



PERSPECTIVES



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Fixing Dangerous Compensation

Compensation problems have been highlighted by many of the reports on the financial crisis, led by the July 2008 report of the Institution of International Finance (See, for example, Report of the IIF Committee on the Market Best Practices: Principles of Conduct and Best Practice Recommendations, Financial Services Industry Response to the Market Turmoil of 2007-2008). These reports have made some sensible recommendations relating to compensation principles, mostly aimed at aligning compensation incentives with risk-adjusted performance and/or providing for recourse when the rewarded performance later results in undesirable outcomes.

However, implementing the right changes in industry regulation and compensation practices will not be easy in this environment. First, news about the billions of dollars in bonuses paid out on Wall Street in January and, more recently, the controversy surrounding the AIG “retention” bonuses have taken the compensation thinking off course. While everyone has a right to be angry about ill-gotten gains, especially if at the taxpayer’s expense, the amount of compensation is not what caused the problem. Rather it is the misalignment of the incentives that motivated behavior inconsistent with consumer interests and with safety and soundness.

Second, the focus on the largest payouts has resulted in most of the attention being placed on executive compensation. The misalignment at the executive level is, in many cases, a function of the misalignment below or visa versa. Incentives that motivated the front-line employee to compromise lending practices or trading practices, for example, enriched everyone in his or her chain of command. Correcting the systemic risk in incentive compensation therefore requires examination of front-line systems and vertical linkages.

Third, while the voice of entrepreneurship can hardly be heard amid the loud calls for control, there is an assumption on both sides of this debate that one must come at the expense of the other, i.e. that the entrepreneurship (a.k.a. greed) of the industry in the past has put the system out of control and that the controls needed now will, and must, curb this driven industry culture. Solutions that focus on capping compensation will, in fact, fail both sides because compensation caps fail to address the misalignment of incentives and at the same time limit the competitiveness of compensation to attract top talent and motivate innovation. However, new practices carefully aimed at better alignment of incentives with safety and soundness need not limit potential or stifle innovation.

The purpose of this article is to make the case for a comprehensive approach to incentive compensation alignment, including key front-line roles; to consider appropriate roles for the regulator, management and the board that provide adequate controls without “taking control”; and to outline the implementation challenges in what may be a substantial transformation in compensation practices for the industry. The focus is on the critical issues in the financial services industry specifically, but many of the lessons learned from the crisis and the new practices under consideration may have relevance in other industries in which financial incentives play an important role in motivating behavior.

The case for front-line controls

Many years ago, mining engineers determined that mine collapse could be prevented by forcing bolts into the walls and ceiling of the mine cavity to essentially replace the pressure of the rock that had been removed from the cavity. The mining engineers learned to calculate how many bolts and how long these bolts needed to be in order for the mine to remain safe and sound. It was a labor intensive process to drill and install these bolts, but it was well worthwhile as it substantially reduced the risk of mine collapse.

Management then discovered that if the laborers installing these bolts were incented “by the bolt” they tended to work a little harder resulting in improved productivity. However, human behavior being what it is, some laborers soon determined that a little compromise on the length of the bolts would increase take home pay and would go unnoticed by management. Of course, they did not, or chose not to believe such compromise would affect safety.

Inch by inch this practice of “short-bolting” led inevitably to mine collapse amid a false sense of security. Mining disasters revealed the fallacy of financial incentives that could encourage unsafe practices, incentives that encourage compromises by otherwise good and caring people, incentives that inevitably could result in disaster. Note that these miners were not taking home million dollar bonuses – the issue is not the amount of the incentive, but rather what practices or compromises will earn the most.

In this life and death example it is easy to see the unacceptable risks introduced by misaligned incentives. However, the parallels to the financial services industry are painful to consider. Beginning with subprime mortgages, brokers and lending officers inch by inch compromised the quality of the loans. Incented to grow the book, they were tempted to bend standards or compromise on compliance, not intending to put their institutions at risk. These loan portfolios were then packaged and sold and repackaged and resold, each time with the apparent security of being “asset-backed”. The true quality of the assets was hidden, like short bolts, resulting in the infection of institutions across the industry and around the globe. While at each hand-off, someone earned a volume or spread-based incentive, and no one was incented to look carefully at the bolts.

It all began at the front-line. The solution has to begin with the alignment of front-line incentives and the vertical chain of command from the point of risk origination.

Roles for the regulator, the board and management

In light of the disaster, dangerous incentives in the financial industry must be curbed. Indeed, in the Financial Stability Forum of the G20 in April, compensation was identified as a key issue to be addressed. Regulators have a role to play, in addition to management and their boards, to eliminate unsafe compensation practices without eliminating the entrepreneurial spirit of the industry.

The regulators can set the stage for change. While an industry led solution may be preferred, it is difficult for any single company to act alone because competitive compensation (which often means comparable) is critical to attracting and retaining talent. If the regulators can establish principles for safe practices in incentive compensation, then individual institutions can restructure compensation incentives knowing competitors will also be re-aligning.

Management of financial institutions must continue to compete for the best talent and motivate top performance. However, the dominant practice of compensation benchmarking is deeply flawed. The mindless matching of competitive compensation has resulted in escalation and the spread of misaligned incentive systems across the industry, creating industry-wide systemic risk. Surely the measure of a winning compensation system should not be “equally dumb”. More than just fixing broken incentive systems, this is an opportunity to rethink the objectives and tools of incentive compensation. Financial institutions can compete more effectively by aligning incentive compensation with differentiated product/market strategy, innovation and execution priorities, for example, within guidelines for safety and soundness. They will be better able to manage business and individual performance by modeling profit and payouts over time for a range of possible market and performance outcomes.

Directors were baffled by the financial meltdown. While many were aware of the subprime bubble, most had no idea of the inherent risk of the complex derivative securities. It may, in fact, be unreasonable to expect the average director to understand the risk inherent in all of today's financial instruments. However, every director understands human behavior and should be asking tough questions about incentive schemes that may be scheming against their good intent. For example, are front-line incentive systems creating systemic risk? Do management incentives systems multiply risk (as a simple function of team performance) rather than balance it (by incorporating team compliance or long term profitability for example)?

More specifically, four principles have been identified to guide the development of new compensation practices in the financial services industry¹:

1. Make compensation policies, objectives and approach transparent to stakeholders
2. Align compensation with long term interests and safety and soundness
3. Incorporate risk-adjusted incentives and/or align timing of payouts more to product life
4. Review policies to maintain alignment of compensation with firm's risk appetite

¹ Institute of International Finance (July 2008, March 2009), High Level Group of Financial Supervision in the EU (February 2009), Congressional Oversight Panel (January 2009), Financial Stability Forum (April 2009)

For each principle, the respective roles of regulators, management and boards need to be carefully defined. In general, the regulators need to define principles and high-level requirements; management should design and test programs consistent with these principles as well as with the risk appetite of the institution; and boards should ensure that these principles are met and that the modeling is done to demonstrate effectiveness and potential outcomes of programs that could represent significant risks. Of course, the board is directly responsible for aligning CEO compensation with these same principles and modeling for effectiveness and risk.

The following table illustrates the respective roles of the three main stakeholders by principle, at a high level. (The specifics will vary by jurisdiction, subsector and institution.)

COMPENSATION PRINCIPLES	REGULATOR	MANAGEMENT	BOARD
Transparency	Set disclosure requirements	Meet or exceed standards	Ensure standards are met or exceeded
Pay-out alignment with long-term interests/safety and soundness	Identify and restrict unsafe practices, especially practices that support contagion	Design and manage competitive programs consistent with long-term interests	Approve and steward policies for safety and competitiveness Design and manage CEO compensation for safety and competitiveness
Pay on risk adjusted performance or on delayed timetables	Define and promote principles, e.g., vertical checks and balances	Design and manage competitive programs based on risk-adjusted returns	Approve and steward policies for safety and competitiveness Design and manage CEO compensation for safety and competitiveness
Maintain alignment with firm's risk tolerance	Set disclosure requirements for key risk parameters	Recommend risk policies; ensure compliance; align compensation incentives	Approve and steward risk policies; ensure compliance in compensation design and management

Implementation challenges

While there seems to be alignment on the principles and there is a commitment by the G20 to act, the path to implementation is through unknown territory for both the regulators and the industry.

The industry would be well-advised to take a proactive approach. In jurisdictions inclined to set rules-based regulatory controls, the regulators may inadvertently get it wrong or make it difficult and costly to comply and/or to demonstrate compliance. While this is new to everyone, industry management will have the best insight on what will work and what can be readily measured. They also know what degrees of freedom will be most important to retain for competitive purposes.

Even in principles-based regulatory jurisdictions, regulators will be struggling to define what they will ask of the industry. They will need to determine how they will measure gaps with defined principles and what to demand of the industry toward compliance, i.e. how much and how fast? For example, in determining the gaps for each incentive scheme, what constitutes a risk-adjusted return, (this is difficult to define and varies by sector, function and product)? Given the many incentive schemes in a single institution, which ones should be in scope? How much holdback is enough or for how long? What speed of change is practical?

While several CEOs have applauded the new principles and will be better able to act knowing regulation will affect all players, a “wait and see” attitude would be foolish. Notwithstanding the job losses in the industry, the war for talent continues and will intensify in the coming years as the new game takes shape and the industry is again trying to attract the best and brightest. In addition to competing for talent, leaders are also competing for market share and need to retain sufficient flexibility in compensation to align incentives with product/market strategy. Those that wait will forego the opportunity to help shape the yet undefined details of the new regulations and implementation approach that could affect their ability to compete.

Recognizing that the whole industry must ultimately transform its compensation schemes, being among the first movers could be a competitive advantage. The key will be to view the change as an industry disruption, therefore requiring new competitive thinking, rather than viewing it as just another compliance exercise.

Aligning the compensation schemes with an organization’s unique priorities and differentiators will be the winning recipe. The following questions need to be addressed for the incentive compensation of each key front-line and executive role: is our compensation scheme reinforcing our product/market strategies and priorities? Is it supporting our key differentiators? Is it rewarding people who live our values, our unique culture? For example, the traditional approach to compensation design has been first benchmark-based and second financially driven. The new approaches should be first strategy-based,

within regulatory guidelines, and then modeled for competitiveness as well as safety and soundness at different performance levels.

A dedicated effort will be required to implement changes. For many financial institutions, they will be breaking new ground just to satisfy the new principles, let alone to be competitive. New metrics will be required, both qualitative as well as quantitative, as well as a better understanding of how compensation will drive behavior. New financial models will need to be developed to analyze the payout profiles and risks inherent in new programs. Finally, there will be a huge communication task with existing staff, recruiters, candidates, executives, directors, regulators and the public.

The copy-and-paste approach that prevailed before the financial crisis embedded lethal systemic risks. While incentive schemes will now be under the watchful eyes of regulators and boards, leading organizations will help develop better regulation and then go beyond compliance, looking for solutions that will make their organization uniquely successful in its market.

Conclusion

The failures of the global financial system have done great harm and, further, have undermined confidence in the way business has been conducted in the past. As a result, more regulation is coming for sure and institutions will be shoring up risk management functions.

Fixing dangerously misaligned incentives may be one of the most important changes coming. In fact, given our understanding of human behavior and the fresh wounds of the current crisis, it is now irresponsible to tolerate incentive systems so misaligned with safety and soundness, just as it was in the mine.

However, the changes don't have to stifle competitiveness. In fact, taking the opportunity to define a new approach that aligns incentives with strategy, within the bounds of safety and soundness, would be a superior competitive approach to the indistinctive practices of the past.

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