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2015 CANADIAN CHIEF EXECUTIVE OFFICER COMPENSATION

2015 Canadian Bank Chief Executive Officer Compensation

In this Gallagher McDowall report, we provide an update to our April 2015 article¹ on the compensation of the Chief Executive Officers (CEOs) of Canada's five major banks, i.e. Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Royal Bank of Canada and Toronto-Dominion Bank.

Four of the five major Canadian banks appointed new CEOs during their past two fiscal years, as follows:

	Bank of Montreal (BMO)	Bank of Nova Scotia (BNS)	Canadian Imperial Bank of Commerce (CIBC)	Royal Bank of Canada (RBC)	Toronto-Dominion Bank (TD)
CEO	Bill Downe	Brian Porter	Victor Dodig	David McKay	Bharat Masrani
Promoted	March 1, 2007	November 1, 2013	September 15, 2014	August 1, 2014	November 1, 2014

Interestingly, each CEO was promoted from within: none were external hires. William Downe at the Bank of Montreal was the only long service CEO, having been promoted some nine years ago:

We were very interested to learn from the banks' recently released management 2015 proxy circulars whether they resisted the temptation to increase the compensation packages of their new CEOs to that of their predecessor CEOs.

We also wanted to find out how big a financial stake the CEOs have in the long term success of their organizations.

1. Target Compensation Comparison

While much of the focus of the business press tends on to the percentage change in the total compensation for the CEOs reported from one year to the next, our focus is on (1) the target compensation of the bank CEOs and (2) how their actual compensation compares to their target compensation.

Each of the banks establishes a target level of total compensation that the CEO can expect to be awarded for achieving the objectives set by the board at the beginning of each year.

Prior to the retirements of Gord Nixon at RBC, Ed Clark at TD, Rick Waugh at BNS, and Gerald McCaughey at CIBC, target total CEO direct compensation² at the five banks ranged from \$9.5 million to \$11.25 million. As can be seen from Table 1, the 2015 target total direct compensation of the current CEOs was noticeably lower, ranging from \$7.5 million to \$10.5 million.

¹ <http://www.mcdowallassociates.com/wp-content/uploads/Are-the-Banks-Changing-Their-CEO-Compensation-April-20151.pdf>

² "Total direct compensation" includes annual base salary, annual incentive awards and the present value of long-term incentives awarded for the year, such as performance stock units, stock options and deferred stock units, as reported to shareholders in the Summary Compensation Table of the management proxy circular. It does not include pension values or miscellaneous compensation items.

Table 1: Target Total Direct Compensation

	BMO	BNS	CIBC	RBC	TD	Median
Base Salary	US \$1,500,000	\$1,000,000	\$1,000,000	\$1,300,000	\$1,000,000	\$1,000,000
Annual Incentive	\$1,900,000 *	\$1,500,000	\$2,275,000	\$1,950,000	\$1,700,000	\$1,900,000
Three Year Equity Incentive Grant	\$3,575,000 *	\$4,550,000	\$3,380,000	\$5,395,000	\$4,200,000	\$4,200,000
Stock Option Grant Value	\$925,000 *	\$1,950,000	\$845,000	\$1,365,000	\$2,100,000	\$1,365,000
Deferred Stock Unit Grant	\$2,640,000 *	Nil	Nil	Nil	Nil	Nil
Target Incentive Compensation	\$9,040,000	\$8,000,000	\$6,500,000	\$8,700,000	\$8,000,000	\$8,000,000
Target Total Direct Compensation	\$10,500,000	\$9,000,000	\$7,500,000	\$10,000,000	\$9,000,000	\$9,000,000
Change From 2014	Nil	+\$1,000,000	Nil	Nil	Nil	Nil

* Estimated from BMO proxy circular disclosures

The 2015 median target CEO total direct compensation of \$9.0 million is 16% lower than the median of \$10.7 million that applied just two years ago.

It should be noted that as of January 1, 2016, RBC's board increased CEO David McKay's base salary from \$1,300,000 to \$1,500,000, his equity compensation target to \$7,500,000, and his overall total direct compensation target to \$11,250,000, the same package his predecessor, Gord Nixon, had. So far, RBC is the only bank to have taken this step, to the best of our knowledge.

2. Actual 2015 Total Direct Compensation

Target total direct compensation is conditional on achieving the organization's and the CEO's performance objectives for the year. How did the CEOs do for 2015?

At three of the big banks (BMO, BNS and TD) the actual 2015 CEO total compensation awards were very close to their target total direct compensation for the year. Meanwhile, the other two banks (CIBC and RBC) awarded their CEOs incentives for 2015 that pushed their total direct compensation 9% above target, as shown in Table 2 on the next page.

Table 2: Actual Total Direct Compensation Awarded for FY 2015

	BMO	BNS	CIBC	RBC	TD	Median
Base Salary	\$1,882,050 Cdn	\$1,000,000	\$1,000,000	\$1,300,000	\$1,000,000	\$1,000,000
Annual Incentive	\$1,361,700 *	\$1,780,000	\$2,502,376	\$2,325,000	\$1,900,000	\$1,900,000
Three Year Equity Incentive Grant	\$3,516,250 *	\$5,200,000	\$3,717,819	\$5,800,000	\$4,211,000	\$4,211,000
Stock Option Grant Value	\$873,000 *	\$1,300,000	\$929,455	\$1,450,000	\$2,079,000	\$1,300,000
Deferred Stock Unit Grant	\$2,522,000 *	Nil	Nil	Nil	Nil	Nil
Total Incentives Awarded	\$8,272,950 *	\$8,280,000	\$7,149,650	\$9,575,000	\$8,200,000	\$8,272,950
% of Target Incentives	92% *	103.5%	111%	111%	102.5%	103.5%
Total Direct Compensation	\$10,155,000	\$9,280,000	\$8,149,650	\$10,875,000	\$9,000,000	\$9,280,000
% of Target	97%	103%	109%	109%	100%	103%

* Reduced by BMO's board from the incentive formula calculations to offset the impact of the strong US dollar on his \$,150,000 US base salary when converted into Canadian dollars

3. Realized Compensation During the Fiscal Year

Most of the FY 2015 compensation awards shown in Table 2 are not equivalent to hard cash, however, nor are they equivalent to "money on deposit" because their equity awards for the year and stock option awards have significant downside risks, as well as upside potential.

Equity unit grants for example are notional deferred awards whose values go up or down directly with changes in a bank's stock price plus the value of dividend payments, usually over a three year period from the original award. In addition, their values may be increased or decreased when they vest based on predetermined performance factors, such as return on equity results or relative total shareholder returns over the vesting period.

Meanwhile, the stock option values shown in Table 2 are entirely hypothetical, having been determined at the time of grant by using option valuation assumptions. Their actual realizable value will be based solely on the increase, if any, of the stock price from their initial grant date until the date they are actually exercised by the executive, which can be over a time period of up to 10 years from the original grant date.

Based on the information provided by the banks in their proxy disclosures, we have estimated in Table 3 on the next page the amount of pre-tax compensation the CEOs actually realized during FY 2015 in the form of cash, equity unit payouts and stock option exercises:

Table 3: Realized Compensation During FY 2015

	BMO	BNS	CIBC	RBC	TD	Median
Total Cash Compensation	\$3,243,750	\$2,780,000	\$3,502,376	\$3,625,000	\$2,700,000	\$3,243,750
Value of Equity Units that Vested in the Year	\$6,546,767	\$1,723,593	\$909,239	\$4,101,757	\$3,680,360	\$3,680,360
Gains on Option Exercises	\$192,974	\$1,922,275	\$212,337	\$391,734	\$16,615,504	\$391,734
Total Realized Equity Compensation	\$6,739,741	\$3,645,868	\$1,121,576	\$4,101,757	\$20,295,864	\$4,101,757
Total Realized Compensation	\$9,983,491	\$6,425,868	\$4,623,952	\$7,726,757	\$22,995,864	\$7,726,757

We note TD's Bharat Masrani realized significant pre-tax gains in 2015 on exercising a number of his stock options that were about to expire, or were close to their 10 year expiry dates. He retained a significant portion of his after tax gains in bank shares.

The differences in the realized compensation of the other four CEOs from one to the other is more reflective of their length of time in the CEO chair.

4. Equity Stakes

Institutional investors look carefully at the extent to which the CEO's financial interests are aligned with their interests as long term shareholders. Two commonly used alignment measures are (a) share ownership guidelines, and (b) the value of their unrealized equity compensation that is at risk.

a. Share Ownership Guidelines

The purpose of share ownership guidelines is to encourage executives to have a real equity stake in the company, either directly or indirectly. Share ownership guidelines are usually expressed as multiples of salary for ease of administration.

As is usual practice, each bank CEO's share ownership for comparison purposes includes (a) the value of real common shares owned directly or indirectly by the CEO, plus (b) the target value of his outstanding but unrealized equity units. The in-the-money value of outstanding stock options is not included for this purpose, however.

As can be seen from Table 4, each of the five bank CEOs has met his stock ownership guideline.

Table 4: Share Ownership Status as of October 31, 2015

	BMO	BNS	CIBC	RBC	TD	Median
Guideline	7 x salary	7 x salary	8 x salary	8 x 3 year average salary	10 x salary	7.5 x salary
Year End Status	30.6 x	16 x	8 x *	12.3 x	47 x	16 x

* *Victor Dodig achieved his share ownership guideline by December 31, 2015 by deferring 100% of his 2015 bonus in notional deferred stock units that he cannot exercise until after he retires from*

b. Value of Unrealized Equity Compensation

Another way of looking at the degree of shareholder alignment is to examine the value of an executive's unrealized equity compensation each year to see how much downside risk he or she has should the stock price drop materially. For this purpose in Table 5, we have taken (a) the target value of each CEO's unrealized equity units as of the fiscal year end, plus (b) the in-the-money value of their unexercised stock options.

Table 5: Value of Unrealized Equity Compensation as of October 31, 2015

	BMO	BNS	CIBC	RBC	TD	Median
2015 Equity Unit Year End Values	\$18.4 million	\$4.4 million	\$1.7 million	\$13.2 million	\$8.5 million	\$8.5 million
2015 Stock Option Year End Values	\$35.9 million	\$9.6 million	\$6.4 million	\$10.4 million	\$24.8 million	\$9.6 million
2015 Total Year End Value	\$54.3 million	\$14.0 million	\$8.1 million	\$23.6 million	\$33.3 million *	\$23.6 million
Corresponding 2014 Total Year End Value	\$64.3 million	\$19.5 million	\$6.9 million	\$38.7 million	\$49.4 million	\$38.7 million
Change in Value	-14%	-28%	+17%	-39%	-33%	-28%
<i>Change in Stock Price in the Year</i>	-7%	-11%	-2%	-7%	-2%	-7%

* *Net of his \$16.6 million pre-tax stock option exercise gains in FY 2015.*

Table 5 also illustrates the leverage effect that relatively small changes in each bank's stock price over one year can have on a CEO's unrealized equity compensation.

5. Pension Benefits

Due to ongoing pressure from Canadian institutional investors, the pension benefits of the bank CEOs are now subject to hard caps on the additional amount of pension they can be credited for each year of additional service as CEO, as well as absolute caps on the maximum pension they can receive when they ultimately retire. These caps prevent CEO pension benefits from being enhanced by granting large annual incentive awards during the period just prior to retirement.

As noted in our bank CEO report last year, the range of potential bank CEO pension benefits shown in Table 6 is significantly lower than the previous norm of \$2.0 to \$2.5 million:

Table 6: Pension Benefits

	BMO	BNS	CIBC	RBC	TD	Median
Additional Annual Pension Credits While CEO	Nil: he has reached his pension cap	\$125,000	\$46,000	\$64,000, increasing to \$110,000 at age 56	\$110,000	\$64,000
Pension Cap at Retirement	\$1,000,000 US at age 60	\$1,500,000 at age 63	\$1,000,000 at age 61	\$1,250,000 at age 60	\$1,350,000 at age 63	\$1,250,000 at age 61

6. Total CEO Stakes

Adding it all up, how big of a personal financial stake do the bank CEOs have in total in the ongoing success of the organizations they lead?

We find their stakes are quite high, as can be seen from Table 7 below in which we combine

- (a) the value of the common shares each CEO owns,
- (b) the value of his unrealized equity compensation, plus
- (c) the actuarial value of his accrued pension benefits

and then compare their total stakes to their 2015 base salaries.

Table 7: Total CEO Financial Stake as of October 31, 2015

	BMO	BNS	CIBC	RBC	TD	Median
Common Shares Owned	\$19.5 million	\$6.0 million	\$1.8 million	\$0.4 million	\$33.5 million	\$6.0 million
Unrealized Equity Compensation Stake	\$54.3 million	\$14.0 million	\$8.1 million	\$23.6 million	\$33.3 million	\$23.6 million
Actuarial Value of Accrued Pension Benefits	\$20.1 million	\$7.0 million	\$4.0 million	\$9.2 million	\$10.0 million	\$9.2 million
Total Value at Stake	\$93.9 million	\$27.0 million	\$13.9 million	\$33.2 million	\$78.8 million	\$33.2 million
Multiple of Base Salary	50 x	27 x	14 x	26 x	79 x	27 x

The variations in the CEO stakes from one bank to another reflect a number of factors, such as differences in their total length of service, and differences in their previous executive position levels.

CONCLUSION

In general, with the exception of RBC, the banks have not increased the compensation packages of their new CEOs back to the previous levels. In addition, their actual 2015 CEO compensation awards were generally in line with their targets.

Realized compensation in the year tends to be lower than the actual awards for the year, while pension benefits have been contained.

Each CEO has a significant stake in the ongoing success of their organization, ranging in value from 14 times salary for Victor Dodig at CIBC and 50 times salary for Bill Downe at BMO.

In a follow up article, we will examine the way in which the five banks pay their senior executives for achieving their performance objectives. While there are some similarities, there are some noticeable differences which we will unpack.

Note: It is with sadness that we note that the founder of McDowall Associates, Robert McDowall, passed away on April 1, 2016.

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