COVER STORY/PAY IN THE SPOTLIGHT

The four-letter word that colors the compensation debate. . . . . p. 23
Bank boards assess changing pay dynamic . . . . p. 27

The sin of wages?

Odds are strong that executive compensation for bankers will evolve as post-crisis anger and angst focus on risk and corporate governance

Executive compensation has been controversial in Corporate America for years, now, but talk to the man on the street about it today, and you'll likely see a kneejerk case of apoplexy, especially if you link the word "banker" to it.

Many bankers feel that their compensation—indeed their industry—has been tarred unfairly by a very broad brush. But in an age when "bank" is used to describe everything from investment bank behemoths to single-office community banks, it's hard to keep the tar off, and to keep the tar from turning into law.

"I understand the angst reverberating through the country today," says banker Ted Awerkamp. "But from a community bank perspective, why have a board of directors if they are going to legislate caps and fences?"

The truth is, says Awerkamp, president and CEO of $1.7 billion-assets Mercantile Bancorp, Quincy, Ill., "community bank shareholders aren't paying crazy numbers" to executives.

Unfortunately for banks like Mercantile, they live in an age of distrust, and Congress is going to at least mandate looks over the shoulder for many, and has already mandated stronger involvement for TARP banks.

Compensation should be a matter of board decision, agrees Charles Elson, professor at the University of Delaware and director of its John L. Weinberg Center for Corporate Governance. "To actually have the government take a role in management bothers me," says Elson. "If you want long-term economic growth, to have the fuel of that growth directed by government is not productive."

But that's not the way things are headed in Washington. We explore this in this opening section, and take deeper looks at two facets—risk and corporate governance—in the two sections that follow.

By Steve Cocheo, executive editor

TARP banks and compensation

In some ways, TARP has been a bait-and-switch game. Bankers were urged to sign up in the earliest days. Only months later did the restrictive compensation limitations of being a TARP bank arise.

"If you are a TARP bank, you are kind of ... *toast*," says compensation consultant Susan O'Donnell, Boston-based managing director for the Pearl Meyer & Partners consultancy. The oversight of the "Pay Czar" is only the overlay of federal limitations imposed on the 400-odd institutions for taking government money. These banks, in the interim final regulations issued in June, face the "TARP 12," a set of proposed requirements. These include: senior executive pay limitations; establishment of wholly independent compensation committees; submission of executive compensation to a nonbinding shareholder vote (the "say on pay" concept); and in some circumstances, "clawbacks," where the government seizes paid earnings (allegedly not earned).

O'Donnell notes that as of mid-August, there have already been more than 100 TARP-based say-on-pay proposals. In no cases did the shareholders' vote result in a nonsupportive outcome, she says, but many came close.

"A 60% 'yes' result is not great," says O'Donnell. "It means that 40% of your shareholders don't like what you are doing."

There are concerns that this is already reducing the incentive component in executive compensation, and shifting pay packages more towards straight salary. "That's clearly in conflict for what's best for the organizations, and for their shareholders," says John Koelmel, president and CEO of First Niagara Financial Group, Inc. The $9.6 billion-assets company, which is growing into a regional powerhouse from an upper New York State base, took TARP funds but repaid them early, and Koelmel is grateful his bank got out before it affected compensation strategy. His own package, he points out, is heavily weighted towards compensation based on performance over time.

Subscribe at www.ababj.com

Say on pay developments

What TARP banks already live with in terms of say-on-pay requirements, all public companies, including banks, could be subject to under the pending Corporate and Financial Institution Compensation Fairness Act, passed by the House this summer. H.R. 3269, would require nonbinding say-on-pay votes; would mandate compensation committees independent of management; and more. Due to ABA advocacy efforts, there is some provision for excluding smaller financial companies, but the matter still has to evolve in the Senate, where it is favored by Chairman Chris Dodd (D.-Conn.) of the Senate Banking Committee.

Where does the impetus come from? House Financial Services Committee Chairman Barney Frank remarked in a recent speech that shareholders had to be involved because, in his view, directors can't do the job.

"We have the radical notion on the Democratic side that the shareholders who own the company ought to be able to set outer limits on pay," said Frank. "That's because the notion that it will be done by the board of directors is fruitless because boards of directors and CEOs are inevitably the closest of collaborators. There is not, and should not be, an adversarial relationship between the CEO and the boards of directors. I think it's impossible to structure one in a well-functioning organization. It's a mistake to think that one day a year, they'll go to arm's length and be labor and management."

The very threat of say-on-pay has driven some changes in behavior. In a joint interview, Patrick Cole and Timothy Reimink of Crowe Horwath, indicated that some financial institutions, believing that say-on-pay is already effectively here, have engaged the firm to facilitate meetings with large stockholders who are not board members. The idea is to get their input on issues such as compensation.

Cole says the meetings have typically been positive. "They are interested in peer group comparisons," he says, "There is an appreciation for fair pay. Actually, it's been a pleasant surprise that these folks don't see a need for reductions in pay. They want to be supportive."

Banker Ted Awerkamp says the desires of community bank shareholders are being misunderstood if anyone thinks they really want "say on pay." His holding company went public in 2005, and this led to a change in director attitude. "Our board became much more involved and much more accountable for salary and benefit judgments," says Awerkamp. "The shareholders want liquidity, they want transparency, but they also expect directors to do their jobs."

Koelmel is blunter about say on pay. "You can wind up with just as much of a train wreck" that way, he says, as some institutions did with the established order.

Brain drain

Ultimately, while everyone has a personal interest in executive compensation if they are in top management, corporate stewardship plays a big part in their concerns. "Brain drain" is what they call the fear that any bank facing compensation restrictions will see the best talent walk.

This isn't just an issue for Wall Street. Awerkamp, for instance, says his company's subsidiary banks compete in local markets, against non-public banks. Any law that pushed restrictions in pay down to the subsidiary banks would put him at a disadvantage to the other institutions, and he doesn't doubt that he would lose talented players.

Say on pay is effectively here, note Patrick Cole (l.) and Timothy Reimink of Crowe Horwath.

Further, Charles Elson worries that some institutions, in a bid to avoid brain drain, will attempt evasion of the letter of the coming laws. That would be terrible for investors, he said.

And that, ultimately, is who all the new efforts are supposed to be helping. *BJ*

The four-letter word that colors the compensation debate

Asked what has been driving the multi-front federal push on financial institution executive compensation, a veteran banking lobbyist boiled all the reports, all the testimony, all the position papers, all the debate, all the chatter, down to a single word: Risk.

Everywhere one looks in the fight over executive compensation in banks and investment banks, lurks risk. Broadly, the worry is that there has been a disconnect between financial services compensation practices and risk management practices.

H.L. Mencken once said that Puritans live in fear that someone, somewhere, was having a good time. And so it is that those lined up for restrictions on compensation fear (with some justification) that untrammeled compensation will plant the seeds for a future crisis while the present one is still being worked out.

It's been a rough battle for banks and their representatives to fight, because it's more than a battle of headlines, op-eds, and congressional floor statements taking great umbrage, like Captain Renault in "Casablanca," at what's been going on.

"Excess risk taking, based on perverse incentives, *did* happen," says consultant Dan Borge. "And it contributed to the mess that we're in now." It's a matter of moving on, and getting on with corrective measures, but in a logical and appropriate way.

Finding the middle way

Borge, a director in the New York offices of the LECG consulting firm, was principal developer of the industry's first enterprise risk management program, at Bankers Trust. But while he sees the need for improved correlation between executive compensation and risk, he insists that there are no simple solutions. He adds that much of the current debate isn't helping: "Anger is not a strategy."

Setting the current agenda was a June statement by Treasury Secretary Timothy Geithner. (See "Pillars of compensation".) Geithner's opening included this sharp declaration:

"This financial crisis had many significant causes, but executive compensation practices were a contributing factor. Incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage."

The questions underlying the debate include: How well will what is in place, or in the wings, work? What will be missing from the equation?

"When people start digging into this matter, things become harder still," says Dan Borge, "because there are so many complexities involved."

A key issue, he feels, is whether an institution has an enterprise risk management viewpoint and mechanism in place. The board has to be on top of ERM, says Borge, before a compensation committee can really be doing its new job on the risk front.

The unanswerable question

A key issue in Geithner's points is for banks to develop the ability to align compensation philosophy and strategy with "the time horizon of risk."

The concept here makes a lot of sense, says Borge. "You don't want to pay people until the party is over." But the tough part is making that concept work in a real-world banking organization.

It all comes down to who is responsible for what, says Borge. "In the ideal world, you'd want to pay an individual no more than the individual's actual contribution to the corporation," and you'd want to do it on a timely basis—timely for the recipient and also timely for the corporation in terms of when it realized income from the person's activities. But the higher up the

Who does what when

Indeed, many bankers and board members continue to work on and sort out the changing roles and attitudes of executive compensation. While it wears the clothing of an HR issue, it is as much an issue of corporate governance.

Over the last year, much has just been "slapped on banks quickly," says Susan O'Donnell, Boston-based managing director for the Pearl Meyer & Partners consultancy. "We'll see the repercussions of this on the back end."

The irony, O'Donnell hears from bankers, is that they are facing potential limitations, or major shifts, to their compensation when many of them are working the hardest of their careers.

Typically, O'Donnell notes, community bank compensation issues have lagged those of the rest of the industry: "But now, they have been shoved up to the forefront with everybody else."

The reaction in many community banks, in the short term, has been to excuse themselves from as much of the current trouble as possible, says O'Donnell. "There has been a huge shift towards increasing base salaries," she says, and pulling away from incentive pay and long-term compensation.

That's a boomerang from the immediate previous trend, towards an emphasis on performance-based pay for top officers. Boards liked that, O'Donnell says, because it encouraged results. Over time, however, when the tide was rising, a certain level of performance pay began to be regarded as an "entitlement," to use O'Donnell's word. "Now, that entitlement mentality has to be readjusted," she says. The other paradox is that as base pay has become reemphasized among community banks, some wonder, "Does the shareholder want to pay salaries to executives when they are not making money for them?" she asks.

Another compensation consultant, Brian Dunn, president of McLagan, a subsidiary of AON Corp., and CEO of Global Compensation, thinks the shift to a base-pay emphasis merely represents a temporary overreaction.

In some cases (banks that took TARP money, for example) "it's the only tool that the Treasury left them," says Dunn.

"There is a lot of healthy skepticism in boardrooms right now," Dunn says. "It's not necessarily hostile; there is creative tension."

Indeed, Dunn thinks that the Geithner pay principles, covered elsewhere in this report, appear poised to bring some changes to bank compensation, even at the community bank level. Dunn believes that boards will begin to push for a great portion of executives' packages to be made up of deferred compensation. The intent will be to tie the delivery of that compensation to long-term performance.

—*Steve Cocheo, executive editor*

Changing currents on pay *Predictions from experts interviewed*

Who pay consultants work for. Traditionally, compensation consultants have been brought in by management. However, the pending Corporate and Financial Institution Compensation Fairness Act (H.R. 3269) would authorize public banks to engage consultants who can demonstrate independence from management.

"It will be somewhat difficult to straddle the line between management and the compensation committee," predicts Brian Dunn, of AON subsidiary McLagan. "Potentially, we will wind up with 'dueling advisors'."

Pearl Meyer's O'Donnell disagrees with that assessment. She believes boards and management will still be able to communicate.

"Good governance is not about creating barriers and walls," says O'Donnell. "The CEO can't be on the governance committee, but they can be an invited guest."

Weaker boards? Charles Elson, professor at the University of Delaware and director of its John L. Weinberg Center for Corporate Governance, fears that "say on pay" legislation will weaken boards, because it would put a traditional board matter effectively in the hands of shareholders directly. He thinks better governance would result if say on pay does not go through, and instead would work to have boards regularly stand for election, bulk up their own holdings in the banks they oversee, and put a stress on member independence. "Say on pay is a half a quarter step that doesn't get us there," says Elson. He believes significant ownership will put board members in better sync with shareholder interests. He regrets that the pending legislation does nothing to push ownership.

Splitting the seats. Pearl Meyer's Susan O'Donnell predicts that as the current leadership retires, banks will increasingly see splits, especially among community banks, between the job of chairman and CEO. She says this is a natural extension of an evolution over the last ten years, from board-as-crony to more board-as-representatives-of-shareholder.

More tailored comparisons. Crowe Horwath LLP consultant Patrick Cole says that he is finding that bank boards are pushing compensation experts for more specific peer groups, when they are putting together comparisons for the sake of setting executive pay packages. Such studies, the bread and butter of the comp business, used to be geographic and size oriented. Now, other descriptors are being used.

Cole says peers are increasingly being chosen based on bank strategy and on business plans.

Subscribe at www.ababj.com

COPYRIGHT INFORMATION

TITLE: The sin of wages?
SOURCE: ABA Bank J 101 no9 S 2009

The magazine publisher is the copyright holder of this article and it is reproduced with permission. Further reproduction of this article in violation of the copyright is prohibited.