Remove Bombs from Options Packages

■ BY DAVID B. MOORE

As the season for voting proxies and attending annual meetings recently came to an end, I became discouraged with the fact that the structure of most bank executives' option packages — and those of most of American industry's executives, for that matter — remains woefully inadequate as a tool for motivating these executives to generate high returns on their shareholders' capital. In most instances, senior bank managers are merely granted a large number of options with a fixed exercise price that vest over the following five years, or some such period.

To illustrate the shareholder abuse perpetrated by such options packages, I'll use the real-world example of ThriftCo — I've changed the name of the actual company to protect the guilty — whose board of directors decided this year it would be in shareholders' best interests to grant the company's CEO 200,000 options. (That 200,000 options equaled almost 3% of the company's total outstanding shares is another issue entirely.)

Now, let's assume that ThriftCo's CEO manages to steer the company to a 10% return on equity — equivalent to the company's cost of equity capital — over the following five years. Let's further assume that ThriftCo retains all of its earnings over the period and that its stock tracks book value over the period; that is, the market efficiently prices ThriftCo's stock by the end of year five.

If ThriftCo's initial book value was $10, then its book value and stock price at the end of year five stood at $16.10. Consequently, ThriftCo's CEO, whose options had a fixed exercise price of $10, has earned himself a tidy $1.22 million option-related bonus payment. And what did ThriftCo's CEO do to deserve such beneficence from the company's shareholders? He merely generated a return on equity equivalent to the company's cost of equity capital. That is, he achieved what every CEO should be required to achieve to avoid being fired. No bonus-worthy behavior was involved, to be sure.

So, despite significant advances in financial theory and the creativity underlying many compensation arrangements, most stock option plans in the corporate world encourage managers to view their companies as the economic equivalent of piggy banks. The options in these plans gain in value simply because management retains earnings, not because management has achieved above-average returns on the capital with which it has been entrusted.

The solution to this problem is simple: Add a provision to option grants that accounts for the company's cost of equity capital. Using the example of ThriftCo above, such a provision would cause the exercise price of the CEO's options to rise 10% a year. This would, in turn, reduce the ultimate value of the ThriftCo CEO's option package to zero — a bonus more closely aligned with his performance.

The logic underlying the solution presented above is elementary: Option packages should hold managers accountable for their company's cost of capital. More specifically, *managers deserve to profit from options only if they can achieve returns on capital that exceed the company's cost of capital.* If the market is efficient in the long term — as I believe it is — then managers who add economic value to their firms will still benefit from option grants, even if the exercise price for the options is rising in line with the company's cost of capital.

As it stands, managers who own options with fixed exercise prices bear no capital costs whatsoever. Consequently, such option holders have an incentive to retain earnings — to build book value — and face no downside risk whatsoever.

Until bank boards of directors start structuring option packages that account for the carrying costs of capital, many bank managers will continue to have an incentive to engage in activities that fail to maximize shareholder value. Although the adoption of such "capital cost-conscious" option plans doesn't guarantee that bank executives will create more economic value for their shareholders, at least these managers will cease to reap monetary benefits — at shareholders' expense — that far exceed the economic value they are adding to their companies.

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