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ARE THE BANKS CHANGING THE COMPENSATION OF THEIR CEOS?

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The past year was unique in Canada's financial sector because four out of five major banks appointed new CEOs in their 2013-2014 fiscal years, as follows:

	Outgoing CEO	New CEO	Appointment Date
Bank of Nova Scotia (BNS)	Rick Waugh	Brian Porter	November 1, 2013
Canadian Imperial Bank of Commerce (CIBC)	Gerry McCaughey	Victor Dodig	September 15, 2014
Royal Bank of Canada (RBC)	Gord Nixon	David McKay	August 1, 2014
Toronto-Dominion Bank (TD)	Ed Clark	Bharat Masrani	November 1, 2014

These appointments give us a unique opportunity to assess whether the banks are changing the compensation of their new CEOs. In addition, we can see how the banks have responded to the Canadian Coalition for Good Governance's emphasis on lower weighting of stock options, capping of pension benefits, no special perquisites, and no generous severance or change of control provisions.

Our analysis is based on the executive compensation disclosures provided by the banks in their management proxy circulars.

TARGET COMPENSATION

With the notable exception of RBC, the banks have reduced their new CEO salaries by one third and reduced their target total direct compensation by from 18 to 25%, as illustrated below:

	Outgoing CEO (millions)	New CEO (millions)	Change
1. Base Salary			
BNS	$1.5	$1.0	-33%
CIBC	$1.5	$1.0	-33%
RBC	$1.5	$1.3	-13%
TD	$1.5	$1.0	-33%
2. Target Total Direct Compensation			
BNS	$10.7	$8.0	-25%
CIBC	$9.5	$7.5	-21%
RBC	$11.3	$10.0	-11%
TD	$11.0	$9.0	-18%

If we include the compensation of the longest-tenured CEO of the Bank of Montreal (BMO), Bill Downe[1], into the analysis, the median CEO compensation of the five major banks for 2014 calls for a base salary of $1.0 million and target total direct compensation of $9.0 million, down from $1.5 million and $10.7 million respectively in 2013.

Unlike typical practice in the past, no promotional awards (such as special bonuses and/or equity awards) were made to any of the four new CEOs.

STOCK OPTIONS

The banks have been reducing the relative weighting of stock options in their incentive compensation awards in response to pressures from institutional investors and from the financial regulators. In recent years, bank stock option award weightings typically represented 50% of long-term incentive (LTI) awards to their top executives. However, for 2014 the median stock option LTI weighting has declined to 20%:

	Stock Option Weightings	Mid-Term Incentive Weightings
BMO	25%	75%
BNS	20%	80%
CIBC	20%	80%
RBC	20%	80%
TD	33%	67%

In a related trend, the banks have been attempting to reduce their top executive stock option weightings to no more than 10% of their *total incentive* awards (i.e. annual incentive cash plus LTI) in order to respond to pressures from the U.S. regulators that are administering the financial institution restraint provisions of the Dodd-Frank legislation.

[1] $1. 5 million base salary and $10.5 million target total direct compensation for 2014.

EQUITY COMPENSATION STAKE

The equity stake of CEOs is usually looked at in relation to a multiple of their base salary. However, in the case of the banks, their CEO equity stake typically is substantial, making the salary comparison less relevant than for other industries. We have developed what we believe to be a more telling approach that compares the CEOs' total equity compensation stake, including unvested in-the-money awards, to their target total direct compensation (target TDC).

On this basis we found the newly appointed CEOs had significantly lower equity compensation stakes than their predecessors had, both absolutely and relatively, with the exception of RBC:

	Outgoing CEO's Last Year In-The-Money Value (millions)	Multiple of Target TDC	New CEO's First Year In-The-Money Value (millions)	Multiple of Target TDC	New CEO Value as Percent of Outgoing CEO Value
BNS	$66.2	6.2	$19.5	1.7	29%
CIBC	$64.4[2]	6.7	$6.9	0.9	11%
RBC	$38.7	2.6	$27.0	2.7	70%
TD	$126.9	11.5	$49.4	5.5	39%
Median	***$65.3***	***6.4***	***$23.2***	***2.2***	***34%***

It should be noted that a significant portion of the outgoing CEOs' equity stakes resulted from stock options they had been awarded over the years, but had not exercised before their expiry dates. As the new CEOs will receive relatively low option awards going forward, they will not have the equity exposure their predecessors had.

[2] Including $42 million of estimated value of previously vested units paid out on or shortly after Mr. McGaughey's September 15, 2014 retirement date.

RETIREMENT BENEFITS

Less generous retirement income arrangements are being provided to all four of the new CEOs than to their predecessors, as follows.

	Outgoing CEO's Arrangement	New CEO's Arrangement
BNS	$2.0 million absolute annual pension cap at age 63	$1.5 million absolute annual pension cap of at age 65
CIBC	Pensionable earnings capped at $2.3 million, but no absolute annual pension cap	$1.0 million absolute annual pension cap at age 61
RBC	$2.0 million annual pension cap at age 60	$0.7 million annual pension cap at age 55, increasing to $1.25 million at age 60
TD	$2.5 million absolute annual pension cap at age 63	$1.35 million absolute annual pension cap at age 63

If we include the US $1.0 million pension cap for BMO, the median CEO annual pension cap has dropped 37.5% from $2.0 million to $1.25 million.

CEO promotions can significantly increase company pension costs due to the retroactive impact of CEO pay increases on the actuarial value of pension credits for previous years of service. Notwithstanding the lower absolute annual pension caps, we estimate the median incremental value of the impact of the promotional increases in the four new CEOs' compensation to be significant at $1.9 million.

PERQUISITES

In the past, it was not unusual for a bank CEO to be given special perquisites. In part due to pressure from institutional investors and increased scrutiny generally, none of the new CEOs were given special perquisites over and above the regular senior executive program.

SEVERANCE AGREEMENTS

Two of the five big banks, RBC and TD, no longer have employment contracts with their CEOs.

Whether or not the bank CEOs have employment contracts, they are typically entitled to two years' cash compensation in severance and benefit continuation in the event of termination without cause, consistent with common law norms at the CEO level.

CHANGE OF CONTROL PROVISIONS

Two of the five big banks (CIBC and RBC) have agreements or policies that specify the amount of severance and benefits their top executives would receive if they were to be terminated or were to resign with good reason following a change of control (COC). In both cases, the amount of the severance treatment is the same as in a non-COC termination without cause situation.

Institutional investors have been pressing companies to no longer allow non-vested equity awards to automatically vest upon a COC. The banks have responded. Accordingly, outstanding unvested mid-term incentive awards (RSUs and PSUs) continue to be subject to their pre-COC vesting requirements at BMO and TD, while at BNS, CIBC and RBC they early vest only on employee termination following a COC. Stock options now early vest following a COC only on employee termination at four of the banks, but not at BNS where they to vest immediately on a COC as in the past.

OUTGOING CEO AWARD TREATMENT

While each of the outgoing CEOs were given regular (or in some cases pro-rata) mid-term and long-term incentive awards for their final period of service notwithstanding their retirements, the way in which these awards were allocated between performance share units (PSUs) and stock options varied as follows:

	Equity award allocations	Vesting
BNS	60% in PSUs and 40% in options	Normal vesting schedule continues
CIBC	Paid in cash	100% immediate on retirement
RBC	100% in PSUs and no options *	Normal vesting schedule continues
TD	67% in PSUs and 33% in options	Normal vesting schedule continues

* No options were awarded for the 2014 year as Mr. Nixon was not an active employee on the date of grant.

TOTAL CEO TURNOVER COST

CEO turnover can be very expensive. To estimate the total cost of the four bank CEO turnovers, we took into account: the cost of any special arrangements under the outgoing CEO's retirement agreement where applicable, the difference between the former CEO's and the new CEO's target total direct compensation, and the incremental impact of the promotions on the new CEOs' pension values.

The results are as follows:

	Incremental Cost of the Outgoing CEO's Retirement Agreement[3] (millions)	Reduction in the New CEO's Target TDC vs. the Outgoing CEO's Target TDC (millions)	First Year Impact of Promotion on the new CEO's Pension Value (millions)	CEO Transition Year Cost (millions)
BNS	-	-$2.7	+$1.5	-$1.2
CIBC	$16.7	-$2.0	+$2.3	+$16.9
RBC	-	-$1.3	+$5.1	+$3.8
TD	-	-$2.0	-$2.5	-$4.5
Median	**-**	***-$2.4***	***+$1.9***	***+$1.3***

[3] In past practice, retiring bank CEOs typically received special payments ("retiring allowances") on their retirement in the order of two times their annual cash compensation. CIBC was the only bank to make such a payment.

CONCLUSION

From the foregoing analysis, we can conclude that the banks have significantly reduced the compensation of their new CEOs. However, we do not know whether they intend to phase in the new CEO's compensation back to the former CEO's level over time.

RBC for one states in its proxy circular that *"the board took a multi-year approach to transitioning Mr. McKay's compensation to the appropriate positioning relative to our peers."*

The three other banks did not make similar comments, so stay tuned!

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