can just ignore performance in setting pay.

While we'd all like to have a nickel every time someone said CEO pay is based on the principles of "pay for performance", research by Fernandes and his colleagues shows that U.S. CEOs aren't being paid double their global counterparts because they are doing a fantastic job. (Additional research supports the argument that U.S. CEO pay has little relationship to a CEO's job performance.)

So, if it's not to do with performance, what is driving CEO pay upward?

Step Three: Get equity.

The research shows that U.S. CEO pay is higher primarily because U.S. CEOs are awarded high levels of equity compensation, which includes pay in the form of company stock and stock options.

But you can't stop there.

Step Four: To make sure the gravy train doesn't stop, get institutional shareholders to believe your equity pay benefits them.

When companies have U.S. institutional owners, boards are more likely to offer high levels of equity compensation (and, in turn, total compensation), the research shows. U.S. institutional owners have pushed for greater equity-based pay based on the assumption that offering pay incentives like stock and stock options boost performance and align pay with performance. That has not been the case, however.

When insiders, rather than institutions, hold more of a company's stock -- for example, in family-owned firms -- "they keep pay down," says Fernandes. There's "better discipline." Insiders do a better job of controlling the CEO than outside institutional owners have, he says.

Step Five: Get an independent committee to determine your pay.

According to the research from Fernandes and Co., regardless of a company's size, higher CEO pay is associated with a board comprised of more independent directors. But isn't it counterintuitive that having more independent directors would lead to higher pay? Perhaps on the surface, yes, but independent directors are likely more attuned to institutional owners' interests.

If U.S. institutional owners want more equity-based pay, which leads to outsized U.S. (versus non U.S.) pay, independent directors are more likely to deliver what they think institutional owners want. The directors are "shielding themselves from [liability] problems" by handing out "higher equity based pay," Fernandes says.

Step Six: Make sure your company is listed in the U.S.

Fernandes says that the U.S. is exporting its pay practices abroad. When non-U.S. firms are traded on U.S. exchanges, the firm's CEO pay gets a boost.

Step Seven: Take advantage of regulation to boost your pay and make the case that your additional pay is in shareholders' best interests. (You are really doing it for them.)

How do you pull this one off? Use regulation and accounting conventions to justify pay increases.

For example, in 1993, Congress passed legislation that limited the amount of base executive pay that companies could deduct in their taxes to $1 million. This legislation is often cited as one of the drivers for the rise of CEO incentive pay.

Another driver has been past U.S. accounting conventions related to stock options. In the past, the expense of paying executives with stock options did not have to be included on the company's income statement. This accounting, which made companies' income statements look better because the stock option compensation did not show up as an expense, is often cited as a key contributor to the rise in CEO incentive pay.

Going forward, James Reda, founder and managing director of compensation firm James F. Reda and Associates, predicts that a new Dodd-Frank requirement to include a chart that compares executive pay with performance will be used as yet another "excuse to increase pay" for CEOs at U.S. companies.

"Companies will use this as a rallying cry to increase pay," he says, and they'll be "slicing and dicing the information any way they like." If one performance metric doesn't work, they'll just change the comparison, Reda says.

Reda predicts in five years we'll see a doubling of U.S. CEO pay from the current levels.

So those are your seven steps to be paid like a U.S. CEO -- although they may not be so easy to duplicate for the non-CEOs among us.

Of course, corporate boards could study other approaches to motivating and rewarding good CEO performance, which does seem to be an issue of concern. A survey released in May by the National Association of Corporate Directors (NACD) with compensation consultants Pearl Meyer & Partners showed that "a total of 33% of respondents … ranked 'the selection of performance goals that align with shareholder value creation' as their top Board issue."

Perhaps institutional owners could also rethink what they want. Has higher equity based pay been worth the money they've spent? What signals do they really want to send?

Higher CEO pay is likely not going to benefit you. It means fewer dollars in the coffers for your raises, no better performance for your company, and more unemployed workers, rather than new hires who could help you with your growing workload.

Maybe it's time for more than a collective sigh. Let's hope the U.S. contagion won't spread too far too fast.

April 13, 2011

How can we address excessive CEO pay?

Corporate boards and companies desperately need to rethink how they evaluate the way they pay their CEOs

FORTUNE -- CEO pay is headed skyward once again, leaving their non-executive minions far behind. Median CEO salaries jumped 27% in 2010 while overall worker pay increased by just 2.1% according to the Bureau of Labor Statistics, USA Today recently reported.

"The current levels of compensation for CEOs in corporate America are, in a word, outrageous," Jack Bogle, founder of The Vanguard Group, said to me in a conversation several years ago, a conversation that covered a number of topics, including the real levels of growth created by corporate CEOs.

CEO compensation practices at U.S. companies have been in the spotlight for a very long time. Back in 1977, Peter Drucker wrote that CEO pay should be no more than 25 times average worker pay. In a 1984 essay, he updated that to say that no more than 20 times average worker pay was appropriate.

"Widen the pay gap much beyond that, Drucker asserted, and it makes it difficult to foster the kind of teamwork that most businesses require to succeed", Rick Wartzman, director of the Drucker Institute, explained in an article for BusinessWeek in 2008 and, more recently, in a letter to the SEC.

Looking at the ratios closely, it's easy to see why there is so much concern about pay today. Following Drucker's principle, if a CEO earned $84 million for nine months work, as Phillipe Dauman at Viacom did (VIA), average worker pay at that company would have to be at least $4.2 million to be in lockstep with Drucker's ideals. If the CEO earned $22 million, as Howard Schultz the CEO of Starbucks (SBUX) did, average worker pay at that company would have to be at least $1.1 million. (Is that the going rate for baristas these days?)

Looking at it another way, if the average worker at a company earned $100,000, a board concerned with the same moral and social issues that concerned Drucker would limit the CEO's pay to $2 million or less. Based on the USA Today analysis, only 4% of the companies would meet that standard this year.

While executive pay has been a hot button management topic for years, it has only recently been in the sights of public policy makers. That's partly because a growing body of research has demonstrated the influence of compensation on CEO and worker behavior, a fact that many policy makers and members of the public woke up to in the aftermath of the financial crisis.

Yet despite all the gnashing of teeth over the last four decades, executive compensation issues have largely gone unsolved. During the recent financial crisis, investors had the opportunity to provide advisory votes on executive pay at financial firms that received TARP funds in 2009, and they gave thumbs up to pay packages at every single one of those institutions. This proxy season, with advisory votes now widely available (thanks to the Dodd Frank Act), only five companies' executive compensation packages have received a thumbs down from shareholders, according to Institutional Shareholder Services, a proxy advisory firm.

But do investors have all the facts they need to use their new say on pay appropriately? Could new metrics help motivate companies and shareholders to solve the intractable ethical and management issues Drucker wrote about years ago?

Better metrics couldn't hurt -- and there are a number of interesting ideas now under review. One new, and timely, metric being discussed in academic circles addresses the problem of incentives that encourage short-term behavior rather than the kind of actions that deliver sustainable corporate results. While companies typically use a mixture of short- and long-term pay incentives, a metric proposed by David Walker, a law professor at Boston University, would provide a measuring stick of the average term of pay.

Companies with a tilt toward providing long-term pay incentives would have a longer average term of pay than those who pay most of their incentives up front with no deferrals. The average term of pay metric would provide a simple way to compare companies' pay plans that would be useful to boards, shareholders and employees. This would also provide a reference point related to appropriate risk management and investment at the firm.

The Dodd Frank Act, passed last summer, requires companies to disclose the ratio of CEO pay to median worker compensation, which would also help stakeholders judge a company's pay plan.

At this time, the SEC has not yet made a proposal on how the new disclosure requirement will work. Nevertheless, the SEC is inviting comment on the rule. Some companies, and their legal advisors, are, unsurprisingly, suggesting that the requirement is not necessary, but the Drucker Institute is firmly in favor of the provision.

And there is good reason to think that the Institute is right. A recently released survey by MetLife puts in perspective the consequences of ignoring compensation issues.

According to the survey, employee loyalty at companies is at a three year low, which employers seem to be unaware of. Nevertheless, at companies with 500 or more employees, nearly 40% of employees "agree that if it's their choice, they hope to be working for a different employer sometime in 2011."

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What drives loyalty or lack thereof? Nearly 80% of the 1,412 employees surveyed for the MetLife report rank salary and wages as "extremely important" to their loyalty to the company. In fact, salary and wages was ranked as the most important issue to employees, outflanking advancement opportunities, company culture, work-life balance, and health and wellness initiatives by wide margins.

Given his views on the importance of pay and its impact on corporate functioning four decades ago, Drucker would not be surprised at these findings. And that's why the metrics proposed by Walker and mandated by Dodd Frank may just be the ticket.

Recalling the adage that "what gets measured gets managed," these metrics may be exactly what is needed to help boards and companies rethink the seemingly intractable compensation and related management issues that have dogged companies for decades. These metrics will also give potential investors and employees (who seem to be itching to move anyway) the information to make wiser decisions about where to invest and work next.

February 10, 2011

Why banker bonus delays work

The FDIC proposed rules this week that would require big banks to space out their bonus payments to senior execs. Here are four reasons why other companies should adopt similar rules.

On Monday, the FDIC approved a draft rule that would require large financial institutions to hold a minimum of half of senior executives' bonuses for at least three years. This falls in line with what some financial institutions have already started to implement on their own. Morgan Stanley (MS), for example, recently announced that they are extending their bonus deferral program to more of their employees.

Bonus deferral or lengthening programs pay out bonuses over a period of years, making payment subject to future performance of the individual, their department or team, or the entire company. The programs may pay out bonuses in a number of forms; in my opinion, the payments under these bonus programs should be in cash.

Other companies, not just banks, have incorporated bonus deferral or lengthening programs in the past, and more companies, not just banks, should consider them now.

Here's why.

Just deserts

Spreading bonus payments out over a period of time can strengthen the relationship between the overall results and the reward. A rude salesperson may complete a sale, but he or she could be putting a wrench in the possibility of future ones. An employee may file the company's annual tax return on time but discover, during the course of a future audit, that significant errors were made. A building manager may have an excellent annual inspection without having kept up with pending laws that require lead time for implementation. On the flip side, a supervisor may invest time helping staff better understand the context of their jobs so they can make better on-the-fly decisions, which will likely result in minor productivity loss in the short term but longer term gains.

At Morgan Stanley, reports from the Financial Times suggest that individuals in the legal and compliance departments were particularly disturbed by the move to include their bonuses in this bonus lengthening program.

Legal and compliance workers, however, are perfect candidates for deferred bonuses. The positive and negative results of legal and compliance efforts can and do take a number of years to manifest. And the long term results of their efforts are critical to preventing future crises similar to the ones we just experienced.

Focus on the long haul

Another benefit to bonus lengthening is the subtle shift of focus in the organization toward the long term. Often, the benefits of research, marketing, and training take years to accrue. But if top managers are more interested in the current year (because they get paid bonuses that way), they may pull needed resources from these areas, worsening performance later on. Changing the incentives to discourage strictly short-term decisions could be very beneficial.

Taking active steps to create long-term thinking is even more important today than it has been in the past. The fast pace enabled by technology pervades the culture at many companies. Revising incentives, like bonuses, can help balance those tendencies by rewarding considered judgment.

Speculators beware

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Shareholders focusing on short-term gains often exert pressure on longer term oriented management teams and boards. A management system with long horizons can send a signal to potential short-term investors that there may be a mismatch between their speculative goals and the company's longer-term views. While discouraging the speculator, this incentive mechanism can also encourage long-term investors who want to invest in firms with a commitment to the long haul.

Creating trust between the manager and the managed

Bonus lengthening programs can also open up the possibility, and the potential, to rewrite a company's social contract with its employees, a contract which has been severely tested over the last three decades. Would executives be so quick to lay people off if, instead of being awarded for the short-term cost savings, they were held accountable for the long-term consequences of that decision?

If bonuses are paid out over the time, it implies a longstanding relationship, which can positively impact both employers and employees.

It's time for other companies to follow this lead.

July 15, 2010

Are compensation committees covering for high CEO pay?

FORTUNE -- When you want to understand whether the CEO runs the board or the board oversees the CEO, a good place to start is to look at the work of the Compensation committee. Compensation committees so impact how companies are run that NYSE and NASDAQ listing standards require that Compensation Committees be comprised only of independent board members.

A new study released by the IRRC Institute provides a report card on some of the activities of compensation committees with insights into how well the committees are doing their job and who's really running the show.

Peer selection

As a benchmark for determining reasonable pay, many Compensation Committees choose a set of "peer" companies to measure themselves against. In proxy disclosures, the reason usually given for choosing a set of comparison companies is to ensure the pay for their CEO is reasonably in line with their peers. However, in picking peers, compensation committees tend to select peers that are larger than the company in terms of both revenue and market capitalization, the study showed. In some cases, peer companies weren't even just a little larger, but were twice the size, in market capitalization, of the company itself. Of course, choosing larger peers helps tend to skew pay benchmarks higher, resulting in higher CEO pay

Pay relative to Peers Chosen

Although many proxies say that peer selection is used to ensure CEO pay is reasonable and in line with peers, the study showed some wide discrepancies between the earnings of CEOs at the peer firms, chosen by the compensation committee, and the awards made by some compensation committees to their own CEOs.

For example, in its latest proxy, which is similar to the one from the year before, petroleum services company Nabor Industries (NBR) states that "In considering the appropriateness of the compensation arrangements ... the Compensation Committee reviewed market data from ... companies in the oilfield sector, which were selected with the input of BDO Seidman based on their industry affiliation and size."

Continuing, the proxy states: "The Compensation Committee did not target ... a specific percentile within the peer group." But maybe they should have -- because it is unclear how the peer companies gave them comfort in the appropriateness of CEO Isenberg's pay for the three years ending 2008. The IRRC/study showed, for that time period, his pay was nowhere close to that of the peers. It was almost 6 times the median for the peers the Committee had selected. (Mr. Isenberg is 80 and has served as Chair and CEO since 1987.)

The historical differences, however, did not appear to concern all Nabor Industry shareholders. A majority of them, despite this, voted down a shareholder proposal for an advisory say on pay.

Meanwhile, in the case of Juniper Networks (JNPR), according to its proxy, consulting firm Mercer's "fees for executive compensation consulting in fiscal year 2009 were approximately $215,000" and among other tasks, included assessing "the alignment of the Company's compensation levels relative to performance against primary peer companies and relative to the Compensation Committee's articulated compensation philosophy".

In the case of the CEOs at Juniper, the IRRC/Proxy Governance study found their pay was, on average,

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4.5 times the selected peers' median over the three years ending 2008. (By the study's measures, both Nabors and Juniper underperformed their peers.) Despite this, at the annual meeting, Juniper shareholders approved increasing the number of shares available for executive compensation by 30 million.

Some other study highlights? Larry Ellison at Oracle (ORCL, Fortune 500) is compensated 4.3 times the pay of the peers looked at by his company's compensation committee. Alleghany Technologies (ATI) CEO: 3.6 times. Massey Energy's (MEE) CEO: 2.7 times.

Admittedly, those are extreme cases. So how prevalent is it that CEO pay is well over the pay for benchmark peers chosen by the Compensation Committee itself? Of the Russell 3000 companies reviewed, in nearly 30% of cases, CEO pay was 1.5 to over 4 times the peer median.

Clearly, this scorecard would suggest some Compensation Committees aren't getting passing marks. Are they just not doing their homework -- or is the CEO doing it for them? That's the question every investor must decide.

July 2, 2010

Should executives be paid with debt? No!

FORTUNE -- As investigators comb through the wreckage of the financial meltdown, one fact remains clear and startling: Credit default swaps and collateralized debt obligations, as well as debt and equity from large financial firms were useless as indicators of fiscal health. One of the biggest revelations has been the utter failure of markets to capture the relevant information required to set accurate prices on securities.

And yet, despite the lessons learned that market pricing can be way off the mark, tying executive pay to equity values has historically been encouraged. Now the use of equity and other financial instruments in compensation is slated to be set into law in Europe, and AIG (AIG, Fortune 500) has just announced a plan to compensate executives partially based on the performance of its debt. Can this possibly work?

According to the Financial Times, "Under legislation expected to pass the European parliament next week," half of any undeferred bonus "would have to be paid in shares or in other securities linked to the bank's performance." Thus, the value of at least some portion of bonus will be based on the value of equity securities or other securities whose prices are set in the global capital markets and dependent on their whims.

It is hard to see how this is a step in the right direction. What once seemed like a sound way to ensure executives were invested in the future health of the company has turned out to be little more than an incentive for them to obscure risk and financial data in order to maximize their own personal profits. The main draw for corporations to tie their market performance to executive compensation is that it sounds good, and in the case of debt based pay, it sounds tough. But is it?

Equity based pay

Despite the popularity of stock as a mechanism for compensating executives, it has not worked well. The newspapers tell us that the prospect of higher equity pay has led to greater risk-taking and financial scandals. Equity prices also violate two tests for good compensation design: (1) can managers control the outcome of the measure? (in this case stock price) and (2) if they can control it, is it an outcome we really want managers focused on? Manipulating stock prices is the last thing shareholders want. Therefore, both empirically and theoretically, tying pay to equity is not a good choice.

The new EU measure makes other options available, however, when it says that rather than shares "other securities linked to the bank's performance could be used". For companies, two such securities come to mind: debt and credit default swaps.

Debt based pay

This more novel compensation technique received a vote of confidence in a May 28 filing with the SEC by AIG. Under the revisions, some of their executives' bonuses will now be tied to its debt, instead of its equity.

AIG will be basing 80% of the value of its bonuses on its junior debt and 20% on AIG's stock. As at most financial firms, bonus pay can make up a healthy percentage of executives' overall compensation.

But is tying pay to debt, even as a partial solution, really the answer? Harvard Law School professor Lucian Bebchuk has argued in a series of papers prepared for the Investor Research Responsibility Center Institute that it is. On the face of it, debt based pay sounds exotic and almost punitive towards executives. Yet the problems with the strategy are remarkably similar to those experts warn about in regards to paying executive with stock.

Take the managerial-control requirement mentioned above. The price of debt responds to interest rates -- when interest rates rise, the price of debt falls, and when interest rates fall, the price of a debt instrument rises. But corporate executives don't control interest-rate levels. Of course, if executives turned their attention towards convincing the Federal Reserve to take actions which would influence the movement of rates, their pay might go up. But is this really what corporate executives should be thinking about?

That brings us to the other useful test for payment mechanisms like this one: Even if managers could control outcomes, are they outcomes they should be striving for? For example, the price of debt also responds to the perceived riskiness of a company, as represented by its credit rating. Managers can control their firms' risk levels, but not credit ratings. Should managers, in the wake of Lehman Brothers' Repo 105 accounting gimmick, be paid in a way that creates incentives to mislead credit raters or bondholders as to the riskiness of a company's debt?

Credit ratings of course have been wildly off the mark, in cases such as Enron and the CDOs at the heart of the financial crisis. And issuing more debt, just so executives can be paid in it (a possibility created by this arrangement) seems misguided.

Credit default swap based pay

Another alternative to equity and debt is one advocated by Columbia Business School professor Patrick Bolton: tying executive pay to the spread on CDS -- or, more precisely, to deviations of a bank's CDS spread from the market average.

Bolton claims that CDS spreads are pretty good predictors of default within a year or so, but the use of CDS spreads also relies on the ability of the market to perceive and properly price risk. As the financial crisis has made painfully clear, especially in the case of opaque financial-services firms such as AIG and more recently the squabble between the firm and Goldman Sachs (GS, Fortune 500) over CDS pricing at the FCIC hearing yesterday, markets can be and are often quite bad at evaluating risk accurately.

Realizing that equity isn't the answer for pay doesn't mean that debt or CDS spreads are

Clearly, compensation should incentivize managers to focus on good long term outcomes for the companies they run and shareholders they report to. But inside information is always more complete than the external information that markets are given to process. In other words, pricing of any corporate instrument -- debt or equity -- is always going to be imperfect. So why give executives a chance to exploit that information gap for personal gain?

Companies that perform risk management, like big banks, will always have more and better information on risks (including future risks) than what the market has from the limited information those companies have to disclose.

While tying pay to risk-adjusted performance metrics based on solid internal information that managers can and should control is more difficult to explain and implement than handing out stock options or bonds, it's a much better solution to keeping executives on the straight and narrow than equity, debt or CDS-spread based pay is.

Designed properly, the incentives for financial-institution executives can be matched with performance metrics that managers can and should actually control. That would keep big banks' customers, bondholders and shareholders interests aligned with each other and with management -- an arrangement that might just be the secret to preventing financial crisis déjà vu.

June 17, 2010

Most big banks not even paying lip service to risk-based pay

FORTUNE -- Last October the Federal Reserve issued proposed guidance to banks on the structure of bank pay. The reason for the guidance was the need for banks to change pay so it would no longer encourage the excessive risk taking that led to the financial crisis.

In proposing the guidance, the Fed asked banks to immediately address the issues in current bank pay: "The Federal Reserve expects all banking organizations to evaluate their incentive compensation arrangements and related risk management, control, and corporate governance processes and immediately address deficiencies in these arrangements or processes that are inconsistent with safety and soundness," the guidance read.

Now the question is being raised: what part of "immediately" do the bankers not understand?

A *New York Times* article on the initial findings of a Federal Reserve review of bank pay practices explains that "many of the bonus and incentive programs that

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economists say contributed to the worst financial crisis since the Great Depression remain in place." Further, "bank executives and directors ... are often in the dark on the pay arrangements of employees whose bets could have a potentially devastating impact on the company."

Major messages of the guidance issued in October were that performance metrics are important to the incentive structure and that both risks and returns should be considered in doling out pay:

"The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees... An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks, as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness." Programs "should be implemented so that actual payments vary based on risks or risk outcomes."

Although the Federal Reserve is not expected to issue formal findings of its reviews until next year, our review of this year's proxies for some of the major banks point to issues the Federal Reserve may need to address in their report:

Bank of America (BAC, Fortune 500): While the proxy states that "financial results should be adjusted, where appropriate, to reflect risk and the effective use of capital to encourage sustainable, risk-appropriate and profitable performance over the long-term", risk adjusted financial results don't appear to be part of the actual plans for executives, as a primary feature, just yet: "The Committee places the greatest emphasis on company-wide financial performance, with a particular focus on earnings, earnings per share, total stockholder return and revenue as collectively the best indicators of our financial performance."

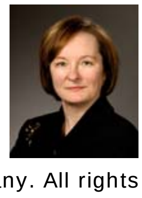
Citigroup (C, Fortune 500): At Citigroup, while some risk related metrics were used in determining top officer pay, they were jumbled together with other measures on the compensation scorecard. The issue with that approach is that employees can't be certain how to take action to generate the best risk adjusted returns. As they note in the proxy, "Citi has strengthened its risk management framework, but the [personnel and compensation] committee is not complacent and recognizes that Citi must constantly improve these practices".

Goldman Sachs (GS, Fortune 500): The way the C-suite is paid sets the tone at the top for how the company is run so it's critical to address their pay. Although there is recognition that "contracts or evaluations should not be based on the percentage of revenues generated by a specific individual", the metrics considered by the Compensation Committee for the top officers include revenues, expenses, earnings, earnings per share and return on equity, none of which take risk into account.

JP Morgan (JPM, Fortune 500): The JP Morgan proxy states that "Incentives are based on risk-adjusted P&L and are calibrated to the underlying risk of the business activity". That sounds right, but when listing the performance criteria for senior level employees, the financial measures cited are "operating earnings; revenue growth; expense management; return on capital; capital and liquidity management; quality of earnings". Including measures such as revenue growth and expense managements can provide mixed signals for individuals in terms of risk and return. Should we goose risky revenue growth? Or eliminate expenses that could help us reduce risk?

Morgan Stanley (MS, Fortune 500): Although a working group at Morgan Stanley reviewed "applicable performance metrics", according to their proxy, performance metrics were not listed as "among the factors considered in making [the] determination" that the compensation programs do not encourage unnecessary or excessive risk. And, in fact, "the Company's core financial metrics - return on equity and total shareholder return" are used in incentive compensation decision making, according to their proxy. Neither of those measures tie pay to the risk that is being taken on. In fact, as the crisis showed, stock prices rose in the period where risks were building but had not yet been exposed. Return on equity, as a measure, can have the opposite effect from limiting risk taking. That's because one way to increase return on equity is for the bank to hold less equity, thus increasing its leverage and potential risk. "Growth in revenues", another metric cited in the proxy, is one which clearly does not consider the risks of that business and the impact on the organization's safety and soundness.

While banks have taken some steps, they still have some distance to travel to meet the intent of using metrics which help shape appropriate motivations and behaviors and adjust bank pay based on risk. One suggestion, not provided in the guidance that might assist in executive and director motivation to consider this task more strongly? Tying a healthy portion of pay to getting this right and ensuring that all signals clearly point to effective risk management.



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