

**CHAIRMAN'S CORNER***by James A. Kaplan***Compensation & Crises:  
The Asymmetric Model****August 6, 2009**

Two articles published on July 31 – one in the *Wall Street Journal* and the other in the *New York Times* – addressed the compensation controversy surrounding the Banking industry.

Floyd Norris, in his *New York Times* article titled “It May Be Outrageous, but Wall Street Pay Didn’t Cause This Crisis,” takes the view that Bank CEOs cannot be blamed for the credit crisis or for the performance of banks during the crisis. The justification is offered that, during the buildup to this meltdown, CEOs focused on the interests of their shareholders and took actions that they believed the market would welcome.

One could argue, then, that if Bank CEOs can’t be blamed for their performance during the credit crisis, then they should not be rewarded in times of success. But in fact, Bank CEOs, for the most part, have been amply rewarded during periods of both success *and* failure over the last decade.

Furthermore, if the Banks took on extreme risk because they thought it was in the best interest of their shareholders and they feared falling behind their industry peers, then their CEOs are being paid vast sums for following someone else’s decision to jump off a cliff.

Unfortunately, there may be some truth to the “Lemming” theory, but it should be pointed out that numerous smaller banks chose not to go over the cliff. Should one conclude the small Banks didn’t have their shareholders’ interests at heart? I would argue the contrary. It wasn’t the CEOs of the smaller banks who lost billions of investors’ and taxpayers’ dollars.

Upon reading the *Wall Street Journal* article, “Bank Bonus Tab: \$33 Billion,” one discovers that six of the nine major banks actually paid out more in bonuses than they made in profits. In fact, their bonus payments exceeded the entire California budget deficit.

**Why Compensation Controls Aren’t Working**

After making the point that bonus compensation despite the economic turmoil was enormously large, if not “excessive,” the article continues to discuss the pitfalls of executive compensation controls and the means of end-running such controls.

If we take a moment to review the facts, certain executive behavioral patterns in the Banking world become crystal-clear.

1. Executive compensation is high, regardless of performance.
2. Whatever their motivation may be, executives are prepared to put their shareholders at extreme risk.
3. Executives are not punished for their mistakes, even when the mistakes are catastrophic.
4. Executives will go to great lengths to dodge any compensation controls that may be imposed by shareholders or regulators.

What conclusions can we reach? Unlike the authors of both articles referred to above, I find the large Bank CEOs are simply greedy. Their primary motive is to extract as much personal wealth as possible over the shortest period of time, regardless of the health of the corporation, the well-being of its employees and customers, or the good-faith expectations of its investors.

The maximization of personal wealth trumps good judgment and long-term goals. The real issue is, how do we turn this to advantage? **Given that personal greed is the supreme motivator for CEOs of mega-Banks, we must devise incentives that take advantage of that greed to align executive behavior with shareholders' interests.** Stratospheric executive compensation must not be tied to stock price in the short-term or the arbitrary valuation assigned to toxic assets, but must be structured to satisfy concrete long-term performance goals.

Of course, we should also consider the possibility that shareholders of these banks may be equally greedy and desirous of pursuing short-term profits at any cost. In that case, in an environment of flagrant risk-taking and fleeing the scene of the crime, our stock market embraces two mutually exclusive spaces: investment, and speculation.

Audit Integrity's analysis works to protect investors by separating those worlds. The metrics used in computing our Accounting & Governance Risk (AGR<sup>®</sup>) scores are derived from behavior historically associated with fraud. The companies we flag for excessive compensation -- particularly short-term compensation -- are also found to be taking on the greatest risks, and have the least transparency. These companies may be interesting to speculators, but rarely, if ever, represent sound long-term investments.

Share prices are on the rise, fueled, no doubt, by speculation; and questions of integrity and good governance are already being set aside. Those who ignore the lessons of the past are now in a position to be dropped off the proverbial cliff yet again.

Below is a sampling of Audit Integrity rated companies that represent a potential conflict between management and investor shareholders. Each company in this sample reflects three important forensic measures:

- **Short-term incentive compensation** is High.
- **Leverage** (Debt/Equity) is High.
- **Accounting transparency** is Low.

Companies with the conditions described above are statistically likely to suffer substantial blow-ups, litigation, and SEC indictments. I can't halt speculation in the markets, but..... *Caveat Emptor.*

**Audit Integrity**  
**Companies at Risk (partial listing)**

<u>Name</u>	<u>Ticker</u>	<u>Market Cap</u>	<u>Current</u> <u>AGR®</u>	<u>Prior Quarter</u> <u>AGR</u>
Alliance Data Systems Corporation	ADS	2,689.0mm	6	2
Alliant Techsystems Inc.	ATK	2,628.5mm	3	4
Delta Air Lines, Inc.	DAL	4,691.5mm	3	1
Fifth Third Bancorp	FITB	4,047.5mm	1	1
Fiserv, Inc.	FISV	7,454.6mm	1	1
Flextronics International Ltd.	FLEX	3,969.9mm	8	15
Hospira, Inc.	HSP	5,960.1mm	10	8
Kinetic Concepts, Inc.	KCI	1,8932.1mm	4	5
Level 3 Communications, Inc.	LVLT	2,586.8mm	6	18
Marshall & Ilsley Corporation	MI	1,633.0mm	10	12
Mylan, Inc.	MYL	3,794.7mm	1	1
New York Community Bancorp, Inc.	NYB	3,786.9mm	6	4
Nexen Inc.	NXY	11,518.1mm	1	6
Seagate Technology	STX	5,479.7mm	10	47
Sirius XM Radio, Inc.	SIRI	1,513.6mm	1	6
SunTrust Banks, Inc.	STI	5,794.5mm	7	16
The Western Union Company	WU	12,623.2mm	3	13
Time Warner Cable Inc.	TWC	10,785.0mm	9	35
Virgin Media Inc.	VMED	3,507.5mm	7	5
Vulcan Materials Company	VMC	5,148.4mm	7	8
Wells Fargo & Company	WFC	117,623.0mm	1	1
WestAmerica Bancorp	WABC	1,374.0mm	1	21

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