HOW BANK CEOs SHOULD BE PAID

The following article by Cliff Weight, of MM&K remuneration consultants Appeared in Financial World June 2008

In May's Financial World I explained that the way bankers are paid does not work. However to change bankers' pay will require leadership from the very top. I believe this will not occur until banks change the way their CEOs are paid.

Part of the problem is that the US model of CEO compensation is broken. It has been for years. Enron, WorldCom, Tyco and Hollander are examples of the CEO having too much influence in setting their own pay. This is still the case as is shown by the large payoffs to the CEOs of NYSE, Citigroup, Merrill Lynch, etc. Their remuneration committees approved the awards. Why?

Too many CEOs in the US have the combined Chairman and CEO role. They strongly influence the choice of their non-executive directors and ensure the Remuneration Committee consists of people minded to continue to vote through excessive pay awards. SOX does not address this problem. Laws and regulations about caps on pay will not work. There is bad precedent in the law of unintended consequences, e.g. s162 of the US Tax Code which limited pay to $1m p.a. unless it was performance related, which led to a huge increase in the use of options and rises in previously sub-$1m salaries up to the $1m restriction.

Analysts contribute to the excessive pay levels of CEOs. Shares surge on the appointment of a big name CEO. Usually such CEOs command much higher compensation packages than lesser known internal appointments. To justify themselves, new CEOs have to do something. They adopt new strategies, which entail more risk. More risk = higher share price volatility* = more chance of a large payout if successful. New hires, not unreasonably, negotiate safety nets[1], in case things don't work out as planned. But they win both ways. The poor shareholder has to suffer the burden and cost of an asymmetric reward package.

> ***Volatility – an explanation:**
> Mathematically, volatility is the standard deviation of share prices expressed as an annual % figure. Thus a company with a 30% volatility will expect its share price to be within 30% of the mean market change with probability 64%; and within 60% with probability 95%.
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> Share options only pay out if the share price goes up, but there is no "give back" if the share price drops – the options merely expire worthlessly even though the accounting standard gives them a value!.
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> Doubling the volatility increases the expected returns from an option by about two thirds.
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> Both options and LTIPs reward and incentivise higher volatility, which is not in the shareholders' best long term interests.

Academic research (performed by people who do not have a conflict of interest) is conclusive: 70% of acquisitions and mergers do not add value. Nevertheless, CEOs are strongly urged to do deals by investment bankers, strategy consultants, accountants and lawyers, whose fees are paid when the deal is done, irrespective of whether the deal generates superior shareholder returns in the long term. An example is RBS whose incentives strongly encouraged its CEO to buy ABN Amro – his odds of achieving the maximum incentive payments were much higher by doing the deal than if he had not.

Banking crises occurred in 1973, 87/88, 91/92, 98 2001/02 and 2007/08. On average every 6 or 7 years. But most long term incentive plans have a 3 year performance period, so allowing CEOs to maximise their expected income by adopting risky business strategies. The cycles are out of synch.

Too often banks pay CEOs as superstar entrepreneurs rather than as excellent administrators. The role of CEO is neither entrepreneur nor administrator, but somewhere in between.

The ABI and others mean well, but their guidelines are too prescriptive and have:

a. produced boilerplate remuneration schemes not suited to individual company circumstances; and
b. allowed executives to maximise their personal wealth by following strategies that are not in the best interests of long term shareholders.

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[1] It is not the existence of the parachute that is the problem – it is the circumstances in which it can be opened. Once an executive has been in post for 3 years, surely 6 months pay on leaving is adequate – if he is a good performer he will be able to find a new job within 6 months.

Bank CEOs do not think and act like owners, because their pay creates and supports a culture of short termism, high risk taking and incentivises asymmetric risks.

Those are some of the problems. I think the CEO pay problem is not insoluble. My seven steps to success are:-

1. Succession planning. If there are lots of other good internal people who can fill vacant slots, banks will not have to recruit externally and pay top dollar.
2. Emphasise teams and recognise leadership rather than superstars.
3. Make sure the Remuneration Committee is made up of independent directors, capable of standing up to the CEO's demands. Ensure the Remuneration Committee appoints its own remuneration advisers, who are independent. Critically evaluate input from advisers who also receive fees from management for other consultancy work.
4. Make sure the Remuneration and Nominations Committees work together and are aware of key executives' desires, motivations, ambitions, career plans, lifestyle goals, wealth and appetite for risk.
5. Beware of risk and volatility. Do scenario analysis and consider, in particular, tail risk. Take more account of risk when setting incentive targets and the level and timing of payments.
6. Be open with shareholders about the CEO's pay - how it is paid and why. Explain the link to performance and show this over a 5 year period. Consult the shareholders to find out what they want. The Combined Code permits companies to explain why they do not wish to comply with the standard approach.
7. Create an ownership culture. Make CEOs think about creating long term value.

Cliff Weight is a director of MM&K, the leading firm of independent remuneration consultants. MM&K's roots are in investment banking, having been founded 35 years' ago by Morgan Grenfell. Our up to date expertise and depth of experience means we are well suited to advise on bankers' pay.